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I. The Problem to Be Solved

In 1987, when I was an IRS field attorney, I saw a disturbing trend emerging in the IRS Statistics of Income data. American income and wealth was becoming increasingly concentrated at the top, and our middle class was stagnating. I knew that human history is filled[1] with examples of prosperous societies that faded when wealth became overly concentrated so that consumers lacked power to buy and the decline in social mobility undermined the efficient use of talent. America is not immune from this phenomenon, as Federal Reserve Governor Sarah Bloom Raskin has observed.[2] When I became a corporate tax planner and was able to observe how the economy works, the causes of this concentration became clear.

Our economy is structured such that all income flows to capital, i.e., to people with money, except to the extent that labor or other players have power to extract a share. As automation

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1. *See* H.G. WELLS, A SHORT HISTORY OF THE WORLD (1922) (for example, the rise and fall of Rome paralleled the rise and decay of the plebeians, and India's glory under egalitarian Buddhism decayed with the reassertion of Brahman caste culture).

2. *See* Sarah Bloom Raskin, Member, Bd. of Governors of the Fed. Reserve Sys., Address at the "Building a Financial Structure for a More Stable and Equitable Economy" 22nd Annual Hyman P. Minsky Conference on the State of the U.S. and World Economies (Apr. 18, 2013); Sarah Bloom Raskin, Member, Bd. of Governors of the Fed. Reserve Sys., Address at the Society of Government Economists and the National Economists Club (May 16, 2013); *see also* Kenneth Rogoff, *The Inequality Wildcard*, PROJECT SYNDICATE (Feb. 4, 2011), http://www.project-syndicate.org/commentary/the-inequality-wildcard.

increased productivity, unskilled workers lost market power while the skilled machine masters remained valuable. As globalization made it easier to access cheap foreign labor, America's unskilled workers lost far more market power, though again higher-skilled workers, whose jobs were more difficult to replicate in third-world locations, were less affected. Thus far, then, the economists' beloved notion of comparative advantage retained some validity – the pie increased, and America's relatively skilled labor force should have been able to claim a healthy slice.

However, another element – an unnecessary self-inflicted wound – undermined that system. America's tax policy, formed during a period when American technology and economic might dominated the world, became suicidal as the rest of the world began to catch up. Our tax system provides a strong incentive to locate high-value, high-profit operations outside of the United States. In some cases, it would cost a company 54% more after tax (for the same pre-tax cost) to build a plant in America than it would cost to build the same plant in any other country, and further the company can make 54% more after-tax operating profit by having that plant in the right country.[3] So, rather than having to use $154MM to build a plant that earns $65MM a year, it can use $100MM to build a plant that earns $100MM a year, which gives it a 137% higher return on its investment. Corporations, as rational actors, have therefore been locating their high-profit operations, the very operations where workers can command high wages, in other countries while foreign governments have structured their systems and worker training to take advantage of the American blunder.

As Congress and the IRS witnessed an increasing portion of the profits of U.S. companies being earned abroad, they put in

3. If the company had to bring home cash from a zero-tax location to build the plant in America, it would have to pay a 35% U.S. tax on the cash repatriation, so that it would have to bring home $154 to net $100 of investable cash. It could avoid that tax cost by instead building the plant in any country except our own. If the profit-making operations were located in a zero-taxed jurisdiction, then the company would be able to keep the full $100 for any $100 earned. If the operations were located in America, it would instead suffer a 35% federal tax plus state taxes, clearing less than $65. For simplicity these figures assume that the 3.1% benefit of section 199 of the Internal Revenue Code, domestic manufacturing deduction, is offset by state taxes.

place rules and audit techniques designed to ensure that the profits allocated abroad were attributable to real foreign substance. Predictably, that merely resulted in corporations moving *more* jobs abroad in order to ensure that the foreign operations had adequate substance. Initiatives such as the Organization for Economic Co-operation and Development's ("OECD") recently published plan for addressing base erosion and profit shifting[4] will further aggravate the problem by increasing the tax risk from maintaining certain high-value jobs in the United States.

You can see the effects clearly in general statistics on the declining share of income flowing to labor.[5] Labor income as a share of total income has declined by about 10% since the 1970s, meaning that capital's share has increased by some 25%, depending on the measure used.[6] Wage and salary accruals as a percentage of total Gross Domestic Product have declined from just under 54% in 1970 to under 44% now.[7] You can see the impact of this loss of market power on different income groups in the details of the American wage statistics. Unskilled workers flatlined back in the late 1970s and then began to lose ground. Typical earnings for a full-time male high school graduate in 1972 were $45,000 (in 2003 dollars), but had dropped to $30,000 by 2005.[8] Over time, this effect has worked its way up through the ranks of increasingly skilled segments of

4. *See generally* ORG. FOR ECON. COOPERATION & DEV., ACTION PLAN ON BASE EROSION AND PROFIT SHIFTING (2013) [hereinafter OECD].

5. *See* Margaret Jacobson & Filippo Occhino, *Behind the Decline in Labor's Share of Income*, FED. RES. BANK OF CLEV. (Feb. 3, 2012) [hereinafter Jacobson & Occhino, *Behind the Decline*], https://www.clevelandfed.org/en/Newsroom%20and%20Events/Publications/Economic%20Trends/2012/Behind%20the%20Decline%20in%20Labors%20Share%20of%20Income.aspx; Margaret Jacobson & Filippo Occhino, *Labor's Declining Share of Income and Rising Inequality*, FED. RES. BANK OF CLEV. (Sept. 25, 2012) [hereinafter Jacobson & Occhino, *Labor's Declining Share of Income*], http://www.clevelandfed.org/research/commentary/2012/2012-13.cfm.

6. Jacobson & Occhino, *Labor's Declining Share of Income*, *supra* note 5.

7. FED. RES. BANK OF ST. LOUIS, SHARES OF GROSS DOMESTIC INCOME: COMPENSATION OF EMPLOYEES, PAID: WAGE AND SALARY ACCRUALS: DISBURSEMENTS: TO PERSONS (2014), http://research.stlouisfed.org/fred2/series/W270RE1A156NBEA.

8. David Deming & Susan Dynarski, *College Aid*, *in* TARGETING INVESTMENTS IN CHILDREN: FIGHTING POVERTY WHEN RESOURCES ARE LIMITED 283, 283-84 (Phillip B. Levine & David J. Zimmerman, eds., 2010).

the workforce, reaching the professional class starting in the late 90s.[9] Statistics compiled from census data by the National Center for Education Statistics show that real median incomes for males with bachelor's degrees or master's degrees peaked in 2001, those for males with professional degrees peaked in 2000, and those for males with doctoral degrees have been basically flat since 1997. Females, who still earn noticeably less than their male peers, followed a similar profile save that females with professional degrees peaked in 2005.[10]

You can also see it in the continuing concentration of income and wealth. While a great deal of recent tax policy has been based on the notion that the top 10% are "wealthy," the income share of the 90 to 95% group has remained essentially level since 1973. The share of the 96% to 99% group increased somewhat from about 13% to 16%. The share of the infamous top 1% increased from 8% to some 23% in the same period, but that is also misleading, as again the real concentration was at the top of the top, with the top 0.1% bracket's share rising from less than 1% to some 6%.[11] It should be noted that the way these effects work through the economy are complicated. While job location decisions by multinationals have decreased employee market power, that effect is largely seen in the wages that smaller businesses pay. In the first decade of the millennium, all real growth in wage income in America accrued to employees of large corporations, while wages of employees of smaller businesses declined or stayed flat.[12] Multinational administration requires

9. News Release, Bureau of Labor Statistics, Employer Costs for Employee Compensation, *available at* http://www.bls.gov/schedule/archives/ecec_nr.htm#2008 (last updated Mar. 12, 2015) (inflation adjusted to June 2013 dollars).

10. NAT'L CTR. FOR EDUC. STAT., DIGEST OF EDUCATION STATISTICS tbl. 395 (2011), *available at* http://nces.ed.gov/programs/digest/d11/tables/dt11_395.asp.

11. EMMANUEL SAEZ, U. OF CAL. AT BERKELEY, STRIKING IT RICHER: THE EVOLUTION OF TOP INCOMES IN THE UNITED STATES Fig. 2, 3 (2013), *available at* elsa.berkeley.edu/~saez/saez-UStopincomes-2012.pdf. The percentage cut-offs in these charts are based upon taxable returns, which exclude a large portion of all return-filing families. *Id.* Thus, the cut-off for the top 1% in 2011 was below $200,000 for all returns. *Id.*

12. JOHN HALTIWANGER ET AL., KAUFFMAN FOUND., BUSINESS DYNAMICS STATISTICS BRIEFING: JOB CREATION, WORKER CHURNING, AND WAGES AT YOUNG BUSINESSES 1, 10-12 (2012), *available at* http://www.kauffman.org/~/media/kauffman_org/research%20reports%20and

a lot of educated labor. The "top of the bottom," the skilled and educated workers below the top half of one percent that have been keeping the upper-middle class alive, are largely the people who administer or serve corporate headquarters,[13] and they are the people who spend their wages to allow retail, food, construction, and service industries to survive.[14] With the

%20covers/2012/11/bds_report_7.pdf.

13. This can be seen intuitively by examining the Bureau of Labor Statistics table of occupational wage data and scanning for occupations of the sort one associates with corporate headquarters – not only management, but HR, accountants, lawyers, analysts, executive secretaries, etc. News Release, Bureau of Labor Statistics, *supra* note 9. The tables show that these occupations earn well more than the average, and further that compensation for employees in larger enterprises is generally significantly higher than that for employees in smaller enterprises. The flat trends in average income shown above are despite a shift in employment to high-skilled jobs, led by increased employment by women in the managerial and professional jobs associated with corporate headquarters, which when coupled with the observations of HALTIWANGER ET AL., *supra* note 12, indicates that American families would have suffered substantially more if corporate headquarters functions had declined. *See generally* Didem Tüzemen & Jonathan Willis, *The Vanishing Middle: Job Polarization and Workers' Response to the Decline in Middle Skill Jobs*, FED. RES. BANK KAN. CITY ECON. REV., 2013, at 5, *available at* https://www.kansascityfed.org/publicat/econrev/pdf/13q1tuzemen-willis.pdf.

14. An immense amount of nonsense has been written asserting that "small business" is the main driver of American employment. Dry cleaners and candle shops did not save Detroit when the major corporate automobile manufacturing operations moved elsewhere. Likewise, the relative economic health of the Minneapolis-St. Paul metroplex obviously does not flow from Minnesotans being superior plumbers or waiters, but rather from the area's ability to attract corporate headquarters with its relatively well-educated professional class, although even there the list is shrinking. *See* Adam Belz & Patrick Kennedy, *The Star-Tribune 100: This Year, It's a Top-Heavy List*, MINNEAPOLIS STAR-TRIBUNE (May 19, 2013), http://www.startribune.com/business/207950651.html. The Twin Cities metropolitan statistical area has 1.6% of the nation's employee income, but some 4% of compensation for corporate management while only1.4% of maintenance and food service compensation. *Regional Data*, Bureau of Econ. Analysis, U.S. Dep't of Commerce, http://www.bea.gov/iTable/iTable.cfm?reqid=70&step=1&isuri=1&acrdn=5#reqid=70&step=30&isuri=1&7022=54&7023=7&7024=naics&7033=-1&7025=5&7026=33460&7027=2013,2008,2003&7001=754&7028=-1&7031=5&7040=-1&7083=percentofmetroportion&7029=55&7090=70 (last visited May 24, 2015). Large corporations are the engines and small business is the caboose they pull, a caboose that provides only twenty-three percent of total U.S. non-owner labor payments. *See* MATTHEW KNITTEL ET AL., OFFICE OF TAX ANALYSIS, DEP'T OF THE TREASURY, METHODOLOGY TO IDENTIFY SMALL BUSINESSES AND THEIR OWNERS 4, 14 (2011), *available at* http://www.treasury.gov/resource-center/tax-policy/tax-

destruction of the ability of would-be retirees to earn a reasonable return on their savings in the aftermath of the 2008 financial meltdown, 47% of working Americans over 50 expect to have to delay retirement by at least three years, and 82% expect to have to work part-time in retirement,[15] the beginning of a vicious cycle in which lack of income will lead to more competition for jobs leading to even lower wages.

In 2005, my colleagues and I, all international tax attorneys who could see what was happening and all parents who feared for our children, decided to look for a fix for this policy problem. We predicted that the decline in middle-class purchasing power would cause our economy to collapse when the rampant government-backed debt stimulus that had been in place since the late 90s began to fail.[16] We knew then that the deficit was getting out of control, so we sought a solution that would be revenue neutral on a current basis and revenue positive over time, even before factoring in increased growth. We developed a proposal that could be enacted in a simple, short bill designed to accomplish the following:

analysis/Documents/OTA-T2011-04-Small-Business-Methodology-Aug-8-2011.pdf. For further discussion on small versus large businesses, see Kelly Edmiston, *The Role of Small and Large Business in Economic Development*, 92 FED. RES. BANK KAN. CITY ECON. REV. 73 (2007), *available at* http://www.kc.frb.org/PUBLICAT/ECONREV/PDF/2q07edmi.pdf; Matt Lykken, *How Important Is Small Business? Plumbers, Plutocrats and Tax Reform*, YAHOO, http://voices.yahoo.com/how-important-small-business-plumbers-plutocrats-8299053.html?cat=3 (last visited May 24, 2015); Alan D. Viard & Amy Rodin, *Big Business: The Other Engine of Economic Growth*, AEI TAX POL'Y OUTLOOK (2009), *available at* http://www.aei.org/article/politics-and-public-opinion/judicial/big-business-the-other-engine-of-economic-growth/.

15. Associated Press-NORC Center for Public Affairs Research Poll, Oct. 14, 2013 http://m.apnews.com/ap/db_289563/contentdetail.htm?contentguid=oZ9ZC7fI.

16. Standard and Poor's is one of many economic analysts who have noted that over-concentration of wealth is bad for economic growth and bad for government revenues. *See* Joe Maguire, *How Increasing Income Inequality Is Dampening U.S. Economic Growth, and Possible Ways to Change the Tide*, S&P RATINGSDIRECT (Aug. 5, 2014), http://www.ncsl.org/Portals/1/Documents/forum/Forum_2014/Income_Inequality.pdf; Gabriel J. Petek, *Income Inequality Weighs on State Tax Revenues*, S&P RATINGS DIRECT (Sept. 15, 2014), http://s3.documentcloud.org/documents/1301747/s-amp-p-income-inequality-weighs-on-state-tax.pdf.

1. To make the U.S.A. the most attractive location on the planet for American companies to locate their high-value operations, so that American workers would regain market power;
2. To allow corporations to bring cash home to invest in those high-value operations;
3. To enable American firms to compete effectively against their foreign rivals;
4. To provide a benefit to middle-class workers who do the right thing and save money for their children's educations and for retirement;
5. To avoid increasing the deficit today, and to provide substantial additional revenues and private savings in order to help prevent a fiscal crisis as the baby boomers retire and the next generation is forced to take on the burden of funding all those retirees;
6. To eliminate the incentive for corporations to take on too much destabilizing debt by eliminating the tax advantage of debt financing;
7. To improve the efficiency of our economy by unlocking cash and encouraging its rapid flow to the most efficient investments;
8. To put an end to corporate tax shenanigans and solve the problem of corporate tax shelters and the complexities of transfer pricing enforcement;
9. To put C corporations on the same basic tax footing as pass-through entities, without double taxation of corporate earnings, so as to eliminate tax distortion of entity choice;
10. To increase corporate responsiveness to shareholders and regulators;
11. To end the current general practice of compensating corporate executives for artificial "growth" that consists only of retaining earnings rather than paying them out as dividends; and
12. To improve the efficiency of our allocation of talent by eliminating the strong tax preference for pursuing unproductive – and often destructive - speculation rather than productive work, while at the same time improving the perceived fairness of our tax system.

In 2007, Laura Hunt[17] and I published the first version of the Shared Economic Growth proposal,[18] with a modified treatment in 2008.[19] Those versions were powerful tools that would accomplish every single one of the goals above, but they contained revenue offsets that were highly unpopular with the wealthy. The 2007 version included an unnecessarily large additional tax on adjusted gross incomes above $500,000, while the 2008 version still included repeal of the step-up in basis at death, which is a tool that enables the moderately wealthy to avoid ever having to pay income tax on a large share of their income.[20] We have learned that it does not pay to annoy the wealthy more than necessary, so we further improved the proposal by striking those parts and adding elements that would be impossible to enact in any context other than as part of the Shared Economic Growth framework, and at the same time made the structure revenue-balanced even if American corporations bring home every dollar they earn abroad.

Since those earlier publications, of course, some other things have changed. The 2008 financial crisis and the economy's subsequent stubborn resistance to all-out stimulus proved that our economic concerns were not merely alarmist.[21] Congress has

17. While Laura and I published our earlier articles together, I am alone on this one and so I wish to note that Laura has been a driving force behind this proposal, but that the opinions expressed in this article are my own and any errors are mine alone.

18. Matthew Lykken & Laura Hunt, *Sharing Economic Growth*, 114 TAX NOTES 691 (2007).

19. Matthew Lykken & Laura Hunt, *Shared Economic Growth: A Proposal for Tax Reform*, 118 TAX NOTES 1221 (2008).

20. Benjamin Franklin said that the only two certainties in life are death and taxes, but this provision allows the one to eliminate the other. Now that the American Taxpayer Relief Act of 2012 has implemented a $10MM estate and gift tax exemption for a married couple (already increased to $10.5MM by the inflation index, and subject to further increase from inherited Deceased Spouse Unused Exemption amounts from another spouse), and with the adoption of a 40% top estate and gift tax rate, most estate planning has now shifted to holding onto appreciated assets until death to maximize the step-up. American Taxpayer Relief Act of 2012, Pub. L. No. 112-240 §302(a), 126 Stat. 2313 (2012).

21. Lack of market power continues to keep down wages, which in turn suppresses overall growth in our demand-driven economy. Neil Shah, *Stagnant Wages Are Crimping Economic Growth*, WALL ST. J. (Aug. 25, 2013), http://online.wsj.com/article/SB10001424127887323980604579028822725730720.html?mod=WSJ_article_RecentColumns_TheOutlook.

been calling loudly for tax reform, and a form of consensus proposal for corporations has emerged, one that would be better than the current system in some ways, but that does not go far enough and that would create substantial problems. Meanwhile, scholars and commentators on the left, right, and center have been recognizing the value of various elements of the Shared Economic Growth proposal and its theoretical underpinnings.[22]

In this article, I outline the latest version of the proposal and explain how it accomplishes all of the aforementioned goals, with reference to some of the recent scholarly works that support it. I then walk through the derivation of the numbers to show that it really works, based on conservative assumptions and without any reliance on economic growth or voodoo, and that it would provide a substantial addition to revenue in the coming years. These numbers are based on 2010 data, the most recent comprehensive data available, and thus prove that the proposal works in the post-2008 economy. I next compare the proposal to the emerging "corporate consensus." Finally, I walk through an analysis of the propriety of certain offsets that can only work as part of the Shared Economic Growth package.

22. *See, e.g.*, JOINT COMM. ON TAX'N, 113TH CONGR., REP. ON PRESENT LAW AND SUGGESTIONS FOR REFORM SUBMITTED TO THE TAX REFORM WORKING GROUPS 498-501 (Joint Comm. Print 2013); Rosanne Altschuler et al., *Capital Income Taxation and Progressivity in a Global Economy*, TAX POL'Y CTR. (May 19, 2010), http://www.taxpolicycenter.org/publications/url.cfm?ID=412093; Reuven S. Avi-Yonah & Amir C. Chenchinski, *Corporate Tax Integration and the Debt/Equity Distinction: The Case For Dividend Deduction*, (Columbia Law Sch. Tax Policy Colloquium 2010), *available at* http://web.law.columbia.edu/sites/default/files/microsites/tax-policy/files/2010/Avi-Yonah_Corporate%20Tax%20Integration_With%20Cover.pdf; Jasper L. Cummings, Jr., *Cost of Capital Confusion*, 118 TAX NOTES 1037 (2008); Megan McArdle, *Why We Should Eliminate the Corporate Income Tax*, ATLANTIC (Oct. 28 2010, 2:16 PM), http://www.theatlantic.com/business/archive/2010/10/why-we-should-eliminate-the-corporate-income-tax/65351/; Steven Rattner, *End Corporate Taxation*, N.Y. TIMES, May 3, 2014, at A19; Eric Toder & Alan D. Viard, *Major Surgery Needed: A Call for Structural Reform of the U.S. Corporate Income Tax*, TAX POL'Y CTR. (Apr. 4, 2014), *available at* http://www.aei.org/files/2014/04/03/-toder-viard-report_132524981261.pdf; Matthew Yglesias, *Scrap the Corporate Income Tax*, SLATE (April 9, 2013, 11:52 AM), http://www.slate.com/articles/business/moneybox/2013/04/corporate_income_tax_reform_it_s_not_possible_we_should_just_get_rid_of.html.

II. What Shared Economic Growth Is and How It Works

Simply, the proposal is to enact a corporate dividends-paid deduction for distributions to shareholders not entitled to a dividends-received deduction, capped at an amount that reduces corporate tax otherwise payable to zero. The deduction could only be used to offset corporate tax accruing after enactment. Losses generated by the deduction could be carried forward and back (but not to pre-enactment years) under the general rules of I.R.C. § 172, so the deduction would not be "free" – if you wanted to maximize the deduction and claim a financial accounting benefit for it, you would have to pay earnings out as a dividend within 2 years. The revenue cost of this change would be offset by several items.

First, special tax rates for dividends received at the individual level would be eliminated. The fundamental idea behind the proposal is that corporate tax is eliminated through a mechanism that collects the tax at the shareholder level if, as, and when the corporate tax is reduced through the payment of a dividend. (Other offsets are needed because a substantial portion of dividends goes to shareholders who are not taxable or who pay tax on a deferred basis.) So, task one is to ensure that shareholders pay tax on the dividends at full ordinary rates. Since the only justification given for allowing reduced rates on dividends is to reduce the double taxation of corporate earnings, this should not be controversial.

The ingenuity of tax planners being what it is, one would expect that the above change would result in even more dividends being replaced by stock buy-backs, so that the shareholders could receive their distributions as capital gains. Therefore, the second offset is to eliminate special capital gains rates except for those on one's own residence or on farm, timber, livestock, or business personal property.[23] It is necessary to the proposal to eliminate capital gains rates for any form of direct or indirect investment in stock, including interests in pass-through

23. The draft bill text, in the interest of simplicity, eliminates special capital gains rates altogether, but I assume that Congress may find this undesirable and so I have not included the relatively small benefit from eliminating special rates for homeowners, rural operations, and non-speculative business operations in the numbers here.

entities that may own stock. I propose to go further and to eliminate special rates for any form of financial asset, speculative real estate, or interest in an entity (aside from small business stock),[24] on the grounds that it is inefficient to subsidize speculation. Since the majority of capital gains benefits relate to direct equity holdings, to capital gain distributions, and to capital gain pass-through,[25] however, special rates for other non-equity items could be preserved without fundamentally undermining the proposal.

Since about 54% of taxable dividends go to families earning over $250,000 per year,[26] these offsets would be enough if it were not for the fact that a large portion of the dividends of U.S. companies flow either to foreigners or to U.S. tax-deferred savings and pension accounts. As to the latter, Congress could deal with the shortfall by imposing a withholding tax on payments to such accounts. However, in light of the goals stated above, I instead proposed to rebalance the burden a bit more between high-income speculators and middle-class workers and savers. In 2008, we proposed a supplemental 7.65% levy on adjusted gross income in excess of $500,000. This subjects persons at that income level to the same personal-side levy that middle-class working people pay on every dollar of their wages for Social Security and Medicare.[27] We proposed that this 7.65%

24. I.R.C. § 1202 (2012). I have been told by a reliable source that the Administration is particularly fond of this special benefit for a taxpayer's first $10,000,000 of gain on stock in a company with assets of less than $50,000,000, which is understandably popular with venture capitalists and Hollywood.

25. Computed from the Internal Revenue Service Statistics of Income. *See Sales of Capital Assets Reported on Individual Tax Returns: Short-Term and Long-Term Capital Gains and Losses*, IRS (2007), http://www.irs.gov/uac/SOI-Tax-Stats-Sales-of-Capital-Assets-Reported-on-Individual-Tax-Returns.

26. Computed from I.R.S. Statistics of Income 2010. *See Individual Statistical Tables by Size of Adjusted Gross Income: Sources of Income, Adjustments Deductions and Exemptions, and Tax Items*, IRS (2010) [hereinafter *2010 Individual Statistical Tables by Size of Adjusted Gross Income*], http://www.irs.gov/uac/SOI-Tax-Stats---Individual-Statistical-Tables-by-Size-of-Adjusted-Gross-Income.

27. Economists generally agree that the additional employer-side portion of this levy also normally falls upon the worker in the form of lower pay, since employers set pay levels based on their all-in cost of hire. *See* CONG. BUDGET OFFICE, AVERAGE FEDERAL TAXES BY INCOME GROUP (2010), http://www.cbo.gov/publication/42870 ("The analysis assumes—as do the analyses of most economists—that the employer's share of payroll taxes is

would be net of any amount already paid due to the lack of a cap on Medicare wages, which did not make much difference because high-income individuals tend to get their money from sources other than wages or self-employment. Not coincidentally, however, the federal government has since chosen to harvest more of this revenue through the new 3.8% levy on unearned income imposed as part of the Health Care and Education Reconciliation Act.[28] We still propose that the 7.65% be a net number, i.e., that it be 7.65% of AGI in excess of $500,000 less any individual-side FICA tax or unearned-income levy on such income, which substantially reduces the value of this offset. Still, this is a particularly helpful offset because it would automatically increase as dividend pay-outs increased, and thus it helps to ensure that the proposal would be currently revenue-neutral across a broad range of circumstances.

Now we come to an offset that is only possible within the Shared Economic Growth framework. Currently, America avoids imposing double taxation on the foreign income of our corporations by allowing them a credit for the foreign tax they paid, so if they earn $100 in the U.K. and pay $20 of U.K. tax, they will get a credit of $20 against the $35 of U.S. tax that they would otherwise owe on that income. Our treaties promise to keep allowing such a credit.[29] However, under Shared Economic Growth corporations would not ever have to suffer double taxation, because they would be entitled to reduce their U.S. corporate income tax to zero merely by paying out their current earnings as dividends.[30] As I discuss further below, this

passed on to employees in the form of lower wages than would otherwise be paid."). Thus, these high-income individuals would still come out ahead of normal workers. *Id.* Moreover, let us stop pretending that this levy is just an insurance premium. The government has repeatedly added unfunded new benefits to Medicare and costs have risen exponentially, so that the premiums paid by any individual have little relationship to the cost of the benefits he or she receives. Real insurance does not work that way.

28. Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, §1402(a)(1), 124 Stat. 1061 (2010).

29. DEP'T OF THE TREASURY, UNITED STATES MODEL INCOME TAX CONVENTION Art. 23 (2006) [hereinafter MODEL TAX CONVENTION], *available at* http://www.treasury.gov/press-center/press-releases/Documents/hp16801.pdf.

30. As discussed below, I also propose to allow corporations to currently expense any investment in U.S. operating assets made out of post-enactment earnings, so that they would only need to pay out un-reinvested earnings in order to achieve zero taxation.

provides an adequate justification for a general treaty override to eliminate foreign tax credits for corporations and replace it with a mere deduction.[31] Corporations claimed $118,000,000,000 in foreign tax credits in 2010, so this change would provide a $77,000,000,000 additional offset, being 65% of $118,000,000,000.[32] Because it would both seriously offend our trading partners and seriously damage our corporations to eliminate the corporate foreign tax credit without otherwise eliminating U.S. corporate tax on foreign income, only Shared Economic Growth offers the opportunity to harvest this offset.

The elimination of the foreign tax credit would immunize the proposal against any revenue shortfall from a decision by American corporations to bring all of their foreign earnings home. When a dollar of previously untaxed income hit their U.S. tax returns by virtue of being distributed up from a foreign subsidiary, it would attract thirty five cents of U.S. tax. The corporation would have to pay out the full dollar in income to its shareholders (or invest it in U.S. operations) in order to reduce that tax to zero. The shareholder-level tax would then be some seventeen cents, as computed below. Thus, the repatriation of foreign earnings would only increase U.S. net tax revenue, and indeed it is quite likely that this increase in revenue would be triggered once corporations were able to repatriate their foreign cash without a tax hit.

Finally, we need an offset to account for the fact that some 19% of U.S. equities are held, directly or indirectly, by foreign persons, with some 20% of U.S. dividends going to foreigners.[33] Here we propose a simple solution, and again an offset that would only be possible as part of the Shared Economic Growth

31. *See infra* notes 136-140 and accompanying text. The "corporate consensus" proposal to move to territorial taxation would likewise require a general treaty override to move from a foreign tax credit to a foreign income exemption system, a change that other nations moving to an exemption system have also made, so the mere need for such an override is not in itself that radical. This is discussed further below.

32. *See Statistics of Income: Returns of Active Corporations*, Table 1, I.R.S. (2010), at cell L12, http://www.irs.gov/file_source/pub/irs-soi/10co01ccr.xls While corporations could eliminate this tax by paying additional dividends, those incremental dividends would produce additional tax revenue. The computations below are based on the all-in effect of these various items.

33. *See infra* note 34 and accompanying text.

package. A 30%[34] withholding tax, on top of any withholding tax already imposed, would apply with respect to deductible dividends (but not dividends in excess of the deduction limit) paid to foreign persons not otherwise subject to U.S. income tax on the dividends. This would be structured primarily as a straight withholding tax with a treaty override, justified by the fact that the gross dividend could be expected to be 54% higher due to the allowance of the dividends-paid deduction, so the net amount payable to the foreign shareholder would be unchanged from current law. The propriety of this is discussed further below, but in short the foreign shareholders would be as well-off as they are today and would be entitled to choose to be taxed the same way as a U.S.-resident shareholder, so they would have no valid complaint.[35]

I would suggest one other component as part of the proposal, though it would have a timing cost that could be offset by other tweaks to corporate taxation. I would allow corporations to expense all U.S. operating investments made out of post-enactment earnings. This would maximize their incentive to bring home the earnings of their foreign subsidiaries and invest

34. This number might need to be tweaked or made adjustable. The 2006 U.S. Model Treaty, Article 10, allows a 15% dividend withholding tax on portfolio dividends, so under current law a typical portfolio investor would receive $85 from a $100 dividend. MODEL TAX CONVENTION, *supra* note 29, at art. 10. Since the payor corporation would receive a 35% benefit for paying the dividend, the dividend would be expected to increase by 54%, since 1/(1-35%)=154%. A 30% withholding tax levy incremental to the current 15% tax applied to a 54% higher dividend yields the same net $85 to the shareholder and the same net revenue to the U.S. government. *See* DEP'T OF THE TREASURY, UNITED STATES MODEL TECHNICAL EXPLANATION ACCOMPANYING THE UNITED STATES MODEL INCOME TAX CONVENTION OF NOVEMBER 15, 2006 Art. 10 (2006), *available at* http://www.treasury.gov/press-center/press-releases/Documents/hp16802.pdf.

35. Some would try to argue that since the average effective tax rate on U.S. corporations is lower than the 35% marginal rate, then foreign investors would not expect to receive a full 54% more in dividends. However, it is a fact that each dollar of dividends paid would save the corporation thirty-five cents, so the corporation would be expected to gross its dividends up to 154% (i.e. by 1/(1-.35)) of the level they would otherwise be, but then stop when they ran out of tax to offset. As the computations below indicate, generally companies will have tax room to do the full gross-up on what they would otherwise pay. Therefore, the fact that the overall effective rate on corporations is lower than 35% today would not, on average, prevent the 54% increase in dividends from today's levels, and in every case the overall value of the foreign shareholder's investment would be unchanged by the implementation of the proposal.

them in new U.S. high-value operations. In essence, the cost of this would be to postpone the collection of the seventeen cents that the government would collect currently if a dollar of investment was instead paid out as a dividend, with the deferral occurring over the period that the investment would otherwise have been depreciated, commonly anywhere between five and fifteen years, with the average time outstanding being closer to two to seven years.[36] Having the government effectively lend a corporation 17% of the cost of a high-value investment for two to seven years seems like pretty cheap stimulus. This is especially true given that the government could eliminate various other corporate tax incentives/giveaways in order to offset this timing effect if desired.

The reader will recall that 100% depreciation was chosen as a stimulus tool after the 2008 crisis, without much noticeable impact. Indeed, traditionally the main effect of accelerated depreciation in our society is to stimulate individuals to claim questionable deductions, not to stimulate genuine corporate investment.[37] This is because relatively few corporations run investment economics that incorporate accurate tax timing in their equipment purchasing decisions, so the temporary accelerated benefit does not make its way into corporate decision making. Further, after the 2008 crisis American corporations mostly did not see any domestic investments that they wanted to make, and instead sat on large piles of cash. With Shared Economic Growth, on the other hand, expensing of operating investments would enable corporate management to hang on to

36. Current law tends to front-load tax depreciation, so 50% of the depreciation or amortization would be taken under current law by the two to seven year mark. *See* I.R.C. § 168 (generally 200% declining balance recovery is allowed with recovery periods that are generally accelerated, such that property with a class life of 10 years has a 5-year recovery period and property with a class life of 15 years has a 7-year recovery period, and property with a class life of 25 years has a 15-year recovery period, so that more than half of the depreciation on property with a 10-year class life is allowed after 2 years, and more than half of the depreciation on property with a 25-year class life is allowed after 7 years) and § 197 (15 year straight-line amortization for acquired goodwill and going concern value).

37. *See, e.g.*, Darryl Cohen & Jason Cummins, *A Retrospective Evaluation of the Effects of Temporary Partial Expensing* (Fin. & Econ. Discussion Series, Div. of Research & Statistics & Monetary Affairs Fed. Reserve Bd., Working Paper No. 2006-19, 2006).

earnings without having to convince the market to reinvest, which would provide a potent practical incentive to make U.S. operating investments. Combined with a change in the international tax provisions to make it more difficult to redeploy foreign earnings cross-border,[38] management could be forced into a choice between investing foreign earnings in U.S. operations or giving them to the shareholders and having to convince investors to give them back. Managers, being what they are, would strongly prefer the former choice. Because Shared Economic Growth would make U.S. high-value operations economically attractive, it would be easy to justify such investments, so management would have the motive (hanging on to earnings), the means (foreign cash) and the opportunity (attractive American investments). Given the various sources of increased income discussed below, providing this investment incentive might not result in any overall current loss of revenue, it certainly could not result in a long-term revenue loss, and one would expect it to produce a substantial revenue gain as those U.S. investments produced increased wages and opportunities for American support businesses.

III. How Shared Economic Growth Accomplishes Its Goals

Shared Economic Growth would produce an extraordinary number of benefits. Let's look at each of the twelve in turn.

A. *Making America the Most Attractive Location on the Planet for American Companies to Locate Their High-Value Operations, so That American Workers Would Regain Market Power*

This one is simple. The proposal would enable corporations to reduce their effective U.S. tax rate to zero. No other developed jurisdiction has a permanent zero corporate tax rate. This would not cause all operations to come back to America. Low-margin

38. This could be done by repealing the I.R.C. § 954(c)(6) exception for dividends from related controlled foreign corporations, and by enacting a provision treating distributions from foreign entities treated as taxable corporations under local law as dividends for purposes of § 954. *See* I.R.C. § 954(c)(6) (2012).

operations that rely on low wages to make any profit would not come here just to have a zero tax rate on their operating losses. Those, however, are not the operations we want anyway. We want high-margin operations that can afford to pay high wages. Those operations are very tax sensitive. Consider the case of a plant that today would earn $50,000,000 of taxable income in a jurisdiction with a 25% tax rate, netting $37.5MM after tax. In the U.S., it would net the full $50,000,000. If it currently paid wages of $10,000,000, it could afford to more than double its payroll and still be better off in the U.S. Even compared to the 12.5% Irish tax rate it would be much better off in the U.S. and could still afford to increase its payroll by some 60% by moving here. While some less-developed countries offer zero tax rates, America would at least be equally good in terms of taxation, and would offer advantages of market proximity and possibly workforce education. In consequence, corporations would want to have their operations here, and over time new operations would be located here and many old operations would relocate. These activities would need workers, increasing the demand side of the curve and allowing workers to extract better pay and working conditions.

Is it realistic to think that wages would rise? The economic literature says yes. In an open economy such as ours, corporate tax has a powerful effect on wages. As a European Union economic study[39] observed,

> Another important distortion created by corporate taxation is the one induced on labour markets. This distortion is well-known in theory but is generally absent from the political debate. Economic theory shows that, under the assumption of mobility of capital, the incidence of the corporate tax is fully borne by labour (Gordon, 1986).[40] Furthermore, this literature insists that capital flight reduces labour productivity and, in fine, wages. Hence, this creates an additional

39. Gaëtan Nicodème, *Corporate Income Tax and Economic Distortions*, *in* TAXATION PAPERS, EUROPEAN UNION 8 (2008).

40. Roger H. Gordon, *Taxation of Investment and Savings in a World Economy*, 76 AM. ECON. REV. 1086 (1986).

> distortion which could be avoided if labour would be taxed directly.
>
> Recently, Arulampalam, Devereux, and Maffini (2007)[41] have investigated this issue using a panel of more than 50,000 companies in nine European countries over 1996-2003. Their results suggest a validation of the theory as each additional euro of corporate tax reduces wages by 92 eurocents in the long-run. Therefore, the incidence of corporate taxation falls almost entirely on labour.

A number of studies using a variety of data sets and methodologies have agreed on the conclusion that the burden of corporate tax falls heavily on labor,[42] and that indeed a dollar increase in corporate tax may reduce overall wages by four dollars.[43] The cost to workers can exceed the corporate tax increase for two reasons. First, the mechanism is not corporate managers insisting that employees accept wage reductions to offset the corporate tax paid, because the employees are unlikely to agree to that sort of negotiation. Rather, corporations react to a high tax rate on their new investments by putting the investments elsewhere, leaving employees in the market who have no job at all and who will thus be willing to take whatever wage they can get. Second, because multinational corporate jobs are generally the high-paying jobs in our economy, when corporate employees are forced to accept lower wages or are thrown back into the market it reduces the price that *both*

41. Wiji Arulampalam et al., *The Direct Incidence of Corporate Income Tax on Wages* (Inst. for Study of Labor ("IZA") Discussion Paper Series, Discussion Paper No. 5293, 2010).

42. *See* Matthew H. Jensen & Apama Mathur, *Corporate Tax Burden on Labor: Theory and Empirical Evidence*, 121 TAX NOTES 1083 (2011); William M. Gentry, *A Review of the Evidence on the Incidence of the Corporate Income Tax* (Dep't of the Treasury, Office of Tax Analysis Papers, Working Paper No. 101, 2007).

43. Bev Dahlby & Ergete Ferede, *What Does It Cost to Raise a Dollar of Revenue?: The Marginal Cost of Public Funds*, 324 C.D. HOWE INST. COMMENT. 1-14 (2011), *available at* http://www.cdhowe.org/pdf/Commentary_324.pdf (a Canadian study finding that provincial corporate tax rates produce an economic burden of several times the corporate tax raised, an effect much higher than personal income taxes or sales taxes).

corporate and non-corporate workers can command. Labor rates drop not just in the multinationals but in purely domestic operations as well, due to the oversupply of workers.

This is important and the economists tend to miss it. They cheerfully assume that "only" 100% of the burden of corporate tax can fall on workers, because once labor rates drop low enough to equal the differential corporate tax costs the companies will, in the long run, move the jobs back (a dubious assumption in itself, as discussed below). But assume that you have a system with three employers, each with one employee, Multinational Corporation, Hardware Hubert Ltd., and Nonprofit Healthcare. All three workers make $20 an hour, and represent 50% of the costs of their businesses, or $50X out of $100X with Multinational Corporation earning a profit equal to 40% of its costs, i.e., $40X. Multinational Corporation could move to Switzerland, still pay $20 an hour, and pay only 10% tax rather than 35%. It demands that its U.S. employee reduce his wages by enough to make up for the tax cost. The tax differential is equal to 25% of the $40X profit, or $10X. The employee must therefore accept a wage cut of 20%, i.e., $10X/$50X. So, 100% of the corporate tax burden has been passed to labor. But now the Multinational Corporation employee would be willing to jump to either of the other two employers for any salary above his new rate of $16 an hour. This competition causes the other two employers to drop pay by 20% to $16.00 an hour. Labor now has absorbed a cost equal to *three times* the differential corporate tax burden, and that is an equilibrium rate that need never change. Further, if the American workers somehow manage to reach a new equilibrium at $16.01 per hour, so that Multinational Corporation does move its operations abroad, actual U.S. corporate tax collections will be zero. In other words, the burden of corporate tax is not restricted to the amount of corporate tax *imposed*, but rather is in theory connected to the amount of corporate tax that *would be* imposed on operations that *could be* located in America, many of which are *not* here partly due to our corporate tax rate. This "scare away" burden tends not to be accounted for in the models or in people's intuitive assumptions.

Another counter-intuitive issue is that, somewhat weirdly, and again because corporate jobs are the driver of good wages, as corporate jobs *decline* as a share of our overall economy, the

multiplier effect of reductions in corporate wages *increases*. If corporate jobs are half of all jobs, which is roughly true today, then employees can in principle bear a burden up to twice the level of corporate tax, as illustrated by our simple model above. If corporate jobs decline to a quarter of all jobs, then American employees can bear a burden equal to up to four times the level of corporate tax. As we chase corporate jobs abroad, then, we become exposed to this strange multiplier, with the effect of corporate tax becoming larger at the same time that corporate employment becomes smaller as a share of the economy.

The other thing that the happy economists tend to discount is the effect of friction on their pretty equilibriums. While they recognize that location decisions are complicated and therefore somewhat "inelastic" as to tax cost, they assume that if a $1 corporate tax differential drives a job abroad today, then if workers accept a $1.01 decrease in compensation that job will come back tomorrow. Corporate location decisions are more complex than that. Companies do not love change, both because it is risky and because they have sunk capital invested in the status quo. They respond more freely to cost differentials for new operations than for existing ones. When a differential reaches a certain point, however, they become unable to resist the impetus to respond and to move even their existing base. Once they make that move abroad, they will be equally reluctant to break the new status quo to move back, and will have to see stable U.S. labor rates low enough in comparison to the foreign rival to compel the move. "Equilibrium" then is really a range with a width set by the level of friction, and once jobs locate abroad we fall to the negative end of that range. Because location decisions are subject to this sort of friction, we have not yet felt the full potential burden of globalization on U.S. wages. Once we break friction and the jobs move, though, we will feel the full effect of both wage competition and tax competition. We do not want to have our labor rates fall to the global common denominator.

As corporations develop larger qualified labor pools and better infrastructure abroad, one could reasonably expect that the inelasticity of location decisions that economists recognize will evaporate, leaving only the type of anti-change friction described above. This will maximize the impact of the corporate

tax differential. The foreign labor pool and infrastructure that can support that disaster have been under development for some time now, and the development is accelerating. Some statistics regarding America's ranking among its OECD peers for 2011 tell the story:[44]

> Percent of adults achieving post-secondary degrees: 12th
>
> Progress in post-secondary education from prior generation: 35th
>
> Percent of students completing upper secondary education: 22nd
>
> Employment rates among Tertiary A/graduate school degree holders: 28th
>
> Proportion of persons with less than upper secondary education earning less than half the median income (a high ranking indicates weak market power for unskilled workers): 1st

Similarly, the 2009 PISA grade-school education rankings place the U.S. 17th overall on the reading scale, and 22nd on the Integrate and Interpret subscale of that score. We ranked 31st in math and 23rd in science.[45] The 2012-13 World Economic Forum competitiveness report[46] ranks the U.S. 7th in overall competitiveness, 14th in infrastructure, 34th in health and primary education, 8th in higher education and training, and 11th in technological readiness. While in 2009 the United States

44. ORG. FOR ECON. COOPERATION & DEV., EDUCATION AT A GLANCE 2013: OECD INDICATORS (2013).

45. ORG. FOR ECON. COOPERATION & DEV., PISA 2009 RESULTS: WHAT STUDENTS KNOW AND CAN DO: STUDENT PERFORMANCE IN READING, MATHEMATICS AND SCIENCE (VOLUME 1) (2010).

46. KLAUS SCHWAB, WORLD ECON. FORUM, THE GLOBAL COMPETITIVENESS REPORT 2012–2013 (2012), *available* at http://www3.weforum.org/docs/WEF_GlobalCompetitivenessReport_2012-13.pdf.

awarded 26% of the OECD's new PhD degrees in science and engineering, China produced more (although of uncertain quality),[47] the number of U.S. PhDs per capita was only half the rate for Switzerland,[48] and the number of those U.S. degrees being awarded to Americans has been declining. In 1995, 27% of U.S. doctorate degrees were awarded to foreign visa holders. In 2011 that had climbed to 36%, primarily from China,[49] and only 64% of those students stay here.[50] Meanwhile American native students are becoming increasingly disinclined to pursue PhDs as various exploitative practices in academia (reduction in stipends, longer time to degree and longer time as post-docs and in non-tenure positions) adversely affects the economic benefit of such a course of study.[51] In 2011, China's patent office overtook the U.S. as the largest in the world, and Japan and China both beat out the U.S. as originators of patents applied for, while since 2008 China has beaten the U.S. in terms of patent applications per R&D dollar spent and has an industrial design registration count by residents that is an order of magnitude larger than America's. The cost of R&D operations is nearly 13% less in the Netherlands than in the U.S., and India, China and Russia are 57%, 46%, and 34% cheaper, respectively.[52] Prior to 2002, America had never run a trade deficit in advanced technology products. Since then we have run such a deficit every year, rising to $82 billion in 2010.[53] America ranks 44th out of 51 countries surveyed, behind Greece, the

47. David Cyranoski et al., *The PhD Factory*, 472 NATURE 276 (2011).

48. *See* ORG. FOR ECON. COOPERATION & DEV., OECD SCIENCE, TECHNOLOGY & INDUSTRY SCOREBOARD 2011L INNOVATION AND GROWTH IN KNOWLEDGE ECONOMIES (2011), *available at* http://dx.doi.org/10.1787/sti_scoreboard-2011-12-en.

49. NAT'L SCI. FOUND., WHO EARNS A U.S. DOCTORATE? http://www.nsf.gov/statistics/sed/digest/2011/theme1.cfm#2 (last visited Apr. 23, 2015).

50. MICHAEL G. FINN, OAK RIDGE INST. FOR SCI. & EDUC., STAY RATES OF FOREIGN DOCTORATE RECIPIENTS FROM U.S. UNIVERSITIES 2009 (2012).

51. Cyranoski et al., *supra* note 47.

52. KPMG, COMPETITIVE ALTERNATIVES: KPMG'S GUIDE TO INTERNATIONAL BUSINESS LOCATION COSTS (2014), http://www.competitivealternatives.com/.

53. Derek Hill, *U.S. Exports of Advanced Technology Products Declined Less Than Other U.S. Exports in 2009*, NAT'L CTR. FOR SCI. & ENG'G STAT. INFOBRIEF (Sept. 2011), *available at* www.nsf.gov/statistics/infbrief/nsf11307/nsf11307.pdf.

Dominican Republic, and Belarus, in efficiency of healthcare and 3rd out of 51 in per-capita healthcare cost, and we make that an employer's problem by foisting an unusual amount of our healthcare and pension costs onto the shoulders of employers.[54] In short, we are not in a position to think that our companies have no viable alternative locations for manufacturing, administration or research and development.[55] This is like climate change. We can see that something is happening, we can see the rise of factors that logically would produce those symptoms, and we know that at some point the buffers that have kept things in bounds will collapse and that the changes will accelerate beyond our control. If we wait until our economy is gutted and our foreign-born college graduates all go home to better opportunities, the next generation will not feel sympathetic when we say, "oops . . . how were *we* to know this would happen?"

Besides the burden that corporate taxation imposes on American labor, economists are in general agreement that corporate tax is the single worst tax in terms of reducing economic growth. The only excuses for tolerating corporate tax have been the potential effect on the overall fairness of the tax system from reducing rates, and the problem of tax gaming by wealthy individuals if they can benefit by shifting their income into a corporate envelope. As the OECD stated in 2010:

> Corporate income taxes are the most harmful for growth as they discourage the activities of firms that are most important for growth: investment in capital and productivity improvements. In addition, most corporate tax systems have a large number of provisions that create tax advantages for specific activities, typically drawing resources away from the sectors in which they can make the greatest contribution to growth. However,

54. *Most Efficient Health Care*, BLOOMBERG, http://www.bloomberg.com/visual-data/best-and-worst/most-efficient-health-care-2014-countries (last visited May 24, 2015)

55. For a useful brief discussion of America's decline, see David S. Mason, *The U.S. No Longer Makes the Grade: Economic Inequality Put an End to the "American Century"*, 92 PHI KAPPA PHI FORUM 4, 4-7 (2012).

> lowering the corporate tax rate substantially below the top personal income tax rate can jeopardize the integrity of the tax system as high-income individuals will attempt to shelter their savings within corporations.[56]

The Shared Economic Growth proposal eliminates both of the problems with eliminating corporate taxation, shifting the tax burden in a manner that actually favors the working classes and that reduces opportunities for individual tax avoidance. It thus eliminates the worst tax in the best way.

B. *Allowing Corporations to Bring Cash Home to Invest in Those High-Value Operations*

Under our current system, corporations generally pay a heavy penalty for bringing their foreign-subsidiary earnings into the U.S., whether to invest them in American operations or to pay dividends. Most of the earnings of controlled subsidiaries are subject to U.S. tax only when they are distributed to, or invested in,[57] the United States. They are then subject to a 35% U.S. tax, with a credit for foreign taxes paid with respect to such earnings.[58] For earnings from zero-tax locations, the penalty is a full 35%. So, if a dollar of zero-taxed earnings is invested in any country other than our own, the corporation gets to invest the full dollar, but if it invests it here it only gets to invest 65 cents. According to the most recent available IRS data on controlled foreign corporations, for the year 2008, such CFCs had foreign tax of $120B on pre-tax earnings of $854B, for a 14%

56. ORG. FOR ECON. COOPERATION & DEV., OECD TAX POLICY STUDIES: TAX POLICY REFORM AND ECONOMIC GROWTH 22 (2010), http://dx.doi.org/10.1787/9789264091085-en.

57. 26 U.S.C. § 956 (2012).

58. *Id.* §§ 11 & 902. The distribution is "grossed-up" by the amount of credits allowed in order to prevent a double benefit. *Id.* § 78. A controlled subsidiary with $100 of earnings that pays a 30% foreign tax will only have $70 left to distribute. The foreign tax credit system seeks to ensure that the original earnings will be taxed at a combined rate of 35%. The arithmetic only works if you add the $30 back as a gross-up, apply U.S. tax to that total, and then allow the $30 credit against the $35 U.S. tax.

average foreign tax rate.[59] On average, then, the U.S. tax burden of bringing those earnings home would be 35%-14%=21%. In practice it tends to be worse, since companies selectively repatriate their higher-tax earnings on an ongoing basis, leaving an even lower tax mix abroad. Thus, for 2008 U.S. parent corporations recognized CFC earnings with a blended tax rate of some 30%,[60] leaving behind earnings with an associated tax credit of only 7.5%. Thus, the distribution of the remaining 2008 earnings would have triggered a 27.5% residual U.S. tax liability.[61]

Shared Economic Growth would take away this penalty for bringing money to America. If the foreign cash was paid out as a dividend to shareholders, the dividend deduction would fully offset the U.S. tax on the dividend received from the foreign subsidiary. If the cash was used to invest in U.S. operations, the tax on repatriation would be fully offset by the expensed deduction for the investment. Rather than saying "we will hit you with a 27.5% liability if you bring any foreign cash into the U.S.," we would encourage corporations to bring home all the cash they wanted and inject it into our economy.

Further, if corporations still proved reluctant to invest in America (which would be hard to understand under the improved tax structure), the Shared Economic Growth platform would make it relatively easy to give them a little more incentive by broadening the scope of subpart F,[62] which subjects various

59. Computed from I.R.S. Statistics of Income 2008. *See Statistics of Income: U.S. Corporations and Their Controlled Foreign Corporations,* IRS (2008), http://www.irs.gov/uac/SOI-Tax-Stats-Controlled-Foreign-Corporations (refer to tax information reported on Form 1118).

60. *Id.* (computed as H11/(H11+G11+C11)). Not coincidentally, the 5% residual U.S. tax that these companies deemed tolerable is about equal to the tax Congress imposed on the special "homeland" dividends under I.R.C. § 965 for 2005. *Id.* At much above that level, many companies start to gag. *Id.*

61. It is worth noting that the administration's global foreign tax credit pooling proposal would serve mainly to shut off the spigot on the tolerable repatriation that corporations do today. If corporations were unable to concentrate their foreign tax credits, they would be that much more reluctant to bring home *any* foreign cash, and thus that much more desperate to find foreign investments for their profits. *See* U.S. DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2014 REVENUE PROPOSALS 48 (2013), http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2014.pdf.

62. 26 U.S.C. § 951 (2012).

forms of mobile income to current U.S. taxation. Broadening subpart F today is problematic, because allowing the deferral of U.S. tax is the only thing that allows American companies to be remotely competitive with their foreign rivals, who are not taxed on foreign income. Since Shared Economic Growth allows the elimination of U.S. tax for companies that deploy their cash properly, however, adoption of the proposal would allow Congress more flexibility without unduly harming our companies. Once foreign subsidiary income was subjected to U.S. tax, that tax could only be relieved if the parent company paid the cash out as a dividend or invested the cash in U.S. operations within two years. I would recommend against doing such a thing up front, since the proposal would enable and encourage companies to fund all economically efficient U.S. investments without the use of such strong-arm tactics, but it would be an available option if companies did not otherwise respond in an economically rational way.

C. *Enabling American Firms to Compete Effectively Against Their Foreign Rivals*

Our current tax system is an awkward compromise intended to make it possible for American companies to compete, but it achieves this goal in a highly dysfunctional way. Every OECD nation except ours now allows their corporations to earn foreign operating income without paying significant home-country tax. As one can see from the fact that, as shown above,[63] American companies incur foreign tax at only an average blended rate of 14%, there are many opportunities to earn foreign income at very low rates, commonly ranging from 0% to 12.5%. Our competitors can bring these earnings home freely.[64]

What would happen if Congress decided to eliminate the ability of our companies to defer U.S. tax on their foreign income until they brought the cash home? Consider a profitable company located in Singapore that is being taxed at an incentive rate of zero. It is up for sale to the highest bidder. Say that it

63. *See supra* note 59 and accompanying text.

64. On the other hand, for companies lucky enough to be based in a country like Ireland or Switzerland, they can earn income in their home country and only have it taxed at those rates.

has a pre-tax present value of $100MM. A non-U.S. company would be able to bid up to $100MM for it. An American company would be able to bid only $65MM, because the 35% U.S. tax that would then be imposed on the income would only leave a profit stream with a present value of 65% of the pre-tax total.[65] So, our companies could not acquire subsidiaries.

Now say that an American company already owned the Singapore operations, which would have a value of $65 in American hands. It would be worth $100 in foreign hands, and so a foreign rival could afford to buy it with no net tax friction. In other words, a rival could pay $100 and the American seller would receive $65 after tax, and so it would be easy to agree on a sale without the buyer having to dream up the "synergies and strategic value" that companies normally use to justify the value loss that taxation imposes on a deal.

Finally, if both an American company and a foreign company owned equivalent Singapore operations, the foreign rival would be able to crush the American if it chose. Why? Because the rival could drop prices until its pretax profit was only 2/3 the level of the American company, and still make enough money (i.e. as much as the American company, after tax) so that the global equity markets would like its stock as much as they liked the stock of the American company.

If our companies could not compete head-to-head, could not buy assets, and could easily sell assets, it is clear that our international operations would end up being liquidated.[66] American companies would be unable to compete outside of the U.S. market. In high-technology industries requiring substantial high-risk R&D, global scope is essential, because a company that cannot spread that R&D cost across global sales

65. If this was an asset purchase with an average depreciation/amortization period of ten years, the American bidder still could not go above $78.85, due to time value of money effects.

66. It would not be difficult to find the buyers. China, for example, now has 85 of the world's top 500 corporations, compared to our 132, and is aggressively pursuing global expansion subsidized by strong domestic advantages. *See* KPMG, THE EMERGENCE OF CHINESE MULTINATIONAL CORPORATIONS (MNCS): LOCAL AND GLOBAL IMPLICATIONS 2 (2013), *available at* http://www.kpmg.com/CN/en/IssuesAndInsights/ArticlesPublications/Newsletters/China-360/Documents/China-360-Issue13-201310-emergence-of-Chinese-MNCs-Local-and-global-implications.pdf.

will not be able to keep up.[67] In time, America would become a low-tech backwater.

We allow the deferral of U.S. tax on foreign income in order to avoid this scenario, but that mechanism is what makes it prohibitively expensive for American companies to bring cash home to make American investments. Many people argue[68] that if we cannot afford to eliminate deferral, then we should copy our rivals and adopt "territorial taxation," i.e., eliminate the taxation of foreign earned income. That would be one approach, and it would likely be better in practice than our current system because it would eliminate the tax pressure to use cash abroad. But still, it would leave foreign investment much more attractive than U.S. investment. Shared Economic Growth, in contrast, would allow us to make American companies competitive while at the same time making our country a preferred location for their most desirable operations.

D. *Providing a Benefit to Middle-Class Workers Who Do the Right Thing and Save Money for Their Children's Educations and for Retirement*

Middle-class savers have been badly punished by the government's response to the 2008 financial crisis. In the name of stimulus, interest rates paid by banks have been forced down to near zero. Whether or not this has actually stimulated the economy, it has certainly served to boost bank spreads so that

67. This is an area where globalization must be given its due. Without global markets, many product development projects would have to be abandoned. This is simple arithmetic. R&D costs must be recouped from the sale of products that use the resulting intellectual property, and if you can only sell profitably in a fraction of the world's markets, then you cannot invest in as much R&D as you could if you were selling into the full global economy.

68. *See* H.R. COMM. ON WAYS AND MEANS, BUSINESS LEADERS IN SUPPORT OF A TERRITORIAL TAX SYSTEM (2011), *available at* http://waysandmeans.house.gov/UploadedFiles/Intl_quotes.pdf; *Territorial vs. Worldwide Taxation*, SENATE REPUBLICAN POL'Y COMM. PAPER, http://www.rpc.senate.gov/policy-papers/territorial-vs-worldwide-taxation; Mihir A. Desai et al., *Repatriation Taxes and Dividend Distortions*, 54 NAT'L TAX J. 829, 851 (2001); *Summary of Staff Discussion Draft: International Business Tax Reform*, CHAIRMAN MAX BAUCUS, U.S. SENATE COMM. ON FIN. (2013), *available at* http://www.finance.senate.gov/imo/media/doc/Chairman's%20Staff%20International%20Discussion%20Draft%20Summary.pdf.

they could have enough profit to slowly and quietly burn off their toxic asset holdings, a hidden $278 billion annual "tax" on household depositors.[69] According to Federal Reserve data,[70] average 6-month CD rates in 2007 were 5.24% while average conventional mortgage rates in that year were 6.34%, a 21% spread. In 2012, the CD rates had dropped to 0.44% while mortgage rates were 3.66%, a 732% spread. Nice for the banks, tragic for depositors. In the meantime, of course, savers saw the stock market collapse in 2008 and remain volatile thereafter. Middle-class parents saving for college or retirement or to try to build a cushion against lay-offs find themselves earning dismal returns, while retirees who thought they had saved enough to provide a reasonable income find that they were sadly mistaken.

Meanwhile, the government has gotten caught in a trap. In 2009, federally chartered depositary institutions held $124.5B in treasury securities and $1,417.4B in Agency and Government Sponsored Entity backed securities. In 2012, these figures were $243.2B and $1,669.7B, respectively, a 24% increase.[71] In the same time period the total assets of such depositary institutions increased only 7%. In short, the banks own a lot of government or government-backed bonds, and if interest rates rise significantly the value of those bonds will drop. If interest rates doubled, the banks could lose 3% of their total assets, plus another 7% or so considering the effects on the value of their

69. This figure is computed from Federal Reserve Flow of Funds data (level table L100) showing total household deposits of $9,997.8 billion for 2012, and using interest rates from Bank of America's 2012 and 2007 annual reports. B of A paid depositors an average interest rate of 3.03% in 2007, but only 0.25% in 2012. This one bank would have paid depositors an extra $17.4 billion in 2012 if interest rates were still at their normal 2007 level. Applying the same spread to total deposits yields the $278 billion total cost to responsible holders of bank savings accounts. It is also interesting to note that Bank of America would have earned $9 billion more on mortgages in 2012 if mortgage interest rates were still at the levels B of A received in 2007, but B of A's reported 2012 average interest rate on mortgages is computed *after* making allowances for non-performing mortgages held by B of A, so some of that $9 billion is due to them being caught with bad mortgages and bleeding off the cost.

70. For the average annual six-month certificate of deposit rates and conventional mortgage rates, see *Selected Interest Rates (Daily) – H.15*, BD. OF GOVERNORS OF FED. RESERVE SYS., http://www.federalreserve.gov/releases/h15/data.htm (last updated Dec. 19, 2013) (referring to six-month negotiable certificates of deposits in secondary market, quoted on an investment basis).

71. *See* Federal Reserve Flow of Funds chart L.110.

$3,997B in mortgage holdings. While the Federal Reserve has decided to hold all of its bonds to maturity so that it will never need to admit to the losses it will suffer on them,[72] the banks are subject to different accounting rules and so (being a creature of the banks that own it) the Fed will conduct the taper in such a way that banks can slowly dispose of these bond and mortgage losses against the extraordinary profits they make at the expense of depositors. Depositors should thus not count on government efforts to raise the returns on their deposits to normal levels any time soon.

However, the middle class does own a significant amount of stock, directly or indirectly. According to the Federal Reserve's 2010 Survey of Consumer Finance, the lower 90% of the population holds some 26% of direct equity, 28% of mutual funds, 57% of insurance company annuities, and 45% of IRAs and 401(k)s.[73] According to the 2010 IRS Statistics of Income tables,[74] families earning under $100,000 a year received 59% of all pension and annuity income. Since defined-benefit plans own some $3.5 trillion of equity,[75] the stability of defined-benefit plans depends on equity values, which is a significant consideration given that many pension plans are stressed.[76]

72. The Fed is not required to account for market-to-market losses, so if it holds the bonds to maturity, it will never record a loss when it will receive the face-value principle. *See* Robert Lenzner, *The Federal Reserve Will Lose Billions but It Just Doesn't Matter*, FORBES.COM (June 6, 2013), http:// http://www.forbes.com/sites/robertlenzner/2013/06/08/the-federal-reserve-will-lose-billions-but-it-just-doesnt-matter/. The Fed will continue to recognize interest income that can be used to reduce the acknowledged federal deficit, but in a lower amount than if the Fed held bonds that would continue to pay out at market interest rates.

73. FED. RESERVE BD., BEFORE-TAX FAMILY INCOME, PERCENTAGE OF FAMILIES THAT SAVED, AND DISTRIBUTION OF FAMILIES, BY SELECTED CHARACTERISTICS OF FAMILIES, 1989–1998 SURVEYS (2010), *available at* http://www.taxpolicycenter.org/taxfacts/Content/PDF/wealth_income.pdf.

74. *See Individual Statistical Tables by Size of Adjusted Gross Income*, *supra* note 26.

75. *See Statistics of Income: U.S. Corporations and Their Controlled Foreign Corporations: Number, Assets, Receipts, Earnings, Taxes, Distributions, Subpart F Income, and Related Party Transactions*, IRS (2008), http://www.irs.gov/uac/SOI-Tax-Stats-Controlled-Foreign-Corporations [hereinafter I.R.S. Statistics of Income] (referring to Federal Reserve Flow of Funds charts L.213 lines 16 and 17, L.116b lines 12 and 13, L.117 line 14, and L.118).

76. *See, e.g.*, CONG. BUDGET OFF., THE UNDERFUNDING OF STATE AND LOCAL

As the above statistics indicate, middle-class equity holdings are skewed towards tax-deferred vehicles such as IRAs, 401(k)s, annuities and pensions. Upon the enactment of Shared Economic Growth, equity values would climb to some extent due to the enhancement of the future corporate earnings stream. The extent of this value bump would depend on Wall Street emotions, as the well-to-do traders would not see *their* net after-tax income from shareholdings jump. More reliably, though, middle-class holders would see a large stream of dividends. Where today the relationship between corporate earnings and share prices is largely mysterious, so that ordinary shareholders can lose money over a period when earnings are doing relatively well, in a Shared Economic Growth world good earnings would translate fairly directly into cash in the pocket (or IRA) of the shareholder. Long-term holders of companies that make reliably good profits could be confident of good returns, freed from the vagaries of Wall Street gamesmanship.

Moreover, Shared Economic Growth would directly boost those distributable earnings. A company that paid a $100 dividend today would be able to boost it to $154 after enactment, because it would receive a 35% tax benefit by paying the dividend. Middle-class investors would be pleased to receive a 54% boost in their tax-deferred earnings, I suspect.[77] This gross-up would apply to all dividends "paid for" by Shared Economic Growth. To take an example based on 2010 numbers, the maximum deductible dividends amount for 2010 would be the total corporate tax, adjusted for the proposed elimination of foreign tax credits, of $299.7B divided by 35%, or $856B in dividends. If corporations had otherwise chosen to pay out $556B in dividends, they would now be able to pay out $856B, 54% more, and have the same retained earnings remaining after the dividend payments. In fact corporations paid $554B out of $1,356B in net earnings before taxes, leaving them with retained earnings of some $579B after tax. Under the proposal their

PENSION PLANS (2011), *available at* http://www.cbo.gov/publication/22042.

77. It should be noted that the maximum average increase in the value of U.S. corporations would be capped at about 36%, rather than 54%, because the average corporate effective rate for 2010, after backing out NOL carryforwards that were largely a hangover from 2008 and not counting foreign tax credits, was some 26.3% rather than the 35% marginal rate. *See Individual Statistical Tables by Size of Adjusted Gross Income*, *supra* note 26.

retained earnings would drop by $77B whether or not they paid dividends, due to the change in foreign tax credits. That change aside, they would have been able to pay an extra $302B in dividends and still have ended up with the same net earnings of $502B. Hypothetically, if they had otherwise paid more than $556B in dividends pre-change, then Shared Economic Growth would not enable a 54% increase on the excess dividends they actually paid, but it still would be a 54% increase on the part of those dividends "paid for" by the dividends-paid deduction. The remaining excess dividends in this hypothetical scenario would not have been deductible before and would not be deductible under the proposal, either, so it need not concern us here.[78]

Thus, Shared Economic Growth would improve the stability of the investments of the middle class, help to insulate them against Wall Street skimming,[79] and give them a 54% tax-deferred bonus. That extra money in the hands of retirees and would-be college students would, in turn, result in spending that would help to stimulate the economy the old fashioned way, through real income in the hands of middle-class consumers.[80]

E. *Avoiding Increasing the Deficit Today, and Providing Substantial Additional Revenues and Private Savings in Order to Prevent a Fiscal Crisis as the Baby Boomers Retire and the Next Generation Is Forced to Take on the Burden of Funding All Those Retirees*

The computations below walk through the components by which Shared Economic Growth achieves current tax neutrality.

78. The shareholder-level current tax revenue per dollar of non-deductible dividend would be about twelve cents under the proposal as compared with about seven cents today, so any such hypothetical excess would produce a revenue benefit if it persisted.

79. High-speed trading, arbitraging of the share price versus asset value of Exchange Trade Funds ("ETFs") by large investors, and other assorted games provide fruitful opportunities for Wall Street to divert the value that should logically flow to shareholders from corporate earnings.

80. Lack of middle-class purchasing power is a major drain on our economy, hurting everyone including the wealthy. *See* J. Bradford Delong, *The Strange Case of American Inequality*, PROJECT SYNDICATE (Dec. 31, 2013), http://www.project-syndicate.org/commentary/j--bradford-delong-asks-why-americans-are-not-clamoring-for-polices-that-would-leave-90--of-them-better-off.

Here, I will focus further on one aspect of those computations, which shows that one could conservatively expect the proposal to fund an extra $22 billion in federal revenues and $145 billion in private retirement draws per year as the baby boomers move through retirement. Part of what makes achieving tax neutrality tricky is that a large portion of U.S. equity is held under tax-deferred arrangements. In 2010, only 32% of dividends received by U.S. persons (excluding intra-group dividends) were reported on individual returns, $187B out of $586B. About 5% of such dividends go to non-taxable sources such as non-profits and governments. This apparently leaves some 63% going to tax deferred vehicles.[81]

As of 2007, only some 8.3% of total IRA assets were in Roth IRAs, though Roths tended to have a somewhat higher percentage of their assets invested in equities.[82] So, say that 10% of IRA-held equities are in Roth form, and make an unrealistically conservative[83] assumption as to the percentage of dividends flowing to IRAs, i.e., assume that anything not definitely held in another way is held through an IRA. This yields a percentage of tax-deferred assets in Roths of 4.3%.

81. It is not clear why this number is quite so high, or indeed whether it actually is that high or if some $95 billion of taxable dividend income is hidden under other tax lines. Judging from Federal Reserve Flow of Funds data, one would anticipate more like 48% going to tax-deferred holders and 47% to taxable households, based on their relative apparent shares of equity ownership. However, the Federal Reserve data necessarily uses various simplifying assumptions to categorize things, so it may be misleading in this respect as well as lacking in certain potentially useful details. For example, the way that the Federal Reserve handles Exchange Traded Funds or flow-through business entities may obscure a sizeable set of dividend flows that are currently taxable. Further, it may be that investors preferentially skew high-dividend equities to their tax-deferred accounts. In any event, I have given priority to the IRS data on the grounds that it is the most conservative in terms of making it difficult to offset the cost of the dividends-paid deduction. My best guess is that the proposal would in fact generate substantial excess revenue on a current basis. As discussed below, this could add some $32 billion per year of revenue under the proposal if the Flow of Funds data presents an accurate picture.

82. Craig Copeland, *Individual Account Retirement Plans: An Analysis of the 2007 Survey of Consumer Finances, with Market Adjustments to June 2009*, 333 EMP. BENEFIT RESEARCH INST. BRIEF, Aug. 2009, at 27 (2009).

83. The Federal Reserve and Employee Benefit Research Institute data suggest that the total cannot actually be that high. *See* EBRI DATABOOK ON EMPLOYEE BENEFITS, http://www.ebri.org/publications/books/?fa=databook.

Round that up to 5%, and you still have 58% of dividends going into retirement arrangements but eventually coming back out and being taxed.

Another source of potential slippage is equities held by defined-benefit retirement plans. Dividends going to such plans do not directly increase taxable pensions. However, they can be expected to generate taxable income in one of several ways. First, by preventing the partial or total failure of such plans (think Detroit), they may increase actual payments to pensioners.[84] Second, by reducing the additional contributions that employers need to make, they may increase employer earnings and thus either be taxable directly (if non-corporate) or by increasing taxable dividends (if corporate). Third, by reducing the burden on state and local governments to make good on their pension commitments, such dividends may reduce the federal deduction for state and local taxes or reduce the amount that the federal government is called upon to share in order to bail out the states.[85] Overall, then, it would appear that increased dividends flowing to defined benefit plans would provide increased revenue or decreased expense through one channel or another. Still, let's be hyper-conservative and take a worst-case scenario, assuming that dividends paid on equities held by state, local and federal pension plans produce no benefit. This would make up to 11% of dividends non-taxable on top of the 5% going to Roth IRAs. So, now we have 48% of dividends being truly tax deferred.

What does that mean in dollar terms? Based on 2010 numbers, Shared Economic Growth would push corporations to

84. Many private defined-benefit plans have run into trouble similar to their local-government counterparts, with companies making workers happy by promising future benefits that they lacked money to pay. PENSION BENEFIT GUARANTY CORP., HELPING SECURE RETIREMENTS PBGC ANNUAL REPORT (2013), *available at* http://www.pbgc.gov/documents/2013-annual-report.pdf. The existing pension safety net, the Pension Benefit Guarantee Corporation, is running a record deficit of $35.7 billion, or 31% of the liabilities it has already assumed. *Id.* Shared Economic Growth would help to stabilize both the private plans and the PBGC. *Id.*

85. As of June 30, 2013, some 35% of the assets of state and local government pensions consisted of stocks. *See* QUARTERLY SURVEY OF PUBLIC PENSIONS: CASH AND SECURITY HOLDINGS FOR THE QUARTER ENDING JUNE 30, 2013 AND PRIOR QUARTERS, U.S. CENSUS BUREAU (2013), *available at* http://www2.census.gov/govs/qpr/2013/2013q2.pdf.

pay additional dividends of $311 billion, before consideration of additional amounts parked under foreign subsidiaries that could be liberated, so 48% of this is $149 billion of dividends going to tax-deferred retirement accounts. Based on the 2010 distribution of IRA and taxable pension receipts, these amounts would ultimately produce tax revenue of 15% of the dividend amount, or $22 billion per year.

The timing of this revenue would coincide with the timing of baby boomer retirement draws. So, under Shared Economic Growth we would be putting $149 billion of dividends per year into the hands of retirees and $22 billion per year into the hands of the federal government. Since this will be the period when the government is desperately trying to figure out how to repay the Social Security "trust fund," every cent of which was spent long ago, this money would undoubtedly come in handy.

F. *Eliminating the Incentive for Corporations to Take on Too Much Destabilizing Debt by Eliminating the Tax Advantage of Debt Financing*

Our current tax system creates a distortion in favor of excessive borrowing by providing a deduction for interest payments but not for dividends. While it is difficult to quantify the social welfare costs of this distortion, they are likely significant.[86] The significance of this distortion increases when a nation becomes vulnerable to economic shocks, as excessive leverage tends to deepen and extend the effect of the shock.[87] As we saw in 2008, the American economy has become susceptible to such shocks, and in its weakened condition our economy will remain so for the foreseeable future.

There are two ways to eliminate this distortion – either eliminate the deduction for debt, or provide an equivalent

86. *See* RUUD A. DE MOOIJ, INT'L MONETARY FUND, TAX BIASES TO DEBT FINANCE: ASSESSING THE PROBLEM, FINDING SOLUTIONS 12-14 (2011), *available at* http://www.imf.org/external/pubs/ft/sdn/2011/sdn1111.pdf.

87. *See* Javier Bianchi, *Overborrowing and Systemic Externalities in the Business Cycle*, 101 AM. ECON. REV. 3400 (2011); *see also* Se-Jik Kim & Mark R. Stone, *Corporate Leverage, Bankruptcy, and Output Adjustment in Post-Crisis East Asia* (Int'l Monetary Fund, Working Paper WP/99/143, 1999), *available at* www.imf.org/external/pubs/ft/wp/1999/wp99143.pdf.

deduction for equity. While several countries have expressed a desire to reduce the deduction for debt out of concern over its destabilizing effect, they have tended towards partial measures due to the difficulties involved in completely eliminating the deduction without unduly reducing investment.[88]

Other countries, such as Belgium, have allowed a deduction based on a statutory rate factor applied to equity levels. This reduction in corporate tax comes with a fiscal cost that can only be overcome if the deduction stimulates adequate growth in taxable profits. In contrast, Shared Economic Growth, by allowing a deduction for dividends paid, would eliminate the tax bias in favor of debt in a manner that collects a full revenue offset at the shareholder level.

The proposal would also eliminate another significant driver of U.S. corporate debt. Because American corporations cannot bring the bulk of their foreign earnings home without an unacceptable tax cost, they sit on foreign cash while incurring large U.S. debts in order to make investments, pay dividends or do stock buy-backs.[89] Because drawing upon their foreign cash to cover their debts would trigger a very large tax hit, their U.S. debt is destabilizing to the economy even though they may have enough foreign cash to pay it off. Moreover, they are soaking up our economy's lending capacity for fundamentally unproductive uses. Under Shared Economic Growth, they would be able to use a combination of U.S. earnings and foreign cash to pay dividends while using foreign cash to make additional U.S. operating investments.

On the other hand, they would be somewhat discouraged from incurring further U.S. debt because the tax-efficient payment of debt principal would need to come from a limited and

88. DE MOOIJ, *supra* note 86, at 14.

89. For example, Microsoft's December 31, 2012 balance sheet shows $68 billion of cash and short-term investments at the same time that they have $12 billion of long-term debt and $8 billion of "other long-term liabilities." 2012 ANNUAL REPORT, MICROSOFT CORP. (2012), *available at* http://www.microsoft.com/investor/reports/ar12/index.html. Apple's December 29, 2012 balance sheet shows $40 billion in cash and marketable securities, as well as $19 billion in long-term liabilities. QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934, APPLE INC. (2012) [hereinafter QUARTERLY REPORT], *available at* http://investor.apple.com/secfiling.cfm?filingID=1193125-13-22339&CIK=320193.

shrinking pool of funds. Since repatriated foreign earnings would trigger U.S. tax unless they were paid out as dividends or invested in operations, and since U.S. taxable income would also need to be paid out as dividends unless it was reinvested in operations, the only cash left over to pay debt principal would be cash income sheltered by non-cash tax deductions or credits. Those deductions would consist primarily of burning off the depreciation on pre-enactment investments[90] or by special deductions or general business credits. From the moment of enactment, then, corporations would have incentive to plan to reduce their outstanding debt. If they wished to borrow for new operating investments, of course, they could still do so, since the cash proceeds of the new borrowing, invested in deductible expenditures, would free the company to retain other operating income to repay the debt later. Borrowing to pay dividends, to do stock buy-backs, or to take other actions that do not produce a deduction, however, would be unwise going forward. Thus, U.S. credit would be freed up to support useful investments rather than being tapped to support keeping cash deployed in other countries.

The proposal would also address another destabilizing bias in our current system. Today, stock analysts tend to focus on growth in financial earnings per share ("EPS"). There are various ways to achieve such growth that do not involve making more money, as such. Stock buy-backs, by reducing shares outstanding, boost EPS. High leverage at today's low interest rates also boosts EPS. Slashing investment boosts EPS in the short run, even if it causes management to sit on idle cash and to decline profitable investments, and the market lives in the short run. Accounting gimmicks can increase EPS until they collapse. Shared Economic Growth could be expected to shift the focus onto sustainable cash yield, i.e., actually making money, while at the same time giving management incentive to find ongoing U.S. operational investments so that they could hold on to more of their cash while still achieving a zero tax rate. While the proposal would be unlikely to cure our addiction to EPS

90. Apple shows some $20 billion in financial book depreciable and amortizable assets. It seems likely that most companies would be able to pay off their debt from this source in a tax-efficient manner if they plan for it. QUARTERLY REPORT, *supra* note 89.

growth at all costs, it should help to partially tame that tiger.

G. *Improving the Efficiency of Our Economy by Unlocking Cash and Encouraging Its Rapid Flow to the Most Efficient Investments*

American corporations are sitting on a record amount of cash. As noted above, many are sitting on cash at the same time that they are piling up domestic debt. Economists have investigated the reasons why companies do this. Not surprisingly, they have found that a major reason is the current tax penalty for bringing foreign cash home.[91] The additional explanation is that corporate management likes to have cash so that they do not have to ask for it from investors or lenders.[92]

Economists like to try to figure things out from statistics rather than by asking the people who know. As one of the people who used to be in a position to know, I can tell you that they are correct, and that other suggestions that have been made are largely erroneous. It is possible to see various false correlations in abstract data. For example, it has been noted that cash hoarding tends to be most pronounced among R&D-intensive industries, and it has been suggested that this is because R&D is risky so the cash provides a needed cushion.[93] While that may be true for start-ups, who burn through cash, for established corporations the correlation is not in itself explanatory. Rather, companies that make their money using technology have an easier time arranging their affairs to put valuable assets, risks and activities in low-tax locations, so they accumulate large amounts of low-tax foreign cash. As noted above, efforts by the U.S. government to interfere with this type of structuring have perversely just served to reinforce it, forcing corporations to

91. *See* C. Fritz Foley et al., *Why Do Firms Hold So Much Cash? A Tax-Based Explanation* 1 (Nat'l Bureau of Econ. Research, Working Paper No. 12649, 2007), *available at* http://www.nber.org/papers/w12649.pdf; *see also* Juan M. Sanchez & Emircan Yurdagul, *Why Are Corporations Holding so Much Cash?*, THE REG'L ECONOMIST (Jan. 2013), http://www.stlouisfed.org/publications/re/articles/?id=2314.

92. *See* Foley et al., *supra* note 91, at 2.

93. *Id.* at 7-8. Other studies have also made this connection, e.g. Mortin Kamien and Nancy Schwartz, *Self-Financing of an R&D Project*, AM. ECON. REV. 68, 252-61 (1978).

move ever-increasing amounts of valuable substance and jobs abroad. Both the structuring and the cash hoarding will continue until we remove the incentives that drive them.

The problem with cash hoarding, whether driven by tax or by management not wanting to have to persuade investors and lenders to provide new money, is that it keeps cash from flowing to its highest and best use in the economy. A corporation can only apply cash to the best investment available to it, considering its organizational limitations. While investors have been remarkably willing to give Google a gigantic fund of cash and to allow its management to try to find amusing and profitable things to do with it, stock analysts and commentators[94] normally suspect that corporations with too much cash will end up spending it on something foolish, and research indicates that they are correct in that suspicion.[95] Even the best corporate managers can only use their money to pursue opportunities that the talents and assets of their organization can handle. If the overall highest and best use of the money would be in an opportunity more suitable to a different organization, then societal value is destroyed by the fact that the cash is locked inside the generating corporation. If we have any real faith in the wisdom of the markets, then we should always seek to liberate excess cash and allow the market to deploy it to where it will do the most good.

Further, there are times such as in 2009 when the market believes that operating investment opportunities are limited because existing production capacity is underutilized, and that what we really need is more consumer demand in order to increase efficient utilization of that existing capacity. In 2009, corporations idled an enormous pile of cash. If, instead, some of that cash had been placed in the hands of middle-class consumers, they would have spent it, increasing demand and

94. *E.g.*, Ben McClure, *Cash: Can a Company Have Too Much?*, INVESTOPEDIA, http://www.investopedia.com/articles/fundamental/03/062503.asp (last visited Apr. 26, 2015).

95. On average, corporate acquisitions destroy value, to the tune of $218 billion between 1980 and 2001. *See* Sara B. Moeller et al., *Do Shareholders of Acquiring Firms Gain From Acquisitions?* 1 (Nat'l Bureau of Econ. Research, Working Paper No. 9523, 2003), *available at* http://www.nber.org/papers/w9523.

giving the economy what it needed. In short, accelerating the circulation of cash by promoting dividends not only allows funds to flow to the best available investment, it allows them to flow to the correct balance between investment and consumption.

This point negates an argument sometimes raised against the significance of corporate cash hoarding. Corporations do not, of course, put their cash under a mattress. They deposit it somewhere or buy liquid securities. We rely on banks to then make those funds available for other investments. But banks do not lend to consumers to buy groceries or clothes (save by credit card debt at 20% interest). They do not lend to risky start-up companies. They do not lend to innovative ventures that may solicit capital from crowd-sourced outlets. In short, having banks redeploy capital is not equivalent to putting cash into the hands of people and letting them make judgments on what to do with it. Bank intermediation does not prevent cash hoarding from being economically inefficient.

Again, Shared Economic Growth addresses the foreign cash problem by allowing companies to bring cash home freely for dividends and domestic investment. Further, it provides a platform to enable congress to push companies to do so if they do not seem to avail themselves of the opportunity at an appropriate level due to management's fondness for cash hoarding.[96]

As to managers engaging in cash hoarding just to protect themselves from having to satisfy investors or in order to boost their personal power and status, Shared Economic Growth would effectively force the pay-out of taxable income or impose a 35% tax penalty for failure to do so. Based on 2010 numbers, this would have forced the payout of 63% of corporate net income. This level of payout is not particularly radical, leaving companies with an average of 37% of their pre-tax earnings as opposed to the 43% they actually retained after tax in 2010. This payout level is especially safe given that management would not

96. Again, I would counsel against actively pushing foreign repatriation in the first instance, as opposed to merely removing obstacles to it. Moving money around in the international context can be difficult and costly, and corporations should have room to make efficient decisions. However, if future monitoring strongly suggests that managers are simply engaged in inefficient hoarding, building up passive assets rather than making profitable investments, then Congress could apply the cattle prod to get things moving.

have to pay out any dollar of earnings that they reinvested in domestic operations, so the proposal would not deprive them of any cash they needed for operations. Over time, if Congress felt it advisable to increase the payout ratio, they would only need to reduce existing corporate tax subsidies, such as repealing the domestic production activities deduction under I.R.C. § 199 as to corporations ($24 billion in 2010[97]). Under the proposal, this would not increase tax on the corporation, but rather would just require companies to pay out a higher percentage of their non-reinvested earnings in order to achieve zero U.S. tax. Such changes would also increase net federal revenue by 17 cents for each dollar of corporate deduction eliminated. Shared Economic Growth would enable a truly fundamental improvement in the efficiency by which cash is pushed towards its highest and best use in our society, but it would do so in a way that allows the government to be gentle and cautious so as to avoid any unforeseen negative disruptions.

H. *Putting an End to Corporate Tax Shenanigans and Solving the Problem of Tax Shelters and the Complexities of Transfer Pricing Enforcement*

Imagine having anywhere between two and five or more IRS auditors sitting in your office every working day of the year, including economists who analyze every purchase, sale or other transfer you make based on a complete electronic download of all your financial records. This is what large American corporations live with. Further, these auditors and specialists are at the top of the IRS pay scale, generally bright people who know what they are looking at. They read the Board minutes, interview executives, travel to foreign locations, and for taxpayers in the Compliance Assurance Process they receive detailed explanations of all significant transactions in real time, in the quarter the transaction is completed, and get to quiz the company to their heart's content. Despite all of this, the government and commentators remain highly concerned that corporations may be managing to avoid paying the appropriate

97. *See Returns of Active Corporations, Form 1120: Table 16, Balance Sheet, Income Statement, Tax, and Selected Other Items, by Major Industry Tax Year 2010*, IRS (2010), www.irs.gov/pub/irs-soi/10co16ccr.xls (refer to cell b77).

amount of tax.[98] If the government can put as much effort as it does into corporate tax administration and yet still feel that it is failing, then the current system is simply not administrable. When you already have senior people looking over a company's shoulder at every transaction every day with full power to obtain any information they want world-wide, there is really nothing more that you can do except to change the system.

Various sorts of proposals have been put forward to address what is perceived as inappropriate tax reduction by corporations.[99] Many of these proposals would undermine the competitive position of American corporations relative to their foreign rivals. As has been discussed above, doing things like repealing the deferral of U.S. tax on foreign subsidiary income would in due course utterly destroy our companies,[100] including both their valuable U.S. headquarters jobs and, in time, their remaining U.S. manufacturing operations. Interfering with the use of corporate tax credits would further inhibit bringing cash home. Attempting to put further controls over the sharing of intangible assets or the already extremely complex realm of transfer pricing would chase more high-value jobs abroad, since it is now reasonably easy to find competent foreign researchers and to just develop everything abroad if that is what it takes to avoid a 35% tax hit. Efforts to shut down corporate tax shelters, meanwhile, have proven to be a game of whack-a-mole, with ingenious planners and financial industry operatives creating new opportunities as old ones come under restriction. We need a better plan.

Under Shared Economic Growth corporate tax shelters would become irrelevant and unwise. If successful, such shelter schemes would serve only to increase the amount of cash a

98. *See, e.g.*, Jane G. Gravelle, *Tax Havens: International Tax Avoidance and Evasion*, CONG. RES. SERVICE 1 (Jan. 15, 2015), http://fas.org/sgp/crs/misc/R40623.pdf; Michael McDonald, *Income Shifting from Transfer Pricing: Further Evidence from Tax Return Data* (Dep't of Treasury Office of Tax Analysis, Working Paper 2, July 2008), *available at* http://www.treasury.gov/resource-center/tax-policy/tax-analysis/documents/otatech02.pdf.

99. Gravelle, *supra* note 98, at 24-29 (offers a partial listing).

100. This can happen with startling speed, as was seen in the shipping industry. *See* Kenneth Kies, *A Perfect Experiment: Deferral and the U.S. Shipping Industry*, 114 TAX NOTES 997 (2007).

corporation could keep from its shareholders, rather than serving to reduce tax expense. If unsuccessful, a typical shelter would fail and be unwound more than two years out, too late to reduce the resulting tax by carrying back losses from additional dividends in a later year. So, a shelter would not reduce tax expense, but it could increase it. Not many Tax VPs would want to take that risk, even before considering penalties.

The incentives to have taxable income arise abroad would be reversed. With the U.S. as effectively a zero-rate jurisdiction, tax managers would want the taxable income here. To the extent that they may have the ability to skew their transfer pricing without moving operations, they would now try to skew it in favor of the U.S. To the extent that they needed to move operations to satisfy the tax auditors in various countries, they would be trying to move operations *in* to America, not out. Instead of horrendously complex international corporate issues characterized by economic imponderables, the IRS would be able to tax nice, simple, Form 1099 dividend income. By fundamentally changing the rules in this manner the IRS would finally be able to win the game, and win it in a way that actually helps our companies and makes them want to have their operations here. Continuing to engage in the audit game of cat-and-mouse when such a simple alternative exists is foolish. Indeed, one has to wonder if the government actually *wants* to win, or if it prefers to just engage in an elaborate charade to lull American voters into thinking that something is being done while lobbyists sleep secure in the knowledge that it is just a show.

I. *Putting C Corporations on the Same Basic Tax Footing as Pass-Through Entities, Without Double Taxation of Corporate Earnings, so As to Eliminate Tax Distortion of Entity Choice*

The earnings of American corporations taxed as such, as opposed to S corporations or limited liability companies that elect to be taxed as pass-throughs, are currently subject to two layers of tax, one at the corporate level and one at the shareholder level. Pass-through entities are not themselves taxable, but instead have their income currently taxed at

individual rates in the hands of their shareholders. As a result, businesses have increasingly been opting to avoid the benefits of proper centralized management and liquid equity markets that enabled corporations to drive the creation of the modern world. In 1980, 83% of American firms were organized as pass-through entities and they represented 14% of business receipts. In 2007, those shares had increased to 94% and 38%, respectively.[101]

As David M. Walker, then comptroller general of the U.S. Government Accountability Office, has stated, the shift away from corporate form "makes workers less productive than they would be under a more neutral tax system. This results in employees receiving lower wages because increases in employee wages are generally tied to increases in employee productivity."[102] While we have seen above that productivity gains have not been passed along to employees overall over the past 30 years, we have also seen that what wage increases there have been have arisen exclusively in the corporate sector. Distortion in choice of entity matters.

Shared Economic Growth would eliminate this distortion in a simple manner. Corporations would pay out their earnings to shareholders as Form 1099 dividend income, or else they would suffer what amounts to a 35% tax penalty for failure to do so. Tax would then be imposed at the shareholder level. The only significant differences would be: 1) C corporations could only pass along taxable income, not operating losses, so C corporations could not be used to play individual tax shelter games; and 2) while tax partnerships can have fabulously complex allocations of income and other tax attributes to their members, C corporations would just issue plain-vanilla dividend income to all. Active tax planners might retain a preference for pass-through form, then, but the current strong double-taxation distortion in favor of pass-throughs would be eliminated, and the system would shift in favor of a form of entity taxation that is much easier to administer and patrol. This would be a win both for the economy and for the IRS (and thereby for the bulk of U.S.

101. CONG. BUDGET OFFICE, TAXING BUSINESSES THROUGH THE INDIVIDUAL INCOME TAX 1 (2012).

102. DONALD M. WALKER, U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-06-1113T, BUSINESS TAX REFORM: SIMPLIFICATION AND INCREASED UNIFORMITY OF TAXATION WOULD YIELD BENEFITS 10 (2006).

taxpayers).

J. *Increasing Corporate Responsiveness to Shareholders and Regulators*

Corporations are often accused of placing operations outside of the United States in order to avoid U.S. regulation.[103] In my experience most major American corporations do not behave that way. Most actually prefer to run all of their operations as if they were in the U.S. and dislike lax environments where they need to exercise extreme diligence in patrolling their suppliers. Singapore has become the most successful business location on the planet not by being lax, but rather by being reliably orderly. In contrast, the Chinese business environment, the wild east, gives western executives nightmares. Regulations become seriously annoying when they involve people making unpredictable decisions and slowing things down, not when they merely establish clear and logical standards that all businesses must follow. Still, when the majority of corporate operations are overseas, it is undeniable that the regulatory leverage of the U.S. government decreases. Multinationals are potent entities, and their international reach and ability to shift investments gives them the power to make credible threats in the face of proposed regulations that they do not like.

However, multinationals are profit-oriented creatures. Given a choice between being in a location with a 0% tax and an annoying, but not devastating, regulation or being in a foreign location with a 25% tax, one can predict where they would choose to locate their high-margin operations. Unless sum of the real cost of compliance plus the wage differential is high enough to overcome the tax rate differential, the corporation would not move its high-margin operations out of the U.S. This would strengthen our government's ability to set appropriate

103. *See* Isaac Shapiro & John Irons, *Regulation, Employment and the Economy: Fears of Job Loss Are Overblown*, ECON. POL'Y INST. (Apr. 12, 2011) *available at* http://www.epi.org/publication/regulation_employment_and_the_economy_fears_of_job_loss_are_overblown/ (notes this concern before going on to demonstrate that there is little evidence for significant corporate flight from regulations).

standards without fear of disproportionate economic consequences. It would help the government, as the supposed representative of the people, to tame the multinational beast.[104]

Further, Shared Economic Growth would provide a platform for helping to make the government listen more closely to ordinary people. The *Citizens United* decision[105] said that corporations must be allowed to speak with their money, but it did not say that they must be allowed a tax deduction for it. Shared Economic Growth would create a general expectation that the U.S. federal tax expense of corporations should be zero. While lobbying expenditures, fines and penalties, a portion of entertainment expense, and so forth are non-deductible now, Congress could enhance the proposal by also providing that such dubious expenditures could not be offset by the dividends-paid deduction (i.e. that an amount of taxable income equal to the non-deductible expenses could not be offset by the dividends-paid deduction), and by providing for line-item financial accounting for federal tax expense. This would then provide a clean, easy-to-read "corruption index" number in every public corporation's SEC filings showing just how much shareholder money they are spending on things that shareholders might not feel good about.

Why should corporations care about their corruption index? That brings us to the second way in which the proposal would help to tame corporations. As discussed above, one of the two main reasons why corporations like to retain large amounts of cash is that they do not want to have to persuade lenders and shareholders to reinvest. While the proposal would allow management to use cash freely to invest in U.S. operations, it would flush out the cash that management might use to acquire the stock of other companies or to engage in other expansionist dreams. Also, as previously discussed, it would provide

104. Here I am resisting using the new politically correct term of "world-wide American companies" because Orwellian terminology makes me uncomfortable. With that said, our companies *are* American, whatever their international scope, and that makes a difference. One need only look to what happened after BP acquired Amoco in a supposed "merger of equals" to see the difference. U.S. offices were wiped out with the loss of many well-paying American jobs, a company that had strong focus on environment, health and safety had a major U.S. explosion and a major U.S. spill, etc.

105. Citizens United v. Fed. Election Comm'n, 558 U.S. 310 (2010).

Congress with the ability to prod corporations to pay out foreign earnings not being used to expand same-country operations, thus requiring an appeal to investors to fund major new foreign operations. Management would have to go to the market more often for money, and would have to be more concerned about how the market views them.

Currently there are various "ethical" mutual funds that seek to invest in companies that are well behaved. Such funds have a problem in that they are keying off of elements on which different people take different views. A very large portion of the American public, on the other hand, could be expected to agree that they do not like their companies to incur fines and penalties, to engage in unusual amounts of entertainment, or to spend a lot of money influencing elections. A simple corruption index statistic at the tax line would provide a vehicle through which unions and pension beneficiaries could pressure their investment trustees to avoid companies with a high index. It would provide a popular measure by which ethical investment funds, trustees, and individual investors could judge corporate behavior.

Similarly, other widely disapproved behaviors outside of this corruption index, such as CEO pay, could become the subject of pressure. Under current law shareholders tend to rely on shareholder initiatives to complain about such things, but the system is wired to insulate management pretty effectively against that weapon. Corporate raiders can threaten management with proxy fights at substantial cost to the corporation, but that vehicle is far from an ideal control mechanism, and it serves only to increase focus on profit. Managers who needed to face the market to get funding for acquisitions and major expansions, in contrast, could face a different scenario. Shareholders could have real power to remind corporations that their owners have concerns in life beyond just profit. If shareholders chose not to use that power, if they decided to be content with profit at any cost, that would be their prerogative, but they would have a chance to redirect things down a more balanced path if they wished to.

K. *Ending the Current General Practice of Compensating Corporate Executives for Artificial "Growth" That Consists Only of Retaining Earnings Rather Than Paying Them Out As Dividends*

Researchers have linked the prevalence of executive stock option plans to management's fondness for engaging in stock buy-backs.[106] The math here is fundamentally straightforward, if not entirely simple. Executive stock options give managers the ability to make money from an increase in share prices, but not to profit from dividends. Say a company with a 1,000 shares outstanding and a per-share price of $10 ($10,000 total value) issues 100 executive stock options with a strike price of $10, i.e., the right to buy 100 new shares for $10 each. The company earns $2,200, or $2.20 per existing share, so that (all else equal) it now has a value of the original $10,000 plus $2,200 for the cash-in-pocket, or $12,200. From the market's point of view, the price per share should now be computed by assuming that the executive stock options are exercised. That would bring in another $1,000 for the share exercise, for a total company value of $13,200, and would leave 1,100 shares outstanding. $13,200 divided into 1,100 shares is $12, and so the share price should rise to $12.[107] If the company pays out those earnings as a $2.20 dividend, the share price will drop back to $10. In that case, management's options would be worth nothing, management would get no benefit from the dividend, and the existing shareholders would get $2.20 per share. Now suppose that, instead, the company uses $1,200 to buy back 100 shares at $12 a share, and the executives then exercise their options. The company will then have 1,000 shares outstanding, $1,000 of remaining cash earnings, and $1,000 from the option exercise.

106. *See, e.g.*, Christine Jolls, *Stock Repurchases and Incentive Compensation* (Nat'l Bureau of Econ. Research, Working Paper No. 6467, 1998), http://www.nber.org/papers/w6467 (finding that the average executive in her sample of firms with repurchase activity enjoyed a $345,000 increase in stock option value as a result of the repurchase activity).

107. Reality is more complicated. The market will probably not value the $2,200 of retained cash as worth $2,200, because the market usually does not quite trust management to invest that money efficiently, based on the market's experience with corporate managers in general. But this illustration is directionally correct.

It will thus have a value of the $12,000 distributed over 1,000 shares, or $12 a share. The executives will therefore have received value of $2 per share on their 100 options, or $200. The prior shareholders will likewise receive $2 per share, rather than $2.20 in the dividend scenario. If the executives chose to exercise their options without paying a dividend or doing a buy-back, they would receive the same $2 a share.

Through stock buy-backs, then, corporate management can shift funds from the pockets of the shareholders into their own, while saying that this is simply compensation for management's great work in making the company grow in value. In our example, though, and commonly in real life, that "growth in value" just arose from refusing to pay shareholders their cash profits. Stock buy-backs give management the same profit on their options that they would receive if they paid out no money at all, but since they involve cash going to a *portion* of the shareholders they offer the image of money "being paid out to the investors." In reality, they involve management picking the investors' pockets.

Now, this is not the whole story. Management cannot, as such, give stock options to themselves – they must be awarded by the Board. Further, there are other reasons why management and the Board prefer to pay out cash as buy-backs rather than dividends. Shareholders do not like it when dividends are reduced, but get less excited when a buy-back program is turned off. Further, analysts and shareholders have been trained to parrot supposed wisdom about the value of growth in earnings per share, even when that "growth" flows only from share repurchases. Be that as it may, it remains a fact that stock buy-backs are a form of trick.

Is this significant? Consider the case of non-deductible excess compensation. I.R.C. § 162(m) limits deductions for compensation paid to executives to $1MM, except for performance-based pay. Because stock prices must rise in order for incentive stock options to be worth anything, stock option plans were deemed to be inherently performance-based, evading the more complex restrictions placed on bonus plans and the like.[108] Because stock prices can be made to rise merely by doing

108. Treas. Reg. § 1.162-27(e)(2)(vi) (2015) provides that:

stock buy-backs, however, options are essentially free from any requirement of real performance. They thus became quite popular, CEO pay ballooned further, and the nature of the incentive both drove risky behavior and reduced dividend pay-outs.[109]

Okay, so it is a trick, it has aggravated a phenomenon (sky-high CEO pay) that most Americans despise, it makes it more difficult to judge real corporate success, and it de-links management focus from operational factors that would really add shareholder and societal value in favor of unproductive, but simpler, financial games. Could it nonetheless be that lowering dividend pay-outs stimulates growth and boosts the economy? While many people choose to think so, the real answer is "no." Robert D. Arnott and Clifford S. Asness did an interesting study[110] in which they checked to see if lower dividend yields and higher within-corporation investment were correlated with higher subsequent growth. They found exactly the reverse. There is a strong positive correlation between dividend pay-out ratios (i.e. the percent of earnings paid out as dividends) and subsequent earnings growth. It is particularly interesting to note that the authors tested whether this appears to be due to management engaging in empire-building through making unproductive investments. Their data was consistent with that hypothesis. In times of low pay-out, more investment was occurring, but that investment was relatively unproductive in

> [c]ompensation attributable to a stock option or a stock appreciation right is deemed to satisfy the requirements of this paragraph (e)(2) if the grant or award is made by the compensation committee; the plan under which the option or right is granted states the maximum number of shares with respect to which options or rights may be granted during a specified period to any employee; and, under the terms of the option or right, the amount of compensation the employee could receive is based solely on an increase in the value of the stock after the date of the grant or award.

109. *See* Kenneth R. Ferris & James S. Wallace, *IRC Section 162(m) and the Law of Unintended Consequences*, SSRN (Dec. 2009), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=942667.

110. Robert D. Arnott & Clifford S. Asness, *Surprise! Higher Dividends = Higher Earnings Growth*, 59 FIN. ANALYSTS J. 70 (2003).

producing future earnings or GDP growth.[111]

As posited above, when corporations pay out their cash into the economy and allow it to be redeployed to its highest and best use, it fosters increased GDP growth and increased overall growth in corporate earnings. The data thus show that Shared Economic Growth should, by increasing dividend pay-outs, directly benefit America's overall growth and profitability.[112] Cash would flow to managers who demonstrate a real ability to use it well, rather than sticking in the pockets of managers focused on financial games.

L. *Improving the Efficiency of Our Allocation of Talent by Eliminating the Strong Tax Preference for Pursuing Unproductive – and Often Destructive - Speculation Rather Than Productive Work, While at the Same Time Improving the Perceived Fairness of Our Tax System*

Consider two families. One family had income of $7,000,000 and is a typical member of the tax group earning between $5MM and $10MM in 2007. They got 27% of their income from salaries and wages, 20% from partnership income (they are "small business"), and 43% from long-term capital gains and qualifying dividends, with the rest from miscellaneous, mostly passive sources. Their tax rate, before FICA, was 22.8%. Counting both the employer and employee side of FICA, it was 23.9%. The other is a dual-professional couple, an engineer and a research scientist, who make $100,000 each, which places them in the top 3% for 2007. Their tax rate, before FICA, was 19.6%. Counting both sides of FICA, it was 34.6%.

The former couple was among those who were profiting heavily from the speculation and financial engineering that led directly to the financial crisis and the meltdown of our economy in 2008. The latter couple was quietly engaged in innovation to drive our economy in the future. If one were to do an opinion poll of the American people, which of the two families' activities would we most wish to encourage? Shouldn't our tax policy

111. *Id.* at 80-81.

112. From the current 31.5% payout ratio, a 54% increase to 48.5% would shift from a predicted ten-year real earnings decline to a predicted ten-year earnings growth. *Id.*

reflect that preference? At minimum, shouldn't our tax policy treat the second couple as favorably as the first? (The 2013 tax changes have closed the gap a little, but the working couple would still be about 5 points worse off on this income profile).

The main driver of the low tax rate on financial speculators is the special low rates on capital gains, which for 2013 are 20% on joint returns over $450,000[113] or zero on qualifying "small business" (i.e. under $50,000,000) stock.[114] We are told that capital gains preferences are necessary for three reasons: 1) to stimulate investment and growth; 2) to avoid locking in cash investments in particular assets when that money could be more efficiently redeployed elsewhere; and 3) to reduce the double taxation of corporate income. Because Shared Economic Growth would eliminate the double taxation of corporate income, the third rationale goes away. Reason (2) has been aggravated by the 2013 changes to the estate tax provisions, which give couples with estates of less than the $10.5MM estate tax threshold an incentive to try to hold onto appreciated assets until death so that they can get a basis step-up and avoid tax altogether. Shared Economic Growth greatly reduces that problem as to stock, however, by squeezing the earnings out of corporations as current dividends, eliminating artificial "gains" from retained earnings. The remaining question, then, is whether low capital gains rates are important to growth.

The answer is "no." Capital gains rates show no correlation with real GDP growth over the 1950-2011 period – indeed, higher tax rates correlate slightly with higher growth.[115] There is no good evidence that reduced capital gains rates stimulate investment to any significant degree.[116] If this seems surprising

113. I.R.C. § 1(g) (2012).

114. I.R.C. § 1202 (2012).

115. *See* Leonard Burman, *Capital Gains Tax Rates and Economic Growth (Or Not)*, FORBES.COM (Mar. 15, 2012), http://www.forbes.com/sites/leonardburman/2012/03/15/capital-gains-tax-rates-and-economic-growth-or-not/;

Tax Reform and the Tax Treatment of Capital Gains: Joint Hearing Before the H. Comm. On Ways and Means and S. Fin. Comm., 112th Cong. 36-52 (2012) (witness testimony of Leonard E. Burman, Daniel Patrick Moynihan, Professor of Pub. Affairs, Maxwell Sch., Syracuse Univ.).

116. *See* THOMAS L. HUNGERFORD, CONG. RES. SERV., THE ECONOMIC EFFECTS OF CAPITAL GAINS TAXATION (2010); Steven Fazarri & Benjamin Herzon, *Capital Gains Tax Cuts, Investment, and Growth* (Levy Econ. Inst.,

based on news stories you have seen, think about who provides the grant money and speaker fees for economists to study the effects of capital gains rates and to issue press releases (hint: they are not poor).[117] The public discussion surrounding capital gains taxation has generally not been one of unbiased academic inquiry, but rather has been characterized by parties seeking to support a conclusion who find persons willing to supply flawed studies to fit that conclusion. This works by doing things such as confusing changes in capital gains *realizations* proximate to a rate change with real changes in economic activity. Further, the public discussions tend to shy away from the dry truths in numbers and to focus instead on the more enjoyable stories of entrepreneurial heroes and simple-minded invocation of common assumptions.[118] The same people who insist that Reagonomics was a wonderful thing ignore the fact that Reagan wisely eliminated capital gains preferences in 1986 because they were not helpful to the economy, and that GDP in 1987 and 1988 grew at the same rate it did in 1985 and 1986. Likewise, the same people who argue ferociously that government interference in the economy just produces efficiency-destroying distortions ignore the fact that capital gains preferences are highly distortive.[119]

Even if one believed, despite the lack of evidence supporting such a belief, that paying normal tax rates on capital gains would cause individuals to spend their money on consumption or put it under a mattress rather than making profitable investments, this expensive subsidy would be difficult to justify. To begin with, in the aftermath of the Great Recession our economy has been demand constrained rather than capital constrained. Therefore, getting the wealthy to spend their

Working Paper No. 147, 1995), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=109968.

117. *Cf*. David Kocieniewski, *Academics Who Defend Wall St. Reap Reward*, N.Y. TIMES, Dec. 28, 2013, at A1.

118. *See generally* Joseph J. Cordes et al., *Academic Rhetoric in the Policy Arena: The Case of Capital Gains Taxation*, 19 E. ECON. J. No. 4, 459 (1993).

119. *See* Alan S. Blinder, *The Under-Taxed Kings of Private Equity*, N.Y. TIMES (July 29, 2007), http://www.nytimes.com/2007/07/29/business/yourmoney/29view.html?ex=1343448000&en=c45247ad01379f01&ei=5124&partner=permalink&exprod=permalink.

money rather than speculate with it would be stimulative and would improve the economy, not hurt it.

Further, special capital gains rates provide the same subsidy for an investment in China Mobile stock or gains on Irish government bonds that they provide for investment in Green Mountain Power or other U.S. companies. Investments in foreign companies or foreign bonds clearly do not provide any significant benefit to the American economy. According to Federal Reserve data, nearly a quarter of the equity owned by U.S. persons in 2012 was foreign.[120] Thus, even if it did stimulate *investment*, this would be an inefficient way to stimulate investment in *America*.

While special capital gains rates are not justifiable as an economic matter, they are absolutely intolerable from a social equity point of view. As a starting point, consider the below table showing 2010 net capital gain realizations by income bracket.[121]

Income Group	Percent of Net Capital Gains, 2010
Top 0.1%	47%
99-99.9%	23%
95-99%	16%
90-95%	4%
80-90%	5%
60-80%	3%
40-60%	1%
20-40%	1%
0-20%	0%

Having 47% of all realizations go to the top 0.1% of the population is not a ratio that promotes equality, and so likewise providing a tax benefit that follows that allocation is not designed to promote equality. A recent study by Dan Ariely of

120. *See* I.R.S. Statistics of Income, *supra* note 75 (referring to Federal Reserve Flow of Funds tbl. L 213).

121. *Distribution of Long-Term Capital Gains and Qualified Dividends by Cash Income Percentile 2010*, TAX POL'Y CTR. (Dec. 11, 2009), http://www.taxpolicycenter.org/T09-0490.

Duke University[122] examined the degree of economic equality that our electorate wants and what they think we have compared to our actual degree of equality. Professor Ariely determined that Americans would like to live in a country where the top 20% of the population would have some 30% of the net wealth and the bottom 20% would have about 10%. They think that in America the top 20% currently has just under 60% of the wealth and the bottom 20% has some 5%. They would be dismayed to learn that in fact the top 20% of Americans own close to 85% while the bottom **40%** own zero.

Of course, the mere fact that Americans want a far more equal society than we have does not mean that it would be correct to adopt Robin Hood redistribution. With regard to capital gains rates, however, the question is whether the government should be allowing an exceptional tax *benefit* that aggravates our skewed wealth distribution. Absent a strong policy or ethical reason to the contrary, the basic principles of democracy would say no, we should not have a policy that goes against the desires of the American public. We have already established that special capital gains rates are not helpful to economic growth, and that not allowing a special benefit is not equivalent to forcible redistribution. Therefore, democracy should prevail and the preference should be abolished.

This is not a radical socialist point of view. Progressive taxation is consistent with classical conservative principles.[123] There is evidence that progressive taxation and increased economic equality help to boost the health of the economy.[124]

122. Dan Ariely, *Americans Want to Live in a Much More Equal Country (They Just Don't Realize It)*, ATLANTIC (Aug. 2, 2012), http://www.theatlantic.com/business/archive/2012/08/americans-want-to-live-in-a-much-more-equal-country-they-just-dont-realize-it/260639/.

123. Mark Hoose, *The Conservative Case for Progressive Taxation*, 40 NEW ENG. L. REV. 69 (2005). There is also increasing agreement that inequality is harmful to the overall economy, ultimately harming the rich as well as the poor. *See, e.g.*, Michael Spence, *The Distributional Challenge*, PROJECT SYNDICATE (Jan. 9, 2014), https://www.project-syndicate.org/commentary/michael-spence-addresses-the-rising-wage-and-income-inequality-that-is-jeopardizing-social-cohesion-and-political-stability-worldwide#.

124. Martin J. McMahon, Jr., *The Matthew Effect and Federal Taxation*, 45 B.C. L. REV. 993 (2004); Iourii Manovskii, *Productivity Gains from Progressive Taxation of Labor Income* (Dept' of Econ., Univ. of W. Ohio, Working Paper, 2002),

Economists have argued that progressive taxation is an efficient mechanism for ensuring that the economic benefits of globalization are distributed in a manner that ensures public support for increasing the economic pie.[125] Mainstream religious teachings also support progressive taxation.[126] There is no good reason not to support the overwhelming American view that our government policies should not be permitted to aggravate our undesirably high level of inequality. Special preferences for capital gains, which are effectively unjustified special preferences for the well-to-do and especially for the über-wealthy, must go. Shared Economic Growth corrects this problem in a manner that adequately negates any colorable concerns that might otherwise favor special capital gains rates.

M. *Other Advantages*

While Shared Economic Growth was not specifically designed to address these concerns, it could be expected to be beneficial.

Few mainland Americans give much thought to Puerto Rico, despite the fact that our fellow citizens there carry the same blue passports as the rest of us. While an extended discussion of Puerto Rican history and the statehood debate is beyond the scope of this article, those who are familiar with the Puerto Rican economy will recognize that it has been heavily dependent upon the ability of Puerto Rico to offer businesses low tax rates outside the reach of the U.S. corporate tax. Proposals to make Puerto Rico a state have been frustrated in part by the fact that local factories could be expected to flee to other nearby islands, such as the Dominican Republic, the minute that Puerto Rico loses its special tax status. Shared Economic Growth would

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http://www.econ.upenn.edu/%7Emanovski/papers/prod_gains_from_prog_tax.pdf.

125. Kenneth F. Scheve & Matthew J. Slaughter, *A New Deal for Globalization: Wages Falling, Protectionism Rising*, FOREIGN AFFAIRS (July 1, 2007); David Wessel, *The Case for Taxing Globalization's Big Winners*, WALL ST. J. (June 14, 2007), http://online.wsj.com/article/SB118177155165934441.html.

126. Matthew J. Barrett, *The Theological Case for Progressive Taxation as Applied to Diocesan Taxes or Assessments Under Canon Law in the United States*, 63 JURIST 312 (2003).

eliminate this problem. Puerto Rico's status could then be determined by the will of its residents and the mainland population without regard to tax. That would be a healthy improvement.

America's racial and ethnic tensions seem to be increasing. Again, that is a very broad topic, but here suffice it to say that the decline of the middle class and the polarization of the workforce is unhelpful in reducing tension. The restoration of the market power of workers would contribute to the personal power and dignity of workers of all backgrounds in a way that government distributions could never hope to do. Our social fabric, as well as our economic fabric, depends on the market power of working people. Proposals to try to boost worker market power by strengthening unions are mere wishful thinking in a context where employers have no incentive not to pick up their operations and move them in response to union muscle flexing. In a world that adds another billion to its population at shorter and shorter intervals, the supply of workers as such is effectively infinite. What we need is to create demand for *American* workers, a limited resource, and Shared Economic Growth would do just that.

Finally, by eliminating existing distortions in investment incentives the proposal could help to encourage filling some odd gaps in our market. We now have an extraordinary number of very wealthy people in this country that cannot figure out enough ways to spend their money. Historically, that sort of development led to the growth and strength of an artisan class who produced the nice things that the wealthy enjoyed, for a healthy price, and the growth and strength of that class produced the sort of Marxian dialectic that put a check on the power of the wealthy. In modern America, while one can find many catalogs filled with startlingly expensive toys, clothes, and junk, there has not been a resurgence of craftsmanship. One does not visit new neighborhoods to find ingenious architecture, quality handmade tiles and carvings, unique graphic arts, and the like, but rather one looks at the preserved structures from a century ago. That is weird, it is a market failure, and it suppresses a huge class of people who might not be academic stars, but who could be amazing craftspeople. Nobody seems to be out there finding, training, and harnessing that talent pool.

Is it a reach to suppose that changing the focus of U.S. industry from the model of investing in foreign plants that make cheap stuff destined for sale in Walmart to a model of finding ways to invest in U.S. production might trigger a return to craftsmanship? Perhaps, but wouldn't it be interesting to try the experiment and see what happens?

IV. The Numbers – Is This Reality, or Is This Just Fantasy?

I have already walked through an overview of the elements of the proposal, so here I will just focus closely on the computation of the numbers, based on 2010 data. The summary is as follows, with all figures in billions. Note that the values of some of these individual numbers depends on the sequence in which one computes them, but the total is not affected by that sequence:

Cost of reducing corporate tax revenue to zero: (This is the maximum cost of the proposal)	($ 223)
7.65% tax on individual income over $500K, gross:	$ 99
Less 2.35%/3.8% Medicare contribution on such income:	($ 13)
Less 3.8% Obamacare tax on passive income:	($ 29)
Turning corporate foreign tax credit into deduction:	$ 77
Elimination of preference rates on qualified dividends:	$ 19
New withholding tax on dividends to foreign holders:	$ 33
Partial repeal of capital gains rates per proposal:	$ 55
Net surplus from above:	$ 18

Amount of dividends above the $554 actually paid in 2010 needed to reduce corporate tax to zero given the change of FTCs to a deduction:	$311
Loss of offset due to companies paying extra dividends to eliminate tax cost of turning FTCs into deductions:	($ 77)
Individual and withholding tax benefit from incremental $311 of dividends at $0.1748 per $1:	$ 54
Total before IRA effects (18-77+54):	($ 5)
Incremental taxable IRA withdrawals:	$ 22
Net benefit:	$ 17

This is a worst-case scenario. If corporations paid out less in dividends, tax revenues would increase by $0.1748 per $1.00 of dividend less than the maximum deductible amount. If they paid out more dividends beyond the deduction limit, revenues would increase by $0.1145 per dollar of additional dividend (there would be no incremental foreign withholding on such dividends). If they brought home more foreign cash and paid it out as dividends, revenues would increase by $0.1752 per $1.00 of repatriated cash. Of course, these figures do not include the revenue benefits of the economic and wage growth that would flow from the proposal.

Because it is not clear when the increased IRA earnings would be paid out, the discussion above treats the benefit from ultimate taxation of increased IRA earnings as a future benefit, but in practice it would be part current and part future. Thus, the current effect of the proposal (leaving aside the expensing of investment of post-enactment earnings in U.S. operating assets) would be somewhere between a $5 billion cost and a $17 billion benefit in this worst-case scenario. I do not propose any further offsets because I believe it is highly likely that there would be enough incremental cash repatriation from abroad to cover any current revenue shortfall. (If corporations repatriated all of their

foreign earnings, it would create an extra tax benefit of $62 billion based on 2010 numbers, so if some 10% of this cash came home it would more than offset the $5 billion worst-case shortfall). If that proved wrong, then it would be relatively easy to plug the gap by tightening up some corporate benefits without inflicting any harm on the businesses in question. In any event, the proposal is at least $17 billion per year revenue positive in the medium and long run.

Now for the details. The total corporate tax figure is from the IRS Statistics of Income ("SOI") spreadsheet,[127] cell B92, which ties to spreadsheet 10co01ccr.xls cell Q12. The gross benefit of the proposed 7.65% levy on income over $500K is from the SOI individual income by type spreadsheet, computed by taking 7.65% times the sum of the Adjusted Gross Income Less Deficit column for the brackets above $500,000. The subtraction for the 2.35%/3.8% Medicare contribution is 2.35% (the employee withholding amount) of the sum of the same brackets in the column for Wages and Salaries, plus 3.8% (i.e. the full self-employment tax amount) of the same total in the Net Income from Business or Profession and Farm Net Income columns. The subtraction for the 3.8% Obamacare passive income levy is 3.8% of the sum of the same brackets in the columns for Taxable Interest, Ordinary Dividends, Capital Gain Distributions, Taxable Net Capital Gains, Rental Net Income, Royalty Net Income, Partnership and S-Corporation Net Income, and Estate and Trust Net Income.

The revenue from converting the corporate foreign tax credit into a deduction is computed as (1-35%) x corporate foreign tax credits claimed, as reported in cell B89 of spreadsheet 10cosbsec2.xls. The elimination of preference rates on qualified dividends is computed by taking the dividend amounts in the Qualified Dividends column of the individual-income-by-type spreadsheet and multiplying each line by a factor that subtracts the 2013 tax rate on qualified dividends for that bracket from the 2013 ordinary income rate for that bracket. For some lines, I had to interpolate. For example, the SOI table has an AGI bracket running from $100,000 to $200,000. There is a marginal

127. I.R.S. Statistics of Income 2010. *2010 Corporation Source Book of Statistics of Income,* IRS (2010), http://www.irs.gov/uac/Tax-Stats-2.

tax rate change at taxable income of $146,400 for a joint return. Dividends and capital gains on directly held stock (as opposed to stock held through IRAs and other retirement arrangements) increase exponentially with income level, and AGI per return rises exponentially as one rises above the median, while the number of returns at any given level of AGI fall off along a bell curve at incomes above the median. Therefore I applied the lower tax rate to 50% of the income in this AGI bracket as a rough approximation of the combined effects of AGI versus taxable income, skewing of AGI, dividends and capital gains towards higher incomes, and skewing of number of returns towards the median. The sensitivity of the computation to these interpolations is only minor, and in fact is completely negated in the next step.

The effect of the partial repeal of capital gains preferences is computed from SOI spreadsheet 10in04atr.xls, cell I49, which shows the total tax reduction for 2010 from the use of alternative rates on capital gains and dividends per the IRS. From this amount, $74.2 billion, I subtracted the $19.6 billion effect of favorable rates on qualified dividends as computed above. I then used the latest information on capital gains by type, from 2007, in spreadsheet 07in01ab.xls, to compute the portion of total capital gains attributable to capital gains on residential, farm, livestock, timber, and business personal property, which I propose to leave at favorable rates because particularly powerful interests will want that. I multiplied the ratio of those gains to total gains by the $54.6 billion net capital gains benefit computed above to get a $1.5 billion subtraction, leaving a revenue increase from the partial repeal of capital gains rates of $53.1 billion.

To compute the value of the new incremental 30% withholding tax on dividends to foreign shareholders, I started with SOI spreadsheet 10it02tc.xls, cell F10, which shows total reported dividends paid to non-U.S. recipients of all types, and simply multiplied that figure by 30% to get $33.4 billion.

The tax yield from the incremental $311 billion of dividends, above the amount actually paid in 2010, needed to eliminate all corporate tax (including the $77 billion in tax raised by eliminating corporate foreign tax credits) is a more complex computation. I proceeded by computing an estimated average

revenue from income and withholding taxes on shareholders per dollar of incremental dividend paid. To do this I started with the tax payable, at full ordinary rates and including the 7.65% AGI tax on income over $500,000, on the ordinary dividends received by U.S. individuals in 2010, which would be $61.4 billion. I added 35% of the estimated 2010 dividends paid to corporate holders not entitled to the dividends received deduction, which is only some $1 billion. This yielded a total tax amount of $63 billion.

I divided this number by the total of net U.S. dividends PAID in 2010 plus a portion of the estimated dividends RECEIVED by U.S. persons from foreign corporations in that year. Since I did not have a good source for dividends received by U.S. persons from foreign corporations, I had to estimate that number by grossing up the dividends paid by U.S. corporations to U.S. persons. Per the Federal Reserve's Flow of Funds table L213 for 2010, total U.S.-held equities totaled $19 trillion, while foreign equities held by U.S. persons composed some $4.6 trillion, or 24.43%, of that total. So, if U.S. and foreign corporations paid dividends at similar yield rates in 2010, then 24.43% of the dividend income received by U.S. persons should have been from foreign corporations. To turn this into a usable estimate of U.S. tax payable per dollar of dividend paid by a U.S. corporation, I needed to take the $443B in dividends paid from U.S. corporations to U.S. persons and divide that number by (1-24.43%), which is $586B. Effectively, this carves out the portion of the U.S. tax payable on dividends attributable to the estimated portion of the dividends that are foreign sourced. By using the $63B U.S. tax payable on dividend income as computed above as the numerator and $586B as the denominator, I computed a U.S. shareholder income tax of $0.1044 per $1.00 of U.S. dividend paid. I then calculated the withholding tax on foreign recipients computed on actual 2010 dividends at a 35% rate (for incremental dividends, one must count both the existing withholding and the incremental new withholding, or 35% total on average), and divided that by the $554B in net dividends paid by U.S. corporations to yield an average expected withholding tax per dollar of dividend of $0.0704, for a total revenue per dollar of dividend of $0.1748.

The SOI data only shows $187B in taxable dividends,

reported as dividend income, out of an estimated $586B in dividends received by U.S. persons. What happened to the rest of them? That is something of a mystery. Some could be buried under other lines, such as partnership or subchapter S income, in which case they would be taxable and would add substantial tax revenue to these computations. Since I do not have visibility to such detail, however, I used the most conservative possible assumption that all of these dividends flowed to equity holders that are either permanently non-taxable (charities, state governments, etc.) or tax-deferred (retirement plans and IRAs). If one uses the Federal Reserve Flow of Funds data for equity holdings, some 4.93% of equities appear to be held by nonprofits and governments, either directly or through mutual funds. This would account for some $29B of the missing dividends as being permanently nontaxable. The remaining $370B would then, by default, be attributable to pension funds, annuities, IRAs, and retirement plans, mostly tax-deferred, but not tax-exempt. This is considerably higher than the $275B that one would expect from the Flow of Funds equity ownership data. That may be a product of the necessarily rough assumptions that the Federal Reserve must make in its full-economy computations, or it may be attributable to a bias in favor of holding high-yield equities under retirement plans, or it may indicate that I am failing to take credit for some $32B in additional tax revenue for dividends hiding under other tax lines. In that case, Shared Economic Growth would be very strongly revenue positive currently, while still providing substantial additional revenue as the baby boomers draw out their retirement funds.

V. Shared Economic Growth vs. the Corporate Consensus

Corporations do not agree with each other very much on tax matters. They all have unique situations and unique preferences. Still, after several years of talk about "fundamental tax reform", a basic approach has emerged and received backing from both Republican and Democratic legislators, largely because it does not require any creativity. I have labeled this the "Corporate Consensus."

The Corporate Consensus has two elements. First, broaden the base and try to lower the rate to something like 25%. That

was the heart of what was done on the individual tax side in the Tax Reform Act of 1986, before we spent the next 26 years narrowing the base again, and so it is relatively easy for people to agree that "that was good, so let's do it again for corporations now." The second element is exempting foreign source income from U.S. tax, otherwise known as adopting "territorial taxation." Our OECD peers all do this, so it is relatively easy to agree, if everyone else does it, we should too.[128]

The Corporate Consensus certainly has positive features. Territorial taxation would allow companies to bring their foreign cash home. If they found some reason to invest that cash in the U.S., they could do it without having the government snatch a large part of the cash before it could be invested. Alternatively, the companies could pay the cash out as dividends or through stock-buy-backs, and if the shareholders found some reason to invest the funds in the U.S., or if they wanted to spend the money, they could do so. So that is better than current law.

Lowering the marginal tax rate would also be helpful. As a general matter, corporations do not make investment decisions on the basis of overall effective rates. They may account for special benefits for particular activities, such as R&D credits or the expensing of geological & geophysical costs, but if they are deciding whether to locate a factory or a refinery in the United States, they generally look at the 35% marginal tax rate (or the 32% rate for domestic production activities after the § 199 deduction), not the overall effective rate they pay on all their U.S. activities. So, lowering the marginal rate to 25%, the same rate as China, would substantially reduce the economic incentive to locate high-margin operations in a jurisdiction with a 12% or 0% tax rate.

However, the Corporate Consensus does not go far enough, and it costs a lot to get there. Start with territorial taxation. One can easily implement a version of territorial taxation that will be scored as revenue neutral. This is done by making the exemption only partial – say 95% - and/or by disallowing the deduction of expenses deemed allocable to the foreign operations. Unclean territorial taxation, however, places a

128. I leave aside the usual parental admonition, "if all of your friends super-glued their heads to the floor, does that mean it would be a good idea for you to do it too?"

probably irresistible temptation in the hands of Congress. If a 95% exemption is okay, could 90% be that much worse? 85%? If we get to 85%, then is 75% really such a big change? 50%? You get the idea. Partial rules invite tinkering whenever a "pay for" is needed, and so today's cure for the ill of trapped cash would likely become less effective over time. Other countries do manage to maintain partial exemptions at steady levels, but other countries also manage to maintain efficient and disciplined health care systems, to exercise some budget discipline, and to do other things that seem to be beyond our political maturity.

Disallowance of expenses allocable to foreign operations would be more actively problematic. Recall that America is no longer the manufacturing center we once were. Our remaining economic core consists of corporate headquarters functions, as discussed above. Say that a company can hire an accountant who will focus on its European operations, in a role that is somewhere in the grey area where stewardship overlaps with support services, and can place that person in the U.S. headquarters or in a European operating company. If the U.S. says that the cost of the employee, located here, would be nondeductible, while the European jurisdiction would be less fussy if a local person there is hired to do the work, where will the corporation place the job?

The other problem with territorial taxation, of course, is that it eliminates an annoying drawback of locating valuable activities abroad. Companies that earn a lot of money have a hard time figuring out how to use all of their foreign cash. They are willing to suffer that annoyance rather than bring it home, as can be seen from Apple's or Microsoft's financial reports, as discussed above, but they do not like it. Territorial taxation would make it easy for a corporation to place as much of its operations as it wanted wherever it wanted them. Thus, it would be important under such a system to ensure that the company was motivated to place its operations in America. We see that countries with territorial tax regimes have tended to try to lower their domestic tax rates as well.[129]

129. For example, the U.K., which recently switched to territorial taxation, has reduced its corporate rate from 26% in 2011 to 21% in 2014. *See Rates and Allowances: Corporation Tax*, HM REVENUE & CUSTOMS,

That brings us back to lowering the corporate marginal rate. The problem there is that many of the benefits that one could dispose of in order to broaden the base happen to benefit domestic activity.[130] Let's look at ten of the top corporate "tax expenditures" for 2010.[131] 1) $7.2B for "Inventory property sales source rule exception." This is the rule under IRC § 863(b) that allows 50% of the income from U.S.-manufactured property sold abroad to be treated as foreign-sourced income and sheltered by excess foreign tax credits. It thus subsidizes exports. 2) $7.0B for the § 199 deduction. This directly subsidizes U.S. production activities. 3) $4.9 billion credit for low-income housing. That is clearly only for domestic activity. 4) $3.2 billion for reduced rates on first $10MM of corporate income. Sacrificing those rates, which tend to apply to corporations that are less global than their larger brethren, in order to reduce overall rates does not do much to help corporations as a whole. 5) $3.6B for LIFO inventory valuation. That only significantly benefits companies with old American operations. 6) $24.1B for depreciation in excess of the alternative depreciation system. That benefit is given exclusively, or nearly exclusively, to domestic operations. 7) $1.8B for charitable deductions to health organizations. That is a domestic benefit. 8) $7.5B for exclusion of interest on public-purpose state and local government bonds. That is a domestic item. 9) $4.0 billion for the R&D credit. That is restricted to R&D performed in the U.S. 10) $1.0 billion for the wind energy credit under I.R.C. §45 – this is restricted to U.S. production

https://www.gov.uk/government/publications/rates-and-allowances-corporation-tax/rates-and-allowances-corporation-tax (last updated Apr. 2, 2015).

130. Reliance on merely lowering the rates has the additional drawback that corporations may not regard the new rates as very stable. Investment in plants invokes long-term thinking based on what is perceived as the stable state. Thus, for example, when the U.S. gave China permanently favorable tariff status instead of mere annual renewals in 2001, it resulted in a pronounced outflow of U.S. jobs, even though the tariff rates were not reduced. *See* Justin R. Pierce & Peter K. Schott, *The Surprisingly Swift Decline of U.S. Manufacturing Employment*, (Fin. and Econ. Discussion Series, Working Paper No. 2014-04, 2013), http://www.federalreserve.gov/pubs/feds/2014/201404/201404abs.html. Shared Economic Growth, in contrast, would provide a reliably permanent zero effective rate. *Id.*

131. JOINT COMM. ON TAX'N, 111TH CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2010-2014 (Joint Comm. Print, 2010).

under § 45(e).

How much new revenue would we need to offset a corporate rate reduction to 25%? The staff of the Congress's Joint Committee on Taxation ("JCT") have addressed this question twice. In a memorandum dated October 27, 2011,[132] the staff concluded that it would be impossible to reduce the corporate rate to 25% in a revenue-neutral manner by eliminating corporate tax expenditures, that the best rate that could be achieved by eliminating all corporate tax expenditures would be 28%, and that even that figure would not be sustainable because it relies heavily on eliminating timing benefits that would reverse later. In this JCT estimate, the revenue loss from reducing the rate to 28% as of January 1, 2012 was estimated to be $40.5B in fiscal 2012 (the federal fiscal year ends on September 30, so this is a partial year effect), $65B in 2013, $71B in 2014, and some $76B a year thereafter. Reducing the rate to 25% would presumably cost some 10/7 times those amounts, or $58B in fiscal 2012 going up to $109B by 2015.

A second study by the JCT staff was reported in a letter dated July 30, 2013.[133] This estimated that the revenue cost of lowering the corporate rate to 25% as of January 1, 2014 would be $73B in fiscal 2014, $112B for 2015, $124B for 2016, and about $131B per year thereafter.

A 25% corporate tax rate would bring the U.S. down to the level of China, but would still be far above the 0% to 12.5% rate that corporations can pay elsewhere. It would not make us an attractive location for business operations, it would just make us less unattractive. However, as the JCT staff concluded, in order to achieve that homely state we would need to sacrifice all of the domestic corporate incentives noted above, plus all other corporate incentives, plus raise taxes on non-corporate taxpayers by some $40B a year.[134] Shared Economic Growth

132. Memorandum from Thomas A. Barthold, Chief of Staff, Joint Comm. on Tax'n, on Revenue Estimates (Oct. 27, 2011), *available at* http://www.novoco.com/hottopics/resource_files/jct-memo_tax-expenditure-repeal_102711.pdf.

133. Letter from Thomas A. Barthold, Joint Comm. on Tax'n, to Hon. Sander Levin, H.R. (July 30, 2013), *available at* http://democrats.waysandmeans.house.gov/sites/democrats.waysandmeans.house.gov/files/Scan001.pdf.

134. The recent proposal of House Ways and Means Chairman Camp

reduces the effective corporate tax rate to zero, and imposes only some $47B per year in taxes on income that does not directly benefit from the corporate tax reduction. Effectively, an extra $7B in offset allows an unbeatable 0% corporate rate instead of a mediocre 25% rate.

Further, with individual tax rates peaking out above 40% all-in, reducing corporate rates to 25% would create a significant incentive to shelter income under a corporate shell, opening up all sorts of new possibilities for the wealthy to avoid paying the same levels of tax faced by normal working professionals. The JCT estimates explicitly do not include the revenue loss from those new tax games. As discussed above, Shared Economic Growth would largely eliminate tax games, rather than creating new ones.

The Corporate Consensus, then, involves going for a long field goal when America is six points behind in the game. It will be difficult to achieve, and while it might be somewhat better than nothing we will still lose. Traditionally, America has preferred to win. To win, we need a strategy that makes America the best location in the world for high-value operations. Shared Economic Growth is such a strategy. The Corporate Consensus is not.

"addresses" this issue largely through budget-window tricks, changing the timing of depreciation and amortization (which will reverse with a vengeance outside the window), imposing a huge one-time tax on accumulated foreign earnings, etc. He also proposes to impose 15% minimum taxation on high-margin foreign subsidiary income, which he labels as "intangible income", even where that income is from active operations related to the local foreign market. For the reasons explained here, that would be highly unlikely to work for long in our global economy, and would instead result in valuable operations shifting into foreign hands, undermining U.S. administrative jobs and our technological edge. Chairman Camp needed to whack corporations with a stick rather than using a carrot because he seeks to reduce direct net taxes on voters, and he ran out of budget-window tricks to fund that one. *See* U.S. HOUSE OF REPRESENTATIVES, COMM. ON WAYS AND MEANS, TAX REFORM ACT OF 2014 DISCUSSION DRAFT (2014), *available at* http://waysandmeans.house.gov/news/documentsingle.aspx?DocumentID=370987.

VI. The Tricky Bits: Treaty Overrides for Withholding Tax and FTCs

Can Congress override a tax treaty through subsequent legislation? Clearly yes, and Congress did so with respect to the foreign tax credit provisions of many treaties in 1975 and 1976.[135] Should Congress do so? That is a more complex question, which appropriately turns on the fundamental expectations of the parties in entering into the treaty.

A. *Replacing the Corporate Foreign Tax Credit with a Deduction*

Let's begin with eliminating foreign tax credits. Other countries have felt free to switch from a foreign tax credit system to a territorial tax system, despite their treaties with the United States providing for the allowance of foreign tax credits. In the two recent cases of the United Kingdom and Japan, both had treaty provisions stating that they would allow a credit for U.S. tax payable on an item of income. The United Kingdom had a technical out in that the treaty provided that such credit would be allowed against the U.K. tax imposed with respect to such income,[136] and the U.K. completely exempts the qualifying

135. Rev. Rul. 80-223, 1980-2 C.B. 217.

136. *See* Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains, U.S.-U.K., *opened for signature* July 24, 2001, 80 Stat. 27 (entered into force Mar. 3, 2003) [hereinafter U.K. Treaty]. Article 23(4) of the U.K. Treaty provides:

> [s]ubject to the provisions of the law of the United Kingdom regarding the allowance as a credit against United Kingdom tax of tax payable in a territory outside the United Kingdom (which shall not affect the general principle hereof):
>
> a) United States tax payable under the laws of the United States and in accordance with this Convention, whether directly or by deduction, on profits, income or chargeable gains from sources within the United States (excluding, in the case of a dividend, United States tax in respect of the profits out of which the dividend is paid) shall be allowed as a credit against any United Kingdom tax computed by reference to the same profits, income or chargeable gains by

foreign income or dividends. Therefore, there is no local tax against which a credit would be allowable under the treaty. In the case of Japan, on the other hand, the treaty again provided that such credit would be allowed against the Japanese tax imposed with respect to such income,[137] but Japan only allows a 95% exemption, and disallows any credit or deduction for the foreign tax paid with regard to the income. Thus, contrary to the express wording of the treaty, Japan does not allow U.S. tax to be taken as a credit against the (limited) Japanese tax on U.S. income.

Why can Japan do this? The treaty does allow them two sets of wiggle words. First, the treaty credit provision is "[s]ubject to the provisions of the laws of Japan regarding the allowance as a credit against the Japanese tax of tax payable in any country other than Japan." So, Japan reserved the right to change its foreign tax credit rules, though clearly the intent was not for Japan to be permitted to simply eliminate foreign tax relief while still enforcing the treaty credit provision against the United States. Second, the provision stated the caveat that "[t]he amount of credit, however, shall not exceed that part of the Japanese tax which is appropriate to that income." Japan would argue that the 95% exemption is intended to account for

> reference to which the United States tax is computed.

Id.

137. *See* Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income, *opened for signature* Nov. 6, 2003, S. Treaty Doc. 108-14 (entered into force Mar. 30, 2004) [hereinafter "Japan Treaty"]. The Japan Treaty provides:

> [s]ubject to the provisions of the laws of Japan regarding the allowance as a credit against the Japanese tax of tax payable in any country other than Japan:
>
> (a) Where a resident of Japan derives income from the United States which may be taxed in the United States in accordance with the provisions of this Convention, the amount of the United States tax payable in respect of that income shall be allowed as a credit against the Japanese tax imposed on that resident. The amount of credit, however, shall not exceed that part of the Japanese tax, which is appropriate to that income.

Id.

the fact that the Japanese parent is likely deducting stewardship expenses equal to some 5% of the U.S. dividends, so that the effective tax on the U.S. income inclusive of apportionable expenses is really zero, and so the "appropriate amount" of U.S. credit is likewise zero.

In either case, then, the important thing is not the allowance of the credit contemplated by the treaty provision, but rather the avoidance of double taxation, as the title of Article 24 of the U.K. treaty ("Relief from Double taxation") indicates. The British and Japanese foreign dividend exemption systems avoid double taxation by simply not taxing (or minimally taxing) the foreign income, and so the credit may be eliminated as unnecessary. The Shared Economic Growth proposal eliminates, or offers to eliminate, U.S. taxation for corporations by allowing a dividends-paid deduction. Thus, it also renders a foreign tax credit unnecessary for corporations.

However, the proposal is less straightforward than the territorial taxation systems in that it requires the corporate recipient of foreign income to do something (pay a dividend) in order to avoid U.S. tax. Is this a critical difference? Arguably not.

In 1976, Congress adopted a law,[138] with treaty overrides, that shifted from a "per country" foreign tax credit system to a world-wide credit computation. Before that change, if a U.S. company earned $100 in the U.K. and paid $30 of U.K. tax, and lost $100 in Germany, it would receive credit for the full $30 of U.K. tax and could use the German loss against other income. After the 1976 Act, it would have net foreign source income of zero and would not be able to claim credit for any of the U.K. tax paid. This change, shifting from "we will allow a credit for U.K. tax paid on U.K. net income" to "we may allow a credit for U.K. tax paid depending on a company's overall global tax position" was considered reasonable. Is a change to "we will eliminate U.S. tax on U.K. income if a company pays out those earnings as dividends" substantially less reasonable? At least then the U.S. tax treatment depends only on what happens to the U.K. earnings, not on what operations in other countries are doing.

138. Tax Reform Act, Pub. L. 94-455, § 1031, 90 Stat. 1520, 1620-24 (1976) (amending I.R.C. § 904).

Now consider a "reform" proposed by the Obama administration in its 2014 revenue proposals.[139] The Administration has proposed that foreign tax credits be subjected to full global pooling. In other words, a U.S. parent would need to pool the earnings and taxes of all of its controlled foreign subsidiaries. To illustrate, if its U.K. subsidiary earned $100 and paid $21 in tax while its Dominican Republic subsidiary earned $100 and paid $0 in tax, then a $79 dividend from its U.K. subsidiary (all of its after-tax income) would result in U.S. tax of $21.63 rather than $14 (i.e. the U.S. tax rate minus the U.K. tax rate times the U.K. earnings) under the current system. Thus, the Administration proposal would say "we will allow credit for U.K. tax paid on U.K. income, but only if and to the extent that the U.S. parent takes dividends of *all* of the earnings of *all* of its foreign subsidiaries." Is that less aggressive than saying "we will eliminate U.S. tax on U.K. source earnings if the U.S. parent pays out the U.K. taxable income as dividends"? The primary difference between the two, in my view, is that the administration proposal would make American corporations extremely reluctant to take dividends from even their high-tax subsidiaries, while Shared Economic Growth would make it easy for companies to bring home and invest as much of their foreign subsidiaries' income as they wished. In terms of treaty policy, the Administration's proposal is *more* aggressive.[140]

Further, at the cost of a little complexity, one could tweak the Shared Economic Growth proposal to make it at least as treaty-compliant as the Japanese law. This could be done by providing that dividends paid would be deemed to come first from foreign source income, and that corporations would have an election between claiming the dividends-paid deduction for dividends paid out of foreign source income, or else claiming a foreign tax credit. So, for example, say that a corporation had $130 of foreign-source taxable income, credits of $30, and U.S.-

139. DEP'T OF TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2014 REVENUE PROPOSALS 48 (2013), *available at* http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2014.pdf.

140. This is not to say that the Administration's proposal is not controversial. *See, e.g.*, Robert H. Dilworth, *Proposed Multilateral FTC Pooling and U.S. Bilateral Tax Treaties,* 55 TAX NOTES INT'L 1045 (2009).

source taxable income of $400. If it elects to take the dividends-paid deduction on foreign source income, it will have a deduction rather than a credit for the $30 of foreign tax. Total taxable income will be $500, and it will need to pay a $500 dividend to eliminate its U.S. tax. If it pays only $400, it will have $35 of U.S. tax. If it instead claims a foreign tax credit, it will have $130 of foreign source taxable income, and its first $130 of dividends will not be deductible. It will have a U.S. tax liability of (35% x $130)-$30 credit or $15.50 on its foreign income, and $400 x 35% = $140 on its domestic income, or $155.50 total. If it pays a dividend of only $400, it will receive a deduction of $400-$130=$270, worth $94.50, and will have total U.S. tax of $155.50-$94.50=$61, rather than the $35 above. If it pays out $500, it will have a deduction of $370 worth $129.50, and will owe U.S. tax of $26 rather than $0. Its minimum U.S. tax, if it paid out $530, would be $15.50, and could go no lower. In short, a company would generally be stupid to elect to take the foreign tax credit, but it would be entitled to do so if it felt desperate to hold on to its cash. Our treaty partners would then have no technical or theoretical grounds for complaint.

B. *The 30% Incremental Withholding Tax*

This is the most difficult piece. Again, Congress clearly has the power to override the treaties to impose such a tax, but would doing so be likely to cause our treaty partners to retaliate?

The justification for the withholding tax would be that the foreign shareholders would suffer no net harm from the combination of the allowance of the dividends-paid deduction and the imposition of the 30% withholding tax, because the 30% withholding tax would apply only with respect to dividends as to which the paying corporation claims a deduction.[141] So, the shareholder would receive a dividend amount grossed-up by an

141. Because the dividends-paid deduction would be capped at current-year taxable earnings plus unused earnings within the NOL carryback period, the corporation would generally know at the time of payment whether or not the dividends in question were deductible. If a corporation paid out aggressively during the taxable year, regulations would provide that there would be initial withholding with a right of the foreign shareholder to reclaim once the corporation certified that the dividends in question exceeded deductible earnings.

amount that would cover the incremental withholding tax, or at minimum would see the value of its shareholding increase by the amount of the withholding tax.

One could make this reality clear by providing for a three-pronged election. As a default case, dividends paid to a foreign party would not be deductible, but the statute would provide that the corporation could achieve this result by paying out a deductible dividend to all shareholders, while withholding and paying over the corporation's own 35% tax liability (as a prepayment on its regular corporate tax liability) with respect to the dividends paid to foreign shareholders, and allocating that differential liability to the foreign shareholders and reducing their dividends accordingly. This could be phrased as a federal provision providing that foreign shares would always constitute a separate class of stock (but one whose character can switch freely depending upon the identity of the shareholder) that would bear the burden of the differential tax treatment of dividends paid on that class of stock. The 35% deduction-offset amount would thus not be treated as a dividend paid to the foreign shareholders, and they would suffer normal withholding tax only on the net amount remaining after the reduction. That would leave them precisely where they are today.

The foreign shareholders would be given an alternative election to have dividends paid to them be deductible to the corporation, with no reduction, and to pay a 30% incremental withholding tax on the entire amount of the deductible dividend.[142] They would also be given a second alternative election to have the dividends paid to them be deductible to the corporation, and to file a return and pay tax on the dividend at the top U.S. individual rates[143] as a simplified form of deemed

142. As is noted below, this simple 30% incremental tax could instead be imposed as a replacement withholding tax of 35%, waiving normal treaty withholding taxes as to deductible dividends, flipping to standard withholding for any non-deductible dividend. That would make the nature of the simplified flow-through tax clearer, but one would think that that goal could be served more easily by just talking about it with our treaty partners.

143. The U.S. is not obligated under the non-discrimination provisions of the treaties to provide the full allowances and reductions available to domestic taxpayers to a foreign taxpayer with limited U.S. income. For example, Article 25(5) of the U.K. Treaty provides: "Nothing in this Article shall be construed as obliging either Contracting State to grant to individuals not resident in that State any of the personal allowances, reliefs and reductions for tax purposes

flow-through income.

What would this do? It would have the result that a corporation paying a dividend to a foreign national would be able to claim a deduction under the same conditions as if it paid the dividend to an American taxpayer,[144] i.e., that the recipient pay U.S. tax thereon at the standard rates or at an appropriate withholding rate. Foreign nationals would be able to pay the same tax on U.S.-source dividend income that a U.S. taxpayer would pay, albeit without the benefit of the lower rate brackets.[145] Alternatively, foreign recipients would be able to elect to rely on the limited treaty withholding tax rates on dividend income, but in that case they would not be able to assert the privilege of holding shares on which a corporation could pay deductible dividends.

Is this approach overly "cute"? Not if you view it against the background of the treatment of the former U.K. Advance Corporation Tax ("ACT"). Under the old ACT scheme, a form of imputation credit, when a U.K. corporation paid a dividend it was obliged to pay tax on the dividend paid at a rate equal to the grossed-up[146] "basic rate" payable by moderate-income individuals, so that the corporation paid out a total amount equal to the dividend (paid to the shareholders) plus the basic rate tax on the grossed-up amount of the dividend (to the government). This tax payment was then effectively credited twice. First, the corporation itself was able to apply the ACT to reduce its corporate tax liability, so that at the end of the day the corporation was liable for tax computed under the normal corporate tax rules.[147] Second, the dividend recipients could credit the ACT against their individual tax liability on the sum

which are granted to individuals so resident or to its nationals." U.K. Treaty, *supra* note 136, at art. 25(5).

144. This complies with the Japan Treaty and the U.S. Treaty. *See* Japan Treaty, *supra* note 137, at art. 24(3); U.K. Treaty, *supra* note 136, at art. 25(3).

145. This complies with the Japan Treaty and the U.S. Treaty. *See* Japan Treaty, *supra* note 137, at art. 24(1); U.K. Treaty, *supra* note 136, at art. 25(1).

146. In other words, at a rate that would equal the basic rate multiplied by the sum of the dividend and the tax.

147. This was the problem with the ACT system. Because corporations were fundamentally liable for the full amount of the regular corporate tax, the ACT system did not provide the incentive that the Shared Economic Growth proposal provides to site valuable operations in the home country.

of the dividend plus the credit[148] (a deemed taxable dividend amount) or receive a refund for the excess ACT credit, subject to various complications that evolved over time.[149]

The U.K. took the position that the ACT was not a withholding tax because the levy was technically imposed on the corporation (although the corporation was immunized against it by being able to credit it against the mainstream corporate tax) rather than the shareholders. However, the gross-up rate computation and the deemed taxable dividend amount at the shareholder level were both based on an amount equal to the nominal dividend *plus the tax*, which implied that the real amount of the dividend was the grossed-up figure, and thus that the levy was actually a levy on the shareholders with the corporation merely acting as a withholding agent. Further, since the ACT credit was a credit against domestic liability, the U.K. took the position that it was under no obligation to allow the credit to foreign shareholders, effectively permitting the U.K. to impose a high-rate withholding tax solely on foreign shareholders.

To see this more clearly, let's consider two scenarios based on U.S. 35% tax rates. In both scenarios, a corporation has net income for the year of $100 after accruing corporate tax expense of $54. In Scenario A, the corporation pays a dividend of $100, pays an ACT-style levy of $54 to the government, and credits that $54 as the payment of the $54 in tax expense it had already accrued. The government then gives the shareholders a $54 credit against their personal liability on a deemed taxable dividend amount of $154. Thus, the corporation has paid out $154, $100 to the shareholders and $54 to the government, and has no further tax liability, and the shareholders have received $154 (including the credit) and are taxed on a $154 deemed dividend. In scenario B, the corporation pays a dividend of $154, but it is not obliged to pay $54 of its own funds to the government. Rather, it is obliged to withhold and pay over $54 from the dividend as a withholding tax on the shareholders. The corporation then receives a $54 credit against its accrued tax, (or equivalently receives a deduction of $154 for the dividends paid),

148. Finance Act, (1972) § 87(2) HALS. STAT. (U.K).

149. *See generally* Rev. Proc. 2000-13, 2000-1 C.B. 515; Rev. Proc. 80-18, 1980-1 C.B. 623.

and the shareholders receive a $54 credit against their regular tax. Thus, the corporation has paid out $154, $100 to the shareholders and $54 to the government, and has no further tax liability, and the shareholders have received $154 and are taxed on a $154 dividend. This is exactly the same as Scenario A, except for one thing, that in Scenario A the corporation records net income for the year of only $100 offset by dividends paid from earnings of $100 while in Scenario B the corporation records net income of $154 offset by dividends paid from earnings of $154, a pure matter of accounting.

In the international context, if the withholding tax in Scenario B was improper, then it would appear that the U.K. engaged in a shocking bit of legerdemain. The standard OECD treaty would apply in Scenario B to say "the withholding tax on a foreign shareholder may not exceed 15% of the distribution, so the maximum withholding tax is 15% of $154 or $23.10." Instead, purely because the accounting liability, as opposed to the economic liability, for the $54 was placed on the paying corporation, the treaty allowed a $54 withholding tax, even though the company's payment of that amount reduced the payable dividend from the $154 that the U.K. tax computation was based on (remember that the tax liability was set at the target tax rate times the sum of the dividend *and the ACT*) to $100, with the *exact same effect* on the shareholder as if a $54 withholding tax had been imposed on the real dividend amount – the amount that U.K. shareholders received and were taxed on – of $154. A taxpayer who tried such a transparent ruse with no significant economic effect would be laughed out of court. The respectable U.K. government, however, was allowed to get away with it without any great furor, and the U.K. was far from alone in enacting similar imputation credit schemes that cut out foreign investors.

That said, it did not escape the attention of Britain's treaty partners that Britain's ACT system was discriminatory and effectively got around the treaty restrictions. The U.S. therefore negotiated a new treaty with the U.K. that effectively re-characterized the tax back into a withholding tax and applied the usual treaty restrictions to it, although this still resulted in the imposition of a withholding tax on U.S. shareholders that

was not imposed on British holders.[150] In any event, this was a matter of negotiation, not a claim of right. As the American Law Institute Advisory Group summarized it, "Foreign countries with imputation systems have generally been reluctant to grant credits to U.S. shareholders, largely because the U.S. does not grant integration credits to foreign (or domestic) shareholders. Nevertheless, some such countries have been willing either to make shareholder credits available to U.S. investors or to reduce otherwise applicable withholding taxes as part of a tax treaty."[151]

The fact that it is a matter for negotiation, not a treaty abrogation, is a key point. The U.S. Treasury has previously recommended that relief for foreign investors under any form of corporate integration should be a matter for negotiation, not a unilateral gift from the United States, in order to ensure that U.S. investors receive overall equivalent treatment on their investments in the treaty partner jurisdiction, and further noted that other countries attempting corporate integration generally took a similar approach.[152] In these negotiations, the United States would properly take the position that America had the right to tax corporate income at full rates. To again quote the A.L.I. Reporter:

> Whether the foreign investment in the U.S. is through the branch of a foreign company, the U.S. subsidiary of a foreign company, or a U.S. company with portfolio foreign shareholders, the United States would seem to have a perfectly legitimate source country claim to tax the income produced by that investment. In the context of

150. *See* Letter of Submittal from C.W. Robinson, Sec'y of State, to the President of the United States (June 8, 1976) (regarding the Convention between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income signed at London on December 31, 1975, and an exchange of notes signed at London on April 13, 1976, modifying certain provisions of the Convention).

151. AM. LAW INST., FEDERAL INCOME TAX PROJECT, TAX ADVISORY GROUP DRAFT NO. 21: REPORTER'S STUDY 144 (1992) [hereinafter REPORTER'S STUDY].

152. U.S. TREASURY DEP'T, REPORT ON INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS--TAXING BUSINESS INCOME ONCE 79 (1992).

> integration, such a claim should not be considered discriminatory, because the U.S. would enforce an equivalent claim against domestic investment through a U.S. company owned by U.S. shareholders by means of an income tax on those shareholders, for which the corporate tax was a withholding device.[153]

In this view, the traditional dividend withholding taxes recognized under the treaties were never intended, under the classical corporate double-taxation scheme upon which the treaties are based, to interfere with full source-country taxation of business income. A country is thus entitled to announce, "we are going to deem corporate income to be taxable at the shareholder level on a modified flow-through basis as to foreign investors, and tax it at our top individual rate." In the scheme proposed above, America would be imposing such a flow-through tax on foreign shareholders in a far-simplified form, avoiding shareholder taxation until cash is distributed, and then effectively passing through all of the corporate deductions and credits to the shareholder because the new withholding tax would be imposed only up to the amount of income corresponding to the corporation's net tax liability. While I have proposed implementing a 30% incremental withholding tax on deductible dividends, this really amounts to a target 35% final withholding tax on deductible dividends with a waiver of normal treaty withholding rates, but with that tax reverting to the normal treaty (or non-treaty) withholding rates on any non-deductible dividends. One could mechanically implement that flip in an explicit way, but our treaty partners should be able to appreciate that the 30% incremental tax on deductible dividends is simpler. There is nothing objectionable about that change in terms of treaty theory.

If our treaty partners responded in kind by making equivalent changes in their own domestic laws, we could choose to grant reciprocal reductions of the withholding tax, and all of the countries involved would still end up with tax systems superior to those they have today. The one thing that I would

153. REPORTER'S STUDY, *supra* note 151, at 149.

caution against would be granting such reciprocal benefits to countries that chose not to impose substantial taxes on the dividend income received by their citizens. Shared Economic Growth is based upon ensuring that income is taxed once, at the individual level, at reasonable rates. If one were to poke holes in the tax net by allowing treaty partners to become havens for dividend-receiving tax exiles, the structure would be threatened. America has the power to prevent people from accessing our resources to build fortunes and then fleeing to a friendly haven to avoid paying back a fair share of what our system helped produce, since few wealthy persons would really be willing to self-banish themselves from our shores and our stock exchanges just to avoid a moderate level of tax. We have far more practical power over individuals in this manner than we have over corporate operations. However, we could lose that power if we are not mindful of the threat of evasion and if we fail to take reasonable steps to control it.

VII. Nothing Else Solves the Problems

As explained above, the Shared Economic Growth proposal meets all of the objectives of corporate tax reform, encouraging U.S. investment and strengthening American companies, essentially eliminating tax shelters and transfer pricing concerns, encouraging the efficient use of capital, reducing the incentives for risky behavior, eliminating double taxation, and improving the progressivity of the system, all in a manner that is simple to administer, safe to implement, and revenue balanced in the short run and revenue positive in the medium to long run, even before factoring in growth. It does all this and more. The numbers are real and the methodology is permissible.

The corporate consensus proposal does not accomplish these goals. Neither imputation credits nor dividend exclusions would get us there. Replacing the corporate tax with a VAT would create terrible progressivity, entity-choice, and tax shelter problems. Treating corporations as traditional flow-throughs would be horrendously complex, and would not give corporations a positive incentive to locate operations in America. There are not a hundred plausible alternatives out there, but there is one that accomplishes the objectives, and one is all we need. The

interesting question then becomes whether anyone in Congress is really interested in accomplishing these goals. Unsolved problems result in a continuing stream of campaign contributions. When one looks at purportedly difficult policy problems, it is often difficult to determine whether Congress really cannot find a good answer, or if they just do not wish to. For corporate taxation, we may now resolve that question. If there is a will to solve the problems, then there is a solution.