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WE NEED TO RAISE TAXES FOR SHAREHOLDERS AND CUT THEM FOR COMPANIES

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During this year's presidential campaign, both Donald Trump and Hillary Clinton have suggested changing the taxes imposed on corporate income. Trump has proposed cutting both corporate and shareholder taxes, and Clinton has proposed raising them. Unfortunately, both candidates have overlooked a way to make the taxes better, reducing tax avoidance and improving living standards for American workers.

Corporate income is taxed at two different levels. A company pays corporate income tax on its profits, and then its shareholders pay an additional tax on any dividends the company pays from its after-tax profits. If the company reinvests the profits, the shares become more valuable and shareholders pay tax on the resulting capital gains when they sell the shares. Dividends and capital gains are taxed at a lower tax rate than ordinary income, and the capital gains tax burden is further reduced because the tax is delayed until the shareholders sell (and is never paid if the shareholders die before selling).

Trump has proposed lowering both corporate and shareholder taxes by slashing the corporate rate from 35% to 15% and removing a surtax that applies to dividends and capital gains. Clinton has proposed raising both taxes by removing some corporate tax breaks, raising capital gains tax rates on assets held from one to six years, imposing a surtax on high-income taxpayers, and taxing some capital gains on assets held until death.

These kinds of proposals are a prescription for partisan deadlock; it's unlikely that Republicans and Democrats will ever agree on whether to raise or cut taxes on corporate income. But there is a better way, one that could be acceptable to both parties. Without changing the overall level of taxation on corporate income, we can strengthen the economy, maintain current levels of tax revenue, and keep the tax system at least as progressive as it is today. We just need to shift much of the tax on corporate income from the corporate to the shareholder level.

The corporate profits tax has fundamental problems that shareholder taxes don't. A corporation's U.S. tax liability depends on two concepts that are hard to define but easy to manipulate: the location of the corporation's legal residence and the location of its profits.

A multinational corporation faces higher U.S. taxes if its parent company is considered a U.S. resident than if not. Although corporations don't really "live" anywhere, Congress has defined a corporation's residence as the location where its charter was issued. A charter is a piece of paper that gives the corporation the legal authority to do business; the place where it is issued may have little connection to the location of the corporation's production, employment, or sales or to where its shareholders live.

A corporation also faces higher U.S. taxes if its profits are deemed to have been earned in the United States. Determining where profits are earned may seem easy, and in some cases it is — the profits from producing steel are earned where the steel factory is located, for example. But what about the profits that come from a company's brand name or know-how or from its patents? There's no good way to determine where those increasingly important intangibles are located.

How do corporations respond to these tax incentives? Just the way you'd expect. They shift the location of their residence and their profits from the United States to lower-tax countries. For example, they move corporate charters abroad through inversion transactions, and they move profits abroad by investing outside the United States or by using transactions that shift ownership of intangible assets and reported income to their affiliates in tax havens in which they have little production or sales.

Shareholder taxes don't face these problems. U.S. taxes on dividends and capital gains apply to the worldwide dividends and gains of shareholders who are residents or citizens of the United States. Individuals' citizenships and residences are fairly easy to define and pretty hard to manipulate. Although shareholders can move abroad and renounce their citizenship, that's a lot more costly than companies changing their corporate charter or shifting their reported income to tax havens.

So, a better way to tax corporate income is to collect less from the corporate income tax and more from shareholder taxes. We recently outlined a plan to do just that.

We propose slashing the corporate tax rate from 35% to 15% and increasing tax rates on dividends and capital gains, taxing them at the same rates as ordinary income. Simply raising capital gains rates, however, is not sufficient because under today's rules shareholders can delay paying capital gains tax by postponing sales of their stocks or avoid the tax entirely by holding them until death. Taxing capital gains realizations at today's ordinary income rates would create overpowering incentives to avoid the tax.

To solve this problem, we propose taxing capital gains each year as they accrue. If share prices went up during the year, the shareholder would be taxed on the increase in value, even if she hadn't sold her shares. If share prices went down, the shareholder would deduct the loss, even if she hadn't sold. Nobody could delay capital gains taxes or escape them entirely by hanging on to their shares until death. Our plan includes provisions to smooth out the swings in tax liability that would arise in volatile stock markets, and we exempt small shareholders from capital gains and dividend taxes altogether.

The plan would raise about the same amount of revenue as the current tax system, and the tax burden would be divided among income groups about the same as now: The highest-income groups would pay a little more and everybody else would pay a little less.

The United States would move from having the highest statutory corporate tax rate in the developed world to having one of the lowest. Incentives to move corporate charters abroad, to invest abroad, and to book profits abroad would be far smaller than they are now. The result would be greater investment in the United States, which would expand the country's capital stock, making American workers more productive and driving up their wages.

Let's sidestep the contentious debate about whether taxes on corporate income should be higher or lower. Let's just make those taxes better. Shifting these taxes from the corporate to the shareholder level would give us a better tax system and a stronger economy.

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