

Replace the Corporate Tax With a Market Capitalization Tax

By Calvin H. Johnson

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The Shelf Project is a collaboration among professionals in the tax community to develop and perfect proposals to help Congress when it needs to raise revenue. Shelf Project proposals are intended to raise revenue, defend the tax base, follow the money, and improve the rationality and efficiency of congressional tax committee report, explaining current law, what is wrong with it, and how to fix it.

Prof. Johnson proposes to replace the corporate tax on publicly traded companies with a quarterly tax paid by the issuer and measured by the published market value of the issuer's traded stock and debt. The tax would be determined by the IRS on the basis of the market value on a randomly determined basis.

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This proposal would replace the 35 percent corporate tax on publicly traded companies with a low 20-basis-point tax on the issuer on the market capitalization including both traded debt and equity. A low-yield corporate tax would remain for corporations that are not publicly traded, and for a transition period, the tax would apply to publicly traded corporations to allow tax credits.

I. Current Law

Section 11 of the code imposes an annual tax on the taxable income of a corporation. Large corporations pay tax at 35 percent for taxable income over \$10 million and at 34 percent for most of the taxable income below \$10 million.

Corporate taxable income rarely describes economic income of the corporation. The disparity between taxable and economic income differs by large amounts, depending on the nature of the corporate investment. Investments in inventory, reported under the first-in, first-out method, generally maintain an adjusted basis close to the

value of the inventory, under the full absorption inventory rules of section 263A. When adjusted basis is kept equal to the investment value, taxable income is equal to economic income. Tax accounting used for corporate taxable income, however, commonly allows adjusted basis to drop below real investment value. When adjusted basis is lower than real value, then taxable income is therefore less than economic income. Some investments are deducted immediately or "expensed" when made, and when investments are expensed, tax does not reduce the rate of return from the investment. The effective tax rate on expensed investments is zero. Among the investments that benefit from the zero effective tax are investments in the development of computer applications and software; pharmaceuticals; oil drilling; development of mines; crop planting; research and experimentation of any kind; advertising; and internal investments in workforce, customer base, and other nonfinancial business intangibles. Nontax generally accepted accounting principles will usually not identify the zero effective tax rate because for most of the expensed investments, the expensing is allowed for both tax and nontax accounting and because GAAP debits tax at 35 percent of GAAP income whether the tax is in fact paid or due.

The disparity between economic and taxable income is also high because corporations develop and buy tax shelters to reduce tax. Large corporations are exempt from the passive activity limitations of section 469, which is otherwise the most effective antisheltering regulation. Debt financing of low-basis investment creates tax shelters automatically. During the 1990s and early 2000s, moreover, corporations also purchased packaged "loss generators." Finally, international rules that depend on the prices set initially by two affiliated corporations do not protect the U.S. tax base from misattribution of income between foreign and domestic sources. It has been said that many "of the best educated and most talented tax lawyers in this country devote their careers to the intricacies of "corporate tax."¹ The high professional fees spent and talent wasted on effective minimization of corporate taxable income are deadweight losses, serving neither the revenue needs nor the economy.

The large differences between effective tax rates on different kinds of corporate investments and the varying sheltering that corporations can achieve warp investment decisions and diminish the economic value of investments: The pretax return from an investment ordinarily identifies the value of the investment derived from real consumer needs and demands, but when tax varies

¹Rebecca S. Rudnick, "Corporate Tax Integration: Liquidity of Investment," *Tax Notes*, Feb. 27, 1989, p. 1107.

among investments, tax warps the posttax returns and motivates investors to put capital into investments with less real social value. When government acts rationally to subsidize or disadvantage an investment, it does so through the federal budget because the budget is the only competitive mechanism in which the government makes hard cost-benefit decisions.

As the corporate tax base has eroded over the last 20 years, corporate tax has declined as a percentage of both government revenue and of GDP. Corporate tax was 22 percent of federal revenue in 1985, and is now 13 percent of federal revenue. Corporate tax was 4 percent of GDP in 1985 and is now 2.4 percent of GDP.² The Office of Management and Budget estimates that receipts from the corporate tax will be \$261 billion in 2007.³ Actual receipts from the corporate tax for 2004, the most recent year for which figures are available, were \$224 billion.⁴

Corporate costs of compliance with the federal corporate tax have been estimated at 1.8 percent of the yield from the tax, which would be about half the compliance cost rate associated with individual income tax.⁵ Old and rough IRS estimates place the noncompliance tax gap from illegal underpayment of corporate tax at 10 percent of the yield.⁶

In addition to distorting investment decisions, the corporate tax increases the financial fragility of corporations because the deduction of interest encourages corporations to acquire new capital in return for debt rather than for equity. The favoritism toward debt has been called the original sin of the corporate tax. The corporate tax system also discourages distributions of corporate earnings that might be used for better investments because the corporate form shields individual shareholders from 15 percent dividend tax as long as the earnings are not distributed.

A partnership, including a limited liability company taxed as a partnership, and a subchapter S corporation are not subject to corporate tax. Taxable income is, instead, computed at the partnership or subchapter S level and apportioned to partners or shareholders, who pay their tax on the income. Under the check-the-box regulations, any business enterprise may elect to be taxed as a partnership, rather than a corporation, unless owner-

ship interests are publicly traded on a stock market.⁷ Business entities not traded on a public market make themselves subject to corporate tax only voluntarily, for example, to take advantage of nontax underaccounting for compensatory stock options or to achieve the low 15 percent to 25 percent taxes on the first \$75,000 of corporate taxable income.

While public trading is the major front line defending collection of corporate tax, the line has been breached in important ways. Publicly traded partnerships are in general taxed as corporations, but there is an exception for publicly traded partnerships that have mostly "passive-type income."⁸ In a recent initial public offering (IPO), a private equity fund offered \$4 billion of the share of fund given to the managers as earned compensation.⁹ Notwithstanding that earned income is not passive-type income, the \$4 billion was claimed as passive-type income because it arose from a partnership interest that had previously been given as compensation. The offering in essence claimed that ordinary sales commissions could be characterized as passive income, so that even after the public offering, the entity would be taxed as a partnership. Given the value of public trading and avoidance of the 35 percent corporate tax, and the energy of the tax planning community, we can expect an explosive increase in entities that are simultaneously publicly traded and not corporations subject to section 11.

II. Reasons for Change

The corporate tax is a complicated and expensive system to miscalculate the income of a corporation. Wide variations in the difference between taxable income and real economic income mean that the tax misleads investors into making investments that waste capital and do not optimally satisfy real demand or needs. Because the tax accounting so badly describes the economic income of a corporation, it is not allocating the tax burden according to ability to pay or any other defensible economic norm. To make an analogy, the alternative minimum tax is a junk tax with a base that is so badly engineered that it has no normative appeal; the corporate tax has evolved similarly into a junk tax. Given the deficit and government needs for revenue, the corporate tax cannot be repealed, but if it could be replaced with a simpler tax with similar distributional and revenue impact, the corporate tax would not be missed.

Under current law, the corporate tax is primarily a tax paid by business entities to allow their owners to gain access to a public market for easy sale of their stock (or

²U.S. Comptroller General David M. Walker, "Corporate Tax Enforcement," Government Accountability Office Testimony to Senate Finance Committee, June 13, 2006, at 6 (GAO analysis of OMB figures).

³OMB, "Fiscal Year 2007, Mid-session Review: Budget of the United States," Table S-8, <http://www.whitehouse.gov/omb/budget/fy2007/pdf/07msr.pdf>.

⁴Statistics of Income Tax Stats — Returns of Active Corporations — Table 1, col. 18, <http://www.irs.gov/pub/irs-soi/04co01accr.xls>.

⁵Joel B. Slemrod and Marsha Blumenthal, "The Income Tax Compliance Cost of Big Business," 24 *Pub. Fin. Q.* 411 (1996). The authors estimate all corporate taxes as bearing corporate planning costs of 2.6 percent and federal costs as 70 percent of that: 70 percent of 2.6 percent equals 1.8 percent.

⁶Walker, *supra* note 2, at 13-14 (but criticizing the inaccuracy of IRS figures).

⁷Section 7704 (treating publicly traded partnerships as corporations, except for some partnerships with passive income only). Michael L. Schler, "Initial Thoughts on the Proposed 'Check-the-Box' Regulations," *Tax Notes*, June 17, 1996, p. 1679, *Doc 96-17699, 96 TNT 118-79* (concluding that the only potential barrier to partnership classification under check-the-box regulation is publicly traded equity).

⁸Section 7704(c).

⁹Blackstone Group LLP prospectus for IPO, *available at*, <http://sec.edgar-online.com/2007/03/22/0001047469-07-002068/Section10.asp>.

other equity interest). Under the check-the-box regulations, a business entity that is not publicly traded can avoid corporate tax if it wants to. The voluntary corporate tax paid by nonpublicly traded entities is for tax minimization or accounting gimmicks and is not important.

Business entities are rational in accepting the corporate tax to gain access to the public market for capital and to give their shareholders liquidity. Under modern corporate governance theory, the best remedy for a public shareholder against management misbehavior is to exit quickly by selling the stock. Remote investors will not give capital to a corporation unless they can quickly turn their holdings into cash.¹⁰ Stock investment is volatile, much like a roller coaster, and quick sale gives the stockholder the chance to get off the roller coaster when he needs to. Shareholders also need and want money for other purposes, and the market liquidity gives the shareholder access to his wealth to use it for any need. In absence of liquidity, investors rationally demand far higher returns because their investment is inaccessible to them in the short term, and they rationally accept lower returns if they have access to instant liquidity.

Indeed, the value of achieving easy sale of stock is now the primary economic justification for the corporate tax.¹¹ Fifty years ago, a business entity accepted the corporate tax to achieve limited liability for its investors, but over the last 50 years, culminating with the check-the-box regulations, it has become well established that an entity can achieve limited liability without accepting the corporate tax. The corporate tax might have originated in 1906 in part to force corporations to disclose their books,¹² but disclosure of corporate income to the investing public has since become a function of nontax accounting, under the supervision of the Financial Accounting Standards Board and the Securities and Exchange Commission.

A tax on access to public markets for capital is a good tax. One recent report estimated that a firm achieved an improvement of 17 percent in the market value of its stock just by listing its stock on a U.S. exchange.¹³ The premium from listing on a U.S. exchange was permanent and robust. The report could find no such premium for listing on the competing London Stock Exchange. Indeed, corporations are willing to pay the 35 percent corporate tax on their net income in perpetuity, whereas if they were not readily traded on a market, they could avoid the tax. Especially for those corporations for which the corporate tax captures much of their economic income, the tolerance of corporate tax is proof of the high value of market access. The tax charged must be less than the value of market access, or the business entities would not

pay the tax. The high value of market liquidity also means that the government can collect a tax without driving substantial volume of business entities out of the market. That will mean that the tax will have a small deadweight loss and that what corporations lose, the government will gain.

Under the Tiebout model, if a jurisdiction can exclude taxpayers from a benefit, it can charge taxpayers for the benefit.¹⁴ Under the Tiebout model, for example, municipalities compete among themselves for potential residents by giving the highest benefits per dollar of tax, customizing the benefits to potential residents. A governmental unit is thus like a large movie theater for the collective consumption of public goods like police, schools, culture, entertainment, and transportation. Some of the advantages of the municipality are provided by the municipal government; and some are just an asset of the municipality's location, history, or existing mix of residents. If a potential resident does not like the mix of goods available to him for the tax that must be paid to reside in the municipality, he can choose some other movie theater. So too, a tax on access to market liquidity is like a ticket to a movie theater. A corporation's willingness to pay the tax is proof that it has ascertained that it gets more value from the access than the tax it must pay. The Tiebout model legitimizes the tax.

Once it is understood that the fundamental modern function of the corporate tax is to tax access to public stock markets, the tax can be rationalized and simplified. The expensive and distortionary miscalculation of income is not necessary to the function.

A market access tax can be at a trivial rate and still replace the revenue from the corporate tax. The market value of stock listed on U.S. markets is at least \$18.5 trillion¹⁵ and the market value of debt is \$20 trillion¹⁶ for a combined value of market capital of \$38.5 trillion. The corporate tax, projected to yield \$261 billion in 2007, could be raised by an annual tax of 0.261/38.5 or about 0.66 percent a year. If the tax were a quarterly tax, for the quarter's access to market liquidity, the tax would be 0.166 percent per quarter or about 17 basis points per

¹⁴Charles Tiebout, "A Pure Theory of Local Expenditures," 64 *J. Pol. Econ.* 416, 418 (1956).

¹⁵As measured by Wilshire 5000 index, which attempts to reach all marketed stock for which quotes are available, <http://www.wilshire.com/Company/PressRoom/PressReleases/Article.html?article=WArelease072002.htm> (Feb. 20, 2007).

¹⁶Excluding government issues, the value of debt traded on a market was \$16.2 trillion in 2005, which extrapolates to \$20 trillion for 2007 at the 10-year average of 11 percent annual growth. U.S. Census Bureau, Statistical Abstracts of the United States 2007, Table 1180, "Volume of Debt Markets" (2005):

Corporate debt	\$5.0 trillion
Mortgage-backed securities	\$5.9 trillion
Asset-backed securities	\$1.9 trillion
Money market securities	\$3.4 trillion
Total	\$16.2 trillion * (1+11%) ² = 20 trillion.

¹⁰See, e.g., Rudnick, *supra* note 1, at 1115.

¹¹*Id.*

¹²Marjorie E. Kornhauser, "Corporate Regulation and the Origins of the Corporate Income Tax," 66 *Ind. L. J.* 53 (1990).

¹³Craig Doidge, G. Andrew Karolyi, and Rene M. Stulz, "Has New York Become Less Competitive in Global Markets? Evaluating Foreign Listing Over Time," NBER Working Paper 13079 (May 2007), available at <http://www.nber.org/papers/w13079>.

quarter.¹⁷ Given the need for revenue, it is proposed that the tax rate be 20 basis points a quarter or 0.8 percent of market value per year. A 20-basis-point-per-quarter tax would yield \$308 billion per year under current conditions.

The drop from a marginal rate tax of 35 percent to a marginal tax rate of 20 basis points will reduce the tax planning that is rational for corporations to undertake. Taxes do their harm at the margin, as taxpayers plan to avoid the high marginal taxes. At 20 basis points per quarter, most corporations will view the tax as a nuisance-level tax at worst, and well worth paying to gain market liquidity.

III. Explanation of Provision

The proposal would adopt a 20-basis-point-per-quarter tax imposed on the issuer on the fair market value of stock and debt traded on an established market. It would provide an exemption from section 11 (corporate tax) for those corporations subjected to the new 20-basis-point-tax.

The tax would be calculated by the IRS on the basis of published information on the fair market value of stock and debt. Calculation by the IRS would ensure that a uniform rule was used across the nation. Calculation by one agency would save tax calculation time nationally because there would be only one agency that would do the calculation rather than hundreds of thousands of corporate accounting departments. The IRS would send bills for the tax and collect the amount due by the ordinary debt collection process. Perhaps it is also possible to remedy failure to pay with the same remedy the electric company uses: Exclude stock of delinquent companies from listing and use of market sale and clearing facilities.

Stock is highly volatile. Values reached by a corporation's stock today might disappear or triple within a short time. The current fair market value is the summation of the best educated appraisals of what the security will be worth in the future, but the appraisals are not locked in amber. The best remedy for values that remain the same for only a short time is to impose a small tax, recalculated many times a year, rather than a large tax calculated on what might be an ephemeral value.

Some small corporations might have the capacity to suppress the value of their stock or debt on the doomsday at which market value is ascertained. One partial remedy is that the IRS would ascertain the day within a quarter by a random process after the date has passed. The IRS might print dates on air-tossed ping balls and ascertain the last quarter's doomsday date at the end of each quarter according to what date the machine pops out.

A vice of the current corporate tax is that it gives an incentive to acquire capital in exchange for debt. Debt is not subject to the corporate income tax, because the interest paid on the debt is deducted from the amounts subject to 35 percent tax. The deduction is a fault of the

corporate tax system because it gives corporations an incentive to adopt capital structures that have too much debt and are vulnerable to liquidation by creditors even with modest downturns in the business cycle. It is thus important to include marketable corporate debt as well as marketable stock in the tax base. Exclusion of debt from the new tax base would require a 41-basis-points-per-quarter tax to yield the target \$308 million revenue.

Indeed, once the tax is rationalized as a tax on market liquidity rather than a tax on badly defined income, publicly traded debt not issued by corporations can be included in the tax base. Including marketed debt other than corporate debt increases the tax base by \$10.2 trillion (2005 figures).

Partnerships whose interests are publicly traded and corporations that have avoided corporate tax under current law would pay the market access tax because they have market access. For publicly traded entities that pay little or no corporate tax, the market access tax would be a tax increase. It is a fault of the current tax system that some entities report no income, even with a large market value for their shares. The fault induces business entities to use the partnership form and suppress corporate taxable income.

For corporations that report taxable income approximating economic income, the shift to a market access tax will represent a sizable tax cut. Assume, for instance, a corporation with \$100 million in assets and \$50 million in marketable debt. Assume it makes and reports taxable income of 10 percent of equity or \$5 million and pays tax at 35 percent or \$1.75 million. Under the 20-basis-point market access tax, the corporation would pay four \$200,000 fees or \$800,000 a year, less than half of what it is now paying.

The tax should be imposed on all outstanding stock of the same class as market stock, but it would not apply to privately placed stock or debt that is not substantially identical to marketed stock. At some point, the tax base might have to be expanded to protect the flanks and cut off end runs around the tax, but it does not look as if that will be necessary at present. Rule 144A of the Securities Act of 1933 allows institutional investors to take securities issued in a private placement for resale among institutional investors. The institutional resales are a partial substitute for a public market and give institutional holders a degree of liquidity. One recent study, however, found a robust 17 percent of market value premium for listing on a U.S. exchange, but could find no enhancement of value for Rule 144A private placements.¹⁸ Private placements thus do not appear at present to be elastic substitutes for full market access.

With a derivative instrument or "swap," an investor can achieve the economic benefits of ownership of stock without actually owning the stock. A swap is a private contract by which an investor agrees to pay amounts by which the stock value is below some set index and will receive, under the contract, the amount by which the stock does better than the index. Swaps evolved from real borrowing and the index was interest due at a fixed rate.

¹⁷A "basis point" is 0.01 percent. One hundred basis points equals 1 percent.

¹⁸Dodge, Karolyi, and Stulz, *supra* note 13.

The perception that allowed the derivative revolution was that real borrowing of the principal amount was not necessary to either the borrower's or creditor's economic needs. Thus a notional principal amount replaced the real borrowing. According to an International Swaps and Derivatives Association market survey, from July 1, 2005, to June 30, 2006, \$12 trillion in equity derivative swaps, measured by notional principal amount, were outstanding.

When notional principal amounts are traded on a well-developed market, there is no reason to exclude the contracts from the small-market fee tax. It should be noted, however, that most swaps are set to have no value to either side at the start, and value arises only because of changes in relative value of the stock and index. The notional principal amount of a swap is never the measure of the fair market value of the contract to either side. Swaps are secondarily of value to the corporation that issues stock in providing another source of liquidity for investors, but the corporation does not in fact get capital to use when swaps are issued. For the present, it is assumed that the market capitalization tax need not extend to swaps and other derivatives. The conclusion, however, is tentative, and the tax would be small enough that it might well be imposed on market-listed derivatives. The broader the base, the lower the rate can be to the benefit of all.

It is assumed that the tax would be imposed on U.S. exchange value even when a corporation lists stock on foreign exchanges. Thus the recent study that found a 17 percent enhancement in value of stock for listing on a U.S. exchange could find no enhancement for listing on the London exchange. Perhaps it might be necessary to protect the tax avoidance flanks of the tax at some point. If a well-developed Cayman Islands exchange arises, it may be necessary to treat the Caymans as a suburb of Greenwich, Conn., and include the Cayman exchange in the base. Or if U.S. brokers shunt U.S. trades for U.S. customers over to some foreign exchange, it might be necessary to expand the tax base to include the easy substitutes. For now, it is assumed provisionally that the value of U.S. exchange trading is so high that taxes to protect the flanks are not necessary.

If the 20-basis-point market capitalization tax is a tax only on the net benefits achieved by access to U.S. equity markets, there is no reason to give a credit against the 20-basis-point tax for tax paid to a foreign jurisdiction. The tax is an entrance fee for U.S. benefits under U.S. control. Even if a protect-the-flanks tax is imposed on foreign trades at some point, it would be a tax imposed because of purely U.S. connections.

It may well be necessary to retain a reduced-level section 11 corporate tax for some transition period to fit into the network of international tax treaties. Tax paid to foreign jurisdictions on foreign income is a credit against U.S. tax imposed on a worldwide basis. In some cases, foreign jurisdictions *may* have made concessions to the United States in tax treaties so that the foreign tax could be credited against U.S. tax. A reduced-level section 11 tax would disappear in practice if credit limitations were lifted, but at least nominally the tax would still be in place. Credits negotiated in treaties would still be in place at least for some transition period.

It may also be necessary to retain a small section 11 tax so that it can be fully offset by tax credits enacted in recent years. Recent credits include the credit for producing fuel from a nonconventional source (section 29), credit for qualified electric vehicles (section 30), credit for Puerto Rico economic activity (section 30A), credit for farm and public transportation gasoline (section 31), credit for alcohol used as fuel (section 40), credit for biodiesel used as fuel (section 40A), credit for increasing research activities (section 41), credit for low-income housing (section 42), credit for enhanced oil recovery (section 43), credit for expenditures to provide access to disable individuals (section 44), credit for electricity produced from some renewable resources (section 45), Indian employment credit (section 45A), credit for clinical testing expenses for specific drugs for rare diseases or conditions (section 45C), credit for new markets (section 45D), credit for small-employer pension plan startup costs (section 45E), credit for employer-provided track maintenance (section 45F), credit for railroad track maintenance (section 45G), credit for production of low-sulfur diesel fuel (section 45H), and credit for production of oil and gas from marginal wells (section 45L). All these credits would have to be made nonrefundable because they were adopted as offsets to an unpopular tax. The credits that would survive under the cost scrutiny appropriate to government budget items can be reenacted as government spending items.

In transition, it is assumed the section 11 tax would also remain in place for corporations whose stock is not publicly traded. Under the check-the-box regulations, those corporations had the initial choice to organize in a way to avoid corporate tax. In the long run, subchapter S or partnership treatment should grow so that all nonpublicly traded business entities are passthrough entities. To encourage a quicker transition to the long run, the low 15 percent and 25 percent tax brackets in section 11 should be thinned to equal the low brackets available to estates and trusts in section 1(e). A corporation should not itself be a tax shelter.

Making publicly traded corporations tax exempt — except for the small quarterly tax — will open some selective loopholes that would have to be managed. For example, a nontraded business entity with large appreciation on its assets might list itself on a stock market for one quarter, sell the assets, and delist. A high-tech venture might deduct millions of dollars of R&D when it is an off-stock-market entity but reap all the fruits of that R&D after its IPO has turned it into a tax-exempt entity. The perpetual quarterly market liquidity tax is an adequate replacement for corporate tax on average and in the long run, but it is not sufficient for *pre-IPO* gain reported only after the entity has become tax exempt. The necessary remedy is to tax the built-in gain at the time of the IPO. The built-in gain can be computed simply as if the IPO were the formation of a new corporation and the gain is the proceeds of the IPO less the net cash and aggregate basis of the assets put into the entity. Some discount from 35 percent tax might be allowed because the tax will not be deferred beyond the IPO. Business entities might also be encouraged to sell appreciated assets, at arm's length, before the IPO to get a lower than

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35 percent tax. Encouraging arm's-length sales will improve the accuracy and ease of the tax on appreciation.

I assume that it is not now necessary to adopt any special remedies for transactions between a tax-exempt listed corporation and a still-taxable related entity. If two entities are truly members of a common pool or economic group, it would be rational to attribute all revenue to the

tax-exempt member and all expenses to the taxable member of the group. I assume that public shareholders of a listed corporation, however, would insist on receiving the revenue attributed to them for tax, and that would offset the tax advantages to the nontraded related entity. This is a tentative conclusion, however, and it should be abandoned if experience warrants it.