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# CORPORATE TAXATION AFTER THE TAX REFORM ACT OF 1986: A STATE OF DISEQUILIBRIUM

ERIC M. ZOLT†

*The Tax Reform Act of 1986 and the Revenue Act of 1987 fundamentally changed the taxation of corporations and their shareholders. In this Article Professor Zolt contends that before the 1986 Act and the 1987 Act, certain biases contained in the individual and corporate tax systems crudely offset each other such that a rough equilibrium governed corporate taxation. Professor Zolt contends the fundamental changes that Congress has imposed have upset that balance resulting in many unexpected and perhaps undesirable consequences.*

*To demonstrate his thesis Professor Zolt surveys the major changes in the two Acts. He then uses a series of quantitative examples to illustrate why those changes will have a "disequilibrating effect" on the corporate tax system and may influence taxpayer decisions on form of business operations, financing, and dividend policy. Professor Zolt concludes his argument by calling on Congress to examine the effects of the 1986 Act and the 1987 Act, and to take some action to restore the balance that the taxation of corporations and their shareholders once enjoyed.*

The pressures to radically reduce individual tax rates and to maintain at least nominal revenue neutrality from tax law changes have resulted in fundamental changes in the corporate tax system. The changes contained in the Tax Reform Act of 1986 (the "1986 Act")<sup>1</sup> and the Revenue Act of 1987 (the "1987 Act")<sup>2</sup> upset a rough equilibrium for corporate taxation that prior tax laws had created. These changes influence taxpayer decisions on form of business operations, financing, and dividend policy, and exacerbate the trend toward placing the burden of the corporate tax primarily on publicly owned corporations. It is unclear whether these consequences are desirable under any of the traditional criteria for evaluating tax law changes. It is certain, however, that the 1986 and 1987 Acts fundamentally changed the corporate tax system. Apart from revenue concerns, Congress did not give much consideration to these fundamental changes and, as a result, many of their consequences were not intended.

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1. Pub. L. No. 99-514, § 141, 100 Stat. 2085 (1986).

2. Pub. L. No. 100-203, § 1001, 101 Stat. 1330 (1987).

This Article describes how the corporate tax system has been knocked off balance, what changes in taxpayer behavior may result from the 1986 and 1987 Acts, and why the corporate tax will be borne increasingly by publicly held corporations. Here is the itinerary. Section I examines the old equilibrium. It reviews the biases created by having a separate, unintegrated corporate tax and the compensating biases in the individual tax system. Section II examines the new disequilibrium. It reviews the changes in the 1986 and 1987 Acts and describes how these changes have upset the compensating biases. Section II then highlights the disequilibrating effects through a series of simple quantitative examples. These examples illustrate how the tax law changes could affect taxpayer decisions on form of business operations, financing, and dividend policy. Section III examines the alternatives available to Congress to restore some balance in the taxation of corporations and their shareholders.

### I. THE OLD EQUILIBRIUM—THE PRE-1986 ACT TAX REGIME

Under the pre-1986 Act regime, a rough equilibrium governed the relationship between the individual and corporate tax systems. That regime was not without tax-induced distortions. A separate, unintegrated corporate tax system, for example, creates a "double tax" on distributed corporate income.<sup>3</sup> Furthermore, such a corporate tax system creates a bias against capital in corporate form and biases in favor of debt financing and retained earnings. Other components of the pre-1986 Act tax system, however—such as the ability to defer shareholder-level tax until corporate earnings are distributed, lower corporate tax rates as compared to individual tax rates, and the favorable rate preference accorded capital gains—roughly compensated for the biases created by a separate corporate tax system. Strong arguments support the position that the tax system should not influence taxpayer decisions on form of business operations, financing, and dividend policy. These decisions should be made on the basis of economic factors apart from tax considerations. The compensating biases greatly contributed to tax neutrality in these decisions.

The concept of compensating biases is important in understanding the relationship between the individual and corporate tax systems. Compensating biases affect the coordination and relative importance of certain provisions of each system, as well as the relative amounts of revenue to be raised by each system.<sup>4</sup> Compensating biases may also have a psychological effect on taxpayers. If taxpayers determine the tax system to be in rough equilibrium with respect to the tax benefits and detriments of certain activities, then they will be less willing to change behavior solely for tax reasons.

This Section examines both the biases created by a separate corporate tax

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3. Distributed corporate income bears a "double tax" because it is taxed at the corporate level when earned and at the shareholder level when distributed.

4. For example, increasing the individual tax rate may increase corporate tax revenues if the rate change results in more taxpayers adopting the corporate form or retaining more funds in the corporation to avoid higher individual tax rates. Conversely, increasing corporate tax rates may increase individual tax revenues if the rate change results in more taxpayers conducting their activities in noncorporate rather than corporate form.

system and the compensating biases contained in the individual income tax system.<sup>5</sup> It then briefly reviews strategies taxpayers developed to minimize aggregate shareholder and corporate tax liabilities under the pre-1986 Act tax regime.

### A. Biases Resulting From a Separate Corporate Tax

#### 1. Bias Against Capital in Corporate Form

The two-tier tax system results in a higher effective tax burden on capital held in corporate form than that imposed on noncorporate investment. Only corporations,<sup>6</sup> as opposed to proprietorships, partnerships, and S corporations,<sup>7</sup> are subject to an entity-level tax. The additional tax burden may induce some behavioral changes. Some economists contend that the corporate tax reduces investment in general<sup>8</sup> and investment in the corporate sector in particular.<sup>9</sup> This analysis depends on certain assumptions regarding certainty,<sup>10</sup> the structure of the tax system,<sup>11</sup> and incidence of the corporate tax. Although it is plausible to assume changes in behavior, it is difficult, if not impossible, to determine

5. The discussion in the text is a summary of aggregate effects. However, the separate corporate tax may affect the allocation of investment among different assets, industries, and sectors, as well as the aggregate level of investment. The tax may also have differing effects on industries that traditionally have different debt levels or different dividend payout levels.

6. Certain trusts and partnerships may be taxed as corporations if they have more corporate than noncorporate characteristics. See Treas. Reg. § 301.7701-2(a) (as revised in 1983); *id.* § 301.7701-3(b) (1967).

7. For a description of S corporations and qualification requirements see *infra* note 48. Unless otherwise indicated, references to "corporations" signify corporations not electing to be taxed as S corporations.

8. See Feldstein, *The Welfare Cost of Capital Income Taxation*, 86 J. POL. ECON. 29 (1978).

9. See Fullerton, Shoven & Whalley, *General Equilibrium Analysis of U.S. Taxation Policy*, in 1978 COMPENDIUM OF TAX RESEARCH 23 (U.S. Treas. Dept. Office of Tax Analysis 1978); Harberger, *The Incidence of the Corporation Income Tax*, 70 J. POL. ECON. 215 (1962). *But see* Stiglitz, *The Corporation Tax*, 5 J. PUB. ECON. 303, 303 (1976) [hereinafter Stiglitz, *Corporation Tax*] (contending that under certain assumptions the corporate tax is nondistortionary and does not affect the financial structure or investment strategy of the corporation); Stiglitz, *Taxation, Corporate Financial Policy, and the Cost of Capital*, 2 J. PUB. ECON. 1, 33 (1973) [hereinafter Stiglitz, *Taxation*] (rejecting Harberger's conclusion that the corporate tax results in an inefficient allocation of resources).

The bias is against new investment in corporate form, not against existing investment. The value of existing investment already reflects the economic cost of the two-tier tax system. Changing the tax system results in a windfall gain to current holders, but does not correct past inequities. For a discussion of how the corporate tax affects stock valuation, see Warren, *The Relation and Integration of Individual and Corporate Taxes*, 94 HARV. L. REV. 719, 726-29 (1981); *see also* Bradford, *The Incidence and Allocation Effects of a Tax on Corporate Distributions*, 15 J. PUB. ECON. 1, 21 (1981) (concluding that proposals to integrate the individual and corporate tax systems may result in windfall gains to existing shareholders and may not make the tax system more efficient).

10. For an analysis of the effects of uncertainty in models measuring distortions caused by the corporate tax, see Gordon, *Uncertainty and the Analysis of Corporate Tax Distortions*, 74 NAT'L TAX ASS'N—TAX INST. OF AM. 31 (1981).

11. The models measuring distortion contain simplifying assumptions with respect to the operation of the tax system that do not fully reflect taxpayer strategies to minimize taxes. For a review of these strategies, see *infra* notes 46-77 and accompanying text. Other economists find the corporate tax to be nondistortionary when factors such as depreciation and interest deductibility are included in the analysis. See, e.g., Flemming, *A Reappraisal of the Corporation Income Tax*, 6 J. PUB. ECON. 163, 169 (1976); King, *Taxation, Corporate Financial Policy, and the Cost of Capital*, 4 J. PUB. ECON. 271, 278 (1975).

the degree of those changes. Behavioral effects are part of the larger question of incidence.

The debate over the incidence of the corporate tax is long-standing and has been thoroughly examined in the legal and economic literature.<sup>12</sup> Whether the corporate tax can be shifted depends on the degree of competition in the particular market and the nature of the long-run adjustment mechanisms in the economy.<sup>13</sup> The empirical results are conflicting and the question likely will never be satisfactorily resolved.<sup>14</sup> Some economists contend that if shareholders bear the tax, the additional tax causes inefficiency because it will cause shifts in resource allocation away from the corporate sector. Based on this assumption, the separate corporate tax results in a bias against investment in the corporate form.<sup>15</sup>

## 2. Bias in Favor of Debt Financing

Corporations have three basic alternatives in generating funds for new projects: issuing new equity, issuing debt, or using retained earnings. In the absence of taxes, and assuming certain other conditions,<sup>16</sup> a corporation's capital structure does not affect its value.<sup>17</sup> This argument is based on the ability of a shareholder to substitute personal for corporate leverage, thereby undoing at the shareholder level any financing strategy adopted at the corporate level.<sup>18</sup>

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12. For a summary of the competing theories of the incidence of the corporate tax, see R. GOODE, *THE CORPORATION INCOME TAX* 44-72 (1951); Griffith, *Integration of the Corporate and Personal Income Taxes and the ALI Proposals*, 23 SANTA CLARA L. REV. 715, 724-31 (1983); see also McLure, *Integration of the Personal and Corporate Income Taxes: The Missing Element in Recent Tax Reform Proposals*, 88 HARV. L. REV. 532, 657 (1975) (arguing that to the extent corporations shift the corporate tax burden to consumers and labor via price and wage adjustments, and assuming integration of the tax system would encourage corporations to reverse this shift, the case for integration on equitable grounds is strengthened).

13. Stiglitz, *Corporation Tax*, *supra* note 9, at 309.

14. See Thurow, *The Economics of Public Finance*, 28 NAT'L TAX J. 185, 187 (1975); see also Klein, *The Incidence of the Corporation Income Tax: A Lawyer's View of a Problem in Economics*, 1965 WIS. L. REV. 576 (reviewing the shortcomings of various empirical studies of the incidence of the corporate tax and finding the results to be wholly inconclusive).

15. Eliminating the corporate tax, however, may not result in a more ideal allocation of resources. Because the United States economy deviates significantly from the perfectly competitive, entirely unregulated economic model, removing the biases resulting from a separate corporate tax will not necessarily result in a movement towards an ideal allocation of resources. See Lipsey & Lancaster, *The General Theory of Second Best*, 24 REV. ECON. STUD. 11 (1956).

16. The primary assumption is the existence of perfect capital markets—that is, markets in which information is available at no cost to all investors, there are no transaction costs or taxes, and investors are rational. An important characteristic of perfect capital markets is that all firms and individuals can borrow or lend on the same terms. Other assumptions focus on a firm's expected future operating earnings and the separation of firms into different risk and return classes.

17. The classic article finding the value of the corporation to be independent of its capital structure is Modigliani & Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 AM. ECON. REV. 261 (1958). For a discussion of the assumptions underlying the Modigliani and Miller position and subsequent commentary, see V. BRUDNEY & M. CHIRELSTEIN, *CORPORATE FINANCE* 372-73, 379-402 (3d ed. 1987), and Gordon & Malkiel, *Corporate Finance*, in *HOW TAXES AFFECT ECONOMIC BEHAVIOR* 131 (H. Aaron & J. Pechman eds. 1981), and the sources cited therein. *But see* Jensen, *Agency Cost of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323, 325 (1986) (finding that the empirical evidence seems to support the view that most leverage-increasing transactions result in significantly positive increases in common stock prices).

18. A shareholder's ability to effectively change any capital structure adopted by a firm eliminates any value that capital structure changes may have to a firm. Firms that are identical in every way except their capital structures should therefore have the same value.

The introduction of taxes, particularly the interest deduction provided in the corporate tax system,<sup>19</sup> complicates the analysis. Using debt allows the corporate-level tax to be avoided, as interest deductions eliminate part, or in some instances all, of the corporation's taxable income.<sup>20</sup> In contrast, dividends are not deductible. Therefore, all other things being equal, the corporation's value increases when debt is substituted for equity in its capital structure.<sup>21</sup>

Several factors may work against the unlimited debt hypothesis.<sup>22</sup> Higher debt levels increase the risk of bankruptcy. As the potential for bankruptcy increases, greater uncertainty arises about the availability of future cash and tax benefits. At some point, therefore, the additional risks of bankruptcy outweigh the additional tax benefits from increased debt. Increased costs associated with greater debt also further limit debt in the capital structure.<sup>23</sup> Creditors may demand more restrictive covenants and monitoring measures as the proportion of debt in the capital structure increases. Conflicts may arise between bondholders and shareholders that may impair a corporation's performance and investment decisions.<sup>24</sup> Finally, the corporate tax benefits accorded debt financing may be tempered by the tax benefits provided for equity financing in the individual tax system.<sup>25</sup> As examined in the following sections,<sup>26</sup> interest income effectively escapes corporate taxation but is heavily taxed at the debt holder level. In contrast, equity income is subject to a corporate-level tax but receives favorable tax treatment at the shareholder level.

### 3. Bias in Favor of Retained Earnings

If one assumes perfect capital markets, the corporation's decision whether to retain or distribute earnings should not affect the value of the corporation.<sup>27</sup> The shareholders can effectively undo any payout strategy adopted by the corpo-

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19. See I.R.C. § 163 (1982).

20. In those cases in which the return from investment equals the cost of borrowing, the corporate-level tax is completely avoided. See also Cordes & Sheffrin, *The Tax Advantage of Debt Finance*, 74 NAT'L TAX ASS'N—TAX INST. OF AM. 44 (1981) (examining the value of debt deductions in light of such competing tax shields as depreciation deductions and net operating losses).

21. The value of the corporation should increase in a linear fashion by the present value of the tax savings from using debt. V. BRUDNEY & M. CHIRELSTEIN, *supra* note 17, at 383-85.

22. No theory appears able to completely explain how firms choose their debt-equity ratio. See generally R. BREALEY & S. MYERS, *PRINCIPLES OF CORPORATE FINANCE* 377-403 (2d ed. 1984) (discussing factors influencing the capital structure decision); Myers, *The Capital Structure Puzzle*, 39 J. FIN. 575 (1984) (advocating the "pecking order framework" for analyzing capital structure, in which a firm prefers internal to external financing and debt to equity if it issues securities).

23. V. BRUDNEY & M. CHIRELSTEIN, *supra* note 17, at 391-93. The increased costs are borne by the shareholders in the form of higher interest payments or reduced operating flexibility. See also Gordon & Malkiel, *supra* note 17, at 163-72 (estimating efficiency costs resulting from high debt-equity ratios).

24. R. BREALEY & S. MYERS, *supra* note 22, at 390-400.

25. See Miller, *Debt and Taxes*, 32 J. FIN. 261, 268-72 (1977).

26. See *infra* text accompanying notes 34-38, 129-40.

27. See Black & Scholes, *The Effects of Dividend Yield and Dividend Policy on Common Stock Prices and Returns*, 1 J. FIN. ECON. 1, 21 (1974) (concluding dividend policy is irrelevant to a firm's value even in the presence of taxes); Miller & Modigliani, *Dividend Policy, Growth and Valuation of Shares*, 34 J. BUS. 411 (1961) (discussing the independence of dividend policy from the value of the corporation).

ration by either selling or buying additional stock. The introduction of taxes, however, creates a bias against dividend distributions. The two-tier tax system affects a corporation's dividend policy because distributed earnings are generally subject to a "double tax": at the corporate level, when the income is earned, and at the shareholder level, when the income is distributed.<sup>28</sup> The effect of the double tax may be reduced by retaining earnings and thereby deferring imposition of the shareholder-level tax.

Tax incentives to accumulate funds at the corporate level may result in a less efficient use of capital than would be the case if the funds were distributed to shareholders.<sup>29</sup> The two-tier tax system encourages corporate managers to act as investment bankers for their shareholders because of the high tax costs of distributing excess funds as dividends.<sup>30</sup> Taxes also influence the form of corporate distributions. The tax system before the 1986 Act created a bias against dividend distributions in favor of nondividend distributions. Dividend distributions were generally taxable to shareholders at ordinary income rates (before the 1986 Act, at rates of up to 50%), while nondividend distributions were generally taxable at capital gain rates (before the 1986 Act, at rates of up to 20%).

Given the strong tax bias against dividends, one could surmise that corporations would refrain from making dividend distributions. Publicly held corporations, however, regularly distribute a significant proportion of their income as dividends.<sup>31</sup> Three explanations have been offered.<sup>32</sup> First, there are enough investors who either prefer dividends or are indifferent to the tax treatment of dividends that the market may value dividends and capital gains equally.<sup>33</sup> Second, despite the tax disadvantages of dividend distributions, shareholders may prefer a steady stream of available income to the transaction costs that would result from selling a portion of their holdings. Third, the payment of dividends may positively influence the market's valuation of the corporation's stock to such an extent that the improvement in investors' valuation of the corporation outweighs the higher tax costs.

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28. For an illustration of tax burdens before and after the 1986 Act, see *infra* notes 105-07 and accompanying text. For a comparison of tax consequences of different dividend strategies before and after the 1986 Act, see *infra* text accompanying notes 141-44.

29. See C. McLURE, JR., MUST CORPORATE INCOME BE TAXED TWICE? 25 (1979); M. NORR, THE TAXATION OF CORPORATIONS AND SHAREHOLDERS 56-57 (1982).

30. Managerial discretion over excess funds may explain the less-than-enthusiastic support many members of the business community give integration. See *infra* note 174.

31. Closely held corporations generally have been successful in paying out corporate earnings without making dividend distributions. See *infra* text accompanying notes 49-50.

32. See V. BRUDNEY & M. CHIRELSTEIN, *supra* note 17, at 492-502 (and sources cited therein); Gordon & Malkiel, *supra* note 17, at 174-76.

33. Corporate investors, for example, prefer dividends to capital gains because the dividends received deduction allows corporations to deduct from their income either 70%, 80%, or 100% of dividends received from domestic corporations, depending on the size of the ownership interest the recipient corporation has in the payor corporation. I.R.C. § 243 (Supp. IV 1986). Tax-exempt investors are indifferent to the tax characterization of distributions as dividends or capital gains. For any given financial policy adopted by a firm, there are likely to be investors who prefer that policy. This phenomenon is known as the "clienteles effect." See generally Auerbach, *Stockholder Tax Rates and Firm Attributes*, 21 J. PUB. ECON. 107 (1983) (examining empirical results for the period 1963-1977 and finding the existence of investor clienteles differentiated by tax rates).

## B. *Compensating Biases*

The biases created by the corporate tax system against capital in corporate form and in favor of debt financing and retained earnings constitute only part of the analysis. A more complete analysis must also consider the compensating biases contained in the individual income tax system.<sup>34</sup> Before the 1986 Act, the individual tax system created a bias in favor of corporate investment through a combination of three factors: the deferral of the shareholder-level tax until earnings are actually distributed; a generally lower corporate (as compared to the individual) tax rate on earnings retained; and the possibility of extracting funds from the corporation at either capital gain rates or at no shareholder-level tax cost if the shares are held until death.<sup>35</sup> The result was that, when considered together, the biases created by the corporate tax system and the biases created by the individual tax system offset each other, albeit in a crude and incomplete fashion.

It can be demonstrated that certain specific biases, under realistic assumptions, offset each other. Because of these compensating effects, the tax system achieves rough equivalence between retained earnings and dividend distributions, and between debt financing and financing by retained earnings. For example, a comparison of the tax benefits and costs of retaining or distributing corporate earnings indicates rough equality.<sup>36</sup> The major tax benefit of retaining earnings results from the ability to defer the shareholder-level tax until the earn-

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34. This position is sometimes referred to as the "new view" of corporate tax. This phrase was used by Professor Auerbach in his article *Tax Integration and the "New View" of the Corporate Tax: A 1980's Perspective*, 74 NAT'L TAX ASS'N-TAX INST. OF AM. 21 (1981); see B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* §§ 1.02 to .03 (5th ed. 1987); W. KLEIN & J. COFFEE, *BUSINESS ORGANIZATION AND FINANCE* 287-95 (2d ed. 1986); Andrews, *Tax Neutrality Between Equity Capital and Debt*, 30 WAYNE L. REV. 1057 (1984); Bradford, *supra* note 9; Bryan, *Leveraged Buyouts and Tax Policy*, 65 N.C.L. REV. 1039, 1051-55 (1987).

35. Historically, the high bracket individual taxpayer used the corporate entity as a tax shelter. The use of the corporate form was especially attractive when the maximum individual tax rate greatly exceeded the maximum corporate tax rate and when the tax rate applicable to ordinary income greatly exceeded the tax rate applicable to capital gains.

Section 1014(a) provides that property acquired from a decedent has a basis of fair market value at the date of death (or six months thereafter if the alternative valuation date is elected under § 2032). I.R.C. § 1014(a) (1982). Therefore, neither the transferee nor the decedent recognizes gain on any predeath appreciation.

36. See Reporter's Study on Corporate Distributions, Appendix to AMERICAN LAW INSTITUTE, *FEDERAL INCOME TAX PROJECT, SUBCHAPTER C: PROPOSALS ON CORPORATE ACQUISITIONS AND DISPOSITIONS* (1982) [hereinafter A.L.I., REPORTER'S STUDY]. Professor William Andrews illustrates this offsetting relationship with the following example. He assumes one dollar of corporate funds is available for either reinvestment in the corporation (retained earnings) or distribution to shareholders (dividend distribution). If the dollar is reinvested in the corporation, produces a return of 18% before tax, and the earnings are subject to a 50% corporate tax (or a 9% after-tax rate of return), the dollar investment triples in about 13 years. This leaves \$3 available for distribution to shareholders, which if distributed and subject to a 50% shareholder-level tax, leaves the shareholder with \$1.50 after tax.

Alternatively, the dollar could immediately be distributed as a dividend to the shareholders. Assuming again a 50% shareholder-level tax, this leaves only \$0.50 to invest. In 13 years, again assuming a 9% after-tax rate of return, this produces about \$1.50, which is the same after-tax result as in the retained earnings alternative above. See *id.* at 349-52. This equivalence depends on critical assumptions: (i) corporate and individual investment opportunities are the same; (ii) corporate and individual tax rates are equal; and (iii) the rate of tax on eventual distribution to shareholders is



ings are distributed. The major tax cost is the imposition of a corporate-level tax on subsequent earnings—a tax that could be avoided by initially distributing the funds to shareholders.

Similarly, the tax system achieves rough neutrality between the tax consequences of debt and retained earnings financing.<sup>37</sup> The major tax benefit of debt financing—the use of interest deductions to reduce corporate-level tax liability—equals the tax cost of choosing to distribute rather than reinvest retained earnings; that is, the immediate shareholder-level tax on distributed funds. There remain, however, several uncompensated biases, most notably those that work against new corporate investment in favor of noncorporate investment, and against dividend distributions in favor of nondividend distributions.<sup>38</sup>

The existence of these uncompensated biases, and to a lesser extent the compensated biases, provokes two quite different responses by tax theorists. One response, championed primarily by academics, would eliminate or reduce biases through integration of the individual and corporate tax systems.<sup>39</sup> There are two basic types of integration proposals: full integration and partial integra-

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equal to the rate of tax on current distributions. A discussion of this relationship is also set forth in Warren, *The Timing of Taxes*, 39 NAT'L TAX J. 499, 501 (1986).

Failure to satisfy the conditions would probably increase the bias in favor of earnings retention. At least before the 1986 Act, the combination of (i) availability of capital gain rates on eventual distribution, (ii) a lower corporate rate than shareholder rate, and (iii) the ability to use the corporation to make portfolio investments in corporate stock (thus taking advantage of the dividends received deduction), created incentives to retain funds in corporate form. A.L.I., REPORTER'S STUDY, *supra*, at 350-51.

37. Professor Andrews examines the equivalence of debt financing and financing with retained earnings with the following example. He assumes a corporation has \$30,000 in retained earnings and is about to undertake a \$30,000 investment expected to yield 10%. One alternative is for the corporation to distribute currently the \$30,000 and to borrow from its shareholders (or from others) at an interest rate of 10%. The corporate-level tax is eliminated, as interest deductions equal the income from the investment. Assuming the shareholders are in a 46% bracket, distributing the \$30,000 to them produces \$16,200 after tax.

Alternatively, the corporation could use accumulated earnings to pay for the investment, in which case there would be no interest deduction. A 10% return on the project yields about \$1,620 after tax (assuming a 46% corporate tax rate), or a 5.4% after-tax rate of return. The after-corporate-tax yield of \$1,620 is equal to a 10% yield on \$16,200. Again, the bias in favor of debt financing (the use of the interest deduction to eliminate the corporate-level tax) and the bias in favor of retained earnings (the value of deferral of the shareholder-level tax that would have resulted if funds had been currently distributed rather than reinvested) are equal. If the shareholder's tax rate is higher than the corporate rate, then financing by accumulated earnings would be preferred to debt financing. If the shareholder rate is less than the corporate rate, then debt financing would be preferred. A.L.I., REPORTER'S STUDY, *supra* note 36, at 351-52.

The conclusion of equivalence ignores the effects of a capital gain tax imposed on a selling shareholder for stock appreciation attributable to retained corporate profits. Although the selling shareholder is taxed on this appreciation, the related retained earnings are still subject to corporate-level tax. See Bryan, *supra* note 34, at 1053-54 n.63.

38. Uncompensated biases exist in three areas: (i) bias against new equity contributions; (ii) bias in favor of nondividend distributions over dividend distributions; and (iii) bias in favor of corporate investment in other corporations over funds distribution. A.L.I., REPORTER'S STUDY, *supra* note 36, at 353-55. For an analysis of the bias in favor of nondividend distributions, see Bryan, *supra* note 34 (maintaining that this bias creates the primary tax incentive for leveraged buyouts).

39. Integration refers to the reciprocal relationship between the individual and corporate tax systems and to the variety of techniques that, while different in form, have the common aim of eliminating or reducing the "extra" tax burden of the corporate income tax on distributed profits. M. NORR, *supra* note 29, at 41.

tion.<sup>40</sup> Full integration proposals offer as a basic premise the taxation of shareholders on their pro rata share of corporate profits, whether or not the profits are distributed.<sup>41</sup> Income under these proposals would be taxed solely at the shareholder level.

The partial integration proposals focus on removing the double tax on distributed earnings while separately taxing retained earnings.<sup>42</sup> To the extent the shareholder tax rate exceeds the corporate tax rate, partial integration does not fully correct for the tax benefit of deferring the shareholder tax until earnings are distributed. Several different approaches to partial integration have been proposed. Some approaches provide relief at the corporate level by allowing the corporation a deduction for all or a portion of dividends paid.<sup>43</sup> Other approaches provide relief at the shareholder level in the form of either a dividends

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40. See C. MCLURE, JR., *supra* note 29, at 227-30 (describing 1977 Treasury Department Proposal); STAFF OF JOINT COMM. ON TAXATION, REPORT ON TAX POLICY AND CAPITAL FORMATION (1977) [hereinafter STAFF 1977 REPORT]; U.S. TREAS. DEPT., BLUEPRINTS FOR BASIC TAX REFORM 68-75 (1977) [hereinafter BLUEPRINTS]; McLure, *supra* note 12; Peel, *A Proposal for Eliminating Double Taxation of Corporate Dividends*, 39 TAX LAW. 1 (1985); Warren, *supra* note 9.

The integration proposals discussed herein are not the sole approach to eliminating the biases created by the two-tier tax system. See, e.g., Shoven & Taubman, *Saving, Capital Income and Taxation*, in THE ECONOMICS OF TAXATION 203 (H. Aaron & M. Boskin eds. 1980); King, *The Cash Flow Corporate Income Tax*, NBER Working Paper No. 1993 (1986) (presenting alternative approaches for eliminating the biases).

41. This approach was endorsed in BLUEPRINTS, *supra* note 40, at 68-75. Four rules form the basis of BLUEPRINTS' tax treatment of corporate profits: (i) each holder of stock on the first day of the corporation's accounting year would be designated the shareholder of record; (ii) each shareholder of record would add (subtract) to his tax base his share of the corporation's income (loss) annually; (iii) the basis of the shareholder of record in his stock would be increased (decreased) by the shareholder's share of income (loss); and (iv) any shareholder's basis in his stock would be reduced, but not below zero, by cash dividends or fair market value of any property distributed to him. Once the shareholder's basis is reduced to zero, the value of any further distributions would be included in income. *Id.* at 69-70.

Reservations about the conduit approach have centered on liquidity problems for shareholders where no corporate distributions are made, administrative problems in identifying shareholders and transferring shares, allocating income for different types of securities, audit adjustments, and the fairness of taxing income not distributed. See R. GOODE, *supra* note 12, at 184-90; C. MCLURE, JR. *supra* note 29, at 146-84; Warren, *supra* note 9, at 740.

42. See M. NORR, *supra* note 29, at 83-149; Comm. on Corps. of the Tax Section of the N.Y. Bar Assoc., *Report on Integration of Corporate and Individual Taxes*, 31 TAX LAW. 37 (1977) [hereinafter *New York Bar Association Integration Report*]; McLure, *supra* note 12, at 550-56.

43. Some proposals limit the amount of the deduction allowing relief only for "normal" distributions—dividends that reflect the cost of equity capital. Limitations may also be tied to a rate of interest, a proportion of dividends paid, or an imputed cost of equity capital. See M. NORR, *supra* note 29, at 100-06. Professor Andrews has proposed allowing a deduction for any dividend paid, but only up to the amount of a reasonable interest rate (the prevailing yield on high-grade corporate bonds) applied to the amount of equity contributed after the proposal becomes effective. See A.L.I., REPORTER'S STUDY, *supra* note 36, at 366-70.

The Treasury's November 1984 report proposed allowing corporations to deduct 50% of dividends paid subject to a source limitation. 2 TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH: THE TREASURY DEPARTMENT REPORT TO THE PRESIDENT ch. 7.01 (1984) [hereinafter TREASURY NOVEMBER 1984 REPORT]. The President's May 1985 proposal modified the Treasury Department approach by limiting the deduction to 10% of dividends paid. PRESIDENT'S TAX PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH AND SIMPLICITY § 6.02 (1985) [hereinafter PRESIDENT'S MAY 1985 PROPOSALS]. Similarly, H.R. 3838, 99th Cong., 2d Sess. § 311 (1985) provided for domestic corporations a deduction for 10% of dividends paid out of earnings taxed after the effective date of the provision. A description of this proposal is set forth in Simon, *Comments on Dividends Paid Deduction of H.R. 3838*, 31 TAX NOTES 609 (1986).

received credit<sup>44</sup> or an exclusion.<sup>45</sup>

Another response to the biases created by the separate, unintegrated corporate tax is to avoid addressing the problem directly and instead to hope that the compensating biases act to keep things balanced. In the past, Congress was able to follow this approach because the compensating biases resulted in rough tax neutrality for taxpayer decisions on form of business operations, financing, and dividend policy. After the 1986 Act, Congress may no longer have that luxury.

### C. *Taxpayer Strategies for Minimizing Taxes Under the Pre-1986 Act Tax Regime*

Before the 1986 Act, taxpayers used three strategies<sup>46</sup> to cope with the two-tier tax system and to mitigate the tax penalty of operating in the corporate form: avoiding the corporate-level tax; deferring payment of tax, whether at the shareholder or corporate level; and extracting corporate earnings at capital gain rates.<sup>47</sup> These strategies made operating in the corporate form palatable and, at times, even preferable. In order to determine the effect of the 1986 and 1987 Acts on taxpayer behavior, this Section reviews taxpayer strategies that developed in the pre-1986 Act tax regime. Section II then examines how changes in the 1986 and 1987 Acts alter these strategies.

#### 1. Avoiding the Corporate-Level Tax

In the pre-1986 Act tax regime, the corporate-level tax could be reduced or eliminated in several ways. First, and most obviously, the corporate-level tax could be avoided by operating in noncorporate form or as an S corporation.<sup>48</sup>

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44. See C. MCLURE, JR., *supra* note 29, at 51-55 (analysis of shareholder credit systems in France and Great Britain). Two versions of a dividends received credit plan were proposed in 1978 by Rep. Al Ullman, Chairman of the House Ways and Means Committee. The Ullman plans provided for a refundable shareholder credit for a portion of dividends received, with shareholders grossing-up their dividends by the amount of the corporate tax attributable to the distribution. 124 CONG. REC. 2,132-34, 7,978-80 (1978); see also Warren, *supra* note 9, at 794-98 (presenting quantitative examples of the effect of the Ullman proposal on shareholders in different tax brackets).

45. For a detailed proposal for excluding dividends from a shareholders' gross income, see Peel, *supra* note 40.

46. A possible fourth strategy of minimizing tax is avoiding shareholder-level tax. Two examples of this strategy are using the stepped-up basis provisions of § 1014 to avoid tax on predeath appreciation, see *supra* note 35, and relying on Code provisions that allow an employee to exclude certain fringe benefits from gross income, see *infra* note 49.

47. The strategies have emerged within the framework of the pre-1986 Act individual and corporate tax systems. See Clark, *Morphogenesis of Subchapter C: An Essay in Statutory Evolution and Reform*, 87 YALE L.J. 90 (1978) (describing the basic principles or decisions the author contends comprise this framework). A similar approach to examining the basic premises of the corporate tax system is included in Faber, *Taxation of Corporations and Shareholders: Premises of the Present System*, 22 SAN DIEGO L. REV. 5 (1985).

48. This type of corporation, which has its roots in the small business relief legislation of the mid-1950s, is treated for tax purposes in a manner similar to partnerships. See Starr, *The S Corporation: Is it the Right Choice?*, 43 N.Y.U. INST. ON FED. TAX. 5-1 (1985); Yelen, *Choosing the S Corporation as the Preferred Entity*, 42 N.Y.U. INST. ON FED. TAX. 13-1 (1984). Requirements for S corporation treatment include: (i) that the corporation be a domestic corporation with only one class of stock; (ii) that the corporation have no more than 35 shareholders; (iii) that the shareholders be individuals, except for certain estates and qualifying trusts, and that no shareholders can be non-resident aliens; and (iv) that the corporation not be a member of an affiliated group or an otherwise

Second, entities that are taxed as regular corporations can reduce or eliminate the corporate-level tax by increasing expenses, in either legitimate or not-so-legitimate ways. Closely held corporations historically have been effective in reducing or eliminating the corporate-level tax, primarily by increasing compensation paid to shareholder-employees.<sup>49</sup> Another strategy for avoiding the corporate-level tax involves shareholders disguising equity contributions as debt to convert nondeductible dividend distributions into deductible interest payments.<sup>50</sup>

More legitimate methods of reducing or eliminating the corporate-level tax rely on the use of depreciation deductions, investment tax credits, interest deductions, net operating losses, and industry-specific preferences. The revision of depreciation allowances in the Economic Recovery Tax Act of 1981 significantly reduced or eliminated tax liability for many corporations.<sup>51</sup> The recent spate of leveraged buyouts substituted debt for equity in capital structures and thus reduced or eliminated tax liability for many corporations that previously had relatively high marginal tax rates.<sup>52</sup> Furthermore, net operating losses, either self-generated or acquired, reduced or eliminated corporate-level tax. A profitable corporation could acquire or combine with a loss corporation to shelter the combined corporation's future income with the loss corporation's past losses.<sup>53</sup>

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"ineligible corporation" within the scope of § 1361(b). I.R.C. § 1361 (Supp. IV 1986); see J. EUSTICE & J. KUNTZ, *FEDERAL INCOME TAXATION OF S CORPORATIONS* ¶¶ 7, 9 (rev. ed. 1985).

49. Items most favored by taxpayers, especially shareholder-employee taxpayers, are those that are deductible by the corporation but not included in income by the employee. See B. BITTKER, *FEDERAL INCOME TAXATION OF INCOME, ESTATES AND GIFTS* ¶¶ 12-14 (1981). Examples include such fringe benefits as a limited amount of the cost of group term life insurance, I.R.C. § 79 (1982 & Supp. III 1985), the cost of qualified prepaid legal service plans, I.R.C. § 120 (1982 & Supp. III 1985), education assistance programs, I.R.C. § 127 (1982 & Supp. III 1985), certain fringe benefits, I.R.C. § 132 (1982 & Supp. III 1985), and meals and lodging furnished to employees for the convenience of the employer, I.R.C. § 119 (1982 & Supp. III 1985). Only slightly less desirable are payments made to qualified pension plans. The corporation receives an immediate deduction for contributions made; the employee recognizes the income only when the funds are distributed, and then often at favorable tax rates.

50. See B. BITTKER & J. EUSTICE, *supra* note 34, ¶¶ 4.01-04; Plumb, *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 *TAX L. REV.* 369 (1971) (overview of debt-equity issue). Related strategies for disguising dividend distributions include bargain sales from the corporation to shareholders, excess rental or royalty payments made by the corporation for the use of shareholder property, and shareholder use of corporate entertainment facilities. See generally Comment, *Disguised Dividends: A Comprehensive Survey*, 3 *UCLA L. REV.* 207 (1956) (reviewing various types of transactions through which a shareholder might receive corporate earnings without payment of a corporate-level tax).

51. See I.R.C. § 168 (1982 & Supp. III 1985). For an examination of the effects of Accelerated Cost Recovery System (ACRS) depreciation, investment tax credits, and industry-specific tax preferences on reducing or eliminating corporate tax liability of 275 large publicly held corporations, see Citizens for Tax Justice, *Corporate Taxpayers and Corporate Freeloaders*, 29 *TAX NOTES* 947 (1985). For a discussion of the effect of ACRS on corporate income and integration proposals, see Warren, *Corporate Integration Proposals and ACRS*, 22 *SAN DIEGO L. REV.* 325 (1985).

52. See Canellos, *The Over-Leveraged Acquisition*, 39 *TAX LAW.* 91 (1985).

53. The 1986 and 1987 Acts impose new limitations on the use and value of net operating losses obtained in acquisitions and combinations involving loss corporations. See Tax Reform Act of 1986, Pub. L. No. 99-514, § 621, 100 Stat. 2085, 2254 (1986) (amending I.R.C. §§ 382-83); Revenue Act of 1987, Pub. L. No. 100-203, §§ 10,225-26, 101 Stat. 1330, 1330-413 to -416 (1987) (amending I.R.C. § 382 and adding I.R.C. § 384); Wootton, *Section 382 After the Tax Reform Act of 1986*, 64 *TAXES* 874 (1986).

Finally, the *General Utilities* doctrine<sup>54</sup> provided an opportunity to avoid recognizing corporate-level gain on certain distributions of appreciated property. Corporate income from the disposition of appreciated property is generally taxed at both the corporate level when the disposition takes place and at the shareholder level when the proceeds are distributed. The *General Utilities* doctrine, however, allowed corporations to avoid tax either by distributing appreciated property to shareholders as a dividend in certain limited instances or by making certain liquidating sales or distributions.<sup>55</sup> The doctrine thus allowed shareholders to extract appreciated property, or the proceeds of the sale of such property, from the corporation at the cost of a single shareholder-level capital gain tax.<sup>56</sup>

Reducing or eliminating corporate-level tax does not affect the structure of the two-tier tax system. It does, however, reduce the aggregate tax cost of operating in corporate form, and it reduces the pressure for formally integrating the individual and corporate tax systems.

## 2. Deferral Techniques

Taxpayers can mitigate the tax burden of operating in the corporate form by using deferral techniques to postpone the recognition of income. Two such techniques are the use of nonrecognition provisions and the use of the retained

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54. The doctrine stems from the 1935 United States Supreme Court decision, *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935). That decision involved facts different from the transactions usually within the scope of the doctrine. In *General Utilities*, a corporation distributed highly appreciated stock in another corporation to its shareholders. The shareholders subsequently sold the stock to a third party. The court held that a corporation did not realize income when it declared an in-kind dividend and paid it with appreciated property. For a good review of the *General Utilities* doctrine and its erosion before the 1986 Act, see Block, *Liquidations Before and After Repeal of General Utilities*, 21 HARV. J. ON LEGIS. 307 (1984).

55. Before the 1986 Act, I.R.C. §§ 336-38 (1982) generally allowed a corporation to avoid a corporate-level tax (other than gain from certain specified items, principally depreciation recapture and certain other items and the recovery of tax benefits): (i) on the in-kind distribution of appreciated assets to shareholders in complete liquidation; (ii) on the sale of appreciated assets in connection with a plan of complete liquidation; or (iii) upon the election by a corporation acquiring at least 80% of a corporation's stock, via a step-up in the basis of the acquired corporation's assets.

In certain limited instances, I.R.C. § 311(d) (1982) provided relief from corporate-level tax on dividend distributions of appreciated property to shareholders. The ability to achieve nonrecognition treatment on nonliquidating distributions of appreciated property was curtailed by the Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 54, 98 Stat. 495, 568 (1984) (amending I.R.C. § 311(d)).

56. This strategy allowed the recipient of the property to receive a stepped-up basis in the assets of the liquidating or acquired corporation. The higher basis would generate additional depreciation or amortization deductions. Closely related to schemes for avoiding the corporate-level tax by transferring appreciated property in liquidation are attempts to avoid recognizing income at the corporate level by transferring in "midstream" liquidation accounts receivable, claims for services rendered, and other sources of future income. See B. BITTKER & J. EUSTICE, *supra* note 34, ¶ 11.62 and cases cited therein; Lyon & Eustice, *Assignment of Income: Fruit and Tree as Irrigated by the P.G. Lake Case*, 17 TAX L. REV. 293, 404-24 (1962) (examining the application of the assignment-of-income doctrine to transfers in connection with complete liquidations). Corporations also have deducted or expensed, under their accounting methods, items that in light of the liquidation distort income either because such items are not fully consumed prior to liquidation or the income relating to such items has not been recognized. See Cartano, *The Tax Benefit Rule in Corporate Liquidations*, 10 J. CORP. TAX'N 216 (1983).

earnings strategy.<sup>57</sup> The Code provides nonrecognition treatment at both the shareholder and corporate levels.<sup>58</sup> Shareholders can take advantage of nonrecognition treatment in the formation of the corporation,<sup>59</sup> certain transfers of shares,<sup>60</sup> and certain changes in form of shareholder investment.<sup>61</sup> Corporations may qualify for nonrecognition treatment in various degrees upon incorporation, subsequent contributions in exchange for stock,<sup>62</sup> certain distributions,<sup>63</sup> reorganizations,<sup>64</sup> S elections,<sup>65</sup> and liquidations.<sup>66</sup>

Corporations using the retained earnings strategy simply defer a shareholder-level tax on corporate earnings by not paying dividends and by allowing the earnings to accumulate until the corporation is liquidated.<sup>67</sup> In addition to deferring the shareholder-level tax, the retained earnings strategy yielded two other important benefits in the pre-1986 Act tax regime. First, the income on

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57. In addition to the Code's nonrecognition provisions and retained earnings strategies, accounting strategies play a large role in taxpayers' attempts to defer tax liability. Accounting strategies have focused on choice of accounting method, selection of fiscal year, choice of inventory method, and use of the installment sales method. The statutory provisions governing accounting periods and methods are set forth in I.R.C. §§ 441-73 (1982, Supp. IV 1986).

58. The mechanics of nonrecognition treatment are generally that a transaction is not taxed currently, and the basis of the old property carries over to the new property. See B. BITTKER, *supra* note 49, ¶ 44 (discussing the mechanics of nonrecognition treatment and the effect of receiving non-qualifying property). Of course, nonrecognition treatment may also work to a taxpayer's disadvantage, either by precluding recognition of loss, or when the present value of tax benefits from a stepped-up basis of the asset exceeds the tax cost of immediate recognition.

59. I.R.C. § 351 (1982) provides generally that no gain or loss shall be recognized on the contribution of property to a corporation, provided that certain conditions are satisfied.

60. A shareholder may give stock without recognition of gain; the transferor takes a carryover basis from the donor. See *id.* §§ 102, 1015 (1982, Supp. IV 1986). Shares of stock are not eligible, however, for like-kind exchange treatment. *Id.* § 1031(a)(2)(B) (1982 & Supp. III 1985).

61. Shareholders generally can use the Code's reorganization provisions to change the form of their equity investment without gain recognition, provided that certain conditions are satisfied. See *id.* §§ 354-68 (1982, Supp. IV 1986).

62. The corporation does not recognize gain or loss from the issuance of stock in exchange for property. *Id.* §§ 118, 1032 (1982, Supp. III 1985 & West Supp. 1988).

63. Nonrecognition treatment for corporations for distributions with respect to their stock has been narrowed considerably. See B. BITTKER & J. EUSTICE, *supra* note 34, ¶¶ 7.20, 7.22.

64. I.R.C. § 361(a) (West Supp. 1988) provides generally that no gain or loss shall be recognized if a corporation or party to a reorganization exchanges property solely for stock or securities in another corporation or a party to a reorganization in pursuance of a plan of reorganization. Section 1032 also shields a corporation issuing its own stock in exchange for money or other property from recognizing gain or loss. *Id.* § 1032 (1982 & Supp. III 1985).

65. No tax results from electing S corporation status; however, for corporations making S elections after December 31, 1986, § 1374 provides for a tax on built-in gains accruing prior to the S election for assets disposed of during the 10-year period following the S election. Tax Reform Act of 1986, Pub. L. No. 99-514, § 632, 100 Stat. 2085, 2275 (1986) (codified at I.R.C. § 1374 (Supp. IV 1986)). Section 10227 of the 1987 Act requires a corporation that maintains its inventories under the last-in, first-out (LIFO) method to include LIFO recapture amounts (the excess of the inventories' value using first-in, first-out (FIFO) over its LIFO value as of the close of the corporation's last year as a C corporation) in income, payable in four equal annual installments, on converting from C to S corporation status. Revenue Act of 1987, Pub. L. No. 100-203, § 10227, 101 Stat. 1330, 1330-416 (1987) (amending I.R.C. § 1363).

66. I.R.C. §§ 336-37 (1982 & Supp. III 1985) (amended 1986). See *infra* text accompanying notes 92-94 for the effect of the 1986 Act changes on the taxation of liquidating corporations.

67. In an effort to prevent taxpayers from using the corporation to shelter accumulated earnings from personal income taxes, Congress enacted an accumulated earnings tax, I.R.C. § 531 (1982 & Supp. IV 1986) and a tax on personal holding companies, I.R.C. § 541 (1982). Neither provision has been particularly successful in preventing use of the retained earnings strategy.

amounts retained was generally subject to the lower corporate tax rate,<sup>68</sup> and sometimes sheltered through the use of corporate tax preferences. Second, the tax rate imposed on funds finally distributed could be substantially lower if the transaction qualified for capital gain treatment or if the stock was held until the death of the shareholder, 'in which case predeath appreciation would escape untaxed.

### 3. Bailout Techniques

In the pre-1986 Act tax regime, a large part of corporate tax planning focused on extracting funds out of corporations in transactions that qualified for capital gain treatment.<sup>69</sup> Before the 1986 Act, capital gains received favorable treatment in three major respects. First, individuals and other noncorporate taxpayers could deduct 60% of their net capital gain, resulting in only 40% of the gain being included in their taxable income.<sup>70</sup> Second, income from capital assets was taxed only when the gain was realized.<sup>71</sup> Third, assets transferred from a decedent received a stepped-up basis, which allowed predeath appreciation to escape untaxed.<sup>72</sup> The combination of these preferences resulted in a very low effective tax rate on capital gains.<sup>73</sup>

Bailout transactions are of different types and complexities. The simplest transaction, a sale of stock to an unrelated buyer, generates capital gain because

68. Historically, the maximum individual tax rate has exceeded the maximum corporate tax rate. For example, from 1979 to 1981, the maximum individual rate exceeded the corporate rate by 24 percentage points. The Economic Recovery Act of 1981 reduced the spread to four points. For a comparison of the top individual and corporate tax rates from 1934 through 1988, see J. EUSTICE, J. KUNTZ, C. LEWIS & T. DEERING, *THE TAX REFORM ACT OF 1986: ANALYSIS AND COMMENTARY* ¶ 2.02(1)(c), at 2-8 (1987).

69. See Lowe, *Bailouts: Their Role in Corporate Planning*, 30 TAX L. REV. 357 (1975).

70. The excluded portion of the capital gain constituted an item of tax preference which could subject an individual to alternative minimum tax liability. I.R.C. §§ 55, 57(a)(9) (1982). This slightly narrowed the gap between the tax rates on capital gain and ordinary income.

71. For a general discussion of realization of gains and losses, see B. BITTKER, *supra* note 49, ¶ 22. Realized gains are subject to tax absent qualification for nonrecognition treatment. See *supra* notes 58-66 and accompanying text. Distortion inherent in the realization requirement applies to all assets, not just capital assets. For a proposal to change the realization requirement for taxation, see Shakow, *Taxation Without Realization: A Proposal for Accrual Taxation*, 134 U. PA. L. REV. 1111 (1986). For an interesting proposal to eliminate the deferral preference for capital assets, see Briner, *Inflation, Deferral and the Neutral Taxation of Capital Gains*, 26 NAT'L TAX J. 565 (1973).

72. This basis adjustment allows gain from all assets, including capital assets, accruing prior to decedent's death to escape taxation. There have been several attempts to repeal this generous provision. One proposal treats the death of a taxpayer as a taxable event and requires constructive realization of gains at death. See Kurtz and Surrey, *Reform of Death and Gift Taxes: The 1969 Treasury Proposals, The Criticisms, and a Rebuttal*, 70 COLUM. L. REV. 1365 (1970). A different approach does not tax the decedent on predeath appreciation but requires the transferee to take a carryover basis in the inherited assets. This approach was adopted in 1976 but never became effective. Tax Reform Act of 1976, Pub. L. No. 94-455, § 1023, 90 Stat. 1520, 1872, *repealed by* Crude Oil Windfall Profit Tax Act of 1980, Pub. L. No. 96-223, § 401(a), 94 Stat. 229, 299. The cost of allowing predeath appreciation to escape untaxed is estimated at almost \$12.4 billion for fiscal year 1988. U.S. OFF. OF MGMT. AND BUDGET, SPECIAL ANALYSES, BUDGET OF THE UNITED STATES GOVERNMENT Table G-2 (fiscal 1988).

73. Examining Treasury Department statistics from 1926 through 1961, Bailey estimated the effective tax rate on capital gains to be approximately 8 to 9%. Bailey, *Capital Gains and Income Taxation*, in *THE TAXATION OF INCOME FROM CAPITAL* 11, 15-26 (A. Harberger & M. Bailey eds. 1969).

the Code makes no attempt to allocate to the selling shareholder her share of the corporation's undistributed earnings and profits.<sup>74</sup> A shareholder receives similar tax treatment on the liquidation of the corporation.<sup>75</sup> More complex are transactions in which the corporation repurchases its own stock. Taxpayers, the IRS, and the courts have struggled in attempting to distinguish between redemptions that have the effect of a sale to an unrelated buyer and redemptions that are disguised dividend transactions.<sup>76</sup> The determination whether to apply sale or dividend treatment becomes more difficult when taxpayers combine the stock redemption with other transactions.<sup>77</sup>

#### 4. Summary

Before the 1986 Act, well-established taxpayer strategies generally allowed closely held entities to choose between subjecting their income to a corporate-level tax and having the income taxed directly to their owners. The corporate-level tax could be avoided directly—by operating in noncorporate form or electing S corporation status—or indirectly—by shifting income away from the corporation through disguised dividends and other techniques. Taxpayers electing to conduct activities in corporate form generally could minimize aggregate shareholder and corporate tax liabilities by retaining funds in corporate form until such time as the funds could be extracted in a transaction qualifying for capital gain treatment. Although publicly held entities had less flexibility in avoiding the corporate-level tax, they typically have succeeded in reducing or eliminating that tax, primarily through the use of depreciation deductions, investment tax credits, interest deductions, net operating losses, and industry-specific tax preferences.

## II. THE NEW DISEQUILIBRIUM—THE POST-1986 ACT TAX REGIME

Before the 1986 Act, a rough equilibrium governed the relationship between the individual and corporate tax systems. Things have changed. The 1986 Act changes destroyed the rough balance by upsetting the compensating biases, and the 1987 Act changes have further aggravated the situation. This Section first reviews the 1986 and 1987 Acts' changes. It then illustrates

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74. The Code treats the sale of corporate stock solely as a shareholder-level event so the amount of the corporation's undistributed earnings and profits is generally not relevant to the characterization of the shareholder's gain.

75. Section 331(a) treats amounts received by a shareholder in a distribution in complete liquidation as if received in full payment in exchange for the stock. I.R.C. § 331(a) (1982).

76. Section 302 attempts to provide greater certainty in determining the tax consequences of a redemption by providing for exchange treatment if the transaction falls into any of the following categories: (i) a redemption that is "not essentially equivalent to a dividend" under § 302(b)(1); (ii) a "substantially disproportionate" redemption under § 302(b)(2); (iii) a complete termination of a shareholder's interest under § 302(b)(3); and (iv) a redemption from a noncorporate shareholder in partial liquidation under § 302(b)(4). *Id.* § 302(b); see B. BITTKER & J. EUSTICE, *supra* note 34, ¶¶ 9.04-10.

77. Examples of different combinations include: (i) the preferred stock bailout; (ii) the divisive bailout; (iii) the security bailout; (iv) the liquidation-reincorporation bailout; and (v) the *General Utilities* bailout. For a description of these transactions see Clark, *supra* note 47, at 95, 113, 120-23, 125-30, 132-35.



through simple quantitative examples the effect of the 1986 Act changes on the compensating biases in the tax system. The Section then highlights the disequilibrating effects of these changes by examining how taxpayer strategies have been altered by the 1986 and 1987 Acts' changes.

A. *The 1986 and 1987 Acts' Changes and Their Impact on the Compensating Biases*

1. The 1986 Act Changes

In the 1986 Act, Congress made three major changes that have had pervasive impact on the compensating biases (collectively, the "1986 Act changes"): Congress eliminated the rate preference for capital gains; it reduced the tax rates for individuals and corporations and set the maximum corporate rate higher than the maximum individual rate; and it repealed the *General Utilities* doctrine.<sup>78</sup> Strong arguments can be made for each of these changes. Reducing rates, eliminating the favorable rate preference for capital gains, and repealing the *General Utilities* doctrine all are likely to improve the tax system.<sup>79</sup> As applied to the relationship between corporations and shareholders, however, these changes, especially in the aggregate, may have highly undesirable consequences. Each of these features of the pre-1986 Act tax system mitigated the "double tax" on distributed corporate income.

The 1986 Act repealed section 1202, the 60% exclusion of net capital gains for individuals.<sup>80</sup> The preferential tax rates for capital gains have been in the tax

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78. In addition to the above changes, the 1986 Act also made operating in the corporate form less attractive by (i) strengthening the corporate minimum tax; see *infra* note 91; (ii) imposing a tax on corporations making S elections after December 31, 1986 for certain built-in gains during a 10-year look-back period, I.R.C. § 1374 (Supp. IV 1986); (iii) limiting the use of net operating losses; see *supra* note 53; and (iv) enacting a series of accounting changes making it more difficult for taxpayers, including corporations, to defer taxes. The accounting changes include requiring use of uniform capitalization rules, I.R.C. § 263A (Supp. IV 1986), imposition of interest charges on the use of certain accounting methods for long-term contracts, I.R.C. § 460 (Supp. IV 1986), limitations on the use of the installment sales method for revolving credit plans and publicly traded property, I.R.C. §§ 453-453A (Supp. IV 1986), restrictions on the use of the cash method of accounting, with exceptions for farming businesses, qualified personal service corporations, and entities that satisfy a \$5 million gross receipts test, I.R.C. § 448 (Supp. IV 1986), changes in the Accelerated Cost Recovery System of depreciation, I.R.C. § 168 (Supp. IV 1986) and repeal of the investment tax credit, Pub. L. No. 99-514, § 211, 100 Stat. 2085, 2166 (1986). For an excellent summary of these provisions, see J. EUSTICE, J. KUNTZ, C. LEWIS & T. DEERING, *supra* note 68, ¶¶ 6.01-05.

79. The 1986 Act reduces tax-induced distortions by reducing the individual and corporate tax rates and by narrowing the range of effective tax rates on various assets and industries. See generally D. FULLERTON, Y. HENDERSON & J. MACKIE, INVESTMENT ALLOCATION AND GROWTH UNDER THE TAX REFORM ACT OF 1986 (U.S. Treas. Dept. Office of Tax Analysis Apr. 1987) (concluding that although the 1986 Act might reduce overall investment and saving incentives, the tax changes should improve allocation of capital among assets and industries). For an analysis of effective tax rates by asset type and industry, see J. GRAVELLE, EFFECTIVE CORPORATE TAX RATES IN THE MAJOR TAX REVISION PLANS: A COMPARISON OF THE HOUSE, SENATE, AND CONFERENCE COMMITTEE VERSIONS Table 2 (Cong. Res. Serv. Rep. 86-854E, Aug. 1986). For arguments supporting the repeal of the rate preference for capital gains and the repeal of the *General Utilities* doctrine, see sources cited *infra* notes 80 & 93-94.

80. Pub. L. No. 99-514, § 301, 100 Stat. 2085, 2216 (1986); For a review of the arguments for and against preferential capital gain treatment, see R. GOODE, THE INDIVIDUAL INCOME TAX 184-221 (1964); Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113, 1131-35 (1974); Blum, *A Handy Summary of the Capital Gains Arguments*, 35 TAXES 247

system since the Revenue Act of 1921.<sup>81</sup> Although proposals to reform capital gain treatment have surfaced regularly, the 1986 Act changes differ from past proposals.<sup>82</sup> After a transition period, capital gains are subject to tax at the same rates as other income.<sup>83</sup> Eliminating the rate preference dramatically departs from past tax treatment,<sup>84</sup> and can result in rate increases of between 40% for high-bracket taxpayers, and over 200% for low-bracket taxpayers.<sup>85</sup>

The centerpiece of the 1986 Act is a reduction in individual tax rates. After a transition period,<sup>86</sup> the maximum individual marginal rate is 28%.<sup>87</sup> A 5% surcharge, however, exists for taxpayers within certain income ranges.<sup>88</sup> Corporations also benefit from reduced tax rates.<sup>89</sup> The 1986 Act reduces the top

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(1957); Minarik, *Capital Gains*, in *HOW TAXES AFFECT ECONOMIC BEHAVIOR* 241-77 (H. Aaron & J. Pechman eds. 1981).

81. For a history of capital gain taxation, see Mayhall, *Capital Gains Taxation—The First One Hundred Years*, 41 *LA. L. REV.* 81 (1980); Minarik, *supra* note 80, at 268-75.

82. Recent proposals were included in both the Treasury November 1984 Report and the President's May 1985 Proposals. Rather than merely repealing the rate preference, the Treasury November 1984 Report eliminated the classification of assets as either capital or noncapital assets. To eliminate the taxation of noneconomic gains, the Treasury November 1984 Report provided for assets (other than debt instruments and inventory) to be indexed for inflation so that only economic gains would be subject to tax. The Treasury November 1984 Report retained the loss limitation rules for investment property and retained the current nonrecognition and realization rules. *TREASURY NOVEMBER 1984 REPORT*, *supra* note 43, ch. 9.01.

A different approach was taken six months later in the President's May 1985 Proposals. The President's proposals reflected an overriding concern to retain the preferential treatment of capital gains as an additional incentive for high-risk venturing. The proposals retained the preferential rates for capital gains by allowing 50% of the net capital gain to be excluded from income and, beginning in 1991, giving individual taxpayers an option to index the basis of capital assets for inflation in lieu of the capital gain rate preference. *PRESIDENT'S MAY 1985 PROPOSALS*, *supra* note 43, § 7.04.

83. Although net capital gains are taxed nominally at 28%, the gains could move other income into the 33% bracket. *See* Gardner & Stewart, *Capital Gains and Losses After the Tax Reform Act of 1986*, 65 *TAXES* 125, 127 (1987).

84. It is also important to focus on the historical difference between rates for ordinary income and long-term capital gains. In 1922, the spread was 43.5 points, as earned income was taxed at 56% and long-term capital gains were taxed at 12.5%. The spread increased following the 1938 Act; ordinary income was taxed at a maximum 79% rate and capital gains were taxed at 15%. More recently the spread has gone from 52 points in 1964, when ordinary income was taxed at a maximum rate of 77% and capital gains were taxed at a maximum rate of 25%, to 33.5 points in 1972 with ordinary income taxed at 70% and capital gains taxed at 36.5%, and then to 30 points beginning in 1982 with earned income taxed at 50% and capital gains taxed at 20%.

85. A comparison of pre-1986 Act rates and rates applicable in 1987 to capital gains is set forth in Gardner & Stewart, *supra* note 83, at 125, 129. Including the effect of state taxes makes the effective increase even greater. *See* Conda, *Next Year's Tax Bill: Fix Capital Gains*, 33 *TAX NOTES* 409 (1986).

86. The rate schedules for 1987 had five conventional tax brackets: 11, 15, 28, 35, and 38.5%. *I.R.C.* § 1(h) (Supp. IV 1986).

87. For single taxpayers, income up to \$17,850 is taxed at 15% with income over that amount taxed at 28%. *Id.* § 1(a). For married taxpayers filing jointly, income up to \$29,750 is taxed at 15% with income over that amount taxed at 28%. *Id.* § 1(a).

88. A 5% surcharge is imposed on single taxpayers with income between \$43,150 and \$89,560 and married taxpayers with income between \$71,900 and \$149,250. Taxpayers thus bear an effective maximum marginal tax rate of 33% for income within those ranges. The first 5% surtax phases out the tax benefit from having part of the individual's income taxed at the 15% rate. The second 5% surtax phases out the tax benefit gained from personal and dependency exemptions so that the ranges are greater than the numbers in the text and depend on the number of exemptions claimed. *See id.* § 1(g).

89. The five-tier rate structure was replaced with a three-tier rate structure effective for taxable years beginning on or after July 1, 1987:

marginal corporate rate from 46% to 34%.<sup>90</sup> A strengthened corporate minimum tax accompanies the corporate tax rate reductions.<sup>91</sup>

The 1986 Act also repeals the *General Utilities* doctrine.<sup>92</sup> Corporations are no longer able to avoid the recognition of gain on certain qualifying dividend distributions or on distributions or sales of appreciated property in connection with a complete liquidation. Supporters of the repeal contend it was a necessary measure to eliminate arbitrary tax results and transactional distortions.<sup>93</sup> Opponents of the repeal view *General Utilities* as a necessary feature of the two-tier tax system that achieved a measure of at least partial integration of the individual and corporate tax systems.<sup>94</sup>

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Taxable Income	Tax Rate
Not over \$50,000	15%
Over \$50,000 but not over \$75,000	25%
Over \$75,000	34%

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*Id.* § 11(b). For taxable years that include July 1, 1987, § 15 prescribes that blended tax rates shall apply. *Id.* § 15.

Although corporate tax rates are reduced, the 1986 Act will increase the corporate tax burden by an estimated \$120 billion over the five-year period between 1987 and 1991. H.R. Rep. No. 841, 99th Cong., 2d Sess., vol. 2, II-865 (1986). The rate reduction is more than offset by increases in the tax base for many corporations, primarily due to repeal of the investment tax credit, accounting changes, and the elimination of some tax preferences for specific industries.

90. Section 11(b) imposes an additional 5% tax on income between \$100,000 and \$335,000, which eliminates the benefits of lower marginal rates on corporate income below \$75,000. Corporations with income over \$335,000 are subject to a flat 34% tax rate. *See* I.R.C. § 11(b) (Supp. IV 1986).

91. Section 701 of the 1986 Act replaces the former add-on corporate minimum tax with a new corporate alternative minimum tax. Pub. L. No. 99-514, § 701, 100 Stat. 2085, 2320-22 (codified at I.R.C. § 55 (Supp. IV 1986)); *see* Gould, *The Corporate Alternative Minimum Tax: A Search for Equity Through a Maze of Complexity*, 64 TAXES 783 (1986); Zimble, *The Corporate Alternative Minimum Tax: Another Look*, 65 TAXES 846 (1987).

92. The repeal of the *General Utilities* doctrine is accomplished by completely revising §§ 311, 336, and 337, and by amending § 338. Section 336(a) now provides that a corporation generally recognizes gain or loss on distributions of property with respect to its stock. The repeal of *General Utilities* also substantially increases the cost of electing under § 338 to step up the basis of assets in a stock acquisition by imposing a corporate-level tax on all gain inherent in the assets. *See generally* Bonovitz, *Impact of the TRA Repeal of General Utilities*, 65 J. TAX'N 388 (1986) (discussing nonrecognition strategies remaining after repeal of *General Utilities*); Hiegel and Schler, *Repeal of General Utilities Doctrine*, 33 TAX NOTES 961 (1986) (discussing the effect of repeal of the *General Utilities* doctrine on corporate acquisitions); Zolt, *The General Utilities Doctrine: Examining the Scope of the Repeal*, 65 TAXES 819 (1987) (discussing taxpayer techniques for disposing of unwanted assets following an acquisition after the repeal of the *General Utilities* doctrine). The 1986 Act provides for special transitional rules for small qualified closely held corporations liquidating before January 1, 1989. Pub. L. No. 99-514, § 633(d), 100 Stat. 2085, 2278-80.

93. For a review of the arguments that have been advanced in favor of the repeal of the *General Utilities* rule, *see* Lewis, *A Proposed New Treatment for Corporate Distributions and Sales in Liquidation*, 3 TAX REVISION COMPENDIUM 1643 (House Comm. on Ways and Means 1958); Blum, *Taxing Transfers of Incorporated Businesses: A Proposal for Improvement*, 52 TAXES 516 (1974); Wolfman, *Corporate Distributions of Appreciated Property: The Case for Repeal of the General Utilities Doctrine*, 22 SAN DIEGO L. REV. 81 (1985); Yin, *General Utilities Repeal: Is Tax Reform Really Going to Pass It By?*, 31 TAX NOTES 1111 (1986).

94. For a review of the arguments against the repeal, *see* Beck, *Distributions in Kind in Corporate Liquidations: A Defense of General Utilities*, 38 TAX LAW. 663 (1985); Gould, *General Utilities Repeal: Tax Reform Should Pass It By*, 32 TAX NOTES 147 (1986); Nolan, *Taxing Corporate Distributions of Appreciated Property: Repeal of the General Utilities Doctrine and Relief Measures*, 22 SAN DIEGO L. REV. 97 (1985).

## 2. The 1987 Act Changes

The 1987 Act changes affecting corporate taxation follow the themes established in the 1986 Act. One group of changes centers on accounting provisions. These changes increase the current tax liability of all taxpayers, including corporations, by restricting opportunities to defer the recognition of income or accelerate expenses. Among other changes, the 1987 Act further limits use of the completed contract method of accounting,<sup>95</sup> prohibits use of the installment sales method by dealers,<sup>96</sup> requires certain farm corporations to use the accrual method of accounting,<sup>97</sup> and imposes additional restrictions on deductibility of reserves for vacation pay.<sup>98</sup>

The second group of changes affects only corporations. The major changes in this group include the reduction in the intercorporate dividends received deduction,<sup>99</sup> the imposition of a LIFO surcharge for regular corporations electing to be taxed as S corporations,<sup>100</sup> further restrictions on the use of net operating losses,<sup>101</sup> and changes in computing a subsidiary's earnings and profits for the purpose of determining gain or loss on the sale of the subsidiary's stock.<sup>102</sup>

The third group of changes in the 1987 Act aims to reinforce the two-tier tax system. These provisions seek to prevent taxpayers from avoiding the scope of the 1986 Act changes. Publicly traded limited partnerships that engage in "active" operations will be taxed as corporations.<sup>103</sup> This stops the trend of new or existing entities adopting the limited partnership form to avoid exposure to a

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95. Pub. L. No. 100-203, § 10203, 101 Stat. 1330, 1330-94 (1987) (amending I.R.C. § 460(a)). The 1987 Act generally requires that 70% of the items under a long-term contract be reported under the percentage of completion contract method and that only the remaining 30% be reported under the taxpayer's normal method of accounting, such as the completed contract method.

96. *Id.* § 10202(b), 101 Stat. at 1330-388 (amending I.R.C. § 453(b)(2)(A) and adding I.R.C. § 453(i)). For dispositions of property occurring after December 31, 1987, all payments to be received from a "dealer disposition" are treated as received in the year of disposition. Dealer dispositions generally include any disposition of personal property by a person who regularly sells or otherwise disposes of property on the installment plan.

97. *Id.* § 10205, 101 Stat. at 1330-395 to -397 (amending I.R.C. § 447). These changes require a family farming corporation to use an accrual method of accounting unless it can establish that its gross receipts are not in excess of \$25 million.

98. *Id.* § 10201, 101 Stat. at 1330-387 to -388 (repealing I.R.C. §§ 81, 463). The 1987 Act repeals the reserve method of accounting for vacation pay. Deductions for any tax year are generally limited to amounts actually paid to employees during the year and amounts vested as of the end of the tax year and paid to employees within two and a half months after the end of such year.

99. *Id.* § 10221, 101 Stat. at 1330-408 to -409 (amending I.R.C. §§ 243, 244, 246, 246A). The intercorporate dividends received deduction is reduced from 80% to 70% if the recipient owns 20% or less of the value and voting power of the payor corporation.

100. *See supra* note 65.

101. Pub. L. No. 100-203, § 10225(b), 101 Stat. at 1330-413 (amending I.R.C. § 382(h)(2)(B)); *id.* § 10226, 101 Stat. at 1330-414 (adding I.R.C. § 384). These provisions extend the special limitations on the use of built-in losses following depreciation deductions and limit the use of preacquisition losses of an acquiring company to offset built-in gains of an acquired company.

102. *Id.* § 10222, 101 Stat. at 1330-410 (adding I.R.C. § 1503(e)). This provision overrules the result in *Woods Investment Co. v. Commissioner*, 85 T.C. 274 (1985), and provides that solely for purposes of determining gain or loss on a disposition, a parent corporation's basis in the stock of a subsidiary with which it files a consolidated return will be determined by computing the subsidiary's earnings and profits without regard to such special adjustments as depreciation and other items.

103. Pub. L. No. 100-203, § 10211, 101 Stat. at 1330-403 to -405 (adding I.R.C. § 7704). Generally, publicly traded partnerships are treated as corporations for federal income tax purposes unless 90% or more of their gross income is passive, such as interest, dividends, real property rents, gains

corporate-level tax. The 1987 Act also limits techniques whereby an acquiring corporation disposes of unwanted appreciated assets, either directly or indirectly, without recognizing corporate-level gain.<sup>104</sup>

### 3. Effect on Compensating Biases in the Tax System

#### a. Bias Against Capital in Corporate Form

Each of the 1986 Act changes increases the relative cost of operating in corporate form. Reversing the relative relationship of the individual and corporate tax rates probably has the greatest impact. Historically, the maximum individual rate has exceeded the maximum corporate rate. By setting the maximum corporate tax rate at 34% and the maximum individual tax rate at 28%, Congress reversed a ranking that has existed since the institution of the individual income tax.

Also important in examining the heightened bias against holding capital in corporate form are changes in the combined individual and corporate tax rates. Income earned and distributed by corporations after the 1986 Act bears a combined marginal tax rate of 52.48%.<sup>105</sup> Because no entity-level tax applies to partnership income, partners are taxed at a maximum 28% of their allocable share of partnership income. This results in a tax rate differential of 24.48%, or stated more dramatically, the combined individual and corporate tax liability is 87.4% greater than the partner's liability. Before the 1986 Act, the aggregate individual-level and corporate-level tax on distributed corporate earnings was 73%, compared to the maximum tax rate on partnership earnings of 50%.<sup>106</sup> This results in a rate differential of 23%, or a 46% greater tax liability than that incurred under the partnership form.

Eliminating the capital gain rate preference also increases the relative tax

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from certain dispositions of real property and certain capital or § 1231 assets, and certain oil and gas and commodities activities.

The 1987 Act made publicly traded partnerships that are not taxed as corporations less attractive by requiring the passive loss rules of § 469 to be applied separately for each partnership and by treating any income earned by an exempt organization from a publicly traded partnership as gross income derived from an unrelated trade or business. *See id.* § 10212, 101 Stat. at 1330-405 to -406 (amending I.R.C. § 469(k)); *id.* § 10213, 101 Stat. at 1330-406 (amending I.R.C. § 512(c)).

104. *See infra* text accompanying notes 159-61. Section 10223 of the 1987 Act limits the use of the "mirror subsidiary" technique by requiring a liquidating corporation to recognize gain on distributions made in complete liquidation unless the distributee corporation owns directly 80% of the liquidating corporation. The 1987 Act also prevents use of the § 355 nonrecognition provisions for spin-offs and § 304 related corporation redemption provisions to transfer unwanted appreciated assets outside of the acquiring group without recognizing a corporate-level gain. *See* Pub. L. No. 100-203, § 10223, 101 Stat. at 1330-411 to -412 (amending I.R.C. §§ 337(c), 355(b)(2)(D)(i)-(ii), and adding I.R.C. § 304(b)(4)).

105. For example, \$100 of corporate earnings after the 1986 Act will be subject to a corporate tax of \$34 (assuming a 34% corporate rate), leaving \$66 available for dividend distribution. The \$66 dividend will be subject to an individual tax of \$18.48 (assuming a 28% individual rate), resulting in an aggregate tax liability of \$52.48. If the individual marginal tax rate is 33%, then the aggregate tax liability would be \$55.78.

106. Before the 1986 Act, \$100 of corporate earnings was subject to a maximum corporate tax of \$46 (assuming a 46% corporate rate), leaving \$54 available for dividend distribution. The \$54 dividend was subject to an individual tax of \$27 (assuming a 50% individual tax rate), resulting in an aggregate tax liability of \$73.

costs of operating in corporate form. The ability to extract funds at the cost of a capital gain tax, whether by sale, liquidation, or bailout transaction, lessened the tax penalty imposed on corporations by the two-tier tax system. Before the 1986 Act, income earned and distributed by a corporation in a transaction qualifying for capital gain treatment was taxed at a combined rate of 56.8%,<sup>107</sup> or just 6.8% greater than the 50% individual-level tax on partnership income.

Repealing the *General Utilities* doctrine also increases the tax cost of operating in corporate form. Imposing a corporate-level tax on appreciated assets on distribution or liquidation will discourage taxpayers from both adopting the corporate form, and liquidating to leave the corporate form.<sup>108</sup> The tax burden differential between corporate and noncorporate investment increases because only corporations are subject to this layer of taxation.

The following examples illustrate the combined effects of changing the tax rates and eliminating the favorable capital gain rate preference. These calculations demonstrate the disparate impact of the 1986 Act changes in a general fashion; they do not constitute a comprehensive examination of the effect of the 1986 Act changes. Comparisons between pre- and post-1986 Act tax rates and after-tax future values are particularly dangerous because of differences in the effective and nominal tax rates borne by individuals and corporations,<sup>109</sup> as well as potentially significant differences in the determination of an entity's taxable income before and after the 1986 Act.<sup>110</sup> Nor do the examples reflect the effects of either the various strategies used by taxpayers to minimize the tax cost of operating within the two-tier tax system<sup>111</sup> or the large holdings by foreign and tax-exempt shareholders whose tax consequences may be much different than the examples suggest.

Let us make the following assumptions in examining how the 1986 Act

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107. The combined tax would be a \$46 corporate-level tax and a \$10.80 individual-level tax (assuming a 20% tax rate and a distribution of \$54).

108. The Joint Committee on Taxation estimates that the additional revenue from corporations for years 1987-1991 from the repeal of the *General Utilities* doctrine will be approximately \$1.7 billion. H.R. Rep. No. 841, 99th Cong., 2d Sess., vol. 2, at II-871 (1986). This estimate is deceptively small. It does not include the lost revenue resulting from liquidations that probably would have occurred but for the repeal of the *General Utilities* doctrine.

109. The nominal tax rate is the statutory rate. The effective tax rate is the percentage reduction in the rate of return due to taxation. See Bittker, *Effective Tax Rates: Fact or Fancy?*, 122 U. PA. L. REV. 780 (1974) (illustrating various methods for computing effective and average tax rates, and evaluating the use of effective tax rates as an analytical tool); Citizens for Tax Justice, *supra* note 51 (study of 275 major corporations; 129 of these companies paid no taxes or received rebates in at least one of the years 1981-84); Weiss, *Effective Corporate Income Tax Rates*, 32 NAT'L TAX J. 380 (1979) (discussing conceptual and methodological differences in computation of effective tax rates); see also R. MUSGRAVE & P. MUSGRAVE, *PUBLIC FINANCE IN THEORY AND PRACTICE* 424-26 (4th ed. 1984) (effective tax rate depends on the nominal rate, depreciation rules, investment credit provisions, rates of inflation, and characteristics of particular investments). For purposes of this analysis, all income is assumed to be subject to tax at the maximum marginal statutory rate but not subject to the 5% surcharge imposed on individuals and corporations.

110. The major thrust of the 1986 Act was the broadening of the tax base while reducing tax rates. Comparisons therefore can be deceptive because increases in an entity's taxable income may compensate for reductions in applicable rates.

111. The absolute and relative results would be much different for taxpayers, for example, who hold stock until death and use I.R.C. § 1014 to escape shareholder-level tax on predeath appreciation.

changes affect the decision whether to invest in the noncorporate or corporate form:

	<u>Pre-1986 Act</u>	<u>Post-1986 Act</u>
Pre-tax Rate of Return (r)	10%	10%
Individual Tax Rate (p)	50%	28%
Corporate Tax Rate (c)	46%	34%
Capital Gain Tax Rate (k)	20%	28%
Initial Wealth (w)	\$100	\$100
Number of Years (y)	10	10

Let us further assume that the same rate of return is available to corporate and noncorporate investors<sup>112</sup> and that the market has not yet adjusted to make the after-tax return on corporate equity equal to the after-tax return on noncorporate investment.<sup>113</sup> Finally, the analysis excludes the quantitative effects of the repeal of the *General Utilities* doctrine.

The individual investor has three investment choices:<sup>114</sup>

(1) Noncorporate Investment—invest directly in the income-producing asset so that only an individual-level tax applies to income from the investment.<sup>115</sup>

(2) Corporate Equity with Annual Dividend Distributions—invest in equity of a corporation holding the income-producing asset, with earnings distributed to the investor in the form of annual dividends. The dividends are taxable to the investor at the individual tax rate. The corporation's earnings are taxed at the corporate rate with no deduction for dividends paid.<sup>116</sup>

(3) Corporate Equity with No Dividend Distributions—invest in equity with earnings retained in corporate form and then paid out to the investor in a lump sum at the end of ten years in a transaction qualifying for capital gain treatment. The corporation is taxed at the corporate rate on earnings and receives no deduction for amounts paid

112. See Warren, *supra* note 9, at 724-25. The assumption, stated somewhat differently, requires that the income-producing asset yield the same rate of return in or out of corporate form.

113. Warren, *supra* note 9, at 725. As discussed in the text accompanying *supra* notes 8-15, the corporate tax may reduce the after-tax return for capital in corporate form resulting in relatively less investment in the corporate sector versus the noncorporate sector until the rates of return become equal.

114. The framework for the analysis of investment alternatives and financing alternatives borrows heavily from Warren, *supra* note 9, at 721-35, who in turn acknowledges M. KING, PUBLIC POLICY AND THE CORPORATION (1977); Flemming, *A Reappraisal of the Corporation Income Tax*, 6 J. PUB. ECON. 163 (1976); King, *Taxation and the Cost of Capital*, 41 REV. ECON. STUD. 21 (1974); Stiglitz, *Corporation Tax*, *supra* note 9; Stiglitz, *Taxation*, *supra* note 9. My approach differs from Warren's approach, however, in that any funds distributed from corporations are assumed to be reinvested in noncorporate assets, rather than reinvested in corporate form. See *id.* at 722.

115. The future value formula for noncorporate investment is  $w[1+r(1-p)]^y$ . Warren, *supra* note 9, at 723 Table 1.

116. The future value formula for corporate equity with annual dividend distributions, assuming dividends are reinvested in noncorporate assets, is

$$w\{1+r(1-p)(1-c) \sum_{n=0}^{y-1} [1+r(1-p)]^n\}.$$

in redemption of equity in year ten.<sup>117</sup>

Table 1 summarizes the after-tax future values of different investment alternatives for pre- and post-1986 Act rates:<sup>118</sup>

Table 1

AFTER-TAX FUTURE VALUE OF INVESTMENT ALTERNATIVES

Alternative	Pre-1986 Act Rates	(Percent of Alternative 1)	Post-1986 Act Rates	(Percent of Alternative 1)
(1) Noncorporate Investment	\$162.89	(100%)	\$200.42	(100%)
(2) Corporate Equity with Annual Dividend Distributions	\$133.96	(82%)	\$166.28	(83%)
(3) Corporate Equity with No Dividend Distributions	\$155.36	(95%)	\$164.43	(82%)

For Alternative 1 (Noncorporate Investment), the before-tax return of 10% from the income-producing asset bears the relevant individual tax rates.<sup>119</sup> Whether or not the after-tax future value for a particular noncorporate investment increases under the post-1986 Act tax regime depends on the investment's change in taxable income from the 1986 Act changes. The reduction in the corporate rate does not affect the after-tax amounts because the investor makes the investment directly without placing the assets in corporate form.

The results for Alternative 2 (Corporate Equity with Annual Dividend Distributions) reflect the impact of the 1986 Act changes. Because of the two-tier tax system, this alternative historically has been the most costly method of distributing corporate earnings to shareholders. After the 1986 Act, however, this alternative yields a greater after-tax amount than pre-1986 Act rate Alternative 1.<sup>120</sup> Although the combined post-1986 individual and corporate tax rate (52.48%) nominally exceeds the individual tax rate (50%) applied to pre-1986 Act Alternative 1, the higher after-tax amount for the post-1986 Act Alternative 2 results from the increased earnings arising from the lower tax rate on noncorporate investment of funds paid out as dividends.<sup>121</sup> Somewhat surprisingly, at least under these restrictive assumptions, the 1986 Act changes do not

117. The future value formula for corporate equity with no dividend distributions is  $w\{k+(1-k)[1+r(1-c)]^P\}$ . Warren, *supra* note 9, at 723 Table 1.

118. In 1981, when Professor Warren did his calculations, the maximum personal tax rate was 70%, and he assumed a 50% corporate tax rate. To illustrate the disparate effect of the individual and corporate tax system on high and low bracket taxpayers, Warren assumed both a 30% and a 70% individual tax rate. See Warren, *supra* note 9, at 722-23.

119. For historical perspective and to aid in comparison with Warren's results, it is interesting to examine results under the pre-1981 tax regime assuming 30% and 70% individual tax rates, a 50% corporate rate, and a 10-year investment horizon. The after-tax future value for a 30% individual tax rate is \$196.72, and for a 70% individual tax rate is \$134.39. Warren, *supra* note 9, at 723.

120. The after-tax future value results under the pre-1981 tax regime for a 10-year investment are as follows: for a 30% individual tax rate, \$148.36 and for a 70% individual tax rate, \$117.20 (assuming distributed funds are reinvested in noncorporate form).

121. See *supra* text accompanying notes 105-07 for a comparison of the combined marginal tax rates and the rate imposed on single-entity income before and after the 1986 Act rate changes. The results in the text depend on the assumption, which is probably unrealistic, that the tax base remains constant. A 35% increase in taxable income after the 1986 Act roughly offsets the 1986 Act rate



greatly alter the relative after-tax future values between Alternatives 1 and 2; the after-tax future value of Alternative 2 remains at roughly 82% of the value of Alternative 1.

Alternative 3 (Corporate Equity with No Dividend Distributions) yields perhaps the most interesting results. First, the 1986 Act's reduction of the individual and corporate tax rates more than compensates for eliminating the capital gain rate preference.<sup>122</sup> Second, and quite startling, the retention strategy no longer is preferred over the distribution approach.<sup>123</sup> The higher corporate tax rate imposed on undistributed earnings generally outweighs the advantage of deferral of the individual-level tax. Thus, high-bracket taxpayers cannot use the corporate form as a tax shelter.<sup>124</sup> Before the 1986 Act, Alternative 3 yielded an after-tax future value that was 95% of the value for Alternative 1. Following the 1986 Act changes, Alternative 3 now yields only 82% of the after-tax future value for Alternative 1.

In summary, the tax cost of operating in the corporate form as compared to the noncorporate form increases greatly after the 1986 Act. Assuming a ten-year investment horizon and no dividend distributions, for post-1986 Act rates investments in corporate form need to earn a 13.83% rate of return to yield the same after-tax future value amount as noncorporate investments yielding 10%.<sup>125</sup> Under pre-1986 Act rates, investments in corporate form (assuming no dividend distributions) needed to earn only an 11.06% rate of return to achieve an after-tax future value equal to noncorporate investments yielding 10%.<sup>126</sup>

Changing the individual and corporate tax rates and the capital gain rate preference assumptions has some interesting effects on the different investment alternatives. For example, setting both the individual and corporate tax rates at 34% results in after-tax future values for Alternative 1 of \$189.48 and for Alternatives 2 and 3 of \$159.06.<sup>127</sup> Equalizing the rates thus eliminates the difference between the corporate equity alternatives but narrows the gap only slightly be-

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reductions. Changing the assumption to reinvesting distributed funds in corporate equity reduces the after-tax value for post-1986 Act Alternative 2 to \$159.08.

122. Assuming no deferral, the pre-1986 Act combined corporate tax and shareholder capital gain tax rate is 56.8%. This compares unfavorably to the post-1986 Act combined individual and corporate tax rate of 52.48%, again assuming no change in the tax base.

123. One of the key factors influencing this comparison is the assumption that funds distributed are reinvested in noncorporate form yielding the same rate of return as corporate investment but subject to only one level of tax at a lower tax rate.

124. The after-tax future value results under the pre-1981 tax regime for a 10-year investment are, for a 30% individual tax rate, \$155.34 and for a 70% individual tax rate, \$145.28. Comparing these results to the result for Alternative 1 (Noncorporate Investment), which is \$134.39, illustrates the advantage to the high-bracket individual taxpayer of using the corporate form. See Warren, *supra* note 9, at 723.

125. The equivalent rate of return with the 100% payout assumption is 13.46%.

126. The equivalent rate of return for pre-1986 Act rates under the 100% payout assumption is 16.06%. For a pre-1986 Act analysis of the pretax rates of return necessary to achieve equal after-tax rates of return for corporate and noncorporate investment, see Shoven, *The Incidence and Efficiency Effects of Taxes on Income from Capital*, 84 J. POL. ECON. 1261 (1976).

127. The effect of the two-tier tax system can be isolated by assuming equal rates for individual and corporate taxpayers and no rate preference for capital gains. The after-tax future values for Alternatives 2 and 3 are about 84% of Alternative 1. See also Table 2 of Warren, *supra* note 9, at 724 (comparing investment alternatives assuming a 50% individual and corporate tax rate).

tween noncorporate and corporate investment alternatives. Reinstating the capital gain rate preference more effectively narrows the gap between noncorporate and corporate investment alternatives. Assuming a maximum capital gain tax rate of 20%, Alternative 3 will yield 86% of Alternative 1.<sup>128</sup> This value compares unfavorably to the 95% result achieved under the pre-1986 tax rates. The reduced effectiveness of using the 20% capital gain rate preference to equalize returns for noncorporate and corporate investments results from the 1986 Act's reduction of the individual tax rate. The spread between the individual and capital gain tax rate is no longer sufficient to compensate for the extra tax at the corporate level.

#### b. Bias in Favor of Debt Financing

As discussed earlier, corporations have three alternatives to finance new investments: using retained earnings, issuing debt, or issuing new equity.<sup>129</sup> The corporate tax system favors debt financing over other types of financing because interest is deductible; no corresponding deduction exists for earnings retained or dividends paid. In the pre-1986 Act tax regime, however, there were compensating biases that favored retained earnings financing and new equity financing over debt financing.<sup>130</sup>

The 1986 Act affects financing decisions in several ways. First, reducing the individual tax rate below the corporate tax rate creates incentives to shift income from the corporation to the shareholder. Debt owed by the corporation to the shareholder achieves exactly this result. Interest on the debt decreases the corporation's income and increases the shareholder's income; this results in the substitution of the shareholder's tax rate for the corporation's tax rate. Second, the 1986 Act substantially reduces the advantages previously accorded retained earnings financing and new equity financing. A higher tax rate applies to earnings retained than to distributions, and the 1986 Act eliminates the ability to extract earnings at capital gain rates. Only the potential to defer shareholder-level tax remains.

Table 2 summarizes the after-tax future values of the financing alternatives before and after the 1986 Act changes. In all alternatives I assume the initial \$100 is already in corporate form. The first alternative involves financing the new investment through the \$100 of retained earnings. All subsequent earnings remain in the corporation until the end of the ten-year investment period. At that point, the earnings are paid out either as a dividend, subject to ordinary income rates, or in redemption, which before the 1986 Act qualified for

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128. Assuming individual and corporate tax rates of 28% and 34%, respectively, the after-tax future value for Alternative 3 is \$171.59 and for Alternative 1 is \$200.42. If the individual and corporate tax rates are set at 34%, the after-tax future value for Alternative 3 (\$171.59) is 91% of the value of Alternative 1 (\$189.48).

129. See *supra* text accompanying notes 16-26.

130. See *supra* text accompanying notes 37-38. The favored status resulted from the generally lower rates applied to earnings retained in the corporation, the deferral of shareholder-level tax until earnings were distributed, and the ability to extract funds at capital gain rates.

favorable capital gain rates.<sup>131</sup> The second alternative assumes the \$100 retained earnings is distributed in year one, either as a dividend or in redemption, and the after-tax proceeds are loaned back to the corporation. The debt is retired in year ten. The after-tax interest payments are reinvested in new debt.<sup>132</sup> The third alternative assumes earnings are distributed in year one, again as either a dividend or in redemption, and that the after-tax proceeds are invested in new equity. Subsequent earnings are then currently distributed as dividends, with the shareholder investing after-tax amounts in noncorporate assets.<sup>133</sup> The final alternative is identical to the previous alternative except that subsequent earnings are retained in the corporation. The corporation redeems the stock in year ten.<sup>134</sup>

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131. The future value formula for retained earnings is  $w(1-t_{10})[1+r(1-c)]^y$  where  $t_{10}$  equals the tax rate on the distribution in year 10 (p if dividend transaction, k if redemption transaction). The after-tax future value results under the pre-1981 tax regime for a 30% individual tax rate and 70% individual tax rate are \$143.34 and \$117.28, respectively, for the redemption alternative, and \$114.02 and \$48.87, respectively, for the dividend distribution alternative. Warren, *supra* note 9, at 731.

132. The future value formula for debt financing is  $w(1-t_0)[1+r(1-p)]^y$  where  $t_0$  equals the tax rate on the initial distribution (p if dividend transaction, k if redemption transaction). The assumption that after-tax interest payments are reinvested in new debt yields the same return as if payments are reinvested in noncorporate assets; in each case, the rate of return is assumed to be 10% and earnings are subject only to an individual-level tax. The after-tax future value results under the pre-1981 tax regime for a 30% individual tax rate and a 70% individual tax rate are \$173.11 and \$96.76, respectively, for the redemption alternative, and \$137.70 and \$40.32, respectively, for the dividend alternative. Warren, *supra* note 9, at 731.

133. The future value formula for equity financing with dividends is

$$w(1-t_0)\{1+r(1-c)(1-p) \sum_{n=0}^{y-1} [1+r(1-p)]^n\}.$$

134. The future value formula for equity financing with retained earnings is  $w(1-t_0)\{t_{10}+(1-t_{10})[1+r(1-c)]^y\}$ .

Table 2  
AFTER-TAX FUTURE VALUE OF FINANCING ALTERNATIVES

Alternative	Pre-1986 Act Rates				Post-1986 Act Rates	
	Initial		Initial			
	Distribution as Redemption	(Percent of Alternative 2)	Distribution as Dividend	(Percent of Alternative 2)	(Percent of Alternative 2)	(Percent of Alternative 2)
(1) Retained Earnings Financing— Distribution in Year 10	\$135.36	(104%)	\$84.60	(104%)	\$136.43	(95%)
(2) Debt Financing— Distribution in Year 1	\$130.31	(100%)	\$81.44	(100%)	\$144.30	(100%)
(3) Equity Financing— Distribution in Year 1 and Subsequent Earnings Paid Out Currently as Dividends <sup>135</sup>	\$107.17	(82%)	\$66.98	(82%)	\$119.72	(83%)
(4) Equity Financing— Distribution in Year 1 and Subsequent Earnings Retained until Year 10 Redemption	\$124.29	(95%)	\$77.68	(95%)	\$118.39	(82%)

A comparison of the pre-1986 Act alternatives reveals that Alternative 1 (Retained Earnings Financing) has a slightly higher after-tax future value than Alternative 2 (Debt Financing). This value results from the pre-1986 Act corporate tax rate (46%) being slightly lower than the pre-1986 individual tax rate (50%). The after-tax future values for Alternative 3 (Equity Financing with Current Dividend Distributions) and Alternative 4 (Equity Financing with Subsequent Earnings Retained) are lower.<sup>136</sup> The low total for Alternative 3 reflects earnings bearing the full brunt of the two-tier tax system. Alternative 4, at least, has the benefits of deferring shareholder-level tax until the year ten redemption and subsequent taxation at capital gain rates.

The post-1986 Act results yield a different ranking. Alternative 2 (Debt Financing) achieves the highest after-tax future value. This value results from the individual tax rate (28%) being reduced below the corporate rate (34%). The debt strategy allows the individual tax rate to be substituted for the corpo-

135. The after-tax future values if the after-tax proceeds are reinvested in corporate equity are \$104.42 and \$65.26 for distributions in redemption and as dividends, respectively, for pre-1986 Act tax rates, and \$114.54 for post-1986 Act rates.

136. The after-tax future value results for Alternative 3 (Equity Financing with Current Dividend Distributions) under the pre-1981 tax regime for a 30% individual tax rate and for a 70% individual tax rate are \$130.55 and \$84.38, respectively, for the redemption alternative, and \$103.85 and \$35.16, respectively, for the dividend distribution alternative.

The after-tax future value results for Alternative 4 (Equity Financing with Subsequent Earnings Retained) under the pre-1981 tax regime for a 30% individual tax rate and for a 70% individual tax rate are \$136.70 and \$104.60, respectively, for the redemption alternative, and \$108.74 and \$43.58, respectively, for the dividend distribution alternative. Warren, *supra* note 9, at 731.

rate tax rate. Although the tax benefit of debt decreases because the 1986 Act reduces the corporate tax rate from 46% to 34%, the relative advantage of debt compared to other financing alternatives increases. Alternative 4 (Equity Financing with Subsequent Earnings Retained) yields the lowest after-tax future value. Retaining funds in the corporation results in the application of the higher corporate tax rate to subsequent earnings.

The relative after-tax values among Alternatives 2, 3, and 4 of Table 2—both before and after the 1986 Act—are identical to the relative after-tax values among Alternatives 1, 2 and 3 of Table 1. This identity occurs because the financing alternatives of Debt Financing, Equity Financing with Current Dividend Distributions, and Equity Financing with Subsequent Earnings Retained bear the same tax burdens (except for the tax on the initial distribution) as the investment alternatives of Noncorporate Investment, Corporate Equity with Annual Dividend Distributions, and Corporate Equity with No Dividend Distributions, respectively.<sup>137</sup> The conclusions are therefore similar. The discrimination against alternatives that distribute funds rather than retain funds in the corporation has been eliminated. More importantly, the gap has widened between debt financing and equity financing, with the alternative of Corporate Equity with No Dividend Distributions being the alternative most adversely affected by the 1986 Act changes.

Changing the individual and corporate tax rates and the capital gain rate preference assumptions has several interesting effects on the different financing alternatives. For example, equalizing the individual and corporate tax rates yields the same after-tax values for Alternatives 1 and 2.<sup>138</sup> Adopting equal rates, however, narrows the gap only slightly between Alternatives 1 and 2 and equity financing Alternatives 3 and 4.<sup>139</sup> As was the case with investment alternatives, reinstating the capital gain rate preference does not substantially close the gap between Alternative 4 and Alternatives 1 and 2.<sup>140</sup>

### c. Bias in Favor of Retained Earnings

Under the pre-1986 Act tax regime, the strategy of currently distributing corporate earnings as dividends has been the most costly method of distributing corporate funds to shareholders.<sup>141</sup> The high aggregate tax cost resulted from the combination of tax at both the corporate and shareholder levels and a histor-

137. Compare formula in note 115 with formula in note 132; compare formula in note 116 with formula in note 133; compare formula in note 117 with formula in note 134.

138. Assuming individual and corporate tax rates of 34%, the after-tax future value for Alternatives 1 and 2 is \$125.06. This is the balance described by Professor Andrews, *see supra* note 37.

139. The after-tax future value for Alternatives 3 and 4 is \$104.98—about 84% of the value for Alternatives 1 and 2.

140. Assuming individual and corporate tax rates of 28% and 34%, respectively, the after-tax future value for Alternative 4 distribution in redemption (\$137.27) is about 86% of Alternative 2 (\$160.34) and 91% of Alternative 1 (\$151.59). If the individual and corporate tax rates are set at 34%, the after-tax future value for Alternative 4 (\$137.27) is about 91% of the value for Alternatives 1 and 2 (\$151.59).

141. *See generally*, J. BRITAIN, CORPORATE DIVIDEND POLICY 74-99 (1966) (examining the effects of individual income tax rates and liberal depreciation allowances on dividend policy).

ically high individual tax rate applied to dividend distributions. In response, the retained earnings strategy was developed.

The 1986 Act changes affect dividend strategy in three ways. First, by setting the maximum individual tax rate below the maximum corporate tax rate, the changes result in a 6% penalty (34%-28%) for keeping funds in corporate form. Second, the repeal of the *General Utilities* doctrine creates the potential for an additional corporate-level tax on asset appreciation (not reflected in the calculations). Finally, the repeal of the capital gain rate preference eliminates the ability to remove accumulated funds at favorable rates.

Table 3 below illustrates the results of several dividend strategies for different investment periods under the pre-and post-1986 Act tax regimes:<sup>142</sup>

Table 3  
AFTER-TAX FUTURE VALUE OF DIVIDEND STRATEGIES

Investment Horizon (Years)	Pre-1986 Act Rates			Post-1986 Act Rates		
	<u>5</u>	<u>10</u>	<u>20</u>	<u>5</u>	<u>10</u>	<u>20</u>
(1) Corporate Equity with 100% payout	\$114.92	\$133.96	\$189.28	\$127.44	\$166.28	\$299.12
(2) Corporate Equity with 50% payout	\$119.25	\$143.42	\$212.03	\$127.28	\$165.43	\$293.93
(3) Corporate Equity with 25% payout	\$121.60	\$149.04	\$228.32	\$127.20	\$164.95	\$290.55
(4) Corporate Equity with 0% payout	\$124.06	\$155.36	\$249.03	\$127.11	\$164.43	\$286.51

There are no surprises in the pre-1986 Act results. As the percentage of earnings retained in the corporation increases, so does the after-tax future value. The longer the investment horizon, the greater the difference in after-tax future values for different dividend strategies. For example, under the five-year investment horizon, Alternative 1 (Corporate Equity with 100% Payout) yields about 93% of the after-tax future value as Alternative 4 (Corporate Equity with No Payout), but only 76% of the value for the 20-year horizon.

The post-1986 Act results illustrate the decimation of the retained earnings strategy. Alternative 1 yields the highest after-tax future value. The variations among the results for the different dividend strategies and the different time horizons are remarkably small. For the five-year investment horizon, the value for the lowest ranking alternative is 99.74% of the value for the highest ranking alternative. Because the 1986 Act narrowed the differences among individual, corporate, and capital gain tax rates, tax considerations may no longer strongly

142. The general future value formula for corporate equity with partial dividend distribution is  $w\{k+(1-k)[1+r(1-c)(1-d)]^y+rd(1-c)(1-p)\sum_{n=1}^y\{[1+r(1-c)(1-d)]^{n-1}[1+r(1-p)]^{y-n}\}$ ,

where  $d$  equals the fraction of after-corporate tax profits distributed as dividends.

influence dividend strategy.<sup>143</sup>

Changing the individual and corporate tax rates and the capital gain rate preference assumptions yields interesting consequences for dividend strategies. Equalizing the individual and corporate tax rates eliminates the variations in values for different dividend strategies. Reinstating the capital gain rate preference would again create incentives for keeping funds in corporate form. The incentives would be greater the larger the spread between the capital gain rate and the individual tax rate. Thus, there will be a greater effect when the individual rate is 34% than when the rate is 28%.<sup>144</sup>

## B. *Effect of 1986 and 1987 Acts' Changes on Taxpayer Strategies*

The 1986 Act, which specifically rejected modest integration proposals, greatly encourages taxpayers to adopt self-help integration measures.<sup>145</sup> The 1987 Act furthers that trend. The revised strategies outlined below all seek to avoid the full economic impact of the two-tier tax system as reinforced by the 1986 and 1987 Acts.

### 1. Avoiding the Corporate-Level Tax

The 1986 and 1987 Acts encourage taxpayers to avoid corporate form initially. Never before has the tax bias against operating as a regular corporation been so great. For both newly organized and existing closely held corporations, electing S corporation treatment will be extremely tempting when a corporation can meet the qualifications.<sup>146</sup> An S election achieves almost complete integration for qualifying corporations.<sup>147</sup> Although the limitations on number of shareholders and classes of stock have limited the use of S corporations in the past, the increased advantages of generally avoiding a corporate-level tax will result in increased creativity in structuring transactions to satisfy S corporation requirements.<sup>148</sup>

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143. This does not mean, however, that taxpayers will abandon such dividend-minimizing techniques as disguising equity as debt, excess compensation to shareholder-employees, and optional share repurchase plans.

144. Assuming a 10-year investment horizon and individual and corporate tax rates of 34% and capital gain tax rate of 20%, the after-tax future value for the lowest ranking alternative (Alternative 1—\$159.06) is about 93% of the highest ranking alternative (Alternative 4—\$171.59). Changing the individual tax rate assumption to 28% yields a value for Alternative 1 (\$166.28) that is about 97% of the value for Alternative 4 (\$171.59).

145. See Canellos, *Corporate Tax Integration: By Design or By Default*, 35 TAX NOTES 999 (1987).

146. See *supra* note 48.

147. S corporations that were taxed as regular corporations before making the election, however, are treated more as separately taxable entities than as conduits under the 1986 Act. I.R.C. § 1374 (Supp. IV 1986) imposes a corporate-level tax on built-in gains accruing during the period the corporation was taxed as a regular C corporation for those corporations that failed to make an S election before January 1, 1987. For all S corporations, the 1986 Act also extends the imposition of a corporate-level tax on distributions of appreciated property whether as dividend distributions or distributions in complete liquidation. *Id.* § 1363(d).

148. For example, joint venture arrangements between S corporations as well as between S corporations and regular corporations or partnerships, will become more popular. See generally Krane and Gallagher, *Preserving Subchapter S Status in Partnership Arrangements and Acquisition Transac-*

The rigid requirements of Subchapter S may be avoided by operating as a partnership pursuant to Subchapter K of the Code. Subchapter K provides several tax benefits unavailable under Subchapter S.<sup>149</sup> An existing corporation's assets may be transferred to a partnership through either liquidation or spin-off. Liquidations became more costly after December 31, 1986, except for those corporations that come within the transitional small business exception to the repeal of the *General Utilities* doctrine.<sup>150</sup> The immediate tax cost of the liquidation to the corporation and the shareholder must be balanced against the tax benefit of avoiding the corporate-level tax and the increased depreciation and amortization deductions resulting from a step-up in basis in connection with the liquidation. In a partnership spin-off, the corporation transfers assets in exchange for a preferred interest in a partnership and the shareholders own the remaining interests directly. The preferred interest could be entitled to a priority on cash distributions and a liquidation preference, while the remaining interests would be entitled to future appreciation. Any future appreciation in the transferred assets would thus escape the corporate-level tax.

The alternatives available to publicly held corporations for avoiding the corporate-level tax are more restricted. Because of the unavailability of S corporation treatment to entities with more than thirty-five shareholders, the primary alternative for avoiding the two-tier tax system through entity classification before the 1987 Act was the master limited partnership form.<sup>151</sup> In the past few years, several different types of master limited partnerships have developed. The roll-up and the roll-out were the first types of master limited partnerships to gain popularity. The roll-up was used primarily in the oil and gas industry to consolidate several relatively small, burnt-out partnerships into a single master limited partnership.<sup>152</sup> The roll-out partnership usually resulted from a corporation contributing substantial assets to a newly-formed limited partnership in

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*tions*, 65 TAXES 862 (1987) (examining the viability of partnership arrangements with S corporations in light of the statutory requirements for S corporation qualification).

149. Four major advantages of partnership tax treatment not available under Subchapter S are: (i) partners, unlike shareholders in S corporations, acquire additional outside basis in their partnership interests equal to their proportionate share of partnership debt (I.R.C. §§ 722, 752(a) (1982 & Supp. III 1985)); (ii) incoming partners who purchase their interests at a premium may be able to step up their allowable inside bases of partnership assets to the extent of the premium if the partnership has a § 754 election in effect (I.R.C. §§ 754, 743(b), 755 (1982 & Supp. III 1985)); (iii) the partnership is not subject to the repeal of the *General Utilities* doctrine, so no partnership-level tax will be imposed on the distribution of appreciated property; and (iv) the special allocation provisions of § 704(b) (1982) afford greater flexibility in allocating economic and tax interests than is available to S corporations, because of the S corporation restriction of one class of stock.

150. See *supra* note 92 (citing the transition rules).

151. Master limited partnerships are partnerships whose interests are publicly traded. For a discussion of the advantages of the master limited partnership form after the 1986 Act, see Freeman, *Some Early Strategies for the Methodical Disincorporation of America After the Tax Reform Act of 1986: Grafting Partnerships onto C Corporations, Running Amok with the Master Limited Partnerships Concept, and Generally Endeavoring to Defeat the Intention of the Draftsmen of the Repeal of General Utilities*, 64 TAXES 962, 967-89 (1986); Limberg, *Master Limited Partnerships Offer Significant Benefits*, 65 J. TAX'N 84 (1986); Sheppard, *Sleeping Dogs: Publicly Traded Limited Partnerships Come of Age*, 34 TAX NOTES 1254 (1987).

152. The partners in the smaller partnerships exchange their interests for interests in the master limited partnership. This exchange allows the original partners to convert their holdings into a more marketable form to facilitate later disposition.



exchange for a general partnership interest and most of the limited partnership interests. The limited partnership interests could then be retained, sold to the public, or distributed to shareholders as a dividend or in partial or complete liquidation.<sup>153</sup>

Before the 1987 Act, master limited partnerships were used primarily in initial public offerings and leveraged buyouts. After the 1986 Act, the use of the partnership form reflected a decision dictated entirely by the increased tax costs of operating in corporate form. The master limited partnership form avoided the corporate-level tax, as well as the operating restrictions imposed by other types of flow-through entities allowed by the Code.<sup>154</sup> The 1987 Act limits the use of master limited partnerships for those publicly held entities engaged in active operations by taxing such entities as corporations. Subject to some qualifications and generous transition rules, publicly held entities can no longer avoid the corporate-level tax by organizing as a limited partnership.<sup>155</sup>

The post-1986 Act tax system places increased pressure on trying to extract corporate-level funds through deductible expenses.<sup>156</sup> For closely held corporations, even greater incentives exist for disguised dividend transactions. For those entities unable to avoid corporate status and not satisfying the requirements for S corporation treatment, increased incentives exist to siphon off corporate income. Several different approaches are available. Shareholders can acquire property—either property already owned by the corporation or new property—and lease it to the corporation. Alternatively, corporate assets could be spun off into partnerships and either leased back to the corporation or operated independently to generate income outside the corporate tax structure.

The 1986 Act changes lead to increased substitution of debt for equity in corporations' capital structures.<sup>157</sup> The relative tax advantages of debt financing increase under the post-1986 Act tax regime because the individual tax rate is now lower than the corporate rate and because some of the biases in the individ-

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153. The roll-out was initially used for passive assets, such as oil-and gas-producing properties, which generated a relatively predictable cash flow and required little management activity. Subsequent roll-outs involved active businesses that required substantial management activity and continued reinvestment. See Sheppard, *supra* note 151, at 1256 (listing of publicly traded limited partnerships by type (e.g. roll-out, roll-up) and by business activity). The roll-out then gained popularity as a takeover defense, whereby treasured assets could be spun off into a limited partnership out of the reach of corporate raiders. The popularity of the roll-out has declined following the repeal of the *General Utilities* doctrine. Although the roll-out previously could be accomplished at relatively little tax cost, the imposition of corporate-level tax on the distribution of appreciated assets substantially increases the cost of this technique.

154. The Code allows flow-through treatment for passive investments in real estate (REITs), mortgages (REMICs), and portfolio securities (RICs), but imposes restrictions to qualify for such treatment. See I.R.C. §§ 856-860, 860A-860G, 851-855 (1982 & Supp. IV 1986). The master limited partnership form allows the benefits of pass-through treatment to be achieved without having to satisfy the qualification requirements.

155. See *supra* note 103.

156. Deductible compensation, for example, will save the corporation a corporate-level tax of 34 cents for each dollar of compensation, while costing the employee-shareholder an individual-level tax of only 28 cents for each dollar received. Similarly, increased incentives will exist for disguising equity as debt to obtain deductible interest payments.

157. For a discussion of increased use of leverage in recent acquisitions, see Canellos, *supra* note 52, at 1002-03.

ual tax system in favor of retained earnings and new equity financing have been eliminated.<sup>158</sup>

Following repeal of the *General Utilities* doctrine but before passage of the 1987 Act, taxpayers structured transactions to avoid the reach of the repeal. Mirror transaction techniques received the most publicity. These transactions were structured to avoid corporate-level gain on the disposition of unwanted assets following an acquisition.<sup>159</sup> Several other techniques were crafted to avoid the full impact of the repeal.<sup>160</sup> These techniques shared many similar elements. The unwanted assets remained in corporate form and retained their historic bases. The 1987 Act, however, effectively destroyed the strategies for avoiding recognition of corporate-level gain on the disposition of unwanted assets following an acquisition.<sup>161</sup>

## 2. Deferral Techniques

With the elimination of the capital gain rate preference, deferral techniques have become the major technique to minimize taxes.<sup>162</sup> The 1986 Act encourages taxpayers to structure transactions to fall within nonrecognition provisions, primarily the reorganization provisions. Three factors combine to increase the attractiveness of tax-free reorganizations.<sup>163</sup> First, elimination of the capital

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158. See *supra* text accompanying notes 135-37.

159. See Kliegman, *Do Mirror Transactions Survive the 1986 Act?*, 66 J. TAX'N 206 (1987); Shepard, *Mirror Moves: Life Without the General Utilities Rule*, 32 TAX NOTES 847 (1986); Zolt, *supra* note 92, at 824-27. The mirror transaction is best described by example. Assume *P* desires to acquire *T* stock for \$200 and that *T* has two operating divisions, *D1* and *D2*, each with a fair market value of \$100 and a basis to *T* of \$50. *P* wishes to keep *D1*, but dispose of *D2* shortly after the acquisition. *P* desires to compute the gain on the sale of *D2* based on its pro rata share of the purchase price (\$100) rather than on *T*'s historic basis in *D2* (\$50). Hoping to accomplish this result, *P* forms two subsidiaries, *S1* and *S2*, and contributes \$100 to each subsidiary. *S1* and *S2* purchase *T* stock for \$200 and then cause *T* to liquidate. In liquidation, *T* distributes the assets of *D1* to *S1* and the assets of *D2* to *S2*. No § 338 election is made. *P* then sells the stock of *S2* to an unrelated party and determines its gain with reference to its \$100 basis in *S2* stock.

This structure works only if it comes within I.R.C. § 337(a) (Supp. IV 1986), an exception to *General Utilities* repeal. Section 337(a) provides for no gain or loss to be recognized to the corporation on a distribution to an 80% distributee in a complete liquidation to which § 332 applies. Qualification depended on the applicability of Reg. § 1.1502-34 (as amended in 1966) to aggregate the holdings of *S1* and *S2* for purposes of satisfying the 80% distributee requirement. The 1987 Act prevents mirror transactions from qualifying for tax-free treatment by requiring the corporate distributee to own directly 80% of the stock of the liquidating corporation. See *supra* note 104.

160. These techniques include: (i) the tiered-mirror technique; (ii) the investment basis adjustment technique; (iii) the § 304-consolidated return technique; (iv) the § 355 technique; and (v) the subsidiary tracking stock technique. For a description of these techniques and the effect of the proposed 1987 Act changes on their continued viability see Zolt, *supra* note 92, at 824-32.

161. See *supra* note 104.

162. Accounting strategies for deferral have been greatly affected by several specific changes in the 1986 Act. See *supra* note 78.

163. The reorganization provisions may take on even greater importance if the Senate Finance Committee's 1985 proposals are adopted. See STAFF OF SENATE COMM. ON FINANCE, 99TH CONG., 1ST SESS., FINAL REPORT ON SUBCHAPTER C, THE SUBCHAPTER C REVISION ACT OF 1985 (Comm. Print 1985). These proposals for changing the tax regime for mergers and acquisitions can be traced back to the AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT, SUBCHAPTER C: PROPOSALS ON CORPORATE ACQUISITIONS AND DISPOSITIONS (1982), and the STAFF OF SENATE COMM. ON FINANCE, 98TH CONG., 1ST SESS., THE REFORM AND SIMPLIFICATION OF THE INCOME TAXATION OF CORPORATIONS (Comm. Print 1983). For a discussion of an earlier draft of these proposals, see Beghe, *The American Law Institute Subchapter C Study: Acquisitions and Distri-*

gain rate preference increases the tax cost to a selling shareholder from a maximum of 20% before the 1986 Act to a maximum of 28% (or 33% within the 5% surcharge range). Second, the value of deductions available to the purchaser that are generated by a stepped-up basis decreases. The tax benefit decreases because of lower corporate tax rates and new rules restricting some of the previous flexibility on purchase price allocations.<sup>164</sup> Finally, the repeal of the *General Utilities* doctrine requires payment of a corporate-level tax on the appreciation in corporate assets either upon a liquidation or a sale by the selling corporation, or when a section 338 election is made by the acquiring corporation to obtain a stepped-up basis in the acquired corporation's assets.<sup>165</sup>

The 1986 Act changes eliminate the attractiveness of the retained earnings strategy. Although the strategy still defers the shareholder-level tax, it no longer allows shareholders to bail out earnings at capital gain rates. In the post-1986 Act tax regime, assuming both shareholders and corporations are at the maximum marginal tax rate, a 6% penalty exists for retaining funds in corporate form.<sup>166</sup>

Exceptions to the undesirability of the retained earnings strategy, how-

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*butions*, 33 TAX LAW. 743 (1980). They would repeal the current statutory requirements for the different types of acquisitive reorganizations and eliminate the judicial requirements of continuity of interest, continuity of business enterprise, and business purpose. Qualifying transactions would have the following tax consequences: the target shareholders receive nonrecognition treatment to the extent they exchange their target stock for stock of the acquiring corporation or an affiliate, or exchange securities for an equal principal amount of securities of any member of the acquiring group, and the target has nonrecognition treatment. The acquiring corporation takes a carryover basis in the target's assets. These proposals allow the parties the option of treating the transaction as taxable or tax-free without regard to the corporate form of the transaction as either a stock or asset sale, and eliminate the old byzantine structure that previously governed acquisitions.

Alternatively, a cost basis election can be made by the acquiring corporation to treat the transaction as a taxable acquisition. In such case, the target recognizes gain or loss with respect to its assets and the acquiring corporation takes a cost basis in the assets acquired. For a summary of the debate over the proposed revisions to the acquisition rules, see LeDuc, *Current Proposals to Restructure the Taxation of Corporate Acquisitions and Dispositions: Substance and Process*, 22 SAN DIEGO L. REV. 17, 54-62 (1985).

164. I.R.C. § 1060 requires that both the target and acquiring corporation allocate purchase price in asset acquisitions under the residual method prescribed in the § 338 regulations. I.R.C. § 1060 (Supp. IV 1986). The regulations require that the purchase price be allocated first to cash and cash equivalents, then to marketable securities, certificates of deposits, government securities, and foreign currency to the extent of their fair market value, then to all other assets except goodwill to the extent of their fair market value, and that any remaining amount be allocated to goodwill. Temp. Treas. Reg. § 1.338(b)-2T (1986). Second-tier allocations under the proportionate method are not allowed.

165. The 1986 Act amended § 338 to treat the "deemed" sale of assets as a taxable transaction in which all gain, not just recapture liability, is recognized in order to obtain a stepped-up basis of the acquired assets. See I.R.C. § 338 (West Supp. 1988). Transactions structured to achieve a stepped-up basis make sense only in such limited circumstances as the following: (i) the selling corporation qualifies for the small corporation exception to the *General Utilities* repeal; (ii) the selling corporation has sufficient net operating losses to absorb the gain; or (iii) the gain to the selling parent corporation of a subsidiary stock approximates the gain on sale of subsidiary assets.

166. With the present structure, the Code provisions aimed at combating the retained earnings strategy may now be even more superfluous than before. See Kwall, *Subchapter G of the Internal Revenue Code: Crusade Without a Cause?*, 5 VA. TAX REV. 223 (1985). The corporation could still, however, be used as an investment vehicle to purchase stock in unrelated corporations in lieu of distributing funds to shareholders. See A.L.L., REPORTER'S STUDY, *supra* note 36, at 487-513. This may support tying repeal of the accumulated earnings and personal holding company tax provisions to repeal of the dividends received deduction for corporations making portfolio investments.

ever, exist for nontax and tax reasons. First, the retained earnings strategy is preferred when investment opportunities are better at the corporate level than at the shareholder level. Second, it is preferred when the tax costs to the shareholder and the corporation of distributing assets outweigh the tax benefit of holding assets in noncorporate form. Finally, a retained earnings strategy is beneficial when one believes that tax law may change again to restore the capital gain rate preference, or to set the maximum individual tax rate above the maximum corporate rate.

Increased use of share repurchase plans evidence a new approach to the retained earnings strategy. These plans, under which publicly held corporations buy back a part of their stock, achieve the exact economic effects of a dividend without any adverse tax consequences to remaining shareholders. Two objectives are achieved. First, remaining shareholders can defer recognizing gain until they dispose of their shares or can take advantage of the stepped-up basis provisions of section 1014. Second, excess funds are distributed by corporations and are therefore not subject to the higher corporate tax rates.<sup>167</sup>

### 3. Bailout Techniques

The 1986 Act changes completely revise taxpayer strategies for bailout techniques. Ending the capital gain rate preference eliminates most of the attractiveness of structuring transactions to achieve capital gain treatment.<sup>168</sup> Structuring transactions to achieve capital gain treatment, however, still has some advantages. First, a transaction qualifying for capital gain treatment allows taxpayers to recover their basis before recognizing any gain. Second, the character of gains and losses as either capital or noncapital remains important in the netting process to determine whether a taxpayer has a net capital gain or loss. Although the 1986 Act eliminates the rate preference, it retains the restrictions on using capital losses to offset ordinary income. Therefore a taxpayer with substantial capital losses will still have great incentive to structure transactions to achieve capital gain treatment.<sup>169</sup>

### 4. Summary

The 1986 and 1987 Acts strongly affect taxpayer strategies. Closely held

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167. There may also be no adverse tax consequences to a selling shareholder if the shareholder was planning to dispose of her shares anyway or if the shareholder is tax-exempt. For a discussion of the economic effects of share repurchase plans and a proposal to tax remaining shareholders as if they received a dividend, see Chirelstein, *Optional Redemptions and Optional Dividends: Taxing the Repurchase of Common Shares*, 78 YALE L.J. 739 (1969).

168. See generally Faber, *Capital Gains v. Dividends in Corporate Transactions: Is the Battle Still Worth Fighting?*, 64 TAXES 865 (1986) (examining several different types of capital gain transactions and concluding that the elimination of the capital gain rate preference significantly reduces but does not eliminate incentives for capital gain treatment).

169. A bailout strategy may be directed at borrowing against appreciated property. By borrowing against assets or stock, a taxpayer can unlock appreciation in the property without causing any gain to be recognized.

Another bailout strategy that acquires even greater appeal after the 1986 Act is the use of I.R.C. § 1014 (1982) to pass property to heirs without a tax on predeath appreciation. Eliminating the capital gain rate preference increases the lock-in effect for elderly taxpayers.

entities generally can still choose between having their income subject to a corporate-level tax or having the income taxed directly to the owners. Following the 1986 Act, the decision to avoid subjecting income to the corporate-level tax becomes easier. Taxpayer strategies before the 1986 Act sought to lessen the biases caused by a separate corporate tax system. These strategies relied heavily on the availability of the capital gain rate preference, corporate tax rates that were lower than individual rates, and the *General Utilities* doctrine.

The 1986 Act has curtailed these strategies. Several post-1986 Act strategies have emerged for closely held entities. Taxpayers will increasingly operate in noncorporate form or elect S corporation status. Closely held entities subject to the corporate tax will make increased efforts to shift income away from the corporation to individuals or partnerships through the use of such arrangements as additional compensation to shareholder-employees, additional debt in the capital structure, and leasing of property by shareholders to the corporation. Taxpayers will expend great effort to qualify under nonrecognition provisions for tax deferral at either the shareholder or corporate level. Publicly held entities have fewer alternatives. Their ability to operate in noncorporate form is severely restricted by the 1987 Act. Several preferences that reduced corporate tax liability have been eliminated or reduced by the 1986 or 1987 Acts, such as investment tax credits and favorable accounting provisions.

The elimination of the potential tax benefits of operating in the corporate form for closely held entities, combined with changes restricting the ability of publicly held entities to reduce corporate-level tax liabilities, will have a dual effect. More closely held entities will elect against C corporation status, and publicly held corporations will be subject to a higher effective tax rate. The corporate tax thus will be borne, in even greater proportion than before, by publicly held rather than closely held entities.

### III. IMPLICATIONS FOR REFORM PROPOSALS

Before the 1986 Act, the corporate tax system, while not perfectly balanced, was in rough equilibrium. Although there were plenty of tax-induced distortions, enough compensating biases existed that, generally, tax considerations influenced but did not dictate taxpayer decisions on form of investment, financing, and dividend policy. Although past tax law changes have affected the compensating biases in the tax system,<sup>170</sup> nothing compares to the disequilibrating effects of the 1986 Act changes. Blinded by the desire to substantially reduce individual tax rates and to maintain revenue neutrality, Congress destroyed the

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170. See generally Taylor, *Tax Policy and Changes to Subchapter C*, 48 LAW & CONTEMP. PROBS. 57 (Autumn 1985) (reviewing changes to Subchapter C effected by previous tax law changes). For example, past tax acts have affected the balance in the individual and corporate tax systems by changing the relative individual and corporate tax rates, by changing the preference accorded capital gains, by reducing corporate tax liabilities through larger depreciation deductions and credits, by relaxing the qualification requirements and simplifying the tax treatment of S corporations, and by changing the ability of a corporation to transfer appreciated property without recognizing a corporate-level gain.

compensating biases in the tax system. The 1987 Act further exacerbated the situation.

The 1986 and 1987 Acts are likely to influence taxpayer behavior in several ways. These changes will strongly influence taxpayers to operate in noncorporate form or as an S corporation, to shift income away from the corporation, to increase the relative amount of debt in the corporation's capital structure, to increase the amount of dividends paid, and to squeeze transactions to fit within various nonrecognition provisions. All of these strategies are forms of self-help integration. Self-help integration results in both costs<sup>171</sup> and benefits<sup>172</sup> to the tax system, and does address some of the problems resulting from the destruction of the compensating biases in the tax system. Tolerating self-help integration, however, is hardly a rational approach to the problems created by the imbalance in the corporate tax system.

Some consequences will certainly follow from self-help integration techniques. There will be increased transaction costs from taxpayers changing the form of operations and operating in more cumbersome forms. The tax system will tax in a dissimilar manner taxpayers who are alike in all but the form of their transactions. The difference in form, however, does not justify different tax treatment. Some consequences are less certain but quite plausible. There may occur a reallocation of resources away from the corporate sector. There also may be increased use of debt and increased payout of corporate earnings as dividends. Because closely held corporations have more opportunities to avoid or reduce the corporate-level tax, the corporate tax may be borne even more disproportionately than in the past by publicly held rather than closely held corporations. Finally, there may be a loss of tax revenues from an erosion of the corporate tax base.

The desirability of these consequences is open to question. Clearly, Congress did not grasp the potential consequences of the 1986 and 1987 Acts on the taxation of corporations and their shareholders, nor did it intend these results. Without further legislative action, the trend towards self-help integration will increase. If Congress finds these consequences undesirable it has three alternatives: it can restore some of the tax incentives to using the corporate form; it can adopt some proposal for integrating the individual and corporate tax system; or it can continue to reinforce the two-tier tax system by adopting further measures to combat self-help integration. Unfortunately, none of the alternatives consti-

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171. Tolerating self-help integration techniques damages the tax system, increases transaction costs and complexity, and reduces tax revenues. *See generally* Canellos, *supra* note 145 (examining self-help integration techniques and arguing for serious consideration of formal integration proposals). Leaving the question whether to integrate the tax system to taxpayer initiative is unsound tax policy. Self-help integration techniques increase transaction costs and complexity as taxpayers change the form of their operations and operate in a more cumbersome form. The techniques result in an erosion of the corporate tax base as capital is shifted from corporate form and income is shifted from corporations to entities taxable only at the individual level.

172. To the extent the two-tier tax system results in inefficiencies and unfairness, self-help integration techniques may reduce those biases and inequities. The self-help integration approach achieves some of the benefits of integration without having to face the political battles that integration proposals would likely engender.

tutes an easy solution to the problems caused by changes in the 1986 and 1987 Acts.

Congress can restore the tax incentives to use the corporate form by reinstating some of the compensating biases. This can be accomplished by reinstating the capital gain rate preference or by setting the maximum individual tax rate higher than the maximum corporate tax rate. These two changes would restore the tax advantage of keeping funds in corporate form and would increase the desirability of the retained earnings strategy.<sup>173</sup> Changing the taxation of capital gains and reversing the relative individual and corporate tax rates, however, may result in distortions in other parts of the tax system. Perhaps the simplest approach is to adopt the same maximum marginal rates for individuals and corporations. The adoption of the same maximum rates at least redresses the current tax penalty for retaining funds in corporate form.

Another approach focuses on integrating the individual and corporate tax systems. The tax system after the 1986 Act is more conducive to integration because the capital gain rate preference has been eliminated and the corporate tax rate has been raised above the individual rate. Politically, however, the chances of adopting a meaningful integration proposal are extremely slim.<sup>174</sup> Although theoretically desirable, integration does not offer much hope as a practical solution to the current imbalance in the corporate tax system.

The final approach is to continue the 1987 Act's tack of curtailing self-help integration techniques. The 1987 Act limits the ability of and the attractiveness for publicly owned entities to operate as limited partnerships in order to avoid the corporate-level tax. The 1987 Act also prevents acquiring corporations from disposing of newly acquired property without a corporate-level tax. Areas of possible future legislative action include: limiting the deductibility of interest, particularly interest incurred in connection with acquisitions or redemptions or for corporations with excessive debt in their capital structure; limiting schemes to siphon-off corporate income to related pass-through entities by attributing income back to the corporation using the property when there is no good economic purpose for the arrangement; and repealing section 1014 to eliminate the shareholder level relief this section affords by allowing predeath appreciation to escape untaxed. Congress has previously attempted to address these problems with mixed success. Even assuming greater progress in combatting self-help integration techniques, ingenious taxpayers will develop new techniques that will then require congressional attention. The approach of combatting self-help inte-

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173. Alternatively, the tax cost of operating in noncorporate form could be increased by subjecting income from noncorporate sources to an additional tax or by allowing certain tax incentives only for entities taxed as corporations.

174. See e.g., comments of Robert Leonard, Chief Tax Counsel of House of Representatives Ways and Means Committee reported in Sheppard, *Subchapter C Reform: Live Aid for Elective Carryover Basis*, 35 TAX NOTES 225, 228 (1987) and of Dennis Ross, Tax Legislative Counsel, Department of Treasury, reported in Sheppard, *Through the Looking Glass*, 35 TAX NOTES 436, 436 (1987). Integration may be politically unacceptable because of the revenue loss, the public resistance for reducing or eliminating the corporate tax, the corporate manager's resistance to tax law changes that encourage distribution of funds to shareholders, and practical problems in designing an integration system given the large holdings by foreign and tax-exempt shareholders.

gration is therefore not a good long-term solution to the imbalance in the corporate tax system.

In conclusion, the taxation of corporations and their shareholders is in an unstable state. The condition results from changes in the 1986 and 1987 Acts. Congress enacted these changes without full consideration of their effect on corporate taxation. The time is ripe for Congress to focus on the taxation of corporations and their shareholders and to re-establish some balance in the corporate tax system.



