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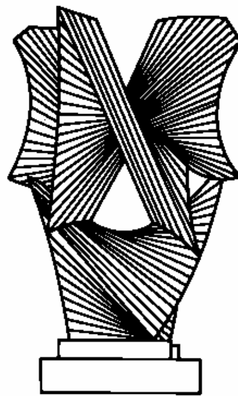

The Irreducible Complexity of Firm-Level Income Taxes: Theory and Doctrine in the Corporate Tax

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January 11, 2007

Abstract

This paper argues that firm-level income taxes have an irreducible core of complexity, stemming from the ability to hold and sell an asset in two ways: directly and through the stock of a subsidiary. Both methods of selling must be taxed but coordinating the tax at each level, stock and assets, leads to complexity and line drawing. There are two implications. First, much of the doctrinal rules found in the current corporate tax can be explained through this overarching framework. Second, reform proposals will not be able to eliminate the core of complexity. The Comprehensive Business Income Tax is used as an example: the paper argues that it will inevitably have much of complexity associated with the current corporate tax.

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The Irreducible Complexity of Firm-Level Income Taxes: Theory and Doctrine in the Corporate Tax

David A. Weisbach[*]

January 11, 2007

This paper will argue that firm-level income taxes have an irreducible core of complexity. The complexity arises because firms can hold assets two ways: directly or through a subsidiary. Dual ownership, as I shall call it, creates complexity because it creates the possibility of multiple realizations of the same economic income. We must measure income at both levels to prevent easy avoidance. If we only tax assets, the firm can sell the stock. If we tax only stock, the firm can sell the assets. Attempting to measure income at both levels, however, requires coordination of the taxes at each level. In theory, every asset sale and every stock sale should produce the same result. This level of coordination, however, is infeasible. The resulting compromises needed to produce an administrable system cause the mis-taxation, complexity, and incoherence we associate with current firm-level tax systems. There is no way out of this dilemma.

There are two payoffs to the analysis. First, the analysis can help clarify current firm-level tax doctrine. Many of the complexities of firm-level taxes arise out of the dual ownership problem. For example, the formation, distribution, and acquisition rules (both taxable and tax-free) of the corporate tax, which make up the vast majority of corporate tax doctrine, can be seen as direct consequences of the dual ownership problem. The same holds for partnership taxation: the formation, distribution, and inside/outside basis adjustment rules in the partnership tax regime arise from the problems created by dual ownership. The dual ownership problem, in a sense, provides an overarching framework for understanding doctrine.

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[*] Walter J. Blum Professor, The University of Chicago Law School. I thank participants at the Harvard Law School Colloquium on Tax Research for comments.

Second, the analysis tells us the extent to which all firm-level income taxes, whether reforms of current law or written on a blank slate, will remain complex. That is, it gives us a sense of the potential simplification gains from reform. The claim is that the simplification gains may not be large because any system will have an irreducible core of complexity due to the dual ownership problem. Of particular interest, in 1992, the Treasury Department proposed a new method of taxing income at the firm-level, known as the Comprehensive Business Income Tax (CBIT).[1] On its face, it is an exceedingly simple method of measuring income at the firm level and, therefore, it holds promise as a tax reform. I will argue that it will end up with the irreducible core of complexity created by the dual ownership problem. While potentially a promising reform for other reasons, the simplification benefits may be less than they otherwise appear.

I will approach the problem using CBIT as a model of a firm-level income tax. CBIT represents the purest, simplest firm-level income tax, and if CBIT has these problems, all firm-level income taxes will as well. Part I will show how CBIT is derived, how it relates to Haig-Simons income, and how it relates to other firm-level income taxes. Part II will illustrate how the dual ownership problem plagues CBIT. CBIT must tax both stock sales and asset sales or be at risk of taxing nothing.

Part III shows how solutions to the dual ownership problem give rise to doctrines resembling those of the current corporate tax, including rules for formations, distributions, and tax-free and taxable acquisitions. That is, Part III shows how existing doctrine can be understood in light of the dual ownership problem. CBIT and, indeed all firm-level income taxes, will face these doctrinal problems. Although partnership tax doctrine can similarly be understood, to keep the discussion manageable, I will focus on corporate tax doctrine.

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[1]The Department of the Treasury, Integration of the Individual and Corporate Tax Systems, Taxing Business Income Once (1992).

Part IV considers possible solutions, focusing on Bill Andrews's 1982 ALI Report for reform of the corporate tax, and the accompanying 1984 Senate Finance Committee Report. These reports are the most thorough rethinking of corporate tax doctrine to date, and I will argue that, although they are potential improvements over current law, they cannot solve the dual ownership problem. In fact, one way of understanding these proposals is as a method of drawing lines to minimize the problems created by dual ownership. Part IV will also discuss George Yin's proposal for reform of the corporate tax. Yin claims that under his reforms, stock sales need not be taxed, directly contrary to the claim made here, that all firm-level taxes must tax stock sales. I will argue that stock sales still would still need to be taxed even if his reforms were enacted.

Before turning to the analysis, it is worth making some preliminary comments. First, the realization requirement underlies all of the analysis in this paper. In a sense, the paper can be seen as an elaboration of Bill Andrews's Achilles' Heel argument about the centrality of the realization requirement to implementing income taxes.[2] For example, the realization requirement is, arguably what gives rise to the need for firm-level taxes. If we imposed only an individual-level income tax with the realization requirement, individuals could park assets in shell corporations and avoid taxes on capital income. Firm-level taxes, whether collected at the firm-level or calculated at the firm level and passed through to owners, can be seen as a necessary back-up to individual-level income taxes that rely on realization. Moreover, if the realization requirement could be eliminated, firm-level taxes would be easy to collect: firms would merely have to pay taxes on the change in value of their securities each period. Without the realization requirement, there would be no irreducible core of complexity. Thus, the realization requirement drives the analysis here. The difference with Andrews's argument is the focus here is on explaining the details of firm-level tax doctrine rather than on critiquing income taxation.

[2] Cite.

Second, any discussion of existing corporate tax doctrine inevitably runs into the question of the double-tax on corporate income. Large portions of the current corporate tax doctrine might have arisen because of double-tax issues rather than because of problems related to dual ownership. Taxes on stock sales, for example, can be seen as resulting from a desire to tax individual income separately from firm income, rather than as an inevitable result of firm-level taxation.

To avoid double-tax issues to the extent possible, I will use examples involving corporate ownership of stock, such as the ownership of a subsidiary, a joint venture, or portfolio shares. Even in our current double tax system, we attempt to impose only a single tax on this type of ownership. Therefore, we can view the relationship between a firm and a subsidiary, joint venture, or other stock ownership, as a single-tax relationship and examine existing doctrine from that perspective. That is, the same dual ownership problems arise in an integrated tax system and under current law for firm ownership of other firms.

The ALI and Senate Finance Reports were in the tradition of the double tax. They were, in fact, attempts to strengthen the two-level tax system. Discussing these reports, therefore, risks raising issues unique to implementing a two-level tax system that would not arise in an integrated system. Many of the examples from those reports have individual shareholders who are separately taxed on dividends and stock sales. The discussion should, I hope, make clear that the issues would remain in an integrated system.

Third, I need to define what I mean by a firm-level tax. The incidence of all taxes is on individuals, not firms. At most, firms can remit taxes. They can be legally liable for taxes in the sense that sanctions will be imposed for failure to remit, but the incidence of any sanctions is ultimately on individuals. They can also be withholding agents, remitting taxes on behalf of individuals, with the individuals ultimately liable for the tax. Withholding taxes can alternatively be final or they can be subject to reconciliation on an individual's return. Withholding can be based on

various levels of information provided to firms and, therefore, can be variously tailored to the circumstances of the individual. The difference between these systems is not particularly clear. For example, it is not clear whether taxes paid by firms in a credit imputation system (in which dividend recipients get tax credits for firm-level taxes) are business level taxes. Firms are legally liable for the taxes and the amounts remitted by the firm are based purely on attributes of the firm not the owners, but there is a reconciliation of taxes on owners' returns and the tax ultimately imposed on the business earnings depends on the attributes of the owners. Similarly, the current law partnership tax regime measures income at the firm-level but requires the partners, not the firm, to remit the taxes. The regime is a mixture of firm and individual-level taxation.

I am concerned here with the measurement of income at the firm level. Thus, the current law partnership regime and a credit-imputation regime are both within the scope of my inquiry. Remittance by firms and reconciliation of tax liability on individual returns both raise issues beyond the scope of discussion here. For example, remittance by firms raises issues about economies of scale in tax compliance, tax auditing, and tax sheltering. Reconciliation of tax liability on individual returns raises issues about whether capital income should be taxed under a graduated rate schedule or otherwise adjusted for individual attributes. These issues are difficult and important. I am concerned here merely with whether income can be measured at the firm level and, therefore, will not generally discuss these issues.

Fourth, the claims made here are not arguments against measuring income (or remitting tax payments) at the corporate level. An argument for or against measuring income at the corporate level would have to compare such a measurement system with other possibilities. Notwithstanding the inevitable difficulties it will present, corporate-level measurement of income may very well be the best method available, primarily because corporations stand at the cross-roads of most

transactions.[3] The argument is not a comparison of corporate to other tax systems and, therefore, does not draw any conclusions about appropriate place to measure income. Instead, it is an attempt to understand the causes of the seeming incoherent, arbitrary lines of everyday corporate tax practice. Similarly, the argument is not about whether we should impose an income tax or a consumption tax. It is about trying to understand how firm-level income taxes work.

Finally, the claim made here is that dual ownership is the core feature of firm-level income taxes, giving rise to the complexity and familiar doctrines we associate with these taxes. It is important to acknowledge, however, that dual ownership has long been recognized as a problem. For example, both the 1992 Treasury study and the 1992 ALI integration study recognized the problems discussed here. The ALI integration study devoted an entire chapter to the problem of taxing stock sales differently than asset sales.[4] Similarly, the ALI 1982 study can be seen as centrally focused on the problems created by dual ownership. Indeed, it is standard to note that firm-level taxes might be needed as a back-up to an individual realization-based income tax because of the ability to park investments in firms, a version of the dual ownership problem. Thus, recognition of the problem is not new. What is new is the claim that dual ownership is the central feature explaining complexity and doctrine in firm-level income taxes.

I. Deriving CBIT and Simple Firm-Level Income Taxes

As noted, I will use CBIT as the paradigmatic firm-level tax. To set the background, this section discusses how CBIT works and how it is related to definitions of income such as the Haig-Simons definition. In particular, income, traditionally defined, has nothing to do with

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[3]Richard M. Bird, Why Tax Corporations?, International Centre for tax Studies, University of Toronto, Working Paper 96-2, at 10.

[4]See p. 115-134.

businesses. It is consumption, which can only be done by individuals not firms, plus change in wealth during a period. Under Haig or Simon's notions, income is a personal attribute, Simon's "command over resources." The question is how business-level taxes come into the picture.

The connection is based on the identity of Haig-Simons income with national product. Al Warren illustrated the identity with the example of an agrarian society that only produces corn.[5] The government could impose a society-wide Haig-Simons income tax at, say, a 10 percent rate. Each individual would remit to the government 10 percent of his corn. If, alternatively, the government merely confiscated 10 percent of the corn as it was harvested, the tax would be identical, both in terms of overall burden and the burden on each individual. Thus, the government can alternatively collect an income tax by taxing Haig-Simons income or by taxing output or product.

Note under both the Haig-Simons approach and under the product approach, the return to investing (i.e., capital income) is taxed. Suppose, for example, that some of the corn is to be replanted rather than consumed. In the product formulation, the government would take 10% when first harvested and also 10% of the corn grown from the replanted corn, reducing the yield to investments, as we know income taxes do. The same holds for the Haig-Simons formulation, as has long ago been demonstrated.

The Haig-Simons formulation is important, as Warren points out, only if we desire to allocate product to individuals in society. We might want to do this so that each individual's tax can be calibrated to their circumstances. The Haig-Simons formulation, for example, allows graduated rates based on an individual's or family's income. If income is measured purely at the business level, we cannot calibrate the tax on the

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[5]Alvin Warren, Would a Consumption Tax Be Fairer Than an Income Tax? 89 Yale L.J. 108, 1083-1090 (1980)

income to individual circumstances because we do not know anything about the ultimate consumer. In the corn example, if the tax is collected in the field as the corn is harvested, we have no idea who will eat the corn and, therefore, cannot impose a rate structure that reflects such facts. If instead, we wait to find out who eats the corn, we can impose different rates on those who get a lot and those who get little.

The product definition of income should translate into a simple and coherent business income tax. Because product is produced by businesses, broadly defined, we can impose an income tax by taxing all businesses directly on their output. The simplest model of such a tax is called an income VAT, or more ponderously "a value added tax of the income type."[6]

David Bradford explained this well and the following paraphrases from him.[7] A normal VAT works by taxing the output at each level of production on a cash-flow basis. I shall use a running example to illustrate. Suppose that a manufacturer builds a machine from raw materials and sells it to a producer for $70. The machine has a 10-year life and produces output which is sold for $10 each year. Total consumption from the machine is $100 (10 years of $10 per year). In a normal (consumption) VAT, the manufacturer would pay a tax on its sales receipts, in this case $70. The producer would deduct its $70 cost when paid (or receive an equivalent credit) and include its $10 receipts each year. There is no net tax on the manufacturer's $70 of taxable receipts on the sale because it is offset by the producer's $70 deduction. On the retail sale, however, the producer will have $10 of taxable receipts each year, and the consumer cannot deduct his cost. The net effect is to tax the $10 of output each year, as it is consumed.

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[6]To my knowledge, the idea was first introduced by Carl Shoup. See, cites. David Bradford reintroduced the idea in David F. Bradford, Fundamental Issues in Consumption Taxation (1996), pp. 15-17.

[7]David F. Bradford, Fundamental Issues in Consumption Taxation (1996).

Note that in a cash flow tax, financial flows are ignored. In the Meade Commission terminology, the tax is real or R-based.[8] Financial flows can be thought of as ways of allocating the rights to real flows to various owners. If the manufacturer was owned by stockholders and had borrowed money, the interest, principal, dividend, and liquidation payments would merely be a way of allocating the $70 receipt to the owners.[9] Because we are collecting the tax purely at the business level, we do not care how the flows are allocated to individuals. We can, therefore, ignore these flows, and VATs around the world take this approach.

Suppose instead of a cash-flow system with immediate deductions for purchases, businesses were required to depreciate their purchases as their value goes down over time. That is, suppose we switch from a consumption tax method of cost recovery to an income tax method while retaining all the other features of the VAT. The manufacturer would still be taxed on its $70 sale. The producer, however, would not be able to deduct the $70 right away. Instead, it would have to capitalize the cost of the machine and recover it through depreciation deductions over its useful life. Suppose for simplicity, that the proper depreciation were straight line, $7 per year. (This is not quite right given the assumptions about the output of the machine, but it is sufficient to illustrate the point.) Each year, the producer would have a net $3 of income each year, consisting of $10 from the sale of its output and a $7 depreciation deduction. The total, between the manufacturer and the producer would still be $100, broken down as $70 to the manufacturer in the first year and $3 per year for 10

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[8] Institute for Fiscal Studies, The Structure and Reform of Direction Taxation: The Report of a Committee Chaired by Professor J.E. Meade (1978).

[9] The manufacturer might have borrowed from a financial intermediary, but that intermediary must ultimately have borrowed from an individual or other “end unit” taxpayer, such as a state or local government or a tax-exempt institution.

years for the producer.[10] The total amount is the same as in the VAT, but the timing has changed. The original consumption VAT taxed the output of the machine when it was consumed. The modified VAT moved the timing up, to the time when the production activities led to an increases in value of the goods to be sold.

The modified VAT, which I will call an income VAT, is an income tax collected entirely at the business level. To see this, imagine that we taxed the individual owners of these businesses under a Haig-Simons method. The owner of the manufacturer would have a $70 gain when the manufacturer sold the machine. The owner of the producer would have no gain or loss on the purchase of the machine because the producer has just exchanged $70 for something of equal value. Each year, as the machine produces output, the owner would have $3 of income because that is the increment to value each year. This is the same pattern as in the simple corporate income tax. Thus, the simple corporate income tax measures income. The tax is identical to a VAT except that it uses income tax cost recovery instead of the cash flow system, hence the name, income VAT. This will be the paradigm simple system.

CBIT works just like an income VAT except that businesses are allowed to deduct wages and individuals are taxed on wages. The advantage of thus moving the collection of the tax on labor income to the individual level is that the labor income portion of tax can be adjusted for individual circumstances. This shifting of the collection point for labor income does not undermine the basic idea behind the income VAT. It should also not affect any of the problems addressed below and, therefore,

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[10]We can break down the $100 in other ways. For example, we can treat the $70 of depreciation deductions as offsetting the tax on the $70 of receipts by the manufacturer. The breakdown is unimportant. The only point of the test is that the total income remains $100.

we can imagine the simple corporate tax system as either the income VAT or CBIT.[11]

Note that financial flows are not taxed under the income VAT or CBIT. Income is measured by taxing the output directly, and it is not necessary to determine how that output is allocated to individuals through their ownership interests in the business. There is, at least in theory, therefore, no need to look at financial flows. The income VAT, in this regard, is just like an R-based consumption VAT except the cost recovery mechanism has changed. The discussion of CBIT by the Treasury is clear that interest and dividends are not deducted at the business level nor taxed at the individual level. It is vague on capital gains, however, with a discussion but no clear position in the issue.[12] I shall assume because we are trying to impose a purely business level tax, individual level capital gains they are not taxed on the theory that they need not be to measure product.

We can move in two steps from CBIT to a system roughly resembling current law. First, we would allow businesses to deduct interest on debt and tax holders of debt. This merely shifts the collection point for interest income, but by doing so, we can tax interest at the rate relevant to its recipient. This shift would be far from trivial because it creates the debt/equity distinction. Moreover, there are many tax-exempt or foreign holders of corporate debt, which means that the tax rate on interest income would change dramatically. The system at this point looks

[11]The Flat Tax and Bradford's X-tax are consumption tax versions (i.e., cash flow) of CBIT. CITES. They operate just like a consumption VAT with a wage deduction at the business level and tax at the individual level. They have the same advantage over a consumption VAT that CBIT has over an income VAT, which is that the tax on wages can be individualized.) Schlunk [date] takes the CBIT idea the furthest, attempting to identify all implicit financial flows and eliminate them from the tax system.

[12]Treasury Report at 83-84.

like the dividend exclusion system proposed separately by the Treasury in 1992 and also by the Bush administration in 2003.[13]

Second, we could add a tax on dividends paid to individuals. This creates the double level tax on dividend income. Thus, it should be evident that anything said about inherent complexities in CBIT is likely to apply to systems more like current law. Section _ below will discuss this claim more explicitly.

Note also that we can move from CBIT to other proposed or actual corporate tax systems. For example, if we take CBIT, add interest deductibility and dividend taxation, like above, and in addition, grant a credit to shareholders for taxes paid at the corporate level, we get the credit imputation system of corporate integration. Alternatively, we could allow dividends to be deducted at the corporate level to create the dividend deduction system.

Finally, we could shift the requirement to remit taxes from the business to the owners. Income would still be measured at the business level but the business would merely report it to the owners who would be responsible for the tax. This gets us to the current law partnership and S corporation regimes and the so-called "shareholder allocation" corporate tax regime (nowhere used, as far as I know). Although the doctrinal details of the various regimes will vary, the central problem of income measurement when there is dual ownership remains.

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[13]Treasury Report at 17-26. The system had complicated rules for determining when dividends were excludible because the Treasury only wanted dividends to be excludible to the extent they represent income for which the business had previously paid tax. It is not necessary to consider these here because we are considering pure systems. CBIT included similar rules and we also skip those here.

II. Dual Ownership and CBIT

The central claim of this paper is that the possibility of dual ownership, owning assets directly or through the stock of a subsidiary company, creates an inevitable core of complexity in firm-level income taxes. This section will illustrate this claim. It will show that if CBIT ignores stock ownership, it can be converted, through simple tax avoidance techniques, into a consumption tax. Both stock and assets must be taxed to prevent this avoidance. Moreover, they have to be taxed identically. If not, sales of one or the other will necessarily under or over-tax income. Taxing stock sales and asset sales identically, however, is too complex to be implemented on any wide-scale basis. The inevitable partial fixes lead to the types of line drawing and incoherence associated with firm-level income taxes.

A. *Ignoring Stock Turns CBIT into a Consumption Tax*

Recall that under a subtraction method VAT, there was no net tax on sales between businesses. Only when a product is sold to a final consumer is a tax imposed. Under an income tax, there is a tax imposed on sales between businesses because the purchasing business cannot immediately deduct its costs but the selling business is immediately taxed on the proceeds. Thus, the sole difference between the two taxes is the tax on sales between businesses. An income tax imposes a tax at each stage of production. A consumption tax imposes a tax only on the final retail sale.

If stock is not taxed, a firm-level income tax can be converted through simple avoidance into a consumption tax. To illustrate, consider the manufacturer and producer chain of production discussed above. Recall that in the base case under the income VAT, the manufacturer sold the machine to the producer and faced a tax on the $70 of gain. The producer then received a $70 basis in the machine which it used to offset its receipts, producing a net tax of $3 each year for 10 years. There was $100 of total income imposed at the time of production.

Suppose that stock sales are not taxed. The income tax could then easily be avoided by transferring stock instead of assets. Instead of selling the machine to the producer, the manufacturer could put the machine into a subsidiary and sell the stock of the subsidiary to the producer. This is not taxed because it is a stock sale. The producer could then cause the subsidiary to make and sell the widgets. The subsidiary, as a business subject to the firm-level tax, would pay a tax on the final sale to the consumer.[14] The tax at the subsidiary level would be $10 each year, for a total of $100. The total tax remains the same, but unlike in an income tax, it is imposed only on final sale. This is the consumption tax pattern: there is no tax at the intermediate stage of production; instead, the tax is imposed on the retail sale. Thus, if stock sales are not taxed, it would be relatively simple to convert a purported income tax into a consumption tax.

Note that the same problem does not arise in a consumption VAT. There is no net tax on transactions between businesses so there is no reason to go to the trouble of incorporating the machine and selling the stock. Thus, the firm-level tax system without a tax on stock sales works for a consumption VAT but not for an income VAT. Table 1 below summarizes.

[14]There is an ambiguity in the example, which is that I assumed the contribution of the machine to the subsidiary was not taxed. The reasons that such a contribution is unlikely to be taxed are discussed below. To the extent this is a problem with the example, we can modify the avoidance strategy so that the machine is originally constructed in the subsidiary, thereby avoiding any possible tax on contribution.

Table 1: Consequences of Not Taxing Stock Sales			
	Net tax on sale from Manufacturer to Producer	Net tax on sale by Producer to customers	Total
Income Tax	$70	$30	$100
Consumption Tax	$0	$100	$100
Avoidance technique	$0	$100	$100

There are two caveats to the claim made here. First, it would be too strong to state that the tax would be turned entirely into a consumption tax. Incorporating and selling stock is not cost free, as evidenced by the fact that this is not the normal method of transacting. Nevertheless, it is not particularly expensive and for large transactions the relative costs would be low. The ultimate tax would be somewhere between an income tax and a consumption tax, depending only how expensive the avoidance strategy is for various types of transactions.

Second, one can imagine trying to limit this avoidance technique. We might, for example look through the sale of the stock of a company that does not carry on a sufficient trade or business and tax the assets instead. Our experience with this approach is not encouraging. For example, there are historic or active business requirements found in various sections of the corporate tax regime, but they tend to be complex, arbitrary, and avoidable. Businesses respond by stuffing subsidiary corporations with unwanted assets, waiting arbitrary periods between sales, and holding meaningless board meetings to avoid these doctrines. Finally, such doctrines would not solve the basic problem because so long as a sufficient grouping of assets is sold, there would be no tax on the transaction.

B. *A complete solution is too complex*

An immediate consequence of the analysis above is that firm-level tax systems must impose taxes on both asset sales and stock sales.[15] The argument, however, has a stronger implication: we must tax both ways of owning and selling assets identically. Taxpayers must face the same consequences regardless of which form of ownership is chosen. If the tax is not identical, one form of sale will necessarily result in under or over-taxation. This, I will argue here, requires tax rules that are beyond the tolerable level of complexity. In the next section, I will argue that the resulting compromises create the core of doctrine that we associate with firm-level taxes.

To make the tax consequences of stock sales and asset sales identical, we must have a system of basis adjustments in which any gain or loss in the stock of a firm has to be reflected in the basis of the firm's assets, and any gain or loss in the assets has to be reflected in the stock.[16] To illustrate with the simple facts of the example used above, if the manufacturer sold the stock of the subsidiary for $70, the basis of the machine would be increased by any gain realized by the manufacturer. If, alternatively, the subsidiary sold the machine, the basis of the stock of the subsidiary would have to be increased by gain realized by the subsidiary. If these adjustments are made, selling stock and selling assets would

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[15]There is a subtlety here. We need to impose a tax because of either an asset sale or a stock sale but the tax can be imposed at a single level, such as at the owner level in a pass-through regime.

[16]Alternatively, we could have a pass-through system in which a stock sale is treated as a partial disposition of all assets. This is equivalent or worse in terms of complexity.

Although not inherent in a pure income tax system, if the tax law, for whatever reason, distinguishes certain types of income from other types, as in the capital gains/ordinary income distinction of current law, the character of stock sales and asset sales would have to be conformed, creating another layer of complexity.

always produce identical results and the firm-level tax system would always measure income perfectly.

Although straightforward under the simple facts in the example, the adjustments quickly become difficult in more complex and realistic cases. If the subsidiary has more than one asset, basis adjustments in the assets due to stock sales have to be allocated among the assets. This requires valuation. For example, suppose that a subsidiary had two assets: Asset 1 has a basis of $70, value of $100, and Asset 2 has a basis of $120 and value of $100. If the parent's basis in the stock matches the asset basis, the parent will have a $190 basis in the stock worth $200. Suppose the parent sells 20 percent of the stock of the subsidiary (basis of $38) for $40, creating a gain of $2. The question is how to make basis adjustments to the assets. To make the correct adjustment, the basis in Asset 1 should reflect realization of 20 percent of the gain (a $6 increase) and the basis in Asset should reflect realization of 20 percent of the loss (a $4 decrease). Without valuation, taxpayers cannot determine the appropriate basis adjustments to the various assets.[17] If stock sales occur regularly (say because some of the shares are publicly traded), valuation would have to occur all the time. If the subsidiary has thousands or even millions of assets, basis would have to be allocated among the assets. Partnership tax gurus will recognize as the problem created by the basis adjustments under section 755. Although conceptually sound, the current adjustments are immensely complex. Previous rules that were simpler but imperfect, lead to easy abuses.

Moreover, the adjustments would have to "tier down" through the various chains of corporate ownership. For example, if Asset 1 in our example was a 30 percent of another company owned as part of a joint venture, adjustments to the assets held by the subsidiary would have to include adjustments to joint venture's stock and in turn to the joint venture's assets (and so forth for any stock owned by the joint venture).

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[17] If the tax rate on gains is different than on losses, he taxpayer will have an incentive to make incorrect valuations.

Valuation would have to occur at each level. To make proper basis adjustments, the joint venture would have to know about casual stock sales by the parent (or grandparent, etc.) of its owners, including the amount of gain realized.

Adjustments would also have to "tier up." If, for example, the joint venture realized gain, the basis in its stock held by the subsidiary would have to be increased, which in turn would have to result in an increase in the basis of the manufacturer's basis in the subsidiary. If there is a complex capital structure, with preferred stock, options, and other types of ownership interests, these adjustments would have to be allocated among the various types of instruments. Moreover, because asset sales occur everyday, these adjustments would have to be made constantly.

These types of adjustments exist in various forms under current law but nowhere are they even close to complete. The two places they appear, to a limited extent, are the consolidated return and the partnership tax regimes. Both are cases where the business is closely held by its owners and, therefore, the information requirements are not thought to be too onerous.[18] In the general case of broadly held businesses, no adjustments of this sort are allowed. Moreover, even in the partnership and consolidated return cases, the adjustments are highly imperfect. In general, they go only one way: gain or loss on assets produces an adjustment to the basis of the ownership interests but gain or loss in an ownership interest does not produce an adjustment to asset basis. Partnerships may elect this second sort of adjustment, (gain or loss in a partnership interest produces an adjustment to asset basis), but even in the partnership context, where casual sales of ownership interests are largely

[18]Consolidated returns involve chains of 80 percent owned domestic corporations. There are not adjustments for minority interests (20 percent or less owners). Partnerships can have more dispersed ownership than this, but they cannot be publicly traded.

prohibited, the adjustments are thought to be too complex to require.[19] Adjustments to asset basis for gain or loss from casual stock sales are not allowed, even on an elective basis, in the consolidated return context.[20]

Not only have these adjustments never been adopted in practice, but no proposal for reform of the corporate tax (that I know of) has suggested making these adjustments in any comprehensive manner.[21] The Treasury Department in its 1992 report called comprehensive adjustments "impossible."[22] It went so far as to refuse to recommend the so-called shareholder allocation prototype, which resembles the partnership regime of current law because of its complexity (and even then, the adjustments would have been only in one direction).[23] The ALI integration report similarly rejected such an approach. The Senate Finance Committee 1984 reform proposal and the ALI 1982 report on reforming the double tax system both recommended that stock basis be equal to net asset basis. This is very much like the partnership or consolidated return regimes, where basis adjustments go only one way. Neither proposal recommended anything like full conformity, however. Perfect conformity between stock

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[19]The statute was changed recently to require these adjustments where there are substantial built-in losses. See section 743(a) and the Jobs Act of 2004. As discussed in section II.C. below, without adjustments of this sort, it is easy to replicate losses (as many times as desired). It is not surprising, therefore, that the statute was eventually changed to try to prevent this abuse. The changes to section 743 still only provide for piecemeal adjustments. Only if the 743 adjustments were mandatory in all cases would the statute provide for complete conformity.

[20]There are rules, discussed below, that allow taxpayers to elect to treat major stock sales (roughly more than 80 percent to a single purchaser within a year) similar to asset sales. These provisions are elective and apply only in limited contexts.

[21]Cite to old partnership tax reform proposals that have a full blown aggregate approach.

[22]Chapter 8, footnote 6, p. 219.

[23]The "dividend reinvestment plans" or DRIPs, proposed by the Treasury, however, are a crude method of adjusting stock basis for gain or loss in the assets.

sales and assets sales has uniformly been rejected in both practice and in reform proposals.

III. Solutions to the Dual Ownership Problem Create Common Corporate Tax Doctrines

Section II argued that both stock sales and asset sales must be taxed and that perfect conformity between the two is not possible with a tolerable level of complexity. The result will be a compromise between conformity and undue complexity. We can see firm-level tax doctrine as an attempt to make a reasonable accommodation between the need to tax stock and asset sales similarly and the need to have an administrable tax system.

This section will illustrate how these compromises result in the doctrinal rules associated with current firm-level taxes. To do so, I will divide corporate tax doctrine into three parts: (i) the rules for contributions and tax-free acquisitions; (ii) the rules for taxable stock and asset sales; and (iii) the rules for distributions. I will illustrate how dual ownership underlies doctrinal complexity in each of these areas. In a paper of manageable length, I can only illustrate the doctrinal problems at the broadest level, but the central problem of dual ownership permeates corporate tax doctrine all the way down. The focus here will be on corporate tax doctrine, but the same arguments could be used to analyze partnership tax doctrine. Part D briefly discusses this latter issue.

A. *Contributions and Tax-Free Acquisitions.*

Consider a company (Parent) that wants to contribute a set of assets to a subsidiary or a joint venture. As argued above, a firm-level income tax has to tax both the assets of the subsidiary and the stock of the subsidiary. This means that on contribution, when the stock is created, we have to determine the basis in the stock and in the assets. There are many possibilities.

One possibility is to tax the transfer to the subsidiary. If a corporation transfers an asset, basis of $15, value of $70 to a subsidiary for stock, the transferor would be taxed on the $55 gain, and both the transferor and the subsidiary would take a fair market value basis in their respective items (stock and asset). Like any exchange of assets for other assets, there would be a valuation problem, but this does not generally stop us from taxing other exchanges. We might also worry about losses. If a transfer to a wholly-owned subsidiary triggered a loss, losses could be realized at will. This issue, however is similar to any transfer of loss property between related parties, and the rules that cover those situations could apply (although they are complex).[24]

It has, however, never been thought to be good tax policy to tax contributions, at least on a wholesale basis. Most contributions are, under current law, tax free, although there are (unintuitive and very complicated) limitations, making some transfers taxable. It is hard to find clear and satisfactory statements of the reasons why we have always taken this approach, but it is not hard to imagine what they might be. Taxing all contributions to corporations would make it very difficult for corporations to operate their business through subsidiaries or joint ventures. Given that we have a realization system, realization events must be defined intelligently and with an eye toward the economic effects. A hair trigger for corporate formations seems unlikely to be wise. This policy presumption is so strong that I am not aware of any proposals to completely eliminate the ability to have tax-free formations.[25]

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[24]Note that taxing contributions at first seems to make the problems explored in Section _ above go away because when the manufacturer contributes the machine to S, the gain is taxed and basis in the stock and asset are both set to fair market value. There is no subsequent taxation of this same gain or offsetting loss. It does not, however, solve the problem because it would not tax appreciation of assets while they are held in a subsidiary.

[25]The most extreme example, to my knowledge, is a proposal by David Shakow. His project is to eliminate the tax-free reorganization rules from the law and he recognizes that tax-free formations are a substitute for tax-free reorganizations. He

An immediate result is that we need rules for tax-free contributions to corporations. The rules of current law are very complex, and they likely could be simplified somewhat.[26] Nevertheless, boundaries will have to be drawn.

A second and more important result is that allowing tax-free formations inevitably allows some acquisitions to be tax-free. After all, what is a formation of a corporation other than an acquisition of assets by the new corporation? To illustrate, go back to the running example. In that example, the manufacturer sold a machine to the producer for $70 and the producer used the machine for 10 years to produce $10 worth of widgets each year. To prevent easy avoidance of the tax, we needed to impose a tax on stock sales as well as asset sales. If formations are tax free, however, the manufacturer could contribute the machine to a joint venture between the manufacturer and the producer in exchange for $70 of preferred stock. The producer would contribute $70 of cash to the joint venture in exchange for all of the common stock (and, therefore, complete control). The manufacturer's preferred stock could have any type of return desired. It would be secured by the $70 of cash and the cash could be invested as directed by the manufacturer. The transaction is a sale disguised as a joint venture. The only difference is that the manufacturer must wait to receive the cash, but, because the securities it holds are

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would, for complicated reasons, restrict tax-free formations to transfers of assets but not stock. That is, a taxpayer would transfer a machine to a new company in exchange for stock but could not transfer the stock of a company holding a machine to a new company in exchange for stock. This still leaves most of the tax-free formation rules intact, allows the very simple transfer of value considered above, and would burden many ordinary transactions.

[26]They have particular problems dealing with liabilities and most particularly with contingent or inchoate liabilities. It is not clear whether simple solutions exist for these problems. For example, the rules for contributions to partnerships also have problems with contingent liabilities.

secured by the cash and the cash is invested at its direction, there is little difference.[27]

The tax benefits of this disguised sale are less than in the case examined above where stock sales were not taxed at all. In that case, the manufacturer was able to receive its $70 completely free of tax. In the case examined here, the manufacturer will eventually be taxed on the $70. The benefit is that it can defer taxation until an indefinite point in the future when it receives its principal payment on the preferred stock. Deferral is not as good as complete exemption, but as is well known, deferral is most of the game in income taxation.

Perhaps limits on tax-free formations could prevent this problem. The most strict limit would be to allow tax-free transfers only to wholly owned companies. Even this would not necessarily work. In our running example, the manufacturer could transfer the machine to a subsidiary corporation in exchange for one share of common stock (worth $1) and 69 shares of preferred, (each worth $1). This transaction would be tax-free because the manufacturer would be the sole owner of the subsidiary. Later, at the time the producer wishes to acquire the machine, it could transfer cash to the corporation in exchange for 70 shares of common stock. This transfer would not be to a wholly owned corporation, but there would be nothing to tax on this second transfer – it was a transfer of cash. The end result is that the producer would control the corporation that owns the machine and the manufacturer would have a cash-like asset, the preferred stock. Thus, even this strict rule would not work. We could try to back up the "wholly owned" rule with rules about ownership changes, time periods, and the like, but complexity quickly becomes an issue.

The partnership rules take a different approach. They put no restrictions on tax-free contributions but then try to look at subsequent

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[27]The major issue would be ensuring that the $70 of cash is not subject to the creditors of the subsidiary. Various structures are available to achieve this to a greater or less extent.

transaction to determine when the contribution was in fact part of a disguised sale. This is a mess because there is no easy line between the two cases, a joint venture and a disguised sale. The law ends up with a complex set of factors that are easily manipulated.

The claim that the formation rules can be used for acquisitions is more than theoretical. There are numerous examples of actual transactions that take this route. One of the most well-known goes by the name the "National Starch" transaction because of the company that used it. Details of the story can be found in corporate tax treatises.[28] I offer a simplified version here.

The target corporation was a company that had a dominant and aged shareholder. The corporation likely went public and the founding shareholder retained a large portion of the stock, say 15 percent. The dominant shareholder likely had a very low basis in the stock and was unwilling to approve any transaction which would trigger gain, particularly in light of the potentially soon stepped-up-basis at death. A buyer would like to purchase target. The other shareholders (the public) wanted cash. The problem was to structure the transaction to allow the dominant shareholder to defer her gain while giving the other shareholders cash.

It turns out that this was not possible within the current reorganization rules. These rules for tax-free reorganizations look in part to the type of consideration used in the transaction, and in this case, there is too much cash. In particular, under current law, the tax-free reorganization rules have as one of their central concepts that the treatment of the entire transaction to all of the involved parties depends crucially on a sufficient portion of the consideration being stock. There are both explicit statutory requirements (which vary tremendously depending on the form) and implicit requirements imposed through

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[28]See, e.g., Ginsburg and Levin, page __.

"continuity" rules, created by courts and regulations. The formation rules contain none of this. The treatment of each party to a formation depends only on the consideration provided to that party.[29] Contributors that receive stock can get tax-free treatment while those that do not, are taxed.

In the National Starch structure, the parties could not use the tax-free reorganization rules because there was too much cash. The parties, however, were able to structure the transaction as a "formation." Suppose that target was worth $100 and the dominant shareholder had stock worth $15, basis of zero. The dominant shareholder and the buyer jointly formed a new corporation, Holdco. The buyer contributed $85 of cash in exchange for all the common stock of Holdco. The dominant shareholder contributed her Target stock in exchange for cash-like preferred stock. Holdco then used its $85 of cash to purchase the remaining shares of Target. That's it.

The formation of Holdco was a tax-free formation. Therefore, the dominant shareholder was able to receive the preferred stock tax-free. Holdco took the dominant shareholder's basis in her Target stock. The cash purchase of the rest of Target was taxable, but this did not affect the tax treatment of the dominant shareholder. The IRS blessed this these results.[30] More complex variations abound and are regularly used in practice.[31]

The conclusion is that if some formations are inevitably tax-free, then some acquisitions will be as well. If we have inconsistent treatments

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[29]The timing of the contributions by other parties can matter, however. Tax-free treatment for contributions to corporations is allowed only if the contributors together control the corporation. To be counted as a contributor, a party must contribute to the corporation as part of the relevant transaction. For example, ___.

[30]Cite.

[31]One of my favorite variations is the "horizontal double dummy," described in Ginburg and Levin, p. __.

– some acquisitions will be taxable and some will be tax-free – we cannot determine the optimal rule by reference to income definitions or by picking the most strict rule. Instead, it is a line drawing question of where, given inconsistent treatment on each side of the line, is the best place to draw the line.

I believe that there are good theories for thinking about line drawing problems of this sort,[32] but the solutions are inevitably complex and have the feeling of arbitrariness about them. The complexity of the current law reorganization rules is well known, and I will spare you a review of the details.[33] They occupy a substantial fraction of a corporate tax practitioner's time. Both Congress and the Treasury regularly modify them in an attempt to remove unnecessary quirks or improve their operation, but the modifications only seem to move the lines from one arbitrary place to another. There have been numerous proposals to simplify the rules. Reform proposals, however, cannot eliminate the problem because they have to draw a line between what is tax-free and what is not. Because tax-free treatment matters and because the number of possible acquisition structures is large, any line will end up being complex.[34]

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[32]Line drawing papers.

[33]See Chapters __ and __ in Ginsburg and Levin.

[34]One possibility, suggested by the ALI among others, is to allow taxpayers to elect. The argument is that if we cannot figure out a reasonable way to draw the line between what is tax-free and what is not, we should just throw in the towel and let taxpayers choose. Election proposals, however, do not solve the problem because they have to determine when taxpayers are allowed to make the election. This is illustrated in the discussion of the ALI proposals for elective carryover basis in Section III below.

The partnership tax rules do not, on their surface, have complex reorganization rules because they allow the equivalent of tax-free reorganizations almost without limit. Morever, the various disguised sales rules in the partnership tax area, which are very complex, can be seen as limits on tax-free acquisitions.

B. *Stock and Asset Sales.*

Suppose that the manufacturer in our running example wants to sell the machine to the producer. Assume for the moment that the manufacturer has a basis of $15 in the machine if held directly. If the machine is held through a subsidiary, assume that the manufacturer has a $15 basis in the stock of the subsidiary, and the subsidiary has a $15 basis in the machine.

Consider two possibilities for delivering machine to the producer. First, the manufacturer could sell the machine to the producer for $70, who in turn produces widgets with the machine and sells them to the public. In this case, the manufacturer has a gain of $55 and pays tax on that at the normal tax rate applicable to business sales (i.e., it is taxed as ordinary income). The producer will have a gain of $30 as it sells the widgets (and claims depreciation deductions on the machine).

Second, the manufacturer could hold the machine through a subsidiary, S, and sell the stock of the subsidiary to the producer. (The use of a subsidiary was discussed above as an avoidance technique but it may often be the most efficient way to sell an asset.) Suppose for now that the producer agrees to pay $70 for the stock. I will say more about the price later, but for now use $70 to illustrate the issues. If the manufacturer's basis in the stock is $15, it will have a $55 gain, as before, although this gain may qualify as a capital gain. Absent coordination rules, discussed below, the machine will retain its basis of $15. In particular, S, its owner, has not sold the machine and, therefore, there is no realization event, no resulting tax, and no adjustment to basis. When the subsidiary produces widgets and sells them for $100, there will be $85 of gain.

The producer will have paid $70 for the stock of the subsidiary which has $100 of cash after selling the widgets. Under both current law and the rules for distributions proposed by many reform regimes (such as Treasury's CBIT and the ALI proposals), the subsidiary could distribute

its $85 of earnings tax-free with no reduction in the producer's basis in the stock.[35] The remaining $15 distribution will reduce basis to $55 in stock that is now worthless. The producer could sell this for zero producing a $55 capital loss. The net result is the same as in the asset sale case, $85 of total taxable income, but it is made up of $140 of gain ($55 plus $85) and $55 of loss that occur at different times.[36]

The following table represents the amounts in the two cases:

Table 2: Stock Sale Asset Sale Nonconformity

	Sale to Producer	Sale to customers	Loss on sale of S	Total
Asset sale	$55 (ordinary income)	$30		$85
Stock sale	$55 (capital gain)	$85 (= $55 + $30)	$55 (capital loss)	$85

The two cases, stock sale and asset sale, have the same total taxable income. There are two differences. In the stock sale case, the $55 gain on the machine that accrued while held by the manufacturer is deferred until the sale to the customers (because the movement of the machine was not taxed on the sale from the manufacturer to the producer). Second, there are offsetting $55 capital gains and losses on the stock. There is a net

[35]Exactly now this works under current law will depend on many details. For example, the $85 distribution might be an extraordinary dividend under section 1059, which means that it reduces basis. If this happens, the system would significantly over-tax the transaction.

[36]To simplify the presentation, the calculations in the text ignore the tax paid by the subsidiary on the sale of the assets. Because the subsidiary will have to pay tax, it will have less to distribute to the producer. The producer, however, will still end up reducing its basis by the $15 of distributions not supported by earnings and, therefore, end up with a $55 capital loss. The net effect is the same.

present value tax on the offsetting capital gains and losses because the loss comes after the gain.[37]

To get a sense of the potential magnitude of the problem, suppose that for good business reasons, the producer acquires the stock of S, intending to hold it and operate the company as a subsidiary for the long term. The manufacturer will have $55 of gain on the sale. If S turns over its inventory relatively quickly, it will have an additional $55 of gain on the sale of the widgets (above the $30 it would have had had it received a cost basis in the machine). If these are close in time, we can just add them, to have a total of $110 gain at time 0. The offsetting loss will only occur when the producer liquidates or sells S, and suppose that is in, say, 24 years. If the after-tax rate of return is 6%, the value of the loss will be approximately 1/4 of its nominal value, or precisely $13.58. The next present value gain will be $110-$13.58 or $96.42, a roughly 75% increase over the proper measure of gain of $55. If deadweight loss go up with the square of the tax rate, the deadweight loss will be more than three times as high as if income were measured correctly.

The extent of the social loss from this mismeasurement of income depends on how important it is to use one form of the transaction instead of another. If the two forms of transacting a perfect substitutes, taxpayers could simply choose the lower-taxed form and the mismeasurement would not matter. If, however, the two are different, taxing one form differently than the other can force inefficient alterations in behavior and social losses.

I assumed that the producer would pay $70 for the stock of the subsidiary. The producer might pay less, in which case the size of the

[37]We could, in theory, impose a separate tax rate on stock sales set so that the net tax equals to the deferral of the gain in the machine. Unfortunately, the timing of the various gains and losses will vary tremendously and the tax rates cannot be set to get it right in all or even most cases. Moreover, adding a capital gains preference of this sort to the income VAT would introduce substantial complexity.

effect just illustrated would be smaller. The reason the producer might pay less is that the subsidiary comes with the built-in gain and a capital loss on the eventual sale or liquidation. These are likely to occur in different periods, with the loss coming after the gain. Moreover, the two might be subject to different tax rates, for example, if the loss can only be used against capital gains or is subject to a risk of disallowance. To the extent that the producer inherits a net tax liability when it purchases the stock of the subsidiary, it might be able to pay less for the stock. The basic principles do not change however. There will still be a gain to the manufacturer, a loss to the producer, and a gain inside the subsidiary.

What is bad for taxpayers in the case of gains is usually good for taxpayers in the case of losses. Suppose our manufacturer purchases the machine for $40 and then finds out that it produces widgets of inferior quality and he can only sell the resulting machine to the producer for $30. If the manufacturer were to sell the machine to the producer, it would have a $10 loss. Suppose, however, the manufacturer puts the machine into a subsidiary and sells the stock. The manufacturer still gets the $10 loss (although now as capital loss, potentially subject to different rates). The machine retains its $40 basis and when converted into widgets sold for $30, produces an additional $10 loss, just like the gain was doubled in the gain case. The double loss, however, has the potential to be permanent. The subsidiary has $30 left, which it distributes with no further tax.

Moreover, the transaction can be repeated indefinitely. The subsidiary can contribute the loss asset to a second tier subsidiary and sell the stock, which in turn can contribute it to a third tier subsidiary and so on. In an extreme case, imagine a parent corporation contributing $100 to a subsidiary, S_1, which in turn contributes it to another subsidiary, S_2 and so on down to S_n. S_n burns the money. The $100 loss is replicated n times in the stock of the various subsidiaries. As each of the subsidiaries is sold, the owner can claim a loss. If t is the tax rate on losses and $(n+1)t > 1$, burning the money creates after-tax gains.

In the gain case, the accounting system ultimately got the total number right: total gain in the example was $85 regardless of form. In the loss case, the accounting system miscalculates the total, creating a permanent rather than temporary difference. The reason that the loss is permanently rather than temporarily duplicated is that S liquidates without tax consequences after it recognizes the loss. The accounting systems could get it right if it required an offsetting gain to be realized (say, by the shareholder) just like in the gain case, there is an offsetting loss on liquidation. Current law does not require this although it has a variety of incomplete and ineffective rules that attempt to prevent loss duplication. Reform proposals such as CBIT or the ALI regimes similarly do not require this.[38]

Both the gain and loss examples illustrate that in the absence of basis adjustments creating conformity between stock and asset sales, there can be large disparities depending on form. The result is the type of tax planning, form-driven inconsistencies, and sheltering opportunities with the current corporate tax. Moreover, there will be pressure for more coordination between the treatment of stock sales and asset sales. As will be discussed Section III, there have been a variety of regimes, both in current law and proposed. Any conformity regime, however, is going to create complexity.

For example, many regimes take the extreme cases illustrated in the examples and allow taxpayers to elect conformity. Thus, in the gain case, the buyer and seller may be able to elect to treat the stock sale as if it were an asset sale. Alternatively, if the asset sale were advantageous, they may be able to elect to treat a stock sale as if it were an asset sale. Any such regimes, however, will need rules for determining when they operate and exactly how conformity is to be achieved. These rules will be complex. Because the basic regime does not provide conformity, the boundaries of

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[38]Treasury discusses the issue Treasury on p. 194, note 14.

these regimes will be important. The types of tax planning and inconsistencies associated with the corporate tax result.

C. *Distributions.*

If stock sales are going to be taxed, we need a system to determine the treatment of distributions. To tax stock sales, we need to know stock basis and, therefore, we need a system to determine which distributions are treated as reductions in basis and which are treated as either tax-free or possibly taxable dividends. To illustrate, suppose a business put $100 into a subsidiary and immediately withdrew it through a distribution. The distribution must reduce the basis in the stock of the subsidiary or the business could sell it to produce an artificial $100 loss. If, alternatively, all distributions reduce basis, many simple transactions would be over-taxed. Suppose, for example, if the business put $100 into a subsidiary and it doubles in value to $200 and tax was paid by the subsidiary. If the distribution of the entire $200 reduced basis, there would be a second tax on the gain (a $200 distribution on a $100 basis produces gain of $100). A more nuanced and accurate rule than the simple "always" or "never" approach is needed.

The most accurate distribution regimes, embodied in the rules governing distributions within consolidated groups (known as the "investment adjustment rules") and in the similar rules for partnerships, attempt to maintain conformity between inside and outside basis. To achieve this, outside basis (i.e., basis in the stock) is increased by any gain and reduced by any loss that is recognized inside the business. All distributions, then, can be treated as a reduction in basis. To illustrate, assume that a corporation puts $100 into a subsidiary. If the $100 is distributed, it reduces basis to zero, which is appropriate given that there are no assets in the subsidiary. If the $100 doubles, after tax to $200, outside basis is increased by the same amount. When the $200 is distributed, basis is reduced to zero. If the subsidiary loses $30 so that it only has $70 left, outside basis is reduced by $30 to $70. Distribution of the remaining cash reduces basis to zero, as is appropriate.

The system can become complex when the business has different classes of interests. Basis adjustments must be allocated to the various interests and there are no easy rules to ensure that this is done properly. Moreover, if inside and outside basis do not start the same, say because the stock was purchased from another shareholder, the adjustments might require basis to be reduced below zero. For example, suppose a business starts out with an asset with $400, its value goes down to $100 and a purchaser purchases all of the stock of the business for $100. If the business then sells the asset for $100, there would be a $300 downward adjustment in the basis of the stock. The basis in the stock, however, was only $100, so the adjustment would reduce basis to negative $200. The partnership and investment adjustment rules deal with this differently and with various degrees of success. Yet a final problem is whether gain or loss should be taxed on the distribution of property. The consolidated return rules require gain or loss to be realized but defer its taxation. The partnership rules do not. The approaches each have merits and flaws and both can become very complex in certain circumstances.

Notwithstanding these complications, we think we know how to treat distributions, at least generally, even if some details are difficult. Moreover, unlike in the stock sale/asset sale case considered above, there are regimes found in current law that actually implement these ideas. The problem is that most commentators who have studied these systems believe that they are too complex to be implemented for widely held corporations. For example, the Treasury rejected the system in part because it was too complex to be administered. (p. 27).[39] It noted that notwithstanding reform studies in other countries that have called for such a system, every country has rejected it.

[39]Note that the Treasury study was considering a so-called shareholder allocation system in which shareholders would remit the tax on income that is measured at the business level. Although shareholder remittance as opposed to business-level remittance may raise issues, the primary objection related to the allocation problems raised by the distribution issues discussed above.

The alternative, used under current law and proposed by the Treasury for CBIT and the ALI for its integration system, is a simpler system that determines whether a distribution reduces basis by measuring earnings of the business. Distributions out of earnings are treated as dividends and do not reduce basis. Distributions beyond earnings reduce basis. These systems are highly inaccurate and subject to abuse.

For example, they allow the duplication of losses illustrated in the discussion of stock sales above. Suppose a business puts $400 into a subsidiary and it loses $300, leaving it with only $100 in cash. The subsidiary will have claimed a loss of $300. When the $100 is distributed, it will reduce basis by $100, down to $300 (because there are no earnings). The business can then sell the shell corporation for $0, claiming a second $300 loss. As illustrated above in the discussion of stock sales, the loss can be replicated without limit.

Similarly, because earnings are not traced to particular shareholders, misallocation of dividends is possible. A standard example is "dividend stripping." In a dividend strip, a taxpayer purchases a share of stock immediately before a dividend and sells it immediately afterwards. For example, a shareholder might pay $105 for a share of stock, receive a $5 dividend, and then sell the stock for $100. The dividend is often tax-preferred (it might, for example, be exempt because of the dividends received deduction), but the $5 loss fully usable, creating a simple arbitrage. A variety of rules attempt to limit these transactions but they are complex and their application uncertain.

Yet another problem with a simple approach is distinguishing between dividend distributions and stock redemptions. Redemptions are often treated like normal sales: the selling shareholder has gain or loss just as if he had sold to any other market participant. If, however, a redemption is pro-rata, there is no difference between a redemption and a dividend. Extensive and complex law has developed to make this distinction but notwithstanding years of experience in the area, notorious tax shelters have appeared in recent years that exploit the issue.

The problem of taxing distributions, therefore, is similar to the problems of contributions, tax-free reorganization, and taxable sales. Dual ownership creates the need for rules that coordinate what is going on inside the corporation with what is going on outside the corporation with respect to its stock. Although it is not difficult to imagine what perfect coordination would look like for distributions, it is generally too difficult to implement this is practice in many cases. The resulting imperfect rules create inconsistencies, planning opportunities, and complexity.

D. *From CBIT to Current Law*

The analysis above consider the doctrinal problems in the abstract, using CBIT as a model. Section IV below considers reform proposals under the double-level tax. In both cases, the dual ownership problem creates a core of unavoidable complexity. The remaining question is whether all firm-level tax regimes have this complexity.

We can roughly divide firm-level tax systems into two categories: taxes like CBIT that are remitted by firms, and pass-through regimes, like the current law partnership regime, where income is measured at the firm level but tax is remitted by the owners. As noted, classification of firm-level taxes is difficult because of the wide variety of systems. Thus, a credit-imputation regime imposes a firm-level tax but gives shareholders credits for taxes paid by the firm. Nevertheless, for purposes of the discussion, the simple classification should be sufficient.

CBIT represents the paradigmatic firm-level tax. Moving from CBIT to systems that more closely resemble current law will not eliminate the core of complexity. There are two key changes that move us from CBIT to current law. The first change is to allow an interest deduction and to tax interest income. This will not change the dual ownership problem at all – none of the problems related to debt-financed transactions. Indeed, all of the examples used above had only equity financing. The second change is to impose a separate tax on stock transactions, including dividends and sales gains or losses, to create a

double-level tax. Double-level taxes are explored in connection with the ALI and Senate Finance Committee proposals in Section IV below. As will be evident, dual ownership creates the same problems under these regimes.

The other major alternative for firm-level taxes is a pass-through regime, like the current law partnership tax regime. A brief examination of the partnership tax regime shows that although it has a different set of solutions, it suffers from the same set of problems.

I separated the doctrinal problems created by dual ownership into three categories: (i) formations and acquisitions, (ii) stock and asset sales, and (iii) distributions. The partnership tax regime has complex rules in each of these areas. Consider each area, very briefly.

The approach to formations taken in the partnership tax is different form that taken in the corporate tax. The rules for obtaining tax-free formations are very loose. There are essentially no restrictions; virtually all contributions to partnerships are tax-free. This choice means that it is easy to use formations as a tax-free method of selling assets. Similar to the transactions discussed above, a seller can contribute an asset to a partnership and a buyer can contribute cash. Therefore, there are a very complex set of rules (actually three sets of rules) designed to distinguish sales from formations. Although quite different in form, these rules can be analogized to the restrictions on formations and tax-free reorganizations found in the corporate area – they try to distinguish what should be taxable and tax-free based on some notions of continued ownership.

The rules for asset and stock sales (here partnership interest sales) are also different than in the corporate area. They are more accurate at the cost of greater complexity. In particular, they attempt to maintain conformity of asset basis (inside basis) and the basis in partnership interests (outside basis) by adjusting outside basis for gain or loss in the assets. If there is conformity, selling an interest will produce the same

amount of gain or loss as selling a pro rata share of assets. In addition, there is an immensely complex partial look-through rule that tries to match the type of gain or loss (ordinary v. capital) on the sale of an interest to a pro rata sale of the asset in some circumstances. Finally, there is an elective rule that allows asset basis to be adjusted for gain or loss realized from the sale of interests. The rule is sufficiently complex that it is elective.

The rules for distributions resemble the ideal rules discussed above, where distributed assets retain their basis and the basis in the interest is correspondingly adjusted. Unfortunately, this does not work in all cases, such as when the asset basis is higher than the basis in the interest, resulting in an imperfect set of adjustments and potential for abuse.

Overall, the partnership rules do a reasonable job of dealing with dual ownership. The cost, however, is complexity. That is, the partnership rules cannot avoid the dilemma created by dual ownership. They merely choose a different place in the accuracy/complexity trade-off than the corporate tax rules do. The complexity is sufficiently high that both the Treasury and the ALI rejected a partnership-type regime for publicly traded corporations.

IV. Reform proposals

This section will discuss major reform proposals to analyze whether they solve the problem of dual ownership and, if not, how dual ownership drives the complexity of the proposals. I start with the Andrews 1982 ALI and Senate Finance Committee 1984 proposals for reform of the structure of the double level tax system. I then discuss a proposal on distributions put forward by George Yin. Yin claims that stock sales need not be taxed, directly contrary to the claim made here. Finally, I discuss the ALI and Treasury integration proposals.

A. *Elective Carryover basis*

The ALI in 1982 and the Senate Finance Committee (SFC) in 1984 put forth similar proposals for major reforms of the corporate tax. Although both were resolutely in the double tax tradition, both focused on the problems of dual ownership, of coordinating the treatment of stock sales and asset sales. They are, I believe the most well-thought out attempts to structure a corporate tax that fits within the broad boundaries of current law.

These proposals do not eliminate the basic problem of dual ownership. By eliminating many of the arbitrary distinctions of current law, they may be a significant improvement on current law. (There are also arguments that they would make current law worse by making it even easier to avoid tax than it is now.) In the end, however, through no fault of the authors, the basic problems remain. Notwithstanding every effort, they cannot eliminate the core of complexity created by dual ownership. In fact, they prove the very point of this paper: even the most carefully thought out corporate tax proposal retains much of the complexity of current law.

Before discussing the proposals, it worth noting again that both proposals are strictly in the double-tax tradition. Indeed, both proposals would strengthen rather than weaken the double tax. It is possible, therefore, that some or many of the decisions made regarding dual ownership reflect policies related to double-taxation rather than to problems relating to measurement of income at the firm-level.[40] In describing the proposals it is inevitable to consider double tax issues to some extent even though this distracts somewhat from the focus on of this

[40]The introduction to the ALI Report, however argues that the problems addressed in the report would exist in single-level tax systems. "The Acquisition Proposals are on the whole quite independent of the integration question. The issues with which they deal would persist under any of the forms of integration widely discussed, and the proposals themselves would still represent sound solutions to those issues." P. 3.

paper income measurement. As the ALI and SFC proposals are the most well-known and well-developed proposals for revising the corporate tax, it is worth examining them despite this mismatch with the basic thrust of the paper.

A second preliminary point is that neither proposal is best seen as fundamental in the sense that it attempts to design a firm-level tax that measures income starting from a blank piece of paper. Instead, both proposals are best seen as engaging in legal archeology in the tradition of the ALI restatements. They try to find the implicit scheme of current law and rationalize it. For example, the ALI states "[p]roposal A1 is a general proposal to restate the tax classification of acquisitions by making this general, implicit categorization of acquisitions the primary, explicit, legal classification." p. 7. On pages 16 - 19 the ALI stated that it is determining the function of the corporate tax by observing existing law. Similarly, "more comprehensive improvement can be achieved by first restating or reinterpreting the existing pattern of classification along more functional lines." p. 32. The SFC is not as explicit in its reasoning but it largely follows the ALI. Because they are exercises in legal archeology rather than tax design starting from scratch, it is possible that there are better systems than those recommended in these proposals.

Notwithstanding these caveats, I am not aware of better attempts to rationalize firm-level taxes. The integration proposals are more fundamental but do not address transactional details. The ALI and SFC reform proposals are tightly focused on statutory details to the exclusion of the major economic distortions of the corporate tax. There is no proposal that does both.

The underlying problem identified by the proposals was the differing treatment of asset and stock purchases. Although the tax law at the time (and now) had a wide variety of potential rules and related tax consequences, the ALI argued acquisitions could be classified into one of two basic types: carryover-basis acquisitions and cost-basis acquisitions. The ALI argued that these categories translate roughly into stock

purchases (carryover basis) and asset purchases (cost basis). p.33. Under the law at the time (and now), transactions would be categorized into one of these categories depending on the chosen form, the type of consideration, and steps taken before or after the acquisition.

To illustrate, consider the following example. Suppose that S owns stock of T corporation, and that B wants to purchase, alternatively, the stock of T or the assets of T. Suppose that S has a $100 basis in the T stock, which has a value of $150, and that T has a basis of $100 in its assets, also worth $150. There are three basic ways for S to sell T or T's assets to B. T can sells its assets to B, S can sell the T stock to B, or S can liquidate T and sell the assets. Ideally, the tax consequences of these economically equivalent ways of selling T would be the same.

The exact results depend on a variety of factors. The core case considered by the ALI was the double-tax case, epitomized when S was an individual (or more generally, S is not a corporation that controls T (in the very particular sens of owning 80 percent of the vote and 80 percent of each class of non-voting stock of T)). In this case, the following results:[41]

Asset sale by T followed by liquidation of T. If B buys the assets of T, T will have gain of $50. If T liquidates, T has no further tax (all of its gain has been realized). S, however, will have gain of $50, creating a second layer of tax. B gets a fair market value basis of $150 in the assets. The end result is two taxes on the $50 gain and a fair market value basis in the assets.

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[41]The major change in current law from the law at the time of the proposal is the repeal of the *General Utilities* doctrine, which provided that a corporation did not recognize gain or loss on the distribution of appreciated property to its shareholders. Both the ALI and the SFC, however, proposed repealing *General Utilities*, and drafted their acquisition proposals in light of repeal. Therefore, we can treat the acquisition proposals as facing a legal landscape that is essentially the same as current law. The examples in the text assume the repeal of *General Utilities*.

Liquidation of T followed by an asset sale by S. Both T and S are taxed on the liquidation. T has $50 of gain and S also has $50 of gain. S will take a fair market value basis in the assets and there will be no further gain when S sells to B. B gets a fair market value basis in the assets. The results are the same as the first case.[42]

Stock sale by S. S has $50 of gain on the stock S. T retains its historic basis of $100 in the assets. When T eventually sells the assets, it will have $50 of gain. There is no further tax to B when T liquidates (either because the liquidation is tax free or because B has a $150 basis in the stock). This is preferred over the other two cases because the gain on the T assets is deferred.

Possible election. If B purchases a sufficient amount of T within a specified period, it can make a section 338 election. S is unaffected and pays tax on its stock gain. If the election is made, T is treated as selling its assets to new T and paying tax on the gain. New T takes a fair market value basis in the assets. The result is that the stock sale becomes just like the asset sale – two levels of tax are paid immediately. B, however, would be unlikely to make the election because it causes an immediate tax to be due in exchange for basis which can be used only over time.

The following table summarizes:

Table 4: The Problem Addressed by the ALI

	T	S	B's basis
Assets/Liquidation	$50	$50	FMV

[42]If S is a corporation and certain ownership requirements are met, neither S nor T are taxed on the liquidation. S would inherit T's $50 basis in the assets and would be taxed on the sale. There would, as a result, be a single tax on the $50. If T sold its assets first, there would be the same single tax on $50.

Liquidation/Assets	$50	$50	FMV
Stock/liquidation	$0	$50	$100
338 election	$50	$50	FMV

An examination of the table shows that stock sales were preferred because they allowed deferral of the $50 gain in the T assets. That is, in an asset sale, gain in both the assets and in the stock are taxed. (Note that there is no relief for the double tax in this case.) In the stock sale case, gain in the stock is taxed, but the assets remain in T, so there is no realization event and no taxation of the gain in the assets. Therefore, the gain is deferred relative to the asset sale.

The results would be different if S was a corporation that controlled T. In this case, the rules create a single level of tax by allowing T to liquidate into S (either before or after an asset sale) without tax. The result is that asset sales are preferred relative to stock sales. The following illustrates:

Asset sale by T followed by liquidation of T. If B buys the assets of T, T will have gain of $50. If T liquidates, T has no further tax (all of its gain has been realized). The liquidation will be tax-free to S. B gets a fair market value basis of $150 in the assets. The end result is a single taxes on the $50 gain (imposed on T) and a fair market value basis in the assets.

Liquidation of T followed by an asset sale by S. Neither T nor S are taxed on the liquidation. S inherits T's $100 basis in the assets. S's basis in its stock entirely disappears. When S sells the assets to B, S realizes $50 of gain. B gets a fair market value basis in the assets. The results are the same as the first case.

Stock sale by S. S has $50 of gain on the stock S. T retains its historic basis of $100 in the assets. When T eventually sells the assets, it will have $50 of gain. B gets a $150 basis in the stock. What happens in

the future in this case depends on the transactional form. If T eventually liquidates, B inherits T's basis and gets no benefit for its $150 basis in its assets.[43]

Possible treatment of stock sale as an asset sale. In the case where S controls T (under a slightly different definition), there is a different election than the one discussed above. Under this so-called 338(h))(10) election, S and B jointly elect to treat the stock sale as an asset sale. A normal 338 election is also available. Both results are given below.

The following table summarizes. As is evident, asset sales are now preferred because there is a single $50 gain and a fair market value basis in the assets, which in a stock sale, the same gain does not create a fair market value basis.

Table 4a: The ALI Problem – Parent/Subsidiary Case			
	T	S	Basis
Assets/Liquidation	$50	$0	FMV
Liquidation/Assets	$0	$50	FMV
Stock/liquidation	$0	$50	$100
Elections			
338	$50	$50	FMV

[43]The major difference between this example and the discussion in Section II above was that in Section II, there was an offsetting loss in B. This can happen under current law and in the example in this section if instead, T recognizes the $50 of gain and distributes the money as part of an ordinary, ongoing dividend distribution, the $50 of dividends is tax-free and does not reduce basis. This leaves B with a basis of $150 in T when it is worth only $100, giving B a $50 loss it can claim if it sells T. Either way – liquidation of T or a dividend distribution from T – however, leaves the stock sale taxed worse than the asset sales.

	338(h)(10)	$50	$0	FMV

There are many other possibilities. For example, if S's basis in the T stock and T's basis in the assets did not match, the results would vary and stock sales and asset sales would produce different results. (There is no general conformity regime under current law, so the conformity assumed in the sample would happen only by coincidence.) If S and T or T and B (after the purchase) file consolidated returns, the results would be similar to but not always the same as illustrated above. And if there are losses in either the T stock or the T assets, the effect of the elections would be quite different – a 338 election would double loss instead of doubling gain. And if B provided S with the right kind of consideration – stock in B or in a corporation that owns B – the entire transaction might be a tax-free reorganization. The main point is that there is no general conformity regime for stock sales and assets sales.

The ALI did not propose to conform the treatment of the two types of transactions. Instead, it proposed to allow taxpayers to elect their treatment regardless of form. Conformity, it argued, would be too difficult. p. 36-39. Thus, the ALI (and the SFC) recommended that a stock purchase of a target corporation be electively treated as an asset purchase, as reflected in the 338 election illustrated above. (The law at the time had a similar set of rules that depended on using a particular transactional form and were not explicitly elective.)[44] Similarly, they recommended an election to treat asset purchases as stock purchases. This latter election was one of the most dramatic proposals in the report and took the name elective carryover basis. It allowed a corporation that purchased the assets of target with cash to elect (jointly with target) to treat the transaction as non-taxable. Although they differ in their details, both the ALI and Senate would have required a significant distribution to target shareholders (who would be taxed on the distribution) or a taxable

[44]Pre-1984, when ALI wrote, the election was through simple structuring. Post-1984, when the SFC wrote, the election was explicit.

liquidation by the target to target shareholders. The combine effect of the election and the taxable distribution to shareholders was similar to a stock sale – a tax on shareholders and a carryover basis at the firm level. To the extent both elections work, they would conform asset and stock purchases.

Both the ALI and the SFC made these proposals applicable to *nonsubsidiary* corporations. In particular, they assumed that S would be taxable, akin to the numbers found in Table 4 above, not Table 4a.[45] The following table summarizes the ALI and SFC proposals:

Table 5: Elective Carryover Basis			
	T	S	B's basis
Assets/Liquidation	$50	$50	FMV
Liquidation/Assets	$50	$50	FMV
Stock/liquidation	$0	$50	$100
Elections			
Stock sale – 338 election	$50	$50	FMV
Asset sale – carryover basis election	$0	$50	$100

As can be seen, a 338 election would treat a stock sale just like an asset sale. A carryover basis election would treat an asset sale just like a stock sale. Thus, taxpayers could use either form and elect to get the tax treatment given to the other form. Because the treatment was to be

[45]In the event that T was a subsidiary, the SFC proposal would require the parent corporation, S, to completely liquidate (and any parents of S to completely liquidate, and so forth). Thus, sales of subsidiaries by operating companies would not be covered. p. 219. The results in Table 4a would continue to apply. The ALI merely suggests that rules concerning subsidiaries should be made as consistent as possible with the rules permitting carryover basis treatment in other cases. proposal A.2.2.

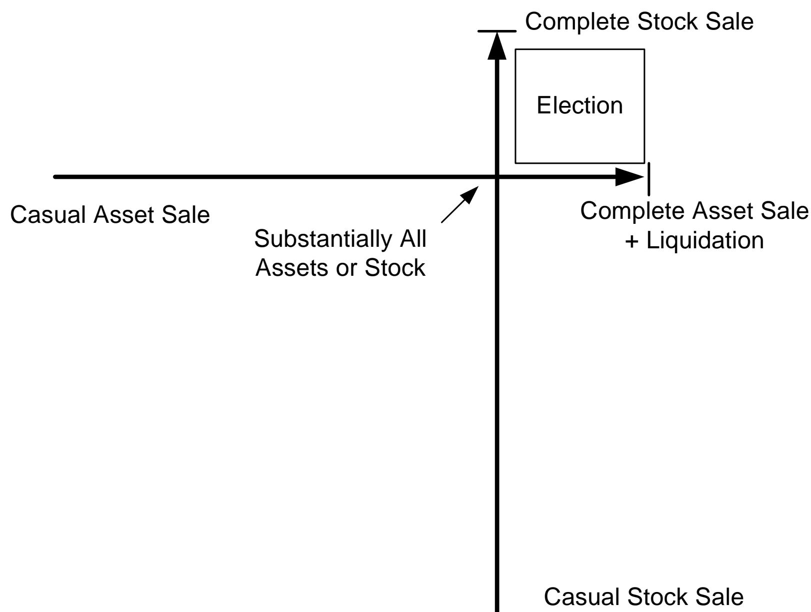
elective, the idea was that complicated tax planning would no longer be necessary. Explicit elections rather than form would govern.

It is worth nothing that while the proposals did not make significant attempts to conform asset and stock sales (the election approach allows a choice of result but does not equalize the results), there are some changes that would reduce the disparities. The most important such change is the rule for stock basis. The proposals differ. The ALI would require the basis in the stock of a subsidiary to equal the basis of the assets held by the subsidiary, creating inside-outside basis conformity. The rules would work similarly to the current law consolidated return rules, where changes to the basis of the subsidiaries assets would produce changes to the basis of the stock, but not vice versa. The major difference is that if a parent purchases subsidiary stock for an amount different than the asset basis, the stock basis would not reflect the purchase price. Thus, if a target corporation has basis of $70, value of $100, and an acquirer purchases the stock of the target for $100, the acquirer would get only a $70 basis in the stock. The SFC proposal differs in that it allows the acquirer to use the $30 premium under these numbers for a period of time (after which it disappears).

A second component of the proposals worth noting is that both would allow tax-free exchanges of stock at the shareholder level. In particular, both would allow a shareholder to exchange stock of a target corporation for stock in an acquiring corporation under specified conditions. The conditions vary in the two proposals, but both would basically limit tax-free exchanges to complete or almost complete acquisitions of a target corporation. In particular, neither would allow casual exchanges of stock to be tax-free.

The claim made here is that neither proposal eliminates the problems created by dual ownership. In particular, neither proposal attempts to create true conformity between stock and asset transactions. Instead, they create an area of elective treatment. Outside of the area of the election, asset sales and stock sales are treated differently. And even in the area of

election, there remains different treatment – taxpayers are merely given the choice of which one they want. To illustrate, consider the following diagram:



The diagram contains two axes. The horizontal axis represents asset sales by a firm. The vertical axis represents stock sales by the shareholders. Neither proposal purports to conform casual asset sales with stock sales or vice versa. A complete asset sale (plus liquidation) and complete stock sale, however, look the same. In both cases, an acquirer gains control of the target business and the shareholders are left with cash (or other consideration). The proposals, therefore, seek to conform these cases even though casual sales are not conformed. They do so by allowing each legal form, stock sale and asset sale (plus liquidation) to elect to be taxed as if it were the other form. Thus, the box in the upper right hand side represents the area of overlap, where the two cases are sufficiently similar that they are to be treated the same (through elections rather than a mandatory rule).

What is immediately apparent from the diagram is that there is a basic inconsistency built into the proposals. Some but not all asset sales are treated like stock sales Some but not all stock sales are treated like asset sales – transactions located in the entire southwestern quadrant of the diagram. Although not in the diagram, the same holds true at the shareholder level. Some but not all stock exchanges are tax-free. Basic inconsistencies built in the core of the tax system, however, inevitably mean complexity, arbitrariness, foot faults, and opportunities for tax planning.

This basic inconsistency leads to the second point: the proposals are immensely complex because they must draw a line between those cases where conformity is allowed and those where it is not. To see the complexity requires delving into the details (or uou can trust me on this and skip the next several paragraphs to spare yourself the pain.)

Carryover basis for asset purchases. The ALI allows nonrecognition of gain or loss only if substantially all the assets of a non-subsidiary corporate transferor are sold to an acquirer and any consideration other than stock of the acquirer is distributed to the shareholders of the target. Proposal B1, p. 73-74. Note the number of technical rules that must be met. We must know what it means to acquire substantially all of the assets of a corporation. Only nonsubsidiary corporations qualify, so we must have a definition of subsidiary. We must have a definition of an acquiring corporation and be able to determine whether the consideration is stock of the acquiring corporation (because this type of consideration need not be distributed). There are time periods for the distribution by target, so we need to be able to define when an acquisition takes place. Finally, if the target does not fully distribute the non-stock consideration, the ALI has a rule for determining the amount and character of any gain. (Proposal B2).

The ALI contains yet another rule for transfers of less than substantially all of a (nonsubsidiary) target's assets. In this case, if the consideration is solely stock of the acquiring corporation, nonrecognition

is allowed. If the consideration also includes cash (or other non-stock assets), nonrecognition is only allowed if a "major portion" of the assets are transfers and the proceeds are distributed in complete or partial liquidation of target. Proposal B3. The lines and complexities multiply. Definitions are needed of "major portion" and partial liquidation. A dollar of non-stock consideration changes the rule. Partial recognition of gain is a possibility, so rules are needed to determine the computation of this amount.

The SFC has a similar definition. The proposal keys off of a definition of "qualified acquisition" which applies for a variety of purposes. A qualified asset acquisition is defined as "(1) any statutory merger or consolidation, or (2) any other transaction in which one corporation acquires at least 70 percent of the gross fair market value and at least 90 percent of the net fair market value of the assets of another corporation held immediately before the acquisition, and the transferor corporation distributes, within 12 months of the acquisition date all of its assets (other than assets retained to meet claims) to its shareholders or creditors." p. 50. This is somewhat more streamlined than the ALI but not much. The definition of "transaction" will be central because the 70/90 rule is measured by whether the relevant assets are acquired as part of a transaction. It recalls the problems with defining "plan of reorganization" under current law. It does not have the "major portion" rule and requires target to completely liquidate. Thus, the simplicity is gained by limiting the ability to make the election, reducing the area of stock/asset sale conformity and increasing the need for tax planning. One element not in the SFC version but in the ALI is the rule requiring the target to not be a subsidiary. The Senate, however, provides a rule about subsidiaries, elsewhere, so any apparent simplification is merely because the complexity is shifted to other provisions.

The SFC also has elaborate consistency rules. These rules are designed to prevent different, advantageous, treatment of various assets of the target. They are too elaborate to describe here – the report gives no less than 15 examples to illustrate their operation. p. 229-230. They

involve related party rules, acquisition periods, deemed acquisitions, multiple complex definitions, and various exceptions. The ALI has a more modest rule which might end up being not so modest application. The "major portion" rule cannot be used if the transfer is part of a larger transfer that is done on a cost basis. Proposal B.3.1.[46]

Both proposals have separate rules for subsidiaries. The SFC is more explicit. It requires that, for there to be a carryover basis sale of target, any controlling corporate shareholder of target completely liquidate (and if that shareholder has a controlling corporate shareholder, it liquidate, so forth up the chain). In effect, carryover basis is not allowed for sales of subsidiaries in the ordinary course. p. 219. If the technical definition of subsidiary is not met, however, corporate shareholders would be fully eligible for carryover basis on the sale of stock. Thus, failing the definition of subsidiary would be key. The ALI merely suggests that rules concerning subsidiaries should be made as consistent as possible with the rules permitting carryover basis treatment in other cases. Proposal A.2.2.

Cost basis for stock purchases. Both proposals also have rules for obtaining cost-basis treatment. Rules for such treatment existed to some extent at the time the proposals were made[47] and have been extended and elaborated on since then. As discussed in Section III.A., Current law providing this treatment, embodied in section 338, is immensely complex. To start, we need a definition setting out the set of stock purchases that will be eligible for the election. The SFC would define a qualified stock acquisition as a transaction or series of transactions during the 12-month acquisition period in which one corporation acquires stock representing control of another corporation. The ALI has a similar rule in Proposal C4. Current law has a very similar rule defining a so-called qualified stock purchase. Experience under current law has shown that the definition

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[46]Actual experience with these consistency rules is not encouraging. Describe old 338 consistency rules – how many pages?

[47]Give details – 338 enacted after ALI but before Senate.

issues, such as the treatment of previously owned stock, redemptions, and similar problems, are very difficult.[48]

Equally difficult is the treatment of the corporation if an election to treat a stock sale as an asset sale is made. Current law has rules for determining the purchase price if there is previously owned stock, related party-owned stock, or stock held by a minority shareholder. The purchase price must then be allocated among the assets. Separate rules, also dealing with minorities and the like determine the basis in the assets. Consistency rules are also necessary.

Shareholder nonrecognition. The ALI does not offer any clear justification for allowing shareholders nonrecognition in a corporate acquisition. After a long discussion, it states that it wants to maintain and rationalize the status quo. This means that the ALI ends up with a set of proposals for shareholder nonrecognition that look very much like current law. In particular, the ALI would not tax shareholders if stock of an acquired corporation is exchanged for solely for stock of one or more acquiring corporations in pursuance of a plan of acquisition. The rule requires definitions of acquired corporation, acquiring corporation, control (including indirect control) and substantially of the properties. In addition, rules are needed for "boot." These are all concepts familiar from the current rules surrounding tax-free reorganizations. The SFC has a similar rule, which allows tax-free exchanges of stock by shareholders. They key the requirements off of the qualified acquisition definition discussed above. p. 52-53 of the SFC report.

To summarize, the ALI and SFC proposals represent the thinking of the very best lawyers on these issues, developed over years of work and consultations. They are both very good. Nevertheless, neither can eliminate the core of complexity created by dual ownership. Neither would likely significantly reduce the expenditures spent on corporate tax

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[48]Seemingly straightforward transactions are difficult to classify under current law. For example, ___.

planning. That these are the best we can do essentially proves the point of the paper: there is a core of complexity in firm-level taxes.

B. *Yin's Proposals for the Treatment of Distributions*

Like with the ALI and SFC proposals for acquisitions, there have been a number of proposals that attempt to reform the treatment of distributions. The 1982 ALI report, in a reporter's study attached to the report, suggests major changes in the rules for distribution. George Yin several years later published an extensive treatment of a similar but slightly modified proposal.[49] Yin's article is important in its own right, but it is especially important for this paper because he claims that his system works without a tax on stock sales. (The ALI does not have this feature, which is the reason for the focus on Yin.) Thus, if his claims are right, the central thesis of this paper is incorrect.

Yin's idea is based on the "new view" of the corporate tax. The new view holds that a tax on corporate distributions does not affect the timing of distributions. One intuition for this is that a tax on distributions is essentially a cash flow tax and we know cash flow taxes are not affected by timing – the present value is the same.[50] Thus, if a dollar is left in the corporation, the future distribution will be the future value of the dollar and the future tax on the distribution will the future value of the tax on a distribution of the dollar today.

To illustrate, suppose that a business owner is deciding whether to have a corporation distribute a dollar or leave inside a corporation until the

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[49] George K. Yin, A Different Approach to the Taxation of Corporate Distributions: Theory and Implementation of a Uniform Corporate-Level Distributions Tax, 78 Georgetown L. Rev. 1837 (1990).

[50] There is no deduction on the contribution to a corporation, so it is not really a cash flow tax. But once the contribution is made, any deduction not granted at that time is sunk. The tax on the withdrawal is exactly like a cash flow tax.

future, when its value will be \$1.50. If the tax rate is τ, the tax on a distribution today is \$$\tau$. If the corporate retains the earnings and distributes \$1.50 in the future, the tax will be \$1.5τ, which is the future value of τ. Thus, the owner is indifferent to the timing of the distribution. Of course, if the after-tax rate of growth is different inside a corporation and outside the corporation, there is an incentive to put the money where the rate of growth is highest, but this is an effect created by the investment opportunities in each place and a tax on the earnings in each location, not by the tax on distributions.

The key to this argument is that the tax on distribution be uniform. If it is likely to change, there is an incentive to pay it when it is low. Moreover, if the rate of tax depends on the form of the distribution, as under current law, there is an incentive to use a low taxed form (such as share repurchases under current law).

Yin's proposal flows directly from these ideas. He suggests that there be a uniform tax on all corporate distributions, remitted by corporations. The only major exception to this rule is that corporations are allowed to distribute originally-contributed capital tax-free when they liquidate. For example, suppose that a corporation has \$100 of earnings and it can distribute it now or retain it and distribute it when the \$100 has grown to \$150. To replicate a shareholder-level tax of 33.3%, Yin would impose a corporate level distribution's tax of 50%. Thus, if the corporation distributed today, it could distribute \$66.7 and pay a tax of \$33.3. This would grow to \$100 in the shareholder's hands. Alternatively, the corporation could distribute \$100 in the future and pay a tax of \$50.

If the shareholder had originally contributed the \$100, there would be a credit of the tax rate multiplied by the contribution when the corporation liquidated. Thus, if the corporation liquidated right away, there would be a \$33.3 tax on the \$66.7 distribution plus a credit of \$33.3, allowing the corporation to return all of the shareholder's cash. If the corporate retained the cash until it grew to \$150, the corporation would

distribute $100, pay a 50 percent tax on this amount, or $50, plus get a credit of $33.3 for the original contribution. At the end of the say, the shareholder would get back $133.3, and, therefore, effectively has paid a tax of $17.7 on $50 of earnings, which is the correct 33.3 percent tax.[51]

There are a variety of other details in the proposal. For example, share repurchases are treated just like any other distribution. Purchases of control of a target corporation by another a corporation is treated as a distribution and the purchasing corporation pays the distribution's tax. Portfolio purchases by corporations, however, are not given this treatment.

Yin argues that this system does not need a tax on stock sales. Gain in a share of stock represents corporate earnings, which are being taxed at the corporate level. A sale of stock is not a distribution, so there is no need to impose a distributions tax. Thus, a tax on stock sales represents a third and distorting tax on corporate investment. As noted in Section II above, it is eventually unwound with a loss, but the difference in timing and hence the present value of the net tax can be significant.

To illustrate, suppose that an investor owns stock with $100 of earnings. With a 50 percent corporate distribution's tax, the individual knows that he can get at most $66.7 out of the company and, therefore will have paid this amount for the stock. Suppose the corporation retains its earnings and they increase to $150 (after corporate taxes). If the investor sells the stock, the new buyer will purchase it for at most $100 because this is the most the buyer can get out of the corporation. The individual

[51]Note that the return of capital provisions do not work if there is any time between a distribution beyond earnings (i.e., of original capital) and a liquidation. This is the reason current law attempts to measure earnings and profits to determine if a distribution is a dividend. Any attempt to determine which distributions are out of earnings and which are out of contributed capital, however, is essentially arbitrary, money being fungible. Yin's proposal takes the idea to an extreme by assuming no distributions are a return of capital until liquidation. Whether refinements are worthwhile would depend on a balance between the additional complexity and the benefit of a more accurate rule.

will have invested $66.7 and it will have grown to $100. This is the same amount the original investment would have received had he not sold the stock and instead received a cash distribution of the earnings from the corporation. Thus, not taxing stock sales makes the investment indifferent between selling and holding. A tax on stock sales would create an incentive to distribute before a sale.

Yin's claim is directly contrary to the thesis here. Here, I think, is how the contradiction can be explained. Yin is focused on the appropriate timing of a tax on distributions and does not address at all the measurement of income at the corporate level. If income is being properly measured at the corporate level, he is correct: A tax on stock sales creates a distortion. The claim here, however, is that not taxing stock sales means that income at the corporate level will not be measured correctly, and that a tax on stock sales is necessary to help. As Yin argues and is illustrated extensively above, a tax on stock sales distorts a variety of incentives, such as the incentive to distribute and the incentive to purchase assets or stock. Nevertheless, I believe there is no choice but to accept these distortions. That is, Yin is correct that a tax on stock sales is not a good idea if one is only analyzing distributions. It becomes necessary once one considers the measurement of income at the corporate level, and the problem is dealing with the problem this necessary tax creates for distributions.

To illustrate, Yin argues that his system works for any tax rate on distributions because the distributions tax is independent of the tax on earnings. To take an extreme case, assume the distributions tax were zero. Leaving aside the interest deduction (or assuming an all equity corporation), this is just CBIT. As is illustrated above, by transferring assets using subsidiary, CBIT can be converted into a consumption tax.

The same holds true if the distributions tax is positive. The present value of the distributions tax does not change by using sales of subsidiaries but the tax on corporate earnings is deferred until retail sale. The net tax is like a consumption tax imposed at the combined rate.

Another way to see this is that the distributions tax is a cash flow tax, so timing does not matter. The tax on corporate earnings, however, is an income tax, and timing is central. By not taxing stock sales, the tax on distributions is unaffected, as Yin argues, but the tax on corporate earnings is very much affected, a point which Yin skips over.

Yin hints at this issue when he discusses whether a tax on stock sales can be seen as a surrogate for the nonexistent corporate income tax on unrealized corporate gains. p. 1897. He argues, however, that "if this is the tax's true function, it certainly operates in a whimsical, ad hoc manner." He also argues that "unless accrual realization is introduced generally into the tax system, there is no reason to treat unrealized corporate-level gains any differently from unrealized shareholder-level gains that would arise (and not be taxed) from investments made out of corporate solution." What these arguments miss is that a tax on stock sales, ad hoc as it may be, is not whimsical. It is necessary to collect a corporate income tax.

One respond is that the avoidance potential is not worth the extra complexity and distortions. Selling assets by selling subsidiaries is a loophole, but it is not worth closing. Whether this argument is correct depends on a judgment about the extent of the likely avoidance and cost of the complexity. In my view, allowing a business to sell subsidiary stock for cash without tax makes avoidance very easy and would be a major mistake. Thus, I believe that this piece of Yin's proposal would not work, and Yin's claim that his system does not need to tax stock sales erroneous.[52]

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[52]Yin's proposal, however, deserves serious study. While relatively simple in conception, a number of serious difficulties arise in implementation. Still has stock/asset sale differences, reorganization rules, a variety of important lines or boundaries in his proposal (most importantly between portfolio stock and subsidiary stock), a requirement of valuation of subsidiary assets (!), problems defining liquidation, etc. Need to understand the pressures at these boundaries and whether, given these boundaries, whether the system would be a sufficient improvement to be worth adopting.

C. *ALI/Treasury Integration Studies*

Most of the above discussion illustrating the problems with measuring income at the business level used the income VAT or CBIT as the prototype. Neither CBIT nor the income VAT have been developed in sufficient detail to know whether they include potential solutions to minimize the problems.[53] This section examines two other integrated corporate tax proposals, the dividend exclusion system and the ALI credit imputation system, to see how they attempt to solve the problems highlighted above.

The dividend exclusion model was developed in detail by the Treasury in a follow-up study to the 1992 Integration Report (the Treasury Recommendation). A dividend exclusion regime is essentially the same as CBIT except that interest is deductible by the borrower and taxed to the lender. Thus, understanding how a dividend exclusion regime works gives insight into the likely details of a CBIT regime.

A casual perusal of the Treasury Recommendation shows that most of the features of the current corporate tax are retained. For example, stock sales are taxed. The distinction between share repurchases and dividends remains, as do the special rules for stock dividends. The distinctions between normal distributions and various types of liquidations also remains. As should be expected from the discussion above, both the stock sale/asset sale consistency rules (338(h)(10)) and the tax-free reorganization rules stay the same. The core of corporate tax doctrine remains exactly as before.

One possible reason for retaining most of the doctrinal complexity of current law is that the Treasury wanted to reduce the number of changes when moving to an integrated system. It noted that "retaining current law significantly simplifies the transition to integration by relying on

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[53]The income VAT is current in use as part of the local tax system in Japan. Cite.

established principles and rules." p.6. It is possible that a dividend exclusion regime would allow some of these complexities to be eliminated. There is, however, no indication that this would be the case. Dividend exclusion is essentially the same as current law except that dividends are tax-exempt rather than taxable. Some of the rules of the current corporate tax are about ensuring that dividends are properly taxed and some of these rules might no longer be necessary. The Treasury Recommendation does contain some changes to current law in this regard. But there is no reason to believe that the core of corporate tax complexity would change. Stock sales are still taxed. Stock sale/asset sale distinctions and conformity rules remain. Tax-free formations and reorganizations remain. Complicated distribution rules remain. A dividend exclusion regime is extremely unlikely to reduce the doctrinal complexity of the corporate tax.

The credit imputation system, in broad stroke, is the same as the dividend exclusion except that individuals are both taxed on dividends and given a credit for taxes paid at the business level. If individuals and businesses are taxed at the same rate, this comes out as a wash. For example, if a business has $100 of earnings and pays a tax of $30, it is left with $70 to distribute. The individual is treated as receiving a $100 dividend from which $30 has been withheld, just like wages are treated under current law. The individual gets a $30 credit, so if his tax rate is 30 percent, it comes out as a wash. If the individual's tax rate is not 30 percent, however, the credit will be either too high or too low. The net tax will end up being at the individual tax rate instead of the business tax rate, which is the only real difference between the credit imputation system and the dividend exclusion system.

The credit imputation approach recommended by the ALI is closely related to the dividend exclusion system. Under the ALI approach, dividends are taxable to shareholder but shareholders also receive a tax credit for taxes paid by the corporation. If tax rates are the same at each level, the two are equal. (The Treasury Report illustrates this at p. 185.) The major difference, therefore, is that the ultimate tax on corporate

income under the credit imputation approach is based on the shareholder's tax rate, while the ultimate tax on corporate income under the dividend exclusion approach is based on the corporate tax rate. Given the minimal differences between the approaches, it would be surprising if the doctrinal complexity were different.

The ALI gives some detail but not a sufficient amount to determine the full level of doctrinal complexity. It is clear that stock sales will continue to be taxed (proposal 6, p. 129) but the ALI does not mention whether the stock sale/asset sale conformity rules would remain. (It references the 1982 ALI report for a discussion of these issues.) The distributions rules of current law (distinguishing a dividend from a redemption) remain (proposal 7, p. 143). The tax-free reorganization rules remain. p. 101. The ALI was likely focused on bigger issues, but it seems clear that it did not see the potential for significant doctrinal simplification as part of its recommendation.

D. *Summary*

My conclusion is that none of the proposed corporate-level taxes avoid the measurement problems illustrated here. Although these systems may significantly reduce some of the economic distortions of current law, they would not eliminate much of the complexity. The basic problems of income measurement that have plagued current law would remain in these systems.

IV. Conclusion

The claim of this paper is that the problem of dual ownership creates inevitable complexity, line drawing, and seeming incoherence in firm-level income taxes. Firm-level income taxes are inevitably forced to choose between accurately measuring income by taxing stock sales and asset sale consistently, and imposing a tolerable level of complexity.

There are huge numbers of potential regimes for taxing income at the firm level, and one paper cannot possibly explore even a small fraction of them. The claim was illustrated using the current corporate law and several of the more prominent reform proposals. The partnership rules of current law could equally have been used for illustration. Other regimes, already proposed or yet to come, might satisfy the constraints better, and the search for better compromises continues. No firm-level income tax, however, can eliminate the underlying problems.

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