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Tax Incentives for Investment: A Free Market Future Versus Our Pork Barrel Past

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Tax Incentives for Investment: A Free Market Future Versus Our Pork Barrel Past

JB McCombs*

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Introduction

With rhythmic clucking and loud squawking unmatched by any conventional henhouse, Congress worries about the strength and growth of the United States economy. Presidents participate in this process, fertilizing new ideas and proudly announcing new laws which are hatched in the Congressional nest.

One significant and ever present issue in this area is the effect of the federal income tax on the economy. Does the tax impose such a burden on saving,

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* Assistant Professor of Law, University of Nebraska College of Law; J.D. 1981, University of Michigan; LL.M. (Taxation) 1986, New York University. This article is dedicated to my best friend, Dr. Dean W. Livelybrooks, Ph.D. (Physics), who (along with his wife, Lisa) housed my wife and me while I was writing this article. I am also indebted to my colleagues Michael Chellis, Mary Lou Fellows, and Jami Changaris Voge for substantive and editorial comments which greatly improved this piece.

investment, and business expenditures (hereinafter, investment)[1] that economic growth is unacceptably curtailed? Various Congresses, with the necessary help from their respective Presidents, have adopted laws that reflect a persistent belief that certain types of investments should receive significant protection from the full weight of the Internal Revenue Code [hereinafter, the Code]. Such protection has been provided in many different ways, including the long term capital gain deduction,[2] the investment tax credit,[3] accelerated depreciation,[4] and the partial exclusion of dividends received by individuals,[5] among others.

A cynic might argue that Presidents, Senators, and Representatives usually have much greater personal investments than most of their constituents, and therefore are adopting the foregoing tax benefits purely out of self-interest. A well informed cynic might consider the unusually large campaign contributions received by members of the tax writing committees in Congress,[6] and conclude that self-interest is being furthered in a different, but more lucrative way. On the surface, however, the comments by politicians about tax benefits for investments indicate that the politicians who support such benefits believe that they will enhance the strength and growth of the economy, for the benefit of

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1. Although the terms "saving," "investment," and "business expenditure" may describe separate and distinct concepts for some purposes, I am proposing that they all be treated similarly for the tax purposes addressed herein. Therefore, for convenience, hereinafter, the term "investment" generally will be used to describe all nonconsumptive expenditures, from a simple savings account, through the purchase of securities, to the purchase of buildings and equipment for use in an operating business. Occasionally, when I need to distinguish between nearly risk free deposits such as bank accounts and U.S. government bonds and more risky uses of funds, I will use "savings" for the former and "investment" for the latter concept.

2. I.R.C. § 1202 (1982) (repealed 1986). Capital gain protection was first adopted in 1921, by Revenue Act of 1921, Pub. L. No. 67-98, § 206, 42 Stat. 227, 232-33 (1921). Unlike the other three incentive provisions mentioned in the text, the long term capital gain deduction is often defended by numerous other arguments, which are not based on investment incentive policies. *See, e.g.*, Blum, *A Handy Summary of the Capital Gains Arguments*, 35 Taxes 247 (1957). In my opinion, all of the arguments in support of a capital gains preference fail under close scrutiny, except the argument based on investment incentive policies.

3. I.R.C. § 46 (1982 & Supp. IV 1986). An investment tax credit was first adopted in 1962, by Revenue Act of 1962, Pub. L. No. 87-834, § 2, 76 Stat. 960, 962-73 (1962).

4. I.R.C. §§ 167, 168 (1982 & Supp. IV 1986). Significant acceleration of depreciation deductions began with I.R.C. § 167 in 1954, under Internal Revenue Code of 1954, Pub. L. No. 83-591, § 167, 68A Stat. 1, 51-52 (1954), and generally increased through periodic enactments until the 1986 Act.

5. I.R.C. § 116 (1982 & Supp. III 1985) (repealed 1986). This provision was first enacted in 1954, by Internal Revenue Code of 1954, Pub. L. No. 83-591, § 116, 68A Stat. 1, 37 (1954).

6. On average, [1986] PAC [political action committee] contributions to members of the Senate Finance and House Ways and Means Committees were substantially greater than contributions to members not connected with the tax reform legislation . . . . The average PAC contribution to incumbents in the House for 1986 was $140,000, but the average Ways and Means Committee member received nearly $240,000 from PACs . . . . The average Senate incumbent received $800,000 from PACs this year, while the four Finance Committee incumbents averaged $1 million in PAC contributions.

Hanlon, *PACs Pad Taxwriters' Campaign Accounts*, 33 Tax Notes 529, 529-30 (1986).

all people.[7] Such tax benefits will lure ever increasing amounts of capital into the productive sector of our economy, thereby producing ever increasing amounts of goods, services, and jobs for all people to enjoy. In this superficially altruistic view of the issue, investors and business owners are simply machines, which are being used to improve the lives of all members of society. Tax benefits for investments and businesses are, of course, the grease necessary to keep those machines in good condition.

In the ultimate "big picture," the only two elements comprising an economy are capital and labor. The tax benefits of the type discussed above are intended to increase the amount of capital invested in the economy. The Reagan administration apparently viewed labor as also deserving of some encouragement in the form of tax benefits.[8] That encouragement was given by reducing the marginal tax rates applicable to every income class.[9] In many income classes, that reduction was dramatic.[10]

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7. "Rep. Patrick L. Swindall, R-Ga., has introduced H.R. 4913, which would reinstate the installment method of accounting for retail dealers. Swindall argued that although repeal of the installment method was intended to raise revenue, it has had the opposite effect by retarding economic growth." Gray, *Congressional Record,* 40 TAX NOTES 105, 105 (1988);

> Sen. Chic Hecht, R-Nev., has introduced S. 2341, which would restore the full deductibility of IRA contributions and allow up to a $2,000 IRA deduction for a nonworking spouse. Hecht called his bill "an important step in returning the incentives to Americans to help save for their futures." Hecht noted that by June 1987, IRA assets plus those in *Keogh* plans resulted in savings of over $350 billion. He argued that this money represents a "long-term capital investment that will boost the American growth and productivity."

Gray, *Congressional Record,* 39 TAX NOTES 777, 777 (1988);

> [Senator] Kasten writes that fears about cutting the [capital gain] tax are misplaced, and he argues that a reduction would pass four of the major tests of tax reform—fairness, equity, efficiency, and economic growth. . . .
>
> Stating that the Federal government can and should support America's competitive edge, [Senators] Cranston and Boschwitz write that this can best be done by using the tax code to direct private investments into "the often risky and long-term ventures that become the job and economic miracles of the future."

Jones, *Commentary,* 39 TAX NOTES 283, 283-84 (1988).

8. > But in one very fundamental way President Reagan was a natural advocate of tax reform; he had a passionate desire for lower individual tax rates. He had vivid memories of his days as a young Hollywood actor, when he was reluctant to make too many movies in one year because more than 90 percent of his pay would go to the government . . . . [O]n his list of domestic priorities, cutting personal tax rates ranked first, second and third.

J. BIRNBAUM & A. MURRAY, SHOWDOWN AT GUCCI GULCH: LAWMAKERS, LOBBYISTS, AND THE UNLIKELY TRIUMPH OF TAX REFORM 21-22 (1987). I am grateful to Bryan Slone, Assistant to the Commissioner of the Internal Revenue Service, for providing me with this Reagan anecdote and its citation.

9. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 101, 95 Stat. 172, 176-85 (1981); Tax Reform Act of 1986, Pub. L. No. 99-514, § 101, 100 Stat. 2085, 2097-99 (1986).

10. In the 1981 Act, the rate for the top income class was reduced from 70% to 50%, which was a 28% reduction; all the other taxable income classes enjoyed reductions (phased in by 1984) of at least 21% of their pre-1981 rates (analyzing rates for married taxpayers filing jointly). Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 101, 95 Stat. 172, 176-

The rate reductions, however, benefitted not only laborers but capitalists as well.[11] The tax benefits available only to capital were retained and even increased during the early Reagan years,[12] thus maintaining the relative position of capital as the favorite child in the economic family.

This traditional family relationship crumbled in the Tax Reform Act of 1986 (hereinafter, the 1986 Act). The rooster and the hens became addicted to an extremely expensive drug known as "low rates." Maintaining capital as a favorite child apparently was sacrificed to help pay for this addiction. The investment tax credit,[13] the deduction for long term capital gain,[14] and the partial exclusion for dividends received by an individual[15] were all repealed by the 1986 Act. Accelerated depreciation on real estate was changed to the straight line method and the depreciation period was lengthened from 19 years to 27.5 or 31.5 years, depending on the type of property.[16] Although the acceleration in calculating depreciation of personal property was increased, that benefit was offset for most categories of personal property by a lengthening of the depreciation period.[17]

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85 (1981).

In the 1986 Act, the rate for the top income class was reduced from 50% to 28%, which was a 44% reduction; some of the lowest taxable income classes experienced increased rates (which were generally offset by other changes such as the larger personal exemption), and the taxable income classes in the middle enjoyed reductions as high as 46% from their pre-1986 rates (analyzing rates for married taxpayers filing jointly and adjusting for the 1986 conversion of the zero bracket amount to a standard deduction). Tax Reform Act of 1986, Pub. L. No. 99-514, § 101, 100 Stat. 2085, 2096-99.

11. The 1981 reduction of the top rate from 70% to 50% benefitted only capital because the previous maximum tax of I.R.C. § 1348 (repealed 1981) had protected most earned income from the rates above 50%.

12. The 1981 Act allowed most business equipment to be depreciated over a five year period, and most depreciable real estate to be depreciated over fifteen years. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 201, 95 Stat. 172, 203-19 (1981). For many assets, this was an extreme reduction in depreciation period.

13. Tax Reform Act of 1986, Pub. L. No. 99-514, § 211, 100 Stat. 2085, 2166-70 (1986) repealed the investment tax credit.

14. Tax Reform Act of 1986, Pub. L. No. 99-514, § 301, 100 Stat. 2085, 2216-18 (1986) repealed the deduction for long term capital gain.

15. Tax Reform Act of 1986, Pub. L. No. 99-514, § 612, 100 Stat. 2085, 2250-51 (1986) repealed the partial exclusion for dividends received by an individual.

16. Tax Reform Act of 1986, Pub. L. No. 99-514, § 201, 100 Stat. 2085, 2121-42 (1986).

17. *Id.* The most helpful way to compare the values of two different depreciation schedules is to calculate the present value of the deductions allowed by each method. The depreciation system in effect immediately before the 1986 Act was called Accelerated Cost Recovery System, or ACRS; the system adopted by the 1986 Act is known among tax professionals as Modified ACRS, or MACRS (I.R.C. § 168 (1982 & Supp. IV 1986), in each case). Each system begins by categorizing an asset according to its "class life" under the Asset Depreciation Range (ADR), as defined in I.R.C. § 167(m) (1982 & Supp. IV 1986) and Rev. Proc. 83-85, 1983-1 C.B. 745, so that common point is an appropriate place to begin a comparison of the two systems.

Under (old) ACRS, a $1,000 asset with a four year ADR class life produced deductions over three years with a discounted present value of $901; under (new) MACRS, the same asset generates deductions over four years with a discounted present value of $915—a 1.6% increase

Until the Tax Reform Act of 1986, capital had long been the favorite child of tax policy. Although much of that favoritism appears to have been abandoned in 1986, there is a strong discomfort with that decision in the political and tax policy arenas.[18] One can easily come to the common sense realization that increasing one's savings causes an immediate, albeit short-run, reduction in one's standard of living, and therefore may require some encouragement; while increasing one's labor generates a prompt increase in one's standard of living, and therefore contains its own immediate incentive mechanism. Even though increased saving will usually increase one's future standard of living, this is a long-term enticement, to which modern Americans do not respond well. The media report dutifully and regularly on the low savings rate in the United States, and the much higher savings rate in our current economic role model, Japan.[19] Without attempting a conclusive economic analysis of the need for capital formation incentives, this article assumes that the historic tax policy favoritism for capital will soon be re-established.

Assuming the Code will be used to encourage saving and investment, this article proposes a particular approach which can be used to achieve that goal. First, a foundation is laid by a comparison of use-based rules to source-based rules, and a discussion of why a use-based system is preferable. The central idea is then presented. It is similar to Professor Andrews' cash flow consumption

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for the taxpayer. For an asset with a six or eight year ADR class life, the ACRS deductions had a present value of $825, while the MACRS deductions have a present value of $850—a 3.0% increase for the taxpayer. In contrast, the ACRS deductions for an asset with a ten, twelve, or fourteen year ADR class life had a present value of $825, while the MACRS deductions have a present value of $794—a 3.8% decrease in value. Assets with an ADR class life of sixteen or eighteen years suffered the greatest reduction, falling from $825 to $719—a 12.8% decrease in the present value of the allowable depreciation deductions. These figures are based on a 10% discount rate.

18. *See supra* note 7;

> [S]upply-side optimism, exemplified by [then] Vice President and Presidential aspirant George Bush, . . . argues that reducing the capital gains rates will generate more economic activity and jobs and will, thereby, increase the Federal government's overall tax take. Given the size of the government's deficit after six years of applying this principle more generally, few people seem much inclined to heed him.

Huddleston, *Treasury Study Suggests That Lower Capital Gains Rates May Actually Boost Federal Revenue,* 39 TAX NOTES 1144, 1144 (1988).

19.
> Americans save less of their income than nearly any other major industrialized nation. And according to preliminary second-quarter figures by the Commerce Department, the annual personal savings rate in the United States this year dropped to 3.2% of total income—a postwar low. . . .
>
> Americans always have been relatively low savers, even at the peaks of U.S. economic growth. The personal savings rate averaged 6.7% of disposable income during the 1960's; 8% during the 1970's; and 6.4% between 1980 and 1985—far lower than other industrialized nations. In 1985, for example, the U.S. personal savings rate was 5.1%, while in Japan it was 22.5%, in West Germany it was 13%, and in Britain it was 11.9%.

Easton, *Americans Find Little Lure in Saving for a Rainy Day,* AM. BANKER, Sept. 4, 1987, at 7.

tax,[20] yet different in an important way which addresses Professor Warren's valid criticism of the Andrews proposal.[21] Briefly, a tax system is proposed that will tax individuals on the amounts they spend for personal consumption, and tax business entities on the amounts that are invested in (or reinvested by) those entities.

The subjects of contributions to and distributions from a corporation are analyzed, and rules are developed to complement the primary tax law changes proposed herein. Any reader with an interest in simplifying the Code (by moving forward, rather than back to some nostalgic prior era) should enjoy the discussion of the numerous statutory rules and trial court issues which can be eliminated upon the adoption of the proposal described herein. Because some readers will criticize a proposed goal simply for lack of a clear path to that goal, the major transition issues are identified and put to rest in the final section of this article.

I. Evaluation of Investment Incentives

A. *Use Versus Source Incentives*

The Code has contained both use-based and source-based incentives for investment. A use-based rule is one which provides a tax benefit based on the use to which one's funds are put. For example, the investment tax credit that was repealed in 1986[22] gave an immediate tax benefit to a taxpayer who used his or her available funds to purchase certain types of assets. The benefit was available regardless of the source of those funds; they could have come from the taxpayer's labor, from prior investments, or from a loan from the local bank.[23]

A slightly different type of use-based incentive is exemplified by accelerated depreciation[24] and the new tax credit for low-income housing.[25] Although the benefit is still granted for making the desired use of one's funds, the benefit is enjoyed in increments, over a period of years, rather than all in the first year.

There are several practical distinctions between immediate and gradual tax benefits. Such practical differences are important in constructing a proposal for

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20. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 Harv. L. Rev. 1113 (1974).

21. Warren, *Fairness and a Consumption-Type or Cash Flow Personal Income Tax*, 88 Harv. L. Rev. 931 (1975).

22. I.R.C. § 38 (Supp. IV 1986) and I.R.C. § 46 (1982 & Supp. IV 1986). The investment tax credit was repealed by Tax Reform Act of 1986, Pub. L. No. 99-514, § 211, 100 Stat. 2085, 2166-70 (1986) (enacting I.R.C. § 49 (Supp. IV 1986)).

23. In certain instances, investment of the proceeds of a nonrecourse loan did not qualify for the credit. *See* I.R.C. § 46(c)(8) (1982 & Supp. IV 1986).

24. I.R.C. § 168 (Supp. IV 1986).

25. I.R.C. § 42 (Supp. IV 1986).

a tax incentive mechanism or system. First, benefits that are fully enjoyed in the first year are probably more effective as incentives,[26] but because of their immediacy they also provide the strongest temptation to abuse them. Second, although most tax preferences constitute government subsidies to the qualifying taxpayers, the subsidy is apparent to more people (i.e., to less sophisticated voters) when it is given immediately. This may be desirable if significant amounts of investment funds are held by unsophisticated investors.[27] On the other hand, any subsidy that might not have broad support from the voters can be more effectively hidden if it is structured as a gradual tax benefit. Finally, the effectiveness of gradual benefits in inducing people to make certain investments may be undermined if potential investors fear that a later Congress will change the law before all the expected benefits have been received.[28] The 1986 Act eliminated many of the benefits promised by the Economic Recovery and Tax Act of 1981, even for those investors who had already purchased assets in response to the 1981 Act.[29] Future Congresses which want to use the gradual benefits method may find that they have to offer even greater amounts of benefits to incite the desired response from untrusting investors.

The Code also contains source-based incentives for investment, which provide preferential tax treatment to income from certain specified sources. For example, before the 1986 Act, gain from the sale of a long-term capital asset[30] was taxed at a much lower rate than gain from the sale of an ordinary asset, or income from labor.[31] The benefit was not affected by the taxpayer's use of the money; it could be reinvested, spent on necessities like food and clothing, or spent on cocaine and fast cars. Another example of a source-based incentive was the exclusion of the first $100 of dividends received by an individual, which was

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26. Theoretically, a rational investor should be concerned only with the discounted present value of the various tax benefit packages being considered, so any comparison of current and future benefits is just tweedle-dum versus tweedle-dee. Such a theoretical view suffers two weaknesses, however. First, from my experience in practice, there are many investors, holding a large aggregate investment fund, who are not rational. This seems especially true when the analysis involves tax benefits. "Tax shelter(!)" is an hallucinogenic drug for many people.

Second, even a rational investor may apply a discount rate to future tax benefits that is higher than the discount rate used by the government in calculating the present value of its cost in providing the benefits. (On an admittedly intuitive basis, I think the reverse is unlikely.) In such a case, the government will achieve greater taxpayer stimulation for a given present value cost by offering an immediate benefit.

27. *See id.*

28. To state this more precisely, such uncertainty, like any other, raises the discount rate applied by the investor to the future benefits. *See supra* note 26.

29. I.R.C. § 469(l) (Supp. IV 1986).

30. I use the phrase "long-term capital asset" as a convenient label for a capital asset that has been held by the taxpayer for the time required by I.R.C. § 1222(3) (Supp. IV 1986) to give rise to long-term capital gain if it is sold (usually 6 or 12 months). It is not, however, a technically defined term in tax law.

31. I.R.C. § 1202 (1982), *repealed by* Tax Reform Act of 1986, Pub. L. No. 99-514, § 301, 100 Stat. 2085, 2216-18 (1986). In fact, § 1202 provided a deduction, not a lower tax rate, but the effect was identical to a lower rate and it is commonly described as such.

also repealed in 1986.[32] Again, the benefit was based on the source of the income, and the use of that income was irrelevant. Unlike the use-based incentives, benefits from source-based rules are always received in the year the income in question is received.

Finally, it is possible to combine use and source requirements into a single tax rule. Simple hypothetical illustrations can be created from the two recently repealed, source-based incentives mentioned above: Imagine a capital gain deduction that only applied to capital gains that were immediately reinvested in capital assets; or a dividend exclusion that required the taxpayer to purchase more stock with the protected dividends.

For actual, rather than hypothetical examples, the Code contains several major rules which require both a specific source and a specific use of the income to obtain the available tax benefit: the various nonrecognition rules. For example, if a taxpayer exchanges stock of one corporation (source requirement) for stock of another corporation (use requirement) pursuant to the corporate reorganization provisions of the Code,[33] the applicable nonrecognition[34] and substituted basis[35] rules will delay the tax liability until the taxpayer later disposes of the new stock in a taxable transaction.

Although the participant in a nonrecognition transaction is usually very conscious of the tax benefit and probably thinks she has received the benefit all in the first year, in fact she will receive the benefit gradually. Because the gain on the old stock will eventually be taxed when the new stock is sold,[36] the only benefit from a nonrecognition rule is the deferral of the tax liability. Deferral is a benefit that is enjoyed incrementally, with the passage of time.[37]

To reinstate the traditional favored status of capital in the Code, one issue that must be addressed is whether the appropriate tax incentive mechanism(s) adopted to achieve such goal should be use-based or source-based. As mentioned earlier, modern Americans do not seem to respond well to promises of future reward.[38] This trait is probably a fundamental part of human nature, but its

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32. I.R.C. § 116 (1982 & Supp. IV 1986), *repealed by* Tax Reform Act of 1986, Pub. L. No. 99-514, § 612, 100 Stat. 2085, 2250-51 (1986).

33. I.R.C. § 368(a) (1982 & Supp. IV 1986).

34. I.R.C. § 354(a) (1982).

35. I.R.C. § 358(a) (1982). The term "substituted basis" is used here in the pre-1984 sense developed by the tax bar, before Congress presumptuously redefined it, to the unfortunate confusion of us all. I.R.C. § 7701(a)(42-44) (Supp. IV 1986).

36. This assumes that the potential gain is not lost through any post-reorganization reduction in the value of the stock.

37. The only nonrecognition rule providing its full benefit immediately is the rule allowing nonrecognition when a decedent's assets pass to her estate, or its beneficiaries, because I.R.C. § 1014 (1982) provides a fair market value basis for the assets. Thus, the benefit is not mere deferral, but complete and immediate escape from tax liability. The tax treatment of decedents' assets, however, does not appear to be intended as an investment incentive.

38. The comment in the text is made with respect to *earthly* rewards, but modern religious leaders may bemoan its aptness in another context. I am not speculating, however, on any possible connection between the two! *Cf. supra* note 19.

strength may vary from one culture to another and from one era to another.

If Americans need an immediate incentive to convince them to invest, where will they find it? Except when tax benefits reach extreme levels, the expected economic return from an investment is normally the largest component of the total return from the investment, and is inevitably a future reward. If a potential investor wants any immediate reward for his decision to save, rather than consume, he must find it in the Code.

The Code speaks to the people whose economic lives it governs. Regardless of whether it speaks with a use-based or source-based accent, to effectively encourage investment requires the Code to address a taxpayer when he holds a discretionary dollar in his hand, when he is deciding whether to consume now or save for future consumption. Listen to the attempted temptation of the old source-based capital gain deduction provision, speaking at the time a taxpayer is trying to decide whether to spend or save a part of his discretionary funds. "Forget that ten day trip to Hawaii. Use that money to invest in a capital asset, and *if* the investment is successful, *in three years* the government will help pay for a fourteen day trip to Hawaii."[39]

Compare that to the attempted allure of the recently repealed, use-based investment tax credit. "Forget that ten day trip to Hawaii. Use the money to invest in a qualifying asset, and *within three months*[40] the government will send you a check for a long weekend at Key West. *If* the investment is successful, you can still have the ten days in Hawaii later."[41]

The latter approach is better suited to our "enjoy now, pay later" society. Whether our preference for immediate gratification arises from human nature, cultural traditions, or some other source, it provides a strong argument for use-based, rather than source-based investment incentives. Not only is there a substantial difference in the timing of the reward, but the use-based method also guarantees the tax portion of the reward regardless of the success of the investment. The tax benefit from a source-based incentive such as the capital gain deduction is contingent upon the success of the investment.

B. *The Political Nature of Traditional Investment Incentives*

Assuming then that the preferable method for reinstating capital as the favorite child in the Code is a use-based mechanism, Congress could look for new methods of implementing that favoritism, or it could reenact some or all of the old methods. The old methods should not be used. Consider the nature of the decisions being made by Congress in this regard. Fundamentally, the first

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39. I.R.C. § 1202 (1982) (repealed 1986) (English translation) (emphasis added).

40. The three month period assumes the taxpayer pays substantial quarterly estimated tax payments, which can be reduced or eliminated in response to the investment. A reduction in the taxpayer's withholding might recover the benefit even sooner.

41. I.R.C. §§ 38, 46 (1982 & Supp. IV 1986) (English translation) (emphasis added).

decision by Congress is the very general one that Americans should shift some of their available funds from consumption to investment. Just as uses of labor and capital are the only two ways to make money, consumption and investment are the only two ways to spend it.

Perhaps most Americans would concede that Congress has the wisdom to make this "consume less, invest more" decision, and that the tax law might properly be used to encourage saving. Adoption of the old methods of encouraging investment, however, goes well beyond that decision, and attempts to direct investment funds into certain types of assets. For instance, the capital gain deduction, accelerated depreciation, and the investment tax credit reflect decisions by Congress that capital assets, buildings, and equipment are more important to the strength and growth of our economy than inventories and interest bearing financial instruments. Assets in the former categories qualify their owners for substantial tax benefits, either when acquired (use-based rules) or when sold (source-based rules); in contrast, the latter asset categories generate little or no tax benefit. Even among the preferred categories, there is much variation. Assets as unproductive as gold bullion enjoy(ed) the same capital gain preference as corporate stock. Income from buildings is taxed much differently than income from nondepreciable assets. Income from equipment receives a significantly different set of benefits, especially when the investment tax credit is in force.

All these different investment incentives, the effects of which are nearly immeasurable,[42] should lead to some demanding questions. Has Congress held the entire U.S. economy in its hands, wisely and accurately measuring the economy's need for more or less of each category of investment? No. The most one can hope for is that they are guessing in good faith. Does Congress react periodically, astutely, to the ebbs and flows of investment funds among the various categories, adjusting the amount of the capital gain deduction, the length of the long-term holding period, the rate of the investment tax credit, and the length and shape of the various depreciation schedules? No. Such adjustments are forged by the force of the world's largest deficits being pressed against a red hot budget; then they are machined to their ultimate shape by high-speed, diamond-tipped lobbyists.

If the balance of more, or less, or no tax benefits among the various investment categories is being determined by such arbitrary forces, perhaps one

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42. The purpose of the papers presented at the Brookings Conference on the Effects of Tax Policy on Investment was to develop models of fixed investment behavior of United States business firms and to evaluate the impact on capital spending of federal tax incentives enacted since the end of the Second World War. The conference did not resolve the issue of the effectiveness of the tax incentives that were used. *Four papers were prepared by competent scholars. Each had the objective of measuring the same phenomenon. Each obtained a significantly different answer.*

TAX INCENTIVES AND CAPITAL SPENDING 1 (G. Fromm ed. 1971) (emphasis added).

can fairly inquire whether some alternative mechanism is available to strike the balance. This author does not believe that Congress has the wisdom to decide when the economy needs more apartments and fewer office buildings, or more farm equipment and less money in bank deposits, or any other balance between competing alternative investments. This article is based upon the conclusion that Congress should restrict its investment encouragement to the generic "consume less, invest more" type, and allow the forces of the (relatively) free market to lead the resulting saved dollars to the appropriate investment categories.

To accomplish the foregoing division of authority between Congress and the market, any post-1986 increase in the Code's capital formation incentive should be in a new form, available to all categories of investment, rather than a reenactment of the old methods that reward only certain types of investments.

II. PROPOSED SOLUTION

A. *A Starting Point: Professor Andrews' Cash Flow Consumption Tax*

The foregoing argument in favor of an investment-neutral, use-based incentive leads to the preliminary conclusion that the ideal tax system would be that in which all consumed income is reported by individuals and all invested income is reported by separately taxable entities, such as corporations. Such complete separation of all income according to its use would allow the development of rules and rates designed specifically for one type of income use. For example, Congress could decide that a 50% marginal tax rate is appropriate for a person who spends $1,000,000 per year on personal consumption. Under the current tax system, the desire to heavily tax that level of luxury living is tempered by the knowledge that the 50% rate will also fall on some income that this person decided to invest. The rate ultimately adopted is a compromise and probably is not the most desired result for either category of income.

In a similar vein, the 1986 Act reflects a decision to allow the deduction of interest paid or accrued in a trade or business,[43] but to severely limit the deduction of interest paid on personal use loans.[44] Because individuals report both consumptive and investment income and deductions on their tax returns, the fungibility of money will greatly inhibit the enforceability of the policy decision reflected in the new interest deduction rules. If all invested income, and thus all business and investment activity, were reported by corporations, Congress could grant an unlimited interest deduction to corporations, and deny the interest deduction to individuals. The restriction against deducting interest for personal use loans would be much more easily enforced than it is currently,

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43. I.R.C. § 163(a) (West 1988).
44. I.R.C. § 163(h) (West 1988).

and there would be no concern about the unintended impact of one rule on the other category of interest.

One system that effectively separates consumed income from invested income is the cash flow consumption tax, which was thoroughly described by Professor William Andrews in 1974.[45] Under Professor Andrews' proposal, all business and investment expenditures are deductible.[46] Thus, all business and investment assets have a zero basis, depreciation is eliminated, and upon the sale of an asset the entire sale price is income.

Invested income is thereby removed from all individual income tax returns, as proposed above, but it is not shifted to the return of any other taxable entity. Invested income is completely removed from the national tax base. Profits earned with the invested income also are not taxed, if they are reinvested. The original invested income and the profits earned with it are not taxed until they are withdrawn from the investment and spent on personal consumption.

The Andrews system goes too far. A well known mathematical analysis shows that if investment principal is deducted initially, and investment profits are not taxed as they are earned, with the entire amount taxed only when it is withdrawn at the conclusion of the investment, the economic effect is equivalent to a zero rate of tax on the earnings from the investment.[47] For those who are not familiar with this analysis, consider that a substantial tax savings is generated by the deduction of the initial investment. If the taxpayer also invests that tax savings, the tax due at the end of the investment can be paid entirely with the original tax savings and the profits earned thereon in the interim. The profits earned by the taxpayer's initial investment are thus left untouched.

Professor Alvin Warren has expanded upon the foregoing criticism of a cash flow consumption tax.[48] As stated above, a consumption tax effectively imposes no tax upon the earnings from investments. If investments (i.e., capital) and labor are the only two sources of income, and the income from capital is not

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45. Andrews, *supra* note 20.

46. *Id.* at 1116.

47. Under the current income tax system, if a taxpayer in the 33% bracket has $1,500 before taxes, and wants to buy a bond, he must pay $500 in tax and buy a $1,000 bond with the remaining funds. If the bond pays 9% ($90 per year), with principal and interest both due at the end of one year, he will receive $1,090 at year's end, pay $30 tax on the interest, and have $1,060 after tax. More importantly for this comparison, if the interest is not taxed, i.e., a 0% rate on investment earnings, he will have *$1,090 after tax.*

The latter result is identical to this taxpayer's experience under a consumption tax. Because the bond purchase is deductible, he can buy a $1,500 bond without paying any tax on his initial investment. This larger bond, also earning 9%, will pay $1,635 at the end of the year ($1,500 principal and $135 interest). Because the bond purchase was deductible, the taxpayer has no basis in the bond, and the entire $1,635 is income. The 33% tax will claim $545, leaving *$1,090 after tax.* This is the same after-tax result as in the last sentence of the previous paragraph, when the bond was purchased with nondeductible dollars and the interest was not taxed at all.

48. Warren, *supra* note 21.

taxed, it appears that labor is bearing the tax burden alone. Thus, the traditional tax policy favoritism for capital is carried to the extreme. Assuming that such an extreme result is not acceptable,[49] in drafting an investment incentive Congress must find some middle ground between the current system and the extreme position of the cash flow consumption tax. Such a "middle ground" system would allow income from capital to be taxed at a rate greater than zero, but less than the rate at which labor income is taxed.[50] Ideally, this system would also be flexible (allowing easy adjustment up or down between zero and the labor tax rate) and simpler than the current system, and have the neutrality that fosters economic efficiency.

B. A Modified Version of the Andrews Consumption Tax

A system satisfying the foregoing criteria can be created. First, treat all business entities (including sole proprietorships) as separately taxable entities. If a taxpayer is allowed a deduction for all capital contributions to business entities, that invested income will be removed from her tax return by the deduction.[51] The contribution to the business entity must then be treated as income of the entity, because the goal is to tax that income under a separate regime, not to exempt it from tax entirely. Income earned from the use of the contributed capital will also, of course, be income of the entity.

Eventually, when the funds begin to flow out from the business entity to the business owner (e.g., shareholder, partner, etc.) for consumptive uses, the process is reversed. A distribution to an owner with respect to her stock or other ownership interest (whether an operating or a redemption distribution) will be fully deductible by the entity, and fully includable in the income of the recipient.

The foregoing pair of deduction/inclusion rules does not, by itself, create any favoritism for capital. The only function of these rules is to separate all income

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49. It certainly is not acceptable to me.

50. I am aware that the current income tax system substantially accomplishes the goal described in this sentence by the use of investment preferences such as those described earlier. Two major elements of capital income are missed by those preferences, however. Interest is taxed at the same rate as labor income, and dividends, due to the double taxation of corporate profits, are taxed more heavily than labor income. Furthermore, the several preferred categories of capital income are taxed at varying rates within this middle ground.

51. Unless other available tax incentives are extremely beneficial, the availability of a current deduction only for a taxpayer's corporate investments would persuade her to conduct all of her saving, investment, and business activities in the corporate form. Sole proprietorships and partnerships with individual partners would no longer be used.

Such intrusion of the tax law into the business entity selection decision is unwarranted. Yet the tax system described and proposed herein requires that the business entity receiving the capital contribution must be a taxable entity. To solve this dilemma, sole proprietorships, partnerships, business trusts and corporations should all be taxed under a single system of business entity taxation that is similar to the current corporate tax, with the significant modifications described below. Thus the use of the terms "business entity," "business," or "entity" and "business owner," "owner," or "investor" throughout this article.

according to use, without regard to source. Income earned elsewhere by the owner's labor and invested in the business is reported on the business entity's return, as is income earned by the entity's capital and re-invested. Income earned by business capital and distributed to the owner for consumptive use is reported on the owner's return, as is any labor income which the business owner earns and consumes. Because all business entities will be subject to a single, uniform system of entity taxation,[52] all business and investment deductions (except the individual investor's initial contribution deduction) will be reported on a new "business entity" return, while all consumptive deductions (as in the current system) will be reported on individual returns.

The foregoing rules and their effects set the stage for the preferential treatment of capital. The preference is achieved by setting individual tax rates and business entity tax rates at different levels. If the entity tax rate is reduced to zero, the system becomes identical to Professor Andrews' cash flow consumption tax.[53] If the entity rate is equal to the individual rate, there is no preferential treatment of capital. When the business tax rate is greater than zero but less than the individual rate, this system creates the "middle ground" mentioned above. Capital receives more favorable tax treatment than labor, but still bears some of the tax burden. Because the preference from the rate differential is available to every capital contribution to any type of business entity, regardless of the particular type of investment made by the entity, this system provides neutrality with respect to the type of investment, as endorsed earlier.[54] The proposed tax system distinguishes only between consumption and investment, and not between any two categories of investment. Finally, not only is a use-based incentive utilized to reward contributions to businesses, but the rate differential also creates the appearance of a use-based penalty on consumptive withdrawals of business funds. Analytically, there is no true penalty, but only the termination of an ongoing benefit. The benefit is the right to defer the cost of the full, individual tax rates for another day, another week, another year, or longer. Nevertheless, after an investor has grown accustomed to the benefit, the threat of losing it will probably inhibit consumptive withdrawals to some degree.

Although this system has a strong theoretical appeal, probably due to its symmetry, at first glance it appears to have a fatal pragmatic flaw. Because capital contributions are income to the recipient, while borrowed funds are not, it appears that businesses will shun equity and finance their operations with excessive proportions of debt. Current corporate tax law favors debt over equity,

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52. *See id.*

53. *See supra* notes 45-47 and accompanying text.

54. This system provides economic neutrality between alternative business or investment uses of capital, *see supra* note 42 and accompanying text, as well as entity selection neutrality, *see supra* note 51.

because interest paid to lenders is deductible,[55] while dividends paid to stockholders are not.[56] Some commentators argue that the current discrimination against equity leads to an undesirable level of debt and resulting financial weakness in the corporate sector.[57] Any system that significantly increased this discrimination, and spread it to the other forms of business entities, would be fatally flawed.

Close examination reveals that the actual effect of this proposed system would be in precisely the opposite direction. The current preference of debt over equity would be replaced with a preference for equity. First, the deductibility of dividends paid eliminates the current advantage of debt over equity in the corporate sector, thus creating a temporary balance between the two. To understand the second step, one must first observe that any proposal of this system presumes that Congress would establish a business tax rate substantially lower than the highest individual rate. The investment incentive created by such rate differential is the primary reason for adopting this proposed system. The opportunity to practice legalized arbitrage with the rate differential, as explained below, is the second step, which establishes a new advantage for equity over debt.

Assume the top individual rate is 40%, and the business rate is a flat 20%. If a potential individual investor has $1,000 of gross income (on which tax has not yet been paid), he has two means by which he can make a direct investment in a business entity which has an active use for his money. He can pay $400 tax on the $1,000, and loan the remaining $600 to the corporation. The loan proceeds will not be income to the corporation, so it can employ the entire $600 in its operations.

Alternatively, the individual can purchase a $1,000 equity interest in the business. The deduction allowed for the purchase price will totally offset the $1,000 of gross income, and he will owe no tax. The business entity, however, will have $1,000 of income, and must pay $200 of tax. Eight hundred dollars will remain for use in the business, as compared to only $600 in the loan situation above. Assuming the business earns a pre-tax profit of 15% on its assets, and pays two-thirds of that (10% of *investible* proceeds) to the supplier of capital, the results for each party are illustrated below.

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55. I.R.C. § 163(a) (1982).

56. The Code does not explicitly state that dividends are not deductible, but neither does it authorize such a deduction. The general rule is that deductions are not allowed without specific statutory authority. *See* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 4-3 (5th ed. 1987).

57. "Reform [of insolvency workouts] should also invite inquiry into more global solutions. The tax code's preferential treatment of debt could be altered, reducing the preference for debt over equity financing and consequently reducing the aggregate costs of workout by reducing the use of debt." Roe, *The Voting Prohibition in Bond Workouts*, 97 YALE L.J. 232, 270 n.118 (1987).

EQUITY

	Amount	Item
INDIVIDUAL		
	$1,000	Gross income
	−1,000	Stock purchase deduction
	0	Taxable income
=>	$ 0	Individual tax
BUSINESS ENTITY		
	$1,000	Gross income
	x 20%	Business tax rate
	200	Business tax
=>	800	Net proceeds
	x 15%	Pre-tax return
	120	Pre-tax profit
	−80	Dividend paid deduction
	40	Taxable income
	x 20%	Business tax rate
	8	Business tax
=>	$ 32	AFTER-TAX NET PROFIT
INDIVIDUAL		
	$ 80	Gross income (dividend)
	x 40%	Individual tax rate
	32	Individual tax
=>	$ 48	AFTER-TAX NET PROFIT

DEBT

	Amount	Item
INDIVIDUAL		
	$1,000	Gross income
	x 40%	Individual tax rate
	400	Individual tax
=>	$ 600	Lendable funds
BUSINESS ENTITY		
	$ 600	Loan proceeds
	x 15%	Pre-tax return
	90	Pre-tax profit
	−60	Interest paid deduction
	30	Taxable income
	x 20%	Business tax rate
	6	Business tax
=>	$ 24	AFTER-TAX NET PROFIT
INDIVIDUAL		
	$ 60	Gross income (interest)
	x 40%	Individual tax rate
	24	Individual tax
=>	$ 36	AFTER-TAX NET PROFIT

Both the individual and the entity earn a greater after-tax net profit by structuring the individual's investment as an equity purchase rather than a loan. This difference is not changed by including the return of the capital in the calculations. Repayment of the $600 loan is not deductible by the entity, and is not income to the lender. Thus the individual lender is left with $600 after

tax, plus his $36 of after-tax interest. Because the redemption of the stock is deductible by the business, it can distribute $1,000 to the shareholder and receive a $200 tax savings or refund.[58] The net distribution cost to the corporation ($800) is therefore the same as the net useable (after-tax) proceeds it initially received from the equity investor. Because the investor deducted the full amount of his investment, his basis in the investment is zero, and the entire $1,000 redemption payment is income. After paying $400 tax on that income, he is left with the same $600 after tax as he received in the loan repayment situation, plus his $48 of after-tax dividend.

The difference in after-tax return is entirely due to the fact that under the equity structure the parties are allowed to use $200 of the government's money, as an incentive for the individual's decision to make this equity investment. Note that the pre-tax gross profit is $30 higher ($120 vs. $90) in the equity alternative. That $30 difference is from the 15% pre-tax return on the $200 tax savings ($200 tax vs. $400 tax) generated by making the equity investment. The $200 tax savings is only temporary, and is entirely reclaimed by the government when the stock or other equity interest is redeemed, but only $10 of the $30 earned with that $200 is taken by this tax system ($8 by the 40% individual tax on the $20 (two-thirds) distributed to the investor and $2 by the 20% business tax on the $10 (one-third) retained by the entity). The remaining $20 is a permanent benefit.

Even though the financial strength of American business may be better served by a pro-equity bias than by the current prejudice against equity, the ideal of theoretical tax policy is tax neutrality in investment decisions. There are legitimate business reasons to use debt for some portion of a business' outside capital needs. There are also legitimate investment reasons for an individual to prefer lending over equity ownership. The foregoing numerical analysis indicates that the proposed system places a tax pressure against those business and investment purposes.

In fact, a supplier and a user of capital can establish a lending relationship, without suffering the tax penalty illustrated above. That illustration is accurate only for a direct transaction between an individual investor and an operating business entity. If the individual creates a wholly owned investment corporation and inserts it between herself and the operating entity, the tax benefits achieved by the equity transaction above can be achieved by a capital contribution to the personal investment corporation, followed by a loan to the operating corporation. This result is illustrated below.

58. The operation of this proposed system requires that all tax savings from distributions be refundable if the entity does not have sufficient current income to absorb the distribution deduction.

TWO-STEP TRANSACTION

INDIVIDUAL		
	$1,000	Gross income
	−1,000	Stock purchase (Investment Corp.) deduction
	0	Taxable income
=>	$ 0	Individual tax
INVESTMENT CORPORATION		
	$1,000	Gross income
	x 20%	Business tax rate
	200	Business tax
=>	$ 800	Net proceeds, loaned to Operating Entity
OPERATING BUSINESS ENTITY		
	$ 800	Loan proceeds
	x 15%	Pre-tax return
	120	Pre-tax profit
	−80	Interest paid deduction
	40	Taxable income
	x 20%	Business tax rate
	8	Business tax
=>	$ 32	AFTER-TAX NET PROFIT
INVESTMENT CORPORATION		
	$ 80	Gross income (interest)
	−80	Dividend paid deduction
	0	Taxable income
	$ 0	Business Tax
INDIVIDUAL		
	$ 80	Gross income (dividend)
	x 40%	Individual tax rate
	32	Individual tax
=>	$ 48	AFTER-TAX NET PROFIT

As in the previous example, return of the capital to the individual investor (via the middle corporation) will leave her with $600 after tax.[59]

Use of an intermediary corporation can create complete tax neutrality between debt and equity in this proposed tax system. Rather than require the parties to incur the cost of such a charade, it is better to modify the proposal to treat loans to business entities as deductible by the lender and income to the borrower.

Comparison of this proposed system, as modified above, to Professor Andrews' cash flow consumption tax reveals that the two are very similar. The critical variation developed in this article is that Professor Andrews taxes the

59. Although a multiple party structure allows a loan to achieve the same tax benefits as an equity investment, it cannot be used to increase or multiply the investment tax benefits beyond those described in the preceding two examples. Insertion of another interim corporation will do no more than shift the point of enjoyment of the described tax benefits or create wash transactions for one or more of the corporations.

initial capital and the earnings thereon at a zero tax rate until they are withdrawn for consumption; by comparison, the system developed herein allows invested capital and re-invested earnings only the smaller favor of a reduced tax rate until they are withdrawn for consumption.

As a convenience for taxpayers with relatively simple investments in securities and cash accounts, a taxable investment trust could be used. Such a trust would be taxed under the business tax rules and rates described herein. If all contributions and withdrawals were required to be in cash, an institutional trustee could calculate the tax results at year end, and provide a completed business entity tax return (Form 1080-BE) and a Form 1099 to the owner and the IRS. Current experience with IRA trusteeship shows that this could be done easily, efficiently, and affordably, thus saving many taxpayers the additional complications of forming and reporting on a more traditional business entity.

C. *Problems Arising from Individual Borrowing*

One final difference between the two systems is that the Andrews proposal, in addition to the rules discussed above, also requires individuals to include their borrowing in their gross income.[60] Under such a rule, borrowed money that is promptly invested has no net effect, because the income created by the borrowing is offset by an equal deduction for the investment. Loan proceeds that are spent on consumption remain as a positive component of taxable income. Such a rule is necessary to prevent a taxpayer from creating a net deduction that shelters his consumed income by investing borrowed money.

The same potential for abuse by taxpayers with strong borrowing ability exists in the system proposed herein. Consider a taxpayer who earns a $60,000 annual salary and spends it all on personal consumption. In late December he borrows $60,000 and purchases stock with it, pledging the stock as collateral. The investment deduction fully offsets the salary income, and he pays no tax. The policy behind this proposed system is to encourage taxpayers to consume less and save more. He has consumed his entire salary, and his investment does not represent any net savings to the economy; he simply invested someone else's savings. He gets the benefit of this tax system without furthering the policy on which it is based.

Although the preceding example is helpful in illustrating the concern about using borrowed funds to create a net deduction that shelters one's consumed income, a slightly different fact pattern is more helpful in showing how the shelter operates, and how it can be prevented. Assuming a system in which loan proceeds are *not* income, consider a case in which the $60,000 loan proceeds are contributed to a corporation, thus generating a $60,000 deduction and a $24,000 tax savings for the individual investor in a 40% tax bracket.

60. Andrews, *supra* note 20, at 1153.

Consider a very hypothetical accountant who completes the investor's tax return that morning, and an equally hypothetical IRS which delivers the $24,000 refund that afternoon. The $24,000 is immediately contributed to the corporation, creating a $9,600 refund, which is also contributed to the corporation. If the ever decreasing refunds are invested *ad infinitum* (hereafter described as "circular refunds"), the ultimate cumulative refund is $40,000 and the total investment reaches $100,000. Therefore, rather than using the first deduction to shelter consumed income, this taxpayer uses the series of deductions to increase the total amount of his investment.[61]

First, analyze the results under the Andrews cash flow consumption tax, if the borrowing is not treated as income. A classical consumption tax such as the Andrews system places no tax burden on invested principal or investment earnings until the funds are withdrawn for consumption. Under such a system, if the initial borrowing by the individual is not treated as income, the taxpayer can earn a profit from the tax system even though his use of the funds earns no economic profit. In the following illustration, the investment is clearly profitless because the taxpayer borrows at 10% interest and then invests at a 10% rate of return. He invests the loan proceeds and the circular refunds for one year, then withdraws all principal and earnings from the investment, pays and deducts the interest due, pays tax on the remaining amount, repays the loan principal, and finds himself with a windfall profit.

CLASSICAL CONSUMPTION TAX

(Except individual borrowing not included in income)

$ 60,000	Loan proceeds (not income, therefore no tax)
$100,000	Invest loan proceeds plus $40,000 of circular refunds; i.e., all tax savings are also invested
x 10%	Annual rate of return on investment
10,000	Investment earnings for one year
+100,000	Investment principal
110,000	Withdrawn from the investment
− 6,000	Interest due (deductible)
104,000	Taxable income
−41,600	Tax due at 40% rate
62,400	After-tax proceeds
−60,000	Repayment of loan principal
$ 2,400	AFTER-TAX WINDFALL PROFIT

In a system which allows complete and immediate deduction of all investments, net deductions from investing borrowed money are not intended. The $40,000

61. If this circular refunds explanation is not clear, an alternative explanation involves a taxpayer who initially borrows and invests $100,000. At a 40% tax rate, the $100,000 contribution deduction generates a $40,000 tax refund, which the taxpayer uses to pay down the loan to $60,000. Thus, he has a net borrowing of $60,000, yet a $100,000 investment. Using either explanation, the result is the same.

of unintended circular refunds earned $4,000 profit during the year. The 40% individual income tax reclaimed $1,600 of that profit plus the $40,000, but the remaining $2,400 was retained by the taxpayer.

Although the illustration is slightly longer due to the business entity tax and deductions, the system proposed in this article suffers from the same problem, as shown below.

PROPOSED INVESTMENT INCENTIVE TAX SYSTEM

(Individual borrowing not included in income)[62]

INDIVIDUAL	
$ 60,000	Loan proceeds (not income, therefore no tax)
$100,000	Loan proceeds plus $40,000 of circular refunds contributed to a business entity; i.e., all tax savings are also contributed
BUSINESS ENTITY	
$100,000	Gross income
x 20%	Business tax rate
20,000	Business tax
⇛ 80,000	Net proceeds
x 10%	Pre-tax return
8,000	Pre-tax profit
−8,000	Dividend paid deduction
0	Business taxable income
$108,000	Total distribution to investor ($8,000 profit plus $80,000 capital plus $20,000 circular refunds)
INDIVIDUAL	
$108,000	Gross income
-6,000	Interest due (deductible)
102,000	Taxable income
−40,800	Tax due at 40% rate
61,200	After-tax proceeds
−60,000	Repayment of loan principal
$ 1,200	AFTER-TAX WINDFALL PROFIT

The most classical, and most obvious, means by which to prevent these windfalls are to include borrowed money in the individual's gross income. With that treatment, the deduction for the $60,000 investment or capital contribution is used to offset the $60,000 of gross income from the borrowing, and cannot be used to generate the $40,000 of circular refunds. Because the windfall in each case is the after-tax profit earned on the

62. This is not the final version of the proposed system. For purposes of fully displaying the analytical development of my ultimate proposal, this tentative version allows an interest deduction by an individual taxpayer, while the ultimate proposal (shown in the next succeeding numerical illustration, *infra* page 687), eliminates the interest deduction for individuals, for reasons developed below.

$40,000, this change eliminates the windfall. As a necessary corollary to this additional rule, repayment of the loan principal becomes a deductible expenditure.[63]

Any proposal, however, which includes borrowing in individual income is politically naive for two reasons, and offers no meaningful alternative for practical application. First, the concept is too foreign to the average American taxpayer, after three generations of an income tax system that ignores borrowing. Second, consumers would be outraged when they were forced to borrow $16,667 (assuming a 40% tax bracket) to buy a $10,000 car.[64] While it may be reasonable to assume that business people are sufficiently sophisticated and well advised to accept the taxation of business borrowing and capital contributions, especially when the lender or contributor receives a concurrent deduction, it is unreasonable to assume similar acceptance by consumers. Inclusion of individual borrowing in gross income is not, however, the only way to prevent the windfall profit described above.

An alternative solution, with which American taxpayers have some experience, is to deny the deduction for interest paid by individuals.[65] A review of the foregoing numerical illustration of the classical consumption tax[66] reveals that the interest paid and deducted was $6,000, and the after-tax windfall profit was $2,400. With a 40% tax rate, denial of the $6,000 interest deduction will increase the total tax by $2,400, thus exactly absorbing the windfall. Such result will occur at any tax rate, because the tax rate initially determines the amount of the circular refunds, from which the windfall is earned. The windfall earned and the tax on the nondeductible interest are therefore synchronized, as long as the tax rate holds constant throughout the investment.[67] Therefore, in the case of the classical consumption tax, the windfall can be eliminated either by taxing the individual's borrowing or by denying the individual's interest deduction.[68]

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63. Andrews, *supra* note 20, at 1153.

64. If a taxpayer borrows $16,667 and the loan proceeds are included in her income, a 40% tax will claim $6,667, leaving $10,000 to purchase a car.

65. The rule of I.R.C. § 265 (Supp. IV 1986), denying the interest deduction if the loan proceeds were used to buy tax exempt bonds, has been in the Code since 1917. War Revenue Act, Pub. L. No. 65-50, §§ 1201, 1207, 40 Stat. 300, 330, 334 (1917). A greater number of taxpayers have dealt with I.R.C. § 163(d) (West 1988), limiting the interest deduction if the loan proceeds were used to purchase investment assets, which has been in the Code since 1972. Tax Reform Act of 1969, Pub. L. No. 91-172, § 221, 83 Stat. 487, 574 (1969). Finally, since 1987 almost all individuals who claim itemized deductions have experienced I.R.C. § 163(h) (West 1988), which totally denies the deduction of interest on (nonresidential) personal use loans, subject only to modest transition protection which is already more than half gone.

66. *See* numerical illustration, *supra* page 684.

67. The effects of changes in the taxpayer's marginal rate from the beginning to the end of the investment are discussed *infra* text accompanying note 72.

68. In the classical consumption tax, a difference arises when the individual can invest the borrowed funds at a rate of return higher than that charged by the lender. Of course, any successful leveraged investment fits such a description. Denial of the interest deduction only

In the system proposed by this article, taxing the individual's borrowing also has the same effect as described above for the consumption tax, and perfectly eliminates the windfall profit. Denial of the interest deduction, however, has a slightly different effect, as illustrated below.

PROPOSED INVESTMENT INCENTIVE TAX SYSTEM

(Individual borrowing not included in income but individual interest deduction not allowed)

INDIVIDUAL	
$ 60,000	Loan proceeds (not income, therefore no tax)
$100,000	Loan proceeds plus $40,000 of circular refunds contributed to a business; i.e., all tax savings are also contributed
BUSINESS ENTITY	
$100,000	Gross income
x 20%	Business tax rate
20,000	Business tax
=> 80,000	Net proceeds
x 10%	Pre-tax return
8,000	Pre-tax profit
−8,000	Dividend paid deduction
0	Business taxable income
$108,000	Total Distribution to Investor ($8,000 profit plus $80,000 capital plus $20,000 circular refunds)
INDIVIDUAL	
$108,000	Gross income and taxable income
−43,200	Tax due at 40% rate
64,800	After-tax proceeds
−66,000	Repayment of loan principal plus interest
$ 1,200	SHORTFALL

In this proposed system, denying the individual interest deduction does not produce the same result as the classical remedy of including individual borrowing in income. The latter merely eliminates the windfall, while the former consumes the entire windfall and creates a shortfall. The amount of the shortfall will vary with the business tax rate, and as a profit margin (investment return minus interest rate) is introduced into the analysis.

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captures the windfall to the extent the investment return is equal to the interest rate. Because denial of the interest deduction (rather than taxation of the loan proceeds) allows the circular refunds to develop at the beginning of the investment, the profit (investment rate minus interest rate) earned on the circular refunds, reduced by the individual tax on such profit, will remain as an uncaptured windfall. This marginal windfall is prevented by the alternative remedy of including all borrowing in income, so the effects of these two remedies are not identical. The comparison of these two remedies in the context of the tax system proposed by this article, segaptext accompanying however, is substantially different, as discussed *infra* pages 687-88.

The cause of this shortfall is the business tax on contributed capital. Although the individual's borrowing is not included in his income, when he contributes the loan proceeds to the entity, the business tax has the effect of a partial, indirect tax on his borrowing. The denial of the interest deduction and the tax on borrowing are presented above as alternative remedies for the windfall. Here the interest deduction is denied completely, and the tax on borrowing is imposed in part (at the 20% corporate rate instead of the 40% individual rate), so the remedies are being used cumulatively instead of alternatively. The overkill creates the shortfall.

Of course, the shortfall can be paid by investing the funds at a higher rate than is being charged by the bank. If the money is borrowed at 10%, and the business tax rate is 20%, the business must earn 12.5% just to pay the shortfall.[69] The individual taxpayer will no longer have to pay the shortfall from separate funds, but the apparent 2.5% profit margin will be completely consumed to pay the extra tax. If the rate of return on the investment exceeds the threshold level necessary to pay the shortfall, the excess return produces an appropriate amount of after-tax profit. For example, if a 10% interest rate and a 20% business tax rate require a threshold investment return of 12.5% to pay the shortfall, and the business earns 14.5%, that 2% excess (14.5% − 12.5%) will provide the investor with a return (after paying tax, including the shortfall, and principal and interest due to the bank) equal to 2% of the original borrowed amount, minus the business tax applicable to that 2% (i.e., 0.4%). The net after-tax, after-bank return will be 1.6% of the borrowed amount, with no additional profit from the circular refunds.

This reflects a tax penalty on an individual's contributions of borrowed money to a business entity, but it is not a cause for concern. The bank can loan the money directly to the business, and the interest paid will be deductible by the business. If necessary, the individual can guarantee the loan, but will not be allowed to claim any deduction for a capital contribution to the business entity.[70] The main purpose of this proposed tax system is to encourage individuals to save more and consume less. People are not furthering that purpose when they invest money borrowed from a

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69. Mathematically, the "breakeven point" at which the profit will just pay the shortfall, is expressed as:

$$\text{required investment rate} = \frac{\text{Interest rate}}{1 - \text{business tax rate}}$$

(I find it especially interesting that the individual tax rate is not a factor in this calculation as long as such rate remains constant throughout the investment.) Applying the numbers used in the text produces the following results:

$$\frac{10\%}{1 - 0.2} = \frac{10\ \%}{0.8} = 12.5\%$$

70. If he is later forced to pay on the guaranty, he will be allowed a deduction then.

bank;[71] by definition, the money in the bank has already been saved, by someone else. Only when they invest their own, true equity funds are they effectively reducing consumptive demand and increasing capital supply in the nation's economy. The small tax penalty described above will be more effective than any army of administrative rules and personnel at restricting the reshuffling of other people's savings in search of tax benefits.

In the simple numerical illustration used above,[72] the tax penalty seems excessive and unnecessary to prevent the windfall. However, any mechanism that just barely captures the windfall in a perfectly stable situation will leave part of the windfall untouched if either the investor or the business entity is subject to a higher tax rate when a deduction is taken than when the corresponding income is recognized. Changes in tax rates, whether statutory or by change in taxpayer circumstances, are often predictable in the tax year preceding the change. For example, the illustration on page 687 shows that with a 40% individual tax rate, 20% business tax rate, 10% interest rate, and 10% investment return, a $60,000 loan produces a $100,000 net contribution and a $1,200 shortfall after one year. If the individual investor's tax rate dropped from 40% at the time of contribution to 38.9% at the time of distribution, the $1,200 shortfall would be eliminated. That original illustration required a 12.5% rate of return to offset the shortfall with greater earnings. This reveals that the system is more vulnerable to games based on rate variations than to interest/investment rate arbitrage. Therefore, the modest penalty reflected in the shortfall is a desirable protective device against abuse. It does not impede any bona fide investments searching for economic profits in the market, because those can be pursued by direct entity borrowing. Ideally, the penalty and shortfall would be larger, to referee the games even more strictly.[73]

Any serious proposal to deny individuals an interest deduction must include a careful discussion of whether such a rule is feasible. For purposes of such a discussion, there are four main categories of interest now being

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71. Of course, investment of others' bank deposits is an important function in our economy. One of my fundamental premises in writing this article, however, is that the decision between one type of investment and another should be entirely market driven. Tax benefits should be offered only at the border between consumption and saving.

72. *See* numerical illustration *supra* page 687.

73. This vulnerability to tax rate variation windfalls is not unique to the rule, proposed herein, which denies the interest deduction to defeat deferral windfalls. The alternative remedy, treating borrowed money as income and loan repayments (principal and interest) as deductions, also is subject to rate variation strategies. Under the latter rule, a taxpayer who expects her tax rate to rise substantially next year will borrow money this December (income) and contribute it to a corporation (deduction) in January.

The difference in the rates for those two years, multiplied by the amount of the loan, represents the tax savings. Although conventional tax analysis would treat such a plan as incurring the tax cost one year before the tax benefit is received, most people pay taxes quite currently through wage withholding and quarterly estimated tax payments, so in most cases the benefit will be received within three months after the cost is incurred.

paid by individuals: investment interest,[74] trade and business interest,[75] personal (nonresidence) interest,[76] and home mortgage interest.[77]

Because the tax system proposed herein will lead all business and investment activities (and, therefore, deductions) into separately taxable business entities, individuals will not be affected if their deductions for investment interest and trade and business interest are repealed. The deduction for personal, nonresidence interest has already been repealed by the 1986 Act,[78] subject only to modest transition protection that is already more than half gone.[79] The only interest category for which this proposal would raise serious contention is home mortgage interest. Realistically, some significant amount of interest on a taxpayer's home mortgage will remain deductible, in spite of the strong theoretical arguments against it. The combined provisions of the 1986 Act and the 1987 Omnibus Budget Reconciliation Act[80] [hereinafter, the 1987 Act], however, already have begun to limit the deductibility of home mortgage interest. They define "qualified residence interest," which is deductible, as the interest on a purchase money mortgage of $1,000,000 or less, plus the interest on a home equity loan of $100,000 or less.[81]

Because all money, including all borrowed money, is fungible, any significant category of deductible interest creates an unstoppable loophole in a rule restricting interest deductions. That is true of the current attempts to disallow deductions for some types of interest,[82] place limits on others,[83] and allow still other types to be deducted without limit.[84] For the millions of upper and upper-middle class taxpayers who have the financial strength to borrow significant amounts without pledging as collateral the asset being purchased with the loan proceeds, interest categorization is just a game, as described in the following paragraph. Only if playing the game is more effort than it is worth will the interest deduction limits be respected.

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74. I.R.C. § 163(d) (West 1988).

75. I.R.C. § 162(a) (1982).

76. I.R.C. § 163(h)(1) (West 1988).

77. Some of these categories can be further divided into subcategories which are not relevant to the current discussion.

78. I.R.C. § 163(h)(1) (West 1988).

79. I.R.C. §§ 163(h)(6), 163(d)(6)(B) (Supp. IV 1986).

80. Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, § 10,102, 101 Stat. 1330 (1987).

81. I.R.C. § 163(h)(3) (West 1988).

82. I.R.C. § 163(h) (West 1988), adopted in 1986, prohibits the deduction of personal (nonresidence) interest, subject only to modest transition rules, which expire at the end of 1990.

83. I.R.C. § 163(h)(3) (West 1988), adopted in 1986, limits the amount of home acquisition debt which can give rise to deductible "qualified residence interest"; I.R.C. § 163(d) (West 1988), in effect since 1972, limits the deduction of interest on debt incurred to purchase investments.

84. I.R.C. § 163(a) (1982).

That is also true of the proposed system, but here the game must be played on a narrower field, because the categories with the largest potential for borrowing (business and investment) will generate nondeductible interest for individuals. A taxpayer will no longer be able to borrow $10,000 to finance a vacation, then point to some $10,000 business or investment expenditure and say, "I spent the loan proceeds on that, and $10,000 of my own cash on the vacation, so the interest is deductible." If an individual taxpayer incurs investment, business, or personal nonresidence interest and wants to deduct it, she will have to disguise it as qualified residence interest. Because the current definition of qualified residence interest encompasses only the interest on loans made to acquire or substantially improve her first or second home (plus $100,000 of unrestricted home equity loans, which should be repealed in connection with the proposed tax system),[85] her ability to re-characterize other interest as deductible is substantially reduced, compared to current law.

This game will also be played on a much shorter field, because current law places an absolute limit of $1,000,000 on home acquisition debt that generates deductible qualified residence interest. For most taxpayers the lender will impose a much lower limit on their ability to borrow for an asset that produces no income. For taxpayers who do not suffer such credit limits, this $1,000,000 ceiling will curtail their ability to incur nonresidence interest and disguise it as a deductible type. The opportunity will arise only when the taxpayer is ready to purchase or substantially improve a home, and has the ability to do so either with his own cash or with borrowed funds. Rather than make the home expenditure with the cash on hand, and later be forced to incur nondeductible interest and the previously described tax penalty on an investment loan, he will borrow for the home and retain his cash for investment. Depending on the nature of the regulatory tracing rules, he may be required to invest the cash first, so the home loan will not be tainted by the presence of readily available equity funding.

As mentioned earlier, if any type of interest is deductible, a loophole is created for the disguise and deduction of other types of interest. Although the treatment of qualified residence interest as the only type deductible by individuals will create such a loophole, and such hole cannot be effectively covered, the definition of the type of deductible interest can place natural limits on the size of the hole. Those limits can be reasonably well enforced. Even though wealthy taxpayers will certainly buy homes with borrowed money, and investments, cars and vacations with their own cash, thus qualifying the interest as deductible, the $1,000,000 limit of current law will put a very effective limit on the amount of interest re-characterization they can achieve. At a 12% interest rate, a single taxpayer or a married couple

85. In my opinion, it should be repealed even under the existing system.

could only deduct, at most, $120,000 of ersatz home mortgage interest per year. Furthermore, if the current $100,000 home equity loan allowance is repealed (as it should be), and the $1,000,000 ceiling is lowered (as it should and probably will be),[86] the size of this loophole will be enforceably reduced, both on a national and a per taxpayer level.

A much larger group of upper-middle class taxpayers will be financially unable to enjoy the full $120,000 per year interest deduction. The tax game envisioned above requires a player to have both $1,000,000 cash and $1,000,000 borrowing ability, and be willing to live in a $1,000,000 home, to play the game to the fullest. The lower of those three categories, in any particular case, will be the effective limit on the taxpayer's ability to take advantage of the deduction. Because most individual taxpayers have borrowing power and home price goals which greatly exceed their cash reserves, the lack of cash will be the effective limit for most taxpayers who are under the $1,000,000 debt ceiling. For example, a person who has $150,000 cash and a $500,000 loan authorization can contribute all the cash to a business and use the loan to buy a home. If he had used the cash plus a $350,000 loan to buy the home, and the remaining $150,000 of the loan authorization to fund the capital contribution, the interest on the latter portion of the loan would be nondeductible. Therefore, the former allocation of resources is the one he will make, and arguably he will have disguised up to $18,000 of investment interest (assuming a 12% interest rate) as qualified residence interest.[87] But there is no way he can make a $200,000 investment and still deduct all the interest, because that will force him to down to a $450,000 home, which cannot carry $500,000 of qualified residence debt. The $50,000 loan shifted to the investment cannot be disguised. Similarly, if he wants only a $100,000 home, and buys it entirely with borrowed money, he can deduct only $12,000 interest (at 12%), regardless of what he does with the rest of his cash and borrowing power. The lowest of available cash, available loan authorization, and home cost, is the effective ceiling on re-character-

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86. A recent article proposed the repeal of the home equity loan deduction and a reduction of qualified home acquisition debt from $1,000,000 to $200,000. "While it may be reasonable to encourage middle-class home ownership, there is no reason to subsidize palaces." Barusch, *Making the Income Tax More Progressive*, 40 TAX NOTES 961, 965 (1988). Hopefully, the $1,000,000 ceiling is just the camel's nose in the tent, and Congress will gradually lower it to raise revenues without raising tax rates.

87. Probably the most defensible reallocation of his transactions, from a tax enforcement perspective, is to allocate the interest proportionately among all his assets, by purchase price. In this simple illustration, the house represents 75.4% of his expenditures, so 75.4% of the loan and 75.4% of the cash should be deemed to have been applied to the home purchase. The remainder (24.6%) of his cash and credit resources should be allocated to the investment contribution. With the interest allocated in the same manner, 75.4% would be deductible and 24.6% ($4,428) would not. Under this approach, one would probably conclude that only $4,428 of the qualified residence interest can properly be characterized as disguised investment interest.

ization of interest through shuffling of resources. Because only 5,120,061 American households have a net worth in excess of $250,000,[88] only a modest number of people will be able to play on a significant portion of the $1,000,000 playing field. The amount of abuse of this loophole, whether measured in terms of revenue loss or moral outrage, should be tolerable.

D. *Summary*

The tax system described and proposed herein meets the various goals and criteria established at the beginning of this article. It allows a clear distinction between the taxation of consumed income and the taxation of invested income. The force of that distinction can be varied easily by Congress, simply by changing the differential between the individual and business entity tax rates. Interestingly, increasing and decreasing the level of investment incentive are separated from the issue of increasing or decreasing federal revenues. Traditional investment incentives have always been revenue losers.[89] If Congress wants to induce more investment without reducing revenues, it can increase the tax rate differential by increasing the top individual rates, at least within a reasonable range of rates.

This system will cause all business and investment income and deductions to be reported on business entity tax returns (all business entities will be taxable, using a single tax return form, and a single set of rules and rates), with only consumed income and personal deductions reported on individual returns. As a result, Congress can freely adopt rates and substantive tax rules applicable only to one of those categories, without compromise or concern over the unintended effect on the other category.

The proposed system adopts a use-based form of tax incentive, which is probably more effective at affecting taxpayer behavior than a source-based incentive.[90] Because the benefit is a continuing one, and only continues until the investment is withdrawn for consumption, the system creates a watchdog at the entity gates, constantly discouraging (although not prohibiting) consumptive withdrawals.

Although the system discourages consumptive withdrawals, there is no discouragement of movement from one business entity to another. Thus, part of the lock-in effect[91] of current tax law is eliminated. Income earned

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88. BUREAU OF THE CENSUS, U.S. DEP'T OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES: 1988, Table No. 726. The foregoing authority uses data from 1984.

89. Supply side advocates continue to deny this. Their denials, however, carry less and less weight, as the supply side Reagan deficits continue to mount. *See supra* note 18.

90. *See supra* text accompanying notes 38-41.

91. A person who bought Chrysler stock at $6 per share and watched it rise to $30 might then decide that a better future is found in Ford stock, but the specter of paying $8 per share in tax on the $24 gain (33% tax rate, *see* I.R.C. § 1(a), (g) (Supp. IV 1986)) might dissuade her from selling the Chrysler stock. She is "locked-in" to the Chrysler stock.

by Corporation A and distributed to Shareholder X for reinvestment in Partnership B will bear the same total tax as income which A retains. The distributed income will be sheltered from A's tax by the distribution deduction, sheltered from X's tax by the contribution deduction, and taxed only to B.[92]

Consider, for a moment, the general outline of what has been described above. This proposal constitutes a meshing of a classical consumption tax system for individuals with an income tax system for business entities. The taxation of capital contributions as income to the recipient entity is not a familiar element in an income tax, but is necessary in this dichotomous structure to prevent investment capital (and the earnings thereon) from totally avoiding taxation.

III. Treatment of Noncash Contributions and Distributions

A. *Contributions of Assets Other Than Cash*

Cash contributions and distributions are handled simply in the proposed system. Contributions (and loans) are deductible by the investor, and income to the entity. Distributions, whether liquidating or nonliquidating, whether of earnings or capital, are deductible by the entity and income to the recipient; and so are loan repayments.

Noncash contributions and distributions must be considered separately because, unlike cash, they usually have bases that differ from their values. Current law provides for nonrecognition of gain or loss in many instances of contributed assets.[93] Such a rule reflects a policy not to burden an incorporation or partnership formation with tax liability. To determine what rule is appropriate in the new system, one must first consider the factual settings in which the issue is likely to arise. Business and investment assets purchased after the proposed system is adopted will almost always be purchased by a taxable business entity, even if it is nothing more than a sole proprietorship with a separate tax identification number and independent taxpayer status. Any well advised individual will use an entity to purchase such assets, to take advantage of the rate differential. After a brief transition period in which current businesses and investments are promptly transferred to taxable business entities, noncash contributions from individuals to businesses will consist primarily of personal use assets which the individual is converting (or pretending to convert) to business or investment use. Therefore, the primary concern in the case of noncash contributions by individuals is to prevent either party from recognizing a deduction or other

92. Lock-in of corporate operating assets containing potential gain will still exist.

93. I.R.C. §§ 351, 721(a) (1982).

tax benefit from a loss that accrued while the asset was being put to personal use. As long as such potential abuse is prevented, the solution can be based entirely on an analysis of contributions from one business entity to another.

As illustrated below, if the contributing investor is a business entity, a net tax deduction equal to the asset basis will be enjoyed by the investor. This is true whether or not the contribution is a recognition event, and whether the asset contains a potential gain or loss.

RECOGNITION TREATMENT

Gain Asset		Loss Asset	
$100	Fair Market Value (FMV)	$45	FMV
– 70	Adjusted Basis (A/B)	– 70	A/B
30	Gain recognized	(25)	Loss recognized
– 100	Contribution deduction	– 45	Contribution deduction
$ 70	Net deduction	$70	Net deduction

NONRECOGNITION TREATMENT

Gain Asset		Loss Asset	
$100	FMV	$45	FMV
– 70	A/B	– 70	A/B
No gain recognition		No loss recognition	
– 70	Contribution deduction	– 70	Contribution deduction
$ 70	Net deduction	$70	Net deduction

The foregoing illustration is based on the fundamental tax concepts that recognized gain creates basis while recognized loss consumes basis, and that basis is never enjoyed twice or wasted. In order to achieve a zero basis in the contributor's investment, all basis brought into or created in the transaction must be deducted. The deduction of the adjusted basis brought into the transaction creates a net deduction, whether deducted entirely as a contribution deduction (gain asset) or partially as a loss deduction and partly as a contribution deduction (loss asset). Any recognition of gain creates additional basis, which allows an additional contribution deduction, but that extra deduction is sufficient only to offset the recognized gain, and is not available to increase the net deduction.

The current policy of tax neutrality in contributions to partnerships and corporations is a good one, and should be pursued in implementing any different tax system or rules. If the net effect on the contributing investor is always the same, as shown above, the investor is indifferent to the choice between recognition and nonrecognition, and the proper tax treatment can be selected by analyzing the alternative effects on the recipient entity. Guidance in this analysis must be obtained from a review of the central function of this proposed tax system—to shift the reporting and taxing of

invested income from the investor to the business entity. To accurately serve that function, the contribution deduction granted to the investor must be equal to the income attributed to the entity. When the recognition rule is analyzed, in the case of a loss asset, the loss deduction must be separated from the contribution deduction, and only the latter amount attributed as income to the entity. The recognition rule is analyzed because, with this proposed system, perhaps nonrecognition is not the only way to achieve the goal of tax neutrality. The following illustrations use the same numerical examples as, and certain results from the preceding illustration.

RECOGNITION RULE

Gain Asset ($70 A/B; $100 FMV)	Loss Asset ($70 A/B; $45 FMV)
$100 Contribution deduction (from above)	$45 Contribution deduction (from above)
—requires—	—requires—
$100 Income to the entity	$45 Income to the entity
—which compares to—	—which compares to—
$ 70 net deduction to investor (from above)	$70 net deduction to investor (from above)

The first and second elements of the illustration establish the required equality of contribution deduction and entity income, then the second and third elements test for the desired tax neutrality. Even though this proposed system inevitably creates income on the entity's receipt of capital, tax neutrality would be achieved if it also grants an equal deduction to the contributor. As shown above, if a noncash capital contribution is a recognition event, net income is created (considering the two parties as a unit) on contribution of a gain asset, and net loss is created upon a contribution of a loss asset. Tax neutrality is not achieved in either case.

In contrast, the following illustration applies the same tax neutrality test in a model which does not require recognition of the investor's potential gain or loss at the time an asset is contributed to a corporation or other business entity.

NONRECOGNITION RULE

Gain Asset ($70A/B; $100 FMV)	Loss Asset ($70 A/B; $45 FMV)
$70 Contribution deduction (from above)	$70 Contribution deduction (from above)
—requires—	—requires—
$70 Income to the entity	$70 Income to the entity
—which compares to—	—which compares to—
$70 Net deduction to investor (from above)	$70 Net deduction to investor (from above)

This illustrates that, even in this fundamentally different approach to taxation of investors and business entities, nonrecognition of the inherent

gain or loss in a contributed asset is still necessary to achieve tax neutrality in equity capital contribution decisions and transactions. Because nonrecognition leads to a contribution deduction equal to the asset's adjusted basis, the amount of the adjusted basis will also be attributed as income to the business and adopted as the entity's adjusted basis in the asset. Conveniently, fair market value need not be determined. This analysis envisions a business entity as the contributing investor, but the rules proposed above will provide the same neutrality to an individual investor; except the intentional nonneutrality of the rate differential, which will encourage all contributions, whether of cash or other assets.

As mentioned earlier, however, contributions of personal use assets by individuals represent a potential for abuse. A person could buy a $10,000 car, use it for five years for purely personal purposes, then contribute it to a corporation and claim a $10,000 deduction. Current law on deduction of personal casualty losses,[94] or on depreciation of personal use assets which are converted to business use,[95] provides a familiar and simple defense against such abuse. The deduction for contribution of a personal use asset should be limited to the lesser of its adjusted basis or fair market value at the date of contribution. To reduce the number of disputes over fair market value, the adjusted basis of a depreciable, personal use asset should be defined (for this purpose) as its initial basis minus the depreciation that would have been allowed if it always had been used for business purposes. Such a rule would place a lower ceiling on the contributor's room for an inflated value estimate.[96]

In another potential abuse area, the high value of the contribution deduction and the zero basis of stock and bonds create strong temptations and large rewards for fraudulent reporting of contributions and securities sales. Transactions handled through registered brokers can be monitored simply. The brokers submit to the IRS the identities of the parties, the security involved, and the amount of proceeds.[97]

Use of such information will be especially effective under the proposed system, because the zero basis in all securities will cause the entire sale proceeds to be income to the seller. A broker's report on the seller will be equivalent to an employer's Form W-2 on an employee.

Transactions that are not handled by a registered broker can be effectively policed by a reporting requirement similar to that adopted for the alimony

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94. *See, e.g.*, Helvering v. Owens, 305 U.S. 468 (1939); I.R.C. § 165(c)(3) (1982); Treas. Reg. § 1.165-7(b)(1) (1960).

95. Treas. Reg. § 1.167(g)-1 (1960).

96. This idea arises from a discussion with Mary Lou Fellows and from Epstein, *The Consumption and Loss of Personal Property Under the Internal Revenue Code,* 23 STAN. L. REV. 454, 463-64 (1971).

97. Such reporting, to the Service and the taxpayer, is already required under I.R.C. § 6045 (1982 & Supp. IV 1986).

deduction in 1984.[98] The payor (here, purchaser) is required to report the name and tax identification number of the recipient (seller).

Finally, the largest abuse potential lies in the ability of a corporation (or other business entity) to purchase inventory, equipment, and any other assets by issuing stock (or similar business interest) for such assets, then promptly redeeming that stock for cash. The seller will have the same amount of gain as from a direct cash sale of the asset, and so will be indifferent to the structure of the transaction. The buyer will have income (from the "contribution") equal to the seller's basis in the asset, and a deduction (from the "redemption distribution") equal to the fair market value of the asset. If, as is generally true for newly manufactured or constructed items, the value is greater than the seller's basis, that excess will be the amount of the buyer's net deduction from the combined transactions.

The first step in stopping such manipulation is to retain the control requirement found in the current version of section 351, and expand its coverage to include partnerships. The noncash contribution qualifies for nonrecognition only if the contributing investor (or group of concurrently contributing investors) is in control of the entity immediately after the contribution.[99] It will be very rare that an arm's length supplier of materials, or equipment, or even buildings will be able to receive an 80% interest in the acquiring entity, so gain will be recognized when such a supplier contributes the desired asset to the acquiring entity. The nonrecognition of gain on the contribution is the fuel that drives the scam described above, so denial of that nonrecognition will stop the abuse.

After adoption of the control requirement, however, the same sort of abuse can be achieved by shifting to a three party transaction. The seller contributes the desired asset to a new, shell corporation, which has no other assets. Therefore, the seller will become the sole shareholder of the shell corporation, satisfying the control requirement and qualifying for nonrecognition on the contribution. Shortly thereafter, the stock of the shell corporation is sold to the buyer, which then acquires the assets by liquidation of, or merger with, the shell corporation. As with the two party transaction described above, the seller experiences the same tax effect as with a direct sale, and the buyer and the shell (viewed as a unit) enjoy a net deduction equal to the seller's gain.

No author wants to propose an idea that must carry an excessive burden of anti-abuse rules,[100] but it appears that the foregoing abuse can be stopped

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98. I.R.C. § 215(c) (Supp. IV 1986); Temp. Treas. Reg. § 1.215-1T (1984).

99. I.R.C. § 351(a) (1982) makes a cross reference to I.R.C. § 368(c) (Supp. IV 1986), which defines "control" as 80% of all voting shares and 80% of all nonvoting shares of stock.

100. The authors of the current Code, however, do not seem particularly concerned about this issue!

with a relatively simple rule. The most direct solution would be to abandon the nonrecognition rule for noncash contributions to a controlled corporation (or other entity). However, that would hinder too many creations of legitimate subsidiaries. The better response is to make the nonrecognition dependent upon the contributing investor(s) having control of the recipient corporation for twelve months after the contribution, rather than the "immediately after" requirement of current law.

B. Distributions in Kind

As mentioned earlier, cash distributions to investors and loan repayments, under the proposed system, are deductible by the entity and income to the recipient. Noncash distributions to investors need further consideration. For corporate distributions, current law requires recognition of gain (but not loss) by the distributing corporation if property is transferred as an operating distribution to a shareholder,[101] recognition of gain and loss if property is transferred as a liquidating distribution to a shareholder who is not a parent of the distributing corporation,[102] and nonrecognition of gain and loss if property is transferred from a liquidating subsidiary to its parent.[103] The current rules for partnership distributions generally provide nonrecognition of gain and loss for a distributing partnership.[104]

Recognition of gain and loss on corporate distributions to shareholders was adopted to more fully enforce the double tax of traditional American corporate taxation. Corporate income is taxed once when the corporation earns it, and again when the shareholders receive it as dividends or liquidation proceeds. Ordinary operating income cannot avoid that double tax, but the gain inherent in appreciated assets could avoid it, if those assets could be distributed without corporate recognition of the gain. Because this proposed system abandons the double taxation of corporate income, recognition by the corporation is not required. Both recognition and nonrecognition rules can be freely considered, for corporations and other types of entities.

Consideration of the likely factual situations in this area is helpful. Because this proposed tax system will cause all business activity to be conducted by taxable business entities, rather than by individuals, an entity will rarely, if ever, distribute business assets to an individual investor, unless the investor intends to promptly recontribute them to another entity. In that event, the effect on the other business of the tax rule being determined

101. I.R.C. § 311 (Supp. IV 1986).
102. I.R.C. § 336(a) (Supp. IV 1986).
103. I.R.C. § 337 (West 1988).
104. I.R.C. § 731(b) (1982).

here should also be considered. Another situation which merits special consideration is the distribution, to an individual investor, of an asset that can be used by the investor for personal consumptive purposes. The function of the individual tax in this proposed system is to measure and tax personal consumption. Ideally the investor will be taxed on the full fair market value of any distributed assets which he retains for consumption.

In analyzing contributions, the investor was discovered to be indifferent to the debate between recognition and nonrecognition.[105] With respect to distributions, the distributing entity is indifferent to the same issue, and for the same reason: The net deduction allowed to the transferor is the same in each case. If a distribution is a nonrecognition event, the entity will deduct the adjusted basis of the asset. If a distribution is a recognition transaction, the entity will experience two tax effects, which will combine to produce, again, a net deduction equal to the adjusted basis of the distributed asset. In a recognition distribution, the loss deduction will consume part of the basis, and therefore the distribution deduction will be reduced by the amount of the loss; gain recognition will increase the basis and therefore increase the distribution deduction by just enough to offset the gain.[106]

If the distributing entity is indifferent to this issue, the decision can be made by reviewing the effect on the investor and any other party which might be involved, and by considering any basic policy issues which might be raised. As with contributions, the most important rule is that the entity's distribution deduction must be equal to the investor's distribution income. That is necessary to achieve one major goal of this proposed system, which is to report all consumed income on individual returns, and only invested income on business returns. The collective purpose of the distribution deduction and the distribution income is to shift a specific amount of income from a business to an individual return; therefore, those two items must be equal.

The main policy consideration in this area is the potential for unintended tax benefits if a nonrecognition rule is adopted. Sale of an asset by one business to another clearly is intended to be a taxable event in this system. If a noncash distribution from a corporation (for example) to a shareholder is a nonrecognition event, a prospective asset purchaser could instead purchase stock from the intended seller, and then present the stock for redemption. The other corporation could transfer the desired asset as the redemption payment. The result is illustrated as follows:

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105. *See supra* Pt. III. A.

106. The two numerical illustrations on page 695 depict these phenomena with respect to contributions to the business entity. Distributions from the entity follow the same patterns.

TRANSACTIONS	"PURCHASER"	"SELLER"
1. $100 stock purchase	$100 deduction	$100 income
2. Redemption with asset ($20 A/B; $100 FMV)	20 income	20 deduction
	$ 80 net deduction	$ 80 net income

A direct sale of the asset would have produced a net gain of $80. The same business result can be accomplished using the foregoing structure, with no net (collective) income to the parties.[107] As structured above, the seller's position is the same as the sale transaction, and the buyer enjoys the full benefit, which is the deductibility of most of the purchase price. The parties can shift as much of the benefit to the seller as they wish, simply by increasing the price of the stock purchase.

To prevent the unintended opportunity identified above, a noncash distribution to a shareholder (or investor in any other business entity) must be a recognition event, as it is in most cases under current law. This conclusion carries some disadvantages which should be identified. It requires a valuation of all distributed assets. It leads to a distinction between a distribution from a subsidiary to a parent (which should certainly be a nonrecognition event), and a distribution to a noncontrolling shareholder. Both of these disadvantages exist under current corporate tax law, so obviously they are not intolerable, but it would have been nice to leave them behind. One advantage of a recognition rule is that an individual investor receiving a consumable asset, such as a car, will be taxed on the fair market value of that consumptive withdrawal, rather than the distributing entity's basis in the asset. Such result is more in keeping with one of the goals of this tax system, which is to measure and tax personal consumption.

Another necessary anti-abuse rule is to prohibit recognition of loss on a nonliquidating distribution. Without such a rule, a business could recognize all its realized losses annually, by distributing its loss assets to its owners and promptly receiving them as capital contributions. There would be no net offsetting tax cost to the owners. Such a rule creates an unfortunate distinction between liquidating and nonliquidating distributions, but that problem accompanies the similar rule under current law.

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107. This abuse potential is thoroughly demonstrated by Esmark, Inc. and Affiliated Companies v. Commissioner, 90 T.C. 171 (1988), in which, pursuant to a pre-existing agreement, Mobil Oil Corporation bought 54% of Esmark's stock on the open market and tendered it to Esmark for redemption. The agreed consideration for the redemption was the stock of Esmark's oil producing subsidiary. The entire transaction was undertaken as a means to "sell" the oil subsidiary to Mobil. A cash sale would have been a taxable event for Esmark, with a tax liability in excess of $100,000,000. *Id.* at 172-79. Under the law at that time, a redemption transaction structured in this manner did not require recognition of gain by the distributing corporation (Esmark). *Id.* at 181-82. The Tax Court upheld the nonrecognition treatment claimed by Esmark. *Id.* at 197-200.

IV. Side Effects of the Proposed System

The intended effects of the proposed system are described above. Of course, any significant change in a ubiquitous law such as the Code will inevitably affect people's actions in many ways besides the intended effects. Some side effects of this proposed system may be difficult or impossible to anticipate. Others are quite predictable.

The capital gain preference can be permanently put to rest. The only legitimate justifications for that preference, of the many that have been suggested,[108] are as an unashamed investment incentive and as a very crude inflation adjustment to basis. The rate differential of the proposed system will provide as much investment incentive as Congress desires, so the use of the capital gain preference for investment incentive becomes unnecessary. Because the only business and investment assets held by individuals will be debt and equity interests in taxable business entities (primarily stock, bonds, and partnership interests), all of which will have a zero basis, the inflation effect on basis will no longer be a concern for individual taxpayers. For operating assets of business entities, tax distortion from inflation will still be a legitimate concern. The smallest, and therefore probably the least sophisticated, entities will have a zero basis in most of their durable assets due to the deduction available under section 179.[109] Businesses which are too large to deduct all of their capital expenditures under section 179 should have the resources and sophistication to adjust all their asset bases for inflation. The Code should be amended to allow such adjustments, which could be made quite simply and inexpensively with computerized accounting systems. Basis adjustment is the most appropriate means to deal with the distorting effects of inflation on the taxation of income from capital.

Finally, the capital loss limitations can be repealed without suffering great revenue loss, because individuals and small businesses, with their zero basis assets, will never suffer capital losses. After the 1986 Act, anticipated re-enactment of the capital gain preference and the revenue costs of allowing capital loss deductions are the only factors keeping the thousands of capital gain and loss provisions and references in the Code. The funeral for these friends would be a rare pleasure, but there is not time or need to identify them all here. It will suffice to say that the foregoing resolution of those

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108. Blum, *A Handy Summary of the Capital Gains Arguments*, 35 Taxes 247 (1957).

109. I.R.C. § 179 (1982 & Supp. IV 1986) allows a taxpayer to deduct, in the year of purchase, up to $10,000 of expenditures on equipment to be used in a trade or business. The deduction is phased out, rather quickly, for taxpayers who purchase more than $200,000 of equipment during the year. To achieve the effect described in the text, in connection with this proposed system, the scope of § 179 should be expanded to include all types of capital expenditures, rather than just equipment, and the $10,000 limit should be increased, perhaps to $20,000.

two factors will, by itself, allow a tremendous shortening and simplification of the Code.

As described in detail earlier, the traditional distinctions between debt and equity are totally eliminated.[110] The attempts to distinguish between the two for tax purposes can be stopped. Section 385,[111] which was intended to help separate debt from equity, but failed,[112] can be repealed. Concern of clients, tax professionals, IRS agents, and the courts, about "thin capitalization"[113] will become history. With the capital vs. ordinary distinction gone, and a zero basis in all stock and bonds, this indifference will be enjoyed by both the business entity and its investors. Dividends, interest, redemption of stock or partnership interest, repayment of loans, and payment of salaries will all be deductible by the entity. Determinations of whether a salary to an employee-shareholder is reasonable[114] will become unnecessary.

All the foregoing payments will also be income to the recipients. Sections 302,[115] 303,[116] and 304,[117] the special tests for the tax treatment of redemptions, can be repealed. The constructive ownership rules of section 318[118] are used primarily in connection with sections 302 and 304, and so will be greatly reduced in significance.[119] Because there is no need to identify dividends as such, the concept of earnings and profits can be abandoned, and therefore sections 312[120] and 316[121] can be repealed.[122]

Section 305(a)[123] provides the very simple rule that a corporation's distribution of a stock dividend is not income to the shareholders. The rest of section 305,[124] and sections 306[125] and 307,[126] provide rather complicated rules to regulate stock dividends and prevent their use in tax avoidance

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110. The leading corporate tax treatise has 83 pages dedicated to debt-equity problems. B. BITTKER & J. EUSTICE, *supra* note 56, at 4-1 to 4-83.

111. I.R.C. § 385 (1982).

112. *See* B. BITTKER & J. EUSTICE, *supra* note 56, at 4-11 to 4-12.

113. *See id.* at 4-23 to 4-24.

114. *See* Charles McCandless Tile Service v. United States, 422 F.2d 1336 (Ct. Cl. 1970); I.R.C. § 162(a)(1) (1982); Harold's Club v. Commissioner, 340 F.2d 861 (9th Cir. 1965).

115. I.R.C. § 302 (1982 & Supp. IV 1986).

116. I.R.C. § 303 (1982 & Supp. IV 1986).

117. I.R.C. § 304 (West 1988).

118. I.R.C. § 318 (1982 & Supp. IV 1986).

119. I.R.C. § 318 is also used in connection with other surviving sections, so it cannot be repealed.

120. I.R.C. § 312 (1982 & Supp. IV 1986).

121. I.R.C. § 316 (1982).

122. Repeal of I.R.C. § 312 is dependent upon either repealing the alternative minimum tax (discussed *infra* note 128 and accompanying text) or abandoning the use of earnings and profits as a tool for calculating alternative minimum taxable income.

123. I.R.C. § 305(a) (1982).

124. I.R.C. § 305 (1982).

125. I.R.C. § 306 (1982 & Supp. IV 1986).

126. I.R.C. § 307 (1982).

schemes. This trio has become less significant with the 1986 repeal of the capital gain deduction. The elimination of all capital distinctions and the zero basis for all stock will allow the entire trio of sections to be repealed, except the simple rule of section 305(a).

The zero basis in all business interests (both debt and equity) will allow a dramatic narrowing of section 1014,[127] which currently allows a fair market value basis of all inherited assets. The most common justification for section 1014 is that estate administrators and beneficiaries are often unable to determine the decedent's actual basis in his or her assets. The one person most capable of locating the basis information, without unreasonable effort and expense, is dead. Under the proposed system, the basis of stock, bonds, and other business interests will always be zero, which can be determined even more easily than the fair market value, which must be ascertained under current law. Even though the retention of the current section 1014 rule for personal use assets represents a flaw from a theoretical tax policy perspective, the magnitude and significance of that flaw will be greatly reduced.

If Congress is willing to rely entirely on the individual/business rate differential for tax-based investment incentives, as this article suggests, the resulting elimination of all the current, investment-specific tax preferences will provide another welcome list of shortenings and simplifications too long to itemize here. Elimination of those preferences will also allow the repeal of the entire alternative minimum tax system.[128] The alternative minimum tax has grown, over the last several years, into one of the major nightmares of taxpayer burden in the Code.

This proposed system clarifies one major issue that has always been unclear in the American income tax system: the status, or role, of corporations. A corporation is not an independent entity in any meaningful sense. It is simply a vehicle which one, or five, or 500,000 persons utilize for conducting some of their investment and business activities. It is a convenient vehicle for the shareholders. Under the proposed system, it also becomes a very convenient vehicle for imposing on the investment and business activities of the shareholders the lighter tax burden Congress has long tried to provide for investments and businesses. To respect this philosophy, and to achieve the goal that every dollar that is saved rather than consumed will receive the same tax benefit, Congress should repeal the accumulated earnings tax[129] and the personal holding company tax[130] when this proposed system is enacted.

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127. I.R.C. § 1014 (1982).
128. I.R.C. §§ 53-59 (West 1988).
129. I.R.C. §§ 531-37 (1982 & Supp. IV 1986).
130. I.R.C. §§ 541-47 (1982 & Supp. IV 1986).

Apart from the philosophical view, a pragmatic analysis calls for the repeal of the two penalty taxes described in the preceding paragraph. These penalty taxes place pressure on certain corporations to distribute their income to the shareholders, for the purpose of triggering the individual tax on the dividends. Even if one of these penalty taxes is successful at forcing a corporate distribution, under the proposed system the shareholder can easily avoid the individual tax on the distribution by contributing the money received to the same or a different corporation. The contribution deduction will offset the gross income from the distribution. Therefore, the penalty taxes will be nothing more than a nuisance, with little substantive effect, and should be repealed.

Because a corporation will be allowed a deduction for all distributions to its shareholders, the section 243[131] deduction for dividends received by a corporation will become a double benefit. It should be repealed.

Subchapter S[132] allows a corporation to elect to avoid the corporate tax, and have all of its taxable income taxed directly and annually to the shareholders, even though the income might not be distributed to them. It allows a corporation to be taxed like a partnership, and avoid the double taxation which the current system imposes on corporate profits. The proposed system will eliminate double taxation for all corporations, so the main purpose of Subchapter S is satisfied. A secondary purpose, or at least an effect, of Subchapter S, is to tax all corporate profits at the shareholders' individual tax rates, rather than the corporation's tax rate. One expectation behind this proposed system is that the business tax rate will be very low, and will always be lower than most, if not all, of the individual tax rates. Numerical illustrations herein have used 20% as an assumed business rate, but that figure was chosen primarily to simplify the arithmetic and make the illustrations easier to follow. If all other identifiable investment incentives can be repealed, thus making taxable income an accurate reflection of true economic profit, perhaps a 15% flat business rate can satisfy the political and revenue demands on this issue.

If the business rate is less than or equal to the lowest individual rate, no one will ever elect to be taxed under Subchapter S. Such an election would not lower the tax burden on anyone, under any circumstances, unless a shareholder was in a zero tax bracket. Individuals in the zero tax bracket rarely own corporate stocks, so do not present a concern in this regard. Any savings they may have can be deposited directly in a personal bank account. The interest earned will be their own income, and will enjoy the protection of their zero tax rate. The more important group is the tax exempt entities, such as pension funds and charitable institutions, but they

131. I.R.C. § 243 (West 1988).
132. I.R.C. §§ 1361-79 (1982 & Supp. IV 1986).

do not qualify under current law to be shareholders of an S corporation. Subchapter S status is generally limited to corporations with 35 or fewer shareholders, all of whom are individuals. Therefore, Subchapter S will become deadwood, and can be repealed.

Section 7704[133] provides a definition of "publicly traded partnership[s]" and subjects them to the corporate tax system. Because all business entities will be taxed under a single set of rules and rates, Section 7704 can be repealed. Future problems of distinguishing corporations from other entities can be avoided completely.

V. Transition Issues

Any major revision of the Code creates transition problems, as has been learned so well in the last several years. The most significant transition problem in enacting the proposed system arises from the intended purpose of the change, rather than any theoretically sound objection. That is, the purpose of this proposed system is to encourage people to "invest more, consume less," but promptly after enactment a massive flow of tax benefits will go to people who have already invested, before enactment, without needing this encouragement. That flow of tax benefits will be enjoyed as pre-enactment investments are restructured to generate investment deductions for their owners.

Objections to this amount, or type of deduction are purely pragmatic rather than theoretically sound, because a $100 basis in a pre-enactment investment represents $100 on which tax has already been paid. Adoption of this proposed system represents a decision that an investment should be deductible, as long as the same amount is taxed to the investment entity which receives the funds. Nevertheless, when a thief decides to "go straight," he quits stealing, but usually does not feel compelled to reimburse all former victims. The revenue loss from allowing deductions for all pre-enactment savings and investments will probably be viewed as a "cost" of enactment, rather than something that should have been done years ago. That cost must be identified in greater detail, analyzed, and minimized by some workable set of transition rules. The following discussion assumes that the investor contribution deduction and business entity distribution deduction proposed herein will be intended only for those post-enactment investments and distributions which are funded by post-enactment earnings.

It is helpful in a situation like this to describe an idealized model rule, as a starting point and a subsequent guide, even though practical problems would prohibit the use of such a model. Ideally, on the last day under the current system, all business and investment assets would be given a zero

133. I.R.C. § 7704 (West 1988).

basis. Each individual would be required to contribute all his or her available cash to a corporation or other entity in exchange for zero basis stock or securities, or similar interests. All partnerships, proprietorships, and other entities would then become separately taxable entities. After all the foregoing was accomplished, each business entity would count its cash, and that amount would be the amount of nondeductible distributions it must make after enactment of the new system, before it could make any deductible distributions.

After the foregoing changes, an individual could not take a deduction for contributing any old assets to a business entity, because an in-kind contribution generates a deduction equal to the adjusted basis of the asset[134] (now zero). Sale of the zero basis asset and contribution of the cash would generate a deduction, but there would be no net deduction because the gain on the sale would exactly offset the contribution deduction. The individual's cash is all trapped inside a corporation, and cannot be withdrawn to make a deductible contribution without, again, creating an offsetting amount of income. For similar reasons, a business will not be able to create a net distribution deduction with any of its old assets.

As was indicated earlier, practical problems would prohibit the use of such a model set of transition rules. The uncompensated confiscation of all asset bases and the forced contribution of all cash to corporations are unthinkable. After a long search for an elegant method to achieve the same ends, this author is abandoning the search.[135] Instead, the chart at the end of this section depicts a pragmatic transition system. Partnerships, proprietorships, and S corporations would be allowed to maintain their nontaxable, flow-through status, or to make an irrevocable election to subject themselves to the "business entity" taxation system described herein. Such election would constitute a deemed contribution of all the entity's assets, thus triggering the deduction for the owners and income to the entity, as described in this article. In the first year, a substantial but tolerable reduction in tax benefits for nontaxable business entities puts pressure on them to incorporate or make the foregoing election to become taxable entities. The main source of such pressure is that trade and business interest and investment interest become only 80% deductible for nontaxable entities. The immediate deductibility of contributions assures that all newly issued stock, securities, and partnership and proprietorship interests will have a zero basis. Because such contributions will trigger an entity-level tax that is equal to or only slightly less than the owners' tax savings, the contributions and zero basis

134. *See supra* note 93 and accompanying text.

135. I have not, however, given up the belief that a more intellectually satisfying transition model is available; I am simply admitting that such a model has temporarily eluded my pursuit!

stocks of the first year will be accomplished at a relatively small cost to the Treasury.

To begin the gradual establishment of the ultimate rate differential, the top individual rates are raised slightly, while the business entity rate is made perfectly flat (i.e., no progression) and lowered slightly. The deductibility of stock purchases will cause a substantial increase in the market price of outstanding stock, so a small excise tax is placed on the first post-enactment sale of any pre-enactment stock (i.e., any stock with a nonzero basis). This excise will capture some (but not all) of the windfall enjoyed by holders of outstanding stock, to help finance the change from which they will derive their unearned profit. Dividends and nondividend (*e.g.*, redemption) distributions become 10% deductible in a smooth, ten year progression toward total deductibility.

In the second transition year the nondeductible portion of trade and business and investment interest is raised to 40%, for any nontaxable entities, as part of the linear five year process of eliminating that deduction for nontaxable entities. The 35% top individual rate bracket that was created in the first year is now divided into a 35% and a 37% bracket. This is a step in the five year movement toward a 15/28/35/40% structure of individual tax rates.

The only changes for taxable business entities in the second transition year are to reduce the business tax rate to 31% (in a ten year movement to 20%), and to increase the partial deduction for dividends paid to 20%.

The third year changes are only those that follow the multi-year patterns described above, phasing in or phasing out various rules and rates. The same is true of the fourth year, except that, in addition, the capital loss limitation and all other distinctions between capital and ordinary income and loss are repealed. Also, all other investment incentives are gradually phased out, beginning in year four and ending in year ten, or sooner. In particular, the goal for the depreciation system should be one that is sufficiently schedular (like ACRS) to be simple for taxpayers and the Service, yet a reasonable approximation of true, economic depreciation. Acceleration which is now in the depreciation schedules for the purpose of incentive should be eliminated.

Transition years five through ten consist entirely of continuations of the gradual changes described above. By the fifth year, the tax system proposed in this article is substantially in effect, with only modest changes scheduled for the last five years.

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* Notes 136 & 137 are appended to chart, *infra* page 709. *Ed.*

136. I steadfastly refuse to swallow the prevailing falsehood that the current system has a top individual tax rate of 28%. *See, e.g.*, S. LIND, S. SCHWARZ, D. LATHROPE & J. ROSENBERG, FUNDAMENTALS OF CORPORATE TAXATION 53 (2d ed. 1987). The 5% surtax of I.R.C. § 1(g) (Supp. IV 1986) will place many taxpayers in the 33% bracket for 1988.

137. These dollar figures are based on a husband and wife, with two dependents, filing jointly.

TRANSITION YEARS

TAXPAYERS OTHER THAN TAXABLE BUSINESS ENTITIES		Current Law	1	2	3	4	5	6	7	8	9	10
Deductible portion of trade and business and investment interest		100%	80%	60%	40%	20%	0%					
Depreciation method		Short lives, accelerated, § 168(a)	Longer life, straight line method § 168(g)		"Schedular-economic" depreciation							
Tax rates for taxpayers in the current 33% bracket''' and above		33%, $71,900 to $192,930,''' then 28%	35% (repeal 5% surtax)	35%, $75,000 to $200,000; then 37%	35%, $75,000 to $200,000; then 38%	35%, $75,000 to $200,000 then 39%	35%, $75,000 to $200,000; then 40%					
ALL TAXPAYERS Treatment of contributions and loans to taxable business entities	STOCK and NEW DEBT	No deduction or credit Basis = cost	100% deduction (or 33% tax credit election) Basis = 0	100% deduction or 31% credit	100% deduction or 29% credit	100% deduction or 27% credit	100% deduction or 25% credit	100% ded. or 24% credit	100% ded. or 23% credit	100% ded. or 22% credit	100% ded or 21% credit	100% ded. or 20% credit
	OLD DEBT:	No deduction Basis = cost	No deduction Basis = cost									
Excise tax on first post-change sale of pre-change stock		None	10%									
TAXABLE BUSINESS ENTITIES												
Tax rate		15%, 25% and 34%	33%	31%	29%	27%	25%	24%	23%	22%	21%	20%
Treatment of borrowed and contributed funds		Not Income	Gross Income									
Deductible portion of distributions	DIVIDENDS:	0%	10%	20%	30%	40%	50%	60%	70%	80%	90%	100%
	OLD STOCK REDEMPTION:	0%	0%									
	NEW STOCK REDEMPTION:	0%	10%	20%	30%	40%	50%	60%	70%	80%	90%	100%
	INTEREST:	100%	100%									
	OLD DEBT PRINCIPAL:	0%	0%									
	NEW DEBT PRINCIPAL:	0%	100%									

Conclusion

The U.S. economy, like any other, needs a steady and strong supply of capital. Ideally, cultural norms would lead people to save a significant part of their incomes, but that does not seem to be happening. For many decades the federal government has taken the position that it should exercise its power in ways that encourage saving, investment, and business activity.

The Internal Revenue Code has long been a major tool in that endeavor. To date, it has been applied to the task rather haphazardly. Investment incentives in the Code have given enormous benefits to some investments and moderate assistance to others, while totally ignoring certain investment categories. Furthermore, extreme complexity, taxpayer burden, and administrative difficulty have been created in the process.

This article has described a truly different way to use the Code to encourage saving and investment. This alternative approach appears to combine simplicity, effectiveness, and revenue flexibility. Its Achilles heel is that it requires Congress to withdraw from the apparently fascinating role of telling Americans how to invest their money. If Congress can exercise that self-discipline, and allow market forces to lead saved dollars to the best investments, this proposed system would constitute a welcome revolution in tax policy.