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UNMASKING THE “MATCHING PRINCIPLE” IN TAX LAW

Julie A. Roin*

INTRODUCTION

WE are accustomed to believing that a taxpayer’s treatment of one transaction may determine the tax consequences of a later, related transaction. For example, the amount of gain a taxpayer recognizes upon the disposition of an asset depends on the circumstances under which the taxpayer acquired the asset and, in particular, on the basis created as a result of that acquisition.¹ We are much less accustomed to believing that the tax consequences of a transaction should be determined by *another* taxpayer’s treatment of the transaction. Most commentators are willing to acknowledge that “Congress is free to enact—and should enact—rules to the effect that the tax treatment of one party is in fact keyed to that of another in *particular types* of transactions.”² But most resist the uniform application of a “‘common law’ income-tax principle holding that the tax treatment of one taxpayer determines the tax treatment of another.”³

* Class of 1963 Research Professor of Law, University of Virginia Law School. I am grateful to Hugh Ault, Saul Levmore, and participants in the 1991 Harvard Seminar on Current Research in Taxation for their helpful comments on earlier drafts of this paper. I would also like to thank the University of Virginia Law School Foundation for its generous financial support.

¹ See I.R.C. § 1001 (1988) (defining gain from the disposition of property as “the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain”).

² Joseph M. Dodge, *The Logic of Tax: Federal Income Tax Theory and Policy* 102 (1989) (emphasis added). The Code mandates consistency between taxpayers in a number of specific situations. See, e.g., I.R.C. § 71(a) (1988) (requiring inclusion of alimony payments in gross income of payee); id. § 215(a) (allowing payor a deduction for alimony payments); id. § 102(a) (excluding gifts from income); id. § 274(b)(1) (limiting deduction for business gifts to \$25 per recipient); id. § 163(e)(1) (allowing issuer a deduction for original issue discount over life of bond); id. § 1272(a) (establishing schedule for inclusion of original issue discount in income of holder).

³ Dodge, *supra* note 2, at 102; see id. (asserting that mandatory joinder is unworkable because there are “too many parties to too many transactions involving too many taxable years for such a system to work”); Cheryl D. Block, *The Trouble With Interest: Reflections on Interest Deductions After the Tax Reform Act of 1986*, 40 U. Fla. L. Rev. 689, 700 n.34

Such opposition is understandable; it is often difficult to join all parties to a transaction for purposes of determining each one's tax liability. Moreover, requiring an absolute matching of tax consequences in all circumstances would conflict with basic features of our current income tax system, such as the co-existence of different accounting systems and the maintenance of multiple, progressive rate schedules. Yet the fact that such a principle cannot be fully implemented in all cases does not mean that examining tax rules for compliance with such a standard is a useless exercise.

In this Article, I argue that "systemic matching"—that is, relating the tax treatment of various parties in a given transaction to each other's tax treatment—should in fact be a basic tool of tax policy analysis. Though the process of matching is no panacea for all of the ills of the tax system, it can advance tax policy goals by isolating problems and the causes of perceived problems. Once isolated, these situations can either be solved or accepted as inevitable side-effects of some other tax policy decisions. Even more important, the failure to match often leads to the mistaken adoption of false solutions to non-problems, creating undesirable economic distortions.

Perhaps the easiest way to think about the matching principle is to regard it as a systemic tax benefit rule. Whereas the familiar, or "real," tax benefit rule enforces consistency in one taxpayer's treatment of a transaction over several years,⁴ the systemic tax benefit rule, or matching principle, aims for consistency in treatment of different taxpayers involved in a transaction. The combined tax effects of the transaction on such taxpayers are examined for conformity with the appropriate pattern of taxation. Because inconsistencies identified through the matching process signal the existence of a relative tax advantage or an opportunity for arbitrage, the presence of inconsis-

(1988) ("The statement in the text should not be taken to suggest that symmetrical treatment of opposite sides of a transaction should always be required."). But cf. Daniel I. Halperin, *Interest in Disguise: Taxing the "Time Value of Money,"* 95 *Yale L.J.* 506, 508 (1986) (arguing that the proper approach to these problems is "to account explicitly for the investment income from what may often be described as disguised loans").

⁴ Though a complete exegesis of the tax benefit rule is beyond the scope of this Article, in general the rule serves to create a balancing entry in a taxpayer's income calculation when necessary to overcome distortions engendered by the annual accounting principle. The rule thus ensures that a given taxpayer neither omits nor counts twice income items affected by transactions taking place in two different taxable years. See 1 Boris I. Bittker, *Federal Taxation of Income, Estates and Gifts* ¶ 5.7.1 (1981).

tencies requires explanation, if not correction. This exercise attempts to ensure that no income item or deduction is overlooked, inadvertently "drops out" of the tax system, or is accidentally included more frequently than it should be.

For example, Congress deliberately created a mismatch by excluding the value of employer-provided accident and health insurance from employees' income pursuant to § 106 of the Code.⁵ The employer's cost of providing such insurance, like other wage expenditures, is properly deductible as a business expense under § 162. In the normal course, however, this deduction would be matched by inclusion in the employee's taxable income. Section 106 eliminates this match, thereby promoting the payment of wages in the form of health insurance rather than cash.⁶ Policymakers are currently debating the effects of this mismatch and reexamining whether its benefits justify its costs.⁷

Part I further explains the matching principle by applying it to several simple transactions. Part II applies the matching principle to more complicated transactions that are often said to provide taxpayers with unreasonable tax advantages. Specifically, the analysis focuses on leveraged business entities and the ability of taxpayers to deduct interest expenses even when the corresponding interest income is earned by tax-exempt organizations, such as charities and pension funds. In Part III, the discussion returns to a less global matching

⁵ Unless otherwise stated, all references to "the Code" contained herein are to the Internal Revenue Code of 1986, as amended, codified at 26 U.S.C. [I.R.C.] §§ 1-9602 (1988 & Supp. II 1990).

⁶ The same results could be achieved, of course, by allowing taxpayers to deduct the cost of purchasing health and accident insurance for themselves and their families. There would again be a mismatch; this time, though, it would consist of treating a consumption expenditure as a business expense. In fact, the Code provides for this alternative treatment in certain circumstances. See I.R.C. § 162(l) (1988) (allowing self-employed individuals to deduct 25% of the cost of purchasing health insurance for themselves and dependents); *id.* § 213(a) (allowing itemizing individuals to deduct medical expenses in excess of 7.5% of adjusted gross income).

⁷ President Clinton has considered proposals to tax employer-paid health insurance in order to curb the spiraling health costs that may be partially attributable to this subsidy. See Susan Dentzer, *Clinton's Taxing Health Reform*, U.S. News & World Rep., Jan. 18, 1993, at 66. In addition, though few dispute the desirability of widespread health insurance coverage, which the mismatch encourages, a number of commentators have questioned whether the current set of tax incentives is the most cost-effective method of achieving that end. See, e.g., 2 Department of the Treasury, *Tax Reform for Fairness, Simplicity, and Economic Growth* 23-24 (1984).

problem that the Supreme Court recently addressed in a case involving the deductibility of parental payments to children undertaking missionary work. In each of these contexts, the matching principle provides a novel method for evaluating transactions and suggests reforms different from those contemplated by Congress, courts, and commentators.

I. THE MATCHING PRINCIPLE

This Part further explains the matching principle by drawing attention to the distinction between the tax treatment of business and consumption transactions, and with this distinction in mind, it explores the application of the matching principle to business gifts and to taxpayers who find and lose property. Analyzing the matching principle in these rather mundane contexts will prepare the reader for the more complicated applications in Parts II and III.

A. *Business Versus Consumption Transactions*

The existence of two traditional patterns of taxation makes implementation of the matching principle more difficult. The first pattern generally applies to business transactions, the second to consumption transactions. Consistency depends upon whether the combined tax consequences of a transaction fit within both an accepted and appropriate pattern of taxation. Therefore, one must determine whether the transaction should properly be viewed as a consumption or business transaction. Unfortunately, the line between the two categories of transactions is not always clear.

In business transactions, application of the matching principle requires that when one taxpayer takes a deduction, another must include the deducted amount in its income. For example, if a merchant hires a painter to paint her store for \$500, the merchant is entitled to deduct the \$500 as a business expense,⁸ whereas the painter

⁸ See I.R.C. § 162(a) (1988). The only possible glitch is if the cost of painting is treated as a capital expense. See id. § 263(a) (disallowing deductions for capital expenditures). Even in that event, however, the merchant will eventually be entitled to deduct the painting expense in the form of a depreciation deduction, see id. § 167, or as a reduction of gain upon sale of the building, see id. § 1011(a). Thus, the matching will take place, albeit after a time lag.

must ordinarily include the \$500 in income.⁹ In short, a tax liability for one party in the system should lead to an offsetting¹⁰ tax “advantage” for someone else in the system. Under this pattern, and disregarding for the moment the complexity added by the two-tier tax on corporate profits, business income is taxed once and only once, no matter how many hands it passes through. One might think of this pattern as looking for the income added at each stage of the production process.

The pattern for consumption transactions—where one party incurs what would be described in the Code as a “personal, living, or family expense[]”¹¹—differs from that established for business transactions. In consumption transactions, income is included in the tax base twice—in the hands of both the payor and the payee. For example, if I hire a painter to paint my house for \$500, the painter must include the \$500 in income¹² although I receive no deduction for my \$500 expenditure.¹³ Thus, the \$500 is, in a sense, included in my income as well.¹⁴ Another way of looking at the prevailing pattern for consumption transactions is to view it as an unfavorable variation of the business pattern.¹⁵ When my painter and I finish paying our taxes, we

⁹ The painter may have business expenditures that reduce his taxable income. Because those expenditures in turn create income for someone else, no income drops out of the system, and it is accurate to say that all \$500 paid to the painter is included in someone's income.

¹⁰ In a system with progressive rate schedules, it is unrealistic to expect that a tax disadvantage to one party will always generate an equal tax advantage to another party. However, to satisfy the matching principle, mismatches in tax rates and timing of inclusions and deductions must be explained or justified to be acceptable.

¹¹ I.R.C. § 262(a) (1988).

¹² See *id.* § 61(a)(1) (defining income as “[c]ompensation for services”).

¹³ See *id.* § 262(a) (providing that “no deduction shall be allowed for personal, living, or family expenses”). The only exception may be if the expenditure were incurred immediately prior to placing the house on the market, in which case it might be counted as an expense of the sale, reducing any profit gained therefrom. But such cases are more properly considered as business expenditures. See *Treas. Reg.* § 1.1034-1(b)(6) (as amended in 1979) (defining “fixing-up expenses” deductible from gain on sale of personal residence).

¹⁴ That is, it is included in my taxable income in the year that I receive it, unless it is received in a tax-exempt fashion. See I.R.C. § 102(a) (1988) (exempting gifts and bequests from gross income). In that case, one might argue that the taxation of the original earner of the income “substitutes” for my taxation. One could just as plausibly argue that the failure to tax the transfer to me makes such transfers a tax preferred consumption item for the transferor, thus necessitating a justification for the preference.

¹⁵ Indeed, from this perspective, the disadvantaged tax treatment accorded consumption transactions overcomes the generally perceived bias in the tax system towards consumption—the so-called “double tax on savings.” See William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 *Harv. L. Rev.* 1113, 1168-69 (1974); Department of the

will retain less money than the merchant and her painter, and the government will have more.

Generally speaking, a transaction that generates tax consequences that differ from these normal patterns will become more or less likely to take place depending upon whether the taxpayers engaging in the transaction benefit from the mismatch. Imagine, for example, that I am trying to decide whether to spend \$500 on a new couch or on a painter who will work on my house. Both projects are worth about the same amount to me—that is, I subjectively value the paint job about as highly as I value the new couch. If Congress decided that house-painting, unlike most other forms of personal consumption, should be a deductible expense, I would be more likely to hire the painter than to purchase a \$500 couch. After all, the after-tax cost of the paint job to me will be only \$335,¹⁶ whereas the after-tax cost of the couch will be \$500.¹⁷ These deviations from the normal pattern have predictable behavioral effects. The deviations will be justified if these effects are desirable, but correction will be required if they are not. Application of the matching principle identifies such mismatches, thereby identifying areas of tax law that require exploration, if not always correction.

B. Business Gifts

The case of business gifts provides an example of an unintended mismatch that required correction. Section 102 of the Code, which exempts gifts from recipients' income, has long been a part of tax law.¹⁸ Taxpayers quickly learned to combine the generosity of this

Treasury, Blueprints for Basic Tax Reform 50-51 (1977); see also Paul Craig Roberts, *The U.S. Supply-Side Revolution*, in *Tax Policy in the Twenty-First Century* 221, 226-27 (Herbert Stein ed., 1988) (decrying bias against savings due to "multiple taxation of saving[s]"). But see, e.g., James M. Bickley, *The Value-Added Tax: Concepts, Issues, and Experience*, 47 *Tax Notes* 447, 456 (1990) (stating that income effect of consumption tax would offset higher rate of return on savings).

¹⁶ Assuming a 33% marginal tax rate, the after tax cost of a \$500 paint job is \$500 minus (.33 x 500), or \$335.

¹⁷ This is true as long as the intent is to leave the couch vendor in the same position as the painter, with \$500 in taxable pre-tax income.

¹⁸ I.R.C. § 102 (1988). Indeed, "[t]he exclusion of property acquired by gift from gross income under the federal income tax laws was made in the first income tax statute passed under the authority of the Sixteenth Amendment, and has been a feature of the income tax statutes ever since." *Commissioner v. Duberstein*, 363 U.S. 278, 284 (1960). A good argument exists for claiming that § 102 violates the matching principle even in its least

provision with the deductibility of business expenditures. That is, employers began to deduct as a business expense the cost of transfers made in the context of a business but outside of an explicit quid pro quo bargain exchange. This combination of provisions caused the transferred amount to drop out of the tax system entirely, thereby improving on the tax treatment generally accorded to business expenditures.

In the most famous of these cases, *Commissioner v. Duberstein*,¹⁹ a businessman bestowed a Cadillac on another business executive who had supplied information regarding potential customers.²⁰ The two businessmen never had an explicit agreement regarding compensation for the information. Indeed, the recipient claimed that he had never expected to receive any compensation and at first declined the car.²¹ The transferor deducted the cost of the Cadillac as a business expense,²² and the question raised in the case was whether the transferee could exclude the value of the Cadillac from income as a gift under § 102 of the Code.²³ The Supreme Court decided the case against the taxpayer-transferee, finding that the transfer at issue did not meet the standard of “detached and disinterested generosity” required of gifts.²⁴ The Court, however, explicitly rejected the contention that gift treatment for a recipient was inconsistent with a transferor’s treatment of the transfer as an “ordinary and necessary” business expense, eligible for a business deduction.²⁵

problematic context, intrafamily gifts. After all, one can easily contend that the transfer of money to an object of natural bounty and affection is a form of consumption, so that the transferred amount should be included in the income of both the transferor when earned and the transferee when received. See Dodge, *supra* note 2, at 103; Henry C. Simons, *Personal Income Taxation* 56-58 (1938). However, the provision eliminates the need to deal with what would otherwise be a thorny administrative tangle—the separation of “gifts” from ordinary, intrafamily “support,” which should be nontaxable as long as the family is considered to constitute one taxable unit. See Dodge, *supra* note 2, at 103. But see Boris I. Bittker, *A “Comprehensive Tax Base” as a Goal of Income Tax Reform*, 80 *Harv. L. Rev.* 925, 946 (1967) (arguing that such concerns “are no more self-evident or compelling . . . than the reasons that led Congress to enact many of the other ‘preferences’ of existing law”).

¹⁹ 363 U.S. 278 (1960).

²⁰ *Id.* at 280-81.

²¹ *Id.* at 280.

²² *Id.* at 281.

²³ *Id.* at 279-80.

²⁴ *Id.* at 285, 291-92.

²⁵ *Id.* at 287-88.

Subsequent taxpayers frequently failed in their attempts to gain favorable treatment because of their inability to prove "detached and disinterested generosity."²⁶ Enough of these transactions took place, however, to prompt congressional action. Its first response, in 1962, was to limit the deduction for business gifts to \$25 per recipient per year,²⁷ while providing a slightly more generous limitation for employee awards.²⁸ As a result, gifts effectively became includable in the hands of the transferor rather than the transferee. In essence, a substitute tax was levied to eliminate the mismatch. Although this reform was successful in ensuring that most business gifts would be subjected to one level of tax, in the same manner as other business expenditures, it ultimately proved unsatisfactory because it allowed employers and employees to engage in rate arbitrage. That is, employers and employees structured their transfers to insure the income's taxation in the hands of the taxpayer facing the lowest marginal rate.²⁹ Furthermore, disallowing the employer's deduction had no effect on employers who, for one reason or another, would not have been entitled to claim a deduction for the gift in any case.³⁰

²⁶ See, e.g., *Russek v. Commissioner*, 20 T.C.M. (CCH) 123 (1961).

²⁷ See I.R.C. § 274(b) (1988). This provision has been revised numerous times since its original enactment in 1962 as part of Pub. L. No. 87-834, 76 Stat. 974. See I.R.C. § 274(o) (1988).

²⁸ For the current version of this provision, see *id.* § 274(j)(2).

²⁹ Generally speaking, it made sense to structure a transfer as a gift if the employer's tax rate was lower than the employee's and as salary if the employer's tax rate was higher than the employee's, as the following numerical example shows. Case 1 compares the employer's after-tax costs of a \$1000 salary payment and a gift calculated to give the same after-tax employee benefit as \$1000 in salary when the employer's marginal tax rate is 34% and the employee's is 28%. Case 2 compares the same costs when the employer's marginal tax rate is 28% and the employee's is 34%. In Case 1, providing compensation in the form of salary is cheaper, whereas providing it in the form of a gift is cheaper in Case 2.

Case 1

Form of Transfer	Benefit to Employee	Cost to Employer
Salary (\$1000)	\$720	\$660
Gift (\$720)	\$720	\$711.50

Case 2

Form of Transfer	Benefit to Employee	Cost to Employer
Salary (\$1000)	\$660	\$720
Gift (\$660)	\$660	\$653

³⁰ Such employers included both tax-exempt organizations and nonbusiness employers. In both cases, § 274(b) would fail to increase the employer's tax obligation on account of a gift, making the decision to avoid the employee-level tax costless and, hence, profitable.

Congress attempted to eliminate these remaining problems by adding § 102(c) to the Code in 1986. This provision disqualifies transfers “by or for an employer to, or for the benefit of, an employee” from the exclusion from gross income allowed by § 102(a). Thus, most transfers from employers to employees no longer qualify as gifts for tax purposes, and they must be included in the gross income of employees as if they were transfers explicitly labeled as wages.³¹ In sum, the history of legislation in the area of business gifts has been one of slow but steady drift towards implementation of the matching principle.

Although Congress has made great progress, some holes remain in the legislative scheme. Because § 102(c) applies only to transfers between employees and employers, taxpayers can continue to engage in rate arbitrage games in other transfers, such as those involving independent contractors and customers. Even in the employer-employee context, an exception to the general inclusionary rules continues to exist for certain employee achievement awards. Awards meeting detailed statutory criteria³² are both excludable from the income of employees³³ and deductible as business expenses by employers.³⁴ Further, some employer gifts presumably remain excludable from employees’ income as de minimis fringe benefits.³⁵ Thus, the ghost of *Duberstein* continues to haunt the halls of the Treasury. Nevertheless, the matching principle proves relatively easy to enforce in the business gift context. The compensatory nature of most such transfers is easy to discern, and the lack of social utility in structuring such transfers as “gifts” is equally obvious.

³¹ This generally does not lead to the double taxation of ostensible “employee gifts” because the § 274(b) limitation on the employer’s deduction applies only to gifts “excludable from gross income of the recipient under section 102.” I.R.C. § 274(b) (1988). Section 274(b)’s deduction limitation thus would not apply to transfers deemed includable in the recipients’ income as a result of § 102(c). Of course, if the employment relationship itself is considered a form of consumption by the employer—domestic help, or a personal trainer, for example—rather than a business expenditure, § 102(c) has the effect of restoring the double taxation appropriate to all consumption expenditures.

³² See I.R.C. § 274(j) (1988).

³³ *Id.* § 74(c).

³⁴ *Id.* § 274(j)(1).

³⁵ See *id.* § 132(a)(4); Treas. Reg. § 1.132-6(e)(1) (1989) (excluding “traditional birthday or holiday gifts of property (not cash) with a low fair market value; occasional theater or sporting event tickets . . . and flowers, fruit, books, or similar property provided to employees under special circumstances (e.g., on account of illness, outstanding performance, or family crisis)”).

C. Finders and Losers

In other situations, however, the application of the matching principle is more difficult. For example, suppose Jane loses a \$20 bill while walking down the street, and Mary comes along and picks it up. Not knowing or not caring who lost the bill, Mary keeps it. Theoretically, Mary is supposed to include the \$20 in income for tax purposes,³⁶ whereas Jane may not deduct her loss.³⁷ Thus a mismatch exists (double inclusion), and the normal pattern for taxing nonconsumptive transactions is violated. Several arguments suggest, however, that this mismatch ought not to be regarded as a violation of the matching principle.

The apparent double taxation can be thought of as taxation on the "wrong" taxpayer, as occurred under § 274(b). Few people in Mary's position report such windfall gains, so Jane's taxation, through the denial of a deduction for her loss, can be viewed as a substitute for the preferred and justifiable taxation of Mary.³⁸ Moreover, we might be suspicious of a deduction by Jane for "missing" money because such a claim is difficult to verify. The denial of Jane's deduction may simply express the concern that Mary does not exist or, at least, cannot be found and taxed.

Alternatively, one might argue that no mismatch exists because the transaction is more properly classified as a consumption transaction rather than a business transaction. Taxation of *both* Jane and Mary is

³⁶ Windfalls are includable in gross income as defined in § 61 of the Internal Revenue Code. See *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955).

³⁷ See I.R.C. § 165(c) (1988) (stating that individuals are allowed to deduct only those losses incurred in a trade or business, in a transaction entered into for profit, or resulting from fire, storm, shipwreck, or other casualty or theft); *id.* § 165(h)(1) (permitting casualty loss deduction only to the extent that the loss arising from the casualty exceeds \$100).

³⁸ Substitute taxation as a partial solution to violations of the matching principle has been previously discussed. See *supra* text accompanying notes 27-31 (discussing I.R.C. § 274(b) (1988)). The use of substitute taxation here is again somewhat problematic, though for a different reason. If the taxation of Jane is truly intended as substitute taxation, one would expect Mary to be relieved of her obligation to pay tax on the income. Providing such relief would not only reduce the number of technical violators of the tax code, who might then sympathize with other, less trivial violators, but also would avoid penalizing honesty. On the other hand, because business taxpayers probably can deduct such losses, one would, under the matching principle, require finders of their losses to include such amounts in income. Because finders, by definition, do not know the source of their recoveries, any rule for the taxation of recoveries would violate the matching principle in some cases. A rule that errs on the side of overinclusiveness is probably the least harmful of the two options. See *infra* text accompanying notes 39-40.

consistent with our general treatment of personal consumption expenditures. The income that supports such expenditures is taxed both in the hands of the original earner and in the hands of the transferee.³⁹ Although it is admittedly difficult to regard dropping money on the street as a form of personal consumption, it may not be wholly inappropriate to explain such losses as the implicit price of a lifestyle—that is, absent-mindedness.

Fortunately, the inability to discern whether a violation of the matching principle exists is less important in this context than in the business gifts context. This is because the consequences of a mismatch in the tax treatment of Jane and Mary are somewhere between inconsequential and desirable. To the extent a mismatch exists, it benefits the government, not the taxpayers. That is, the government collects more tax than seems appropriate under the circumstances, whereas Jane and Mary, taken together, pay too much tax. Theoretically, this gives the government an incentive to encourage individuals to drop money on the street, but it strains credulity to believe that any government would or could provide such encouragement. Thus, the long-term result of this mismatch—if it is that—is to discourage taxpayers from dropping money on the street—a result that one would have a hard time faulting.

In contrast, mismatches and inconsistencies that operate to the detriment of the government and to the benefit of taxpayers tend to create more serious distortions. For example, some mismatches allow income to drop out of the tax base altogether, as did the original treatment of business gifts, or to be taxed once, as in the case of consumption items. Over time, taxpayers learn to utilize the mismatches to reduce their tax liabilities. Because this reduction does not directly increase any other taxpayer's tax liability, no taxpayer has any incentive to interfere with such schemes. Indeed, those with the best opportunity to interfere, other participants in the income-generating transaction, are far more likely to try to obtain some of the benefits of the tax reduction for themselves through bargaining than to prevent the tax reduction from taking place. Not only does the tax base erode as more taxpayers take advantage of the "loophole," but also the

³⁹ Taxpayers may not deduct expenditures for "personal, living, or family expenses." I.R.C. § 262(a) (1988). No provision in the Code allows the recipients of such expenditures to exclude such amounts from their income.

transactions that give rise to mismatches occur more frequently than they would in a no-tax world.⁴⁰ The increase in such transactions may be undesirable even if there is no erosion of the tax base.⁴¹

It is a mismatch of this type that arguably underlies the much maligned phenomenon of the "leveraged takeover,"⁴² or more generally, the substitution of corporate debt for equity.⁴³ The way in which

⁴⁰ The growth of the fringe benefit portion of overall compensation packages provides a perfect example of this iterative process. These benefits, the cost of which are generally deductible by the employer and excludable from the income of employees, grew from an average of about 3.5% of the compensation package in 1960 to 4.9% in 1970 and 9% in 1981. James E. Long & Frank A. Scott, Jr., *The Impact of the 1981 Tax Act on Fringe Benefits and Federal Tax Revenues*, 37 *Nat'l Tax J.* 185, 185 (1984).

⁴¹ Although any tax-induced behavioral change theoretically represents a departure from preexisting equilibrium, some of these departures may be justified on normative grounds. Indeed, the favorable treatment of fringe benefits has traditionally been justified as a mechanism for inducing employers to provide, and employees to accept, socially valuable and individually undervalued forms of compensation. See, e.g., S. Rep. No. 830, 88th Cong., 2d Sess. 46 (1964), *reprinted in* 1964 U.S.C.C.A.N. 1673, 1718 (stating that purpose of life insurance exemption is to encourage employers to provide life insurance); S. Rep. No. 938, 94th Cong., 2d Sess., pt. 2, at 38-39 (1976), *reprinted in* 1976 U.S.C.C.A.N. 3439, 3474-75 (ascribing same general purpose to exclusion of prepaid legal services). Other tax-induced behaviors, however, may not serve or may even contravene the public interest. For example, excluding the value of employer-provided parking from employees' income, an administrative practice now enacted into law, Energy Policy Act of 1992, Pub. L. No. 102-486, § 1911(b), 1992 U.S.C.A.N. (106 Stat.) 3012-14 (codified at I.R.C. § 132(f)(1)(C)), has long been thought to add to air pollution and highway overcrowding by discouraging carpooling and the use of mass transit. See Donald C. Shoup, *Cashing Out Free Parking*, 36 *Transp. Q.* 351, 364 (1982); GAO Reports, *Tax Laws Encourage Driving Over Use of Mass Transit*, 57 *Tax Notes* 320 (1992). Congress may be coming around to this view as well. As of January 1, 1993, taxpayers may exclude no more than \$155 of such benefits per month. Energy Policy Act of 1992, Pub. L. No. 102-486, § 1911(b), 1992 U.S.C.A.N. (106 Stat.) 3012-14 (codified at I.R.C. § 132(f)(2)(B)). Some have argued that the allowance of a deduction for personal casualty losses—a deviation from the pattern of taxing all consumption expenditures twice, see *supra* text accompanying notes 11-15—discourages the private purchase of insurance. Instead, taxpayers rely on "free" government insurance, where the premiums in reality are paid by other taxpayers, and in the process incur more risk than they actually desire. See Louis Kaplow, *The Income Tax As Insurance: The Casualty Loss and Medical Expense Deductions and the Exclusion of Medical Insurance Premiums*, 79 *Cal. L. Rev.* 1485 (1991).

⁴² In a leveraged takeover, an investor or group of investors uses borrowed funds to purchase a controlling interest in the outstanding shares of a target corporation. Though such transactions take many forms, typically the investors establish a corporation that borrows the funds necessary to purchase the desired shares of the target. This acquiring corporation then purchases the target company's shares, after which the two corporations merge. The surviving corporation thus assumes responsibility for repaying the acquisition debt.

⁴³ Though leveraged buyouts are the most familiar method of adding debt to corporate structures, similar results can be achieved through corporate restructurings (recapitalizations), debt-financed business expansions, internal share repurchases, and extraordinary dividends.

this mismatch materializes, however, is somewhat more complicated than is generally recognized and, like the finder-loser example, raises the question of whether a mismatch exists at all. This phenomenon, along with the various congressional measures taken to remedy the apparent mismatch, is the subject of Part II.

II. LEVERAGE, CORPORATE TAX INTEGRATION, AND THE MATCHING PROBLEM OF TAX-EXEMPT INVESTORS

It is generally agreed that corporations have increasingly turned to banks and the bond market, rather than to the stock market, to raise capital.⁴⁴ This increased reliance on debt is not limited to the financing of expansions of corporate activities—there has been a wave of refinancing of existing operations with increased debt, including “junk bonds,” and less equity. These corporate acquisitions and recapitalizations have been condemned for leaving businesses and those who rely upon them susceptible to disaster even in mild recessions.⁴⁵ They have also sparked fears that the changes in capital structure will lead to “corporate cannibalism,” with parts of ongoing entities sold or liquidated in order to service or buy down heavy debt loads. Such ownership changes threaten employee security, to say nothing of the stability of the community in which the business entities are located.

Much of the blame for this phenomenon has been laid at the door of the tax system, which allegedly favors the use of debt rather than equity in corporate structures.⁴⁶ Or, to put the problem in the terms used in this Article, overleveraging is the result of failing to match interest deductions with interest income inclusions. If the value of

See Willard B. Taylor & M. Bernard Aidinoff, *Approaches to Debt: Is Integration the Answer?*, 67 *Taxes* 931, 931 (1989).

⁴⁴ See, e.g., Paul J. Robertson, Zoel Daughtrey & Daryl V. Burckel, *Debt or Equity? An Empirical Analysis of Tax Court Classification During the Period 1955-1987*, 47 *Tax Notes* 707, 707 (1990) (“Since 1983, over \$300 billion of corporate equities have been retired by nonfinancial corporations, while borrowing has increased by over \$600 billion.”); Peter C. Canellos, *The Over-Leveraged Acquisition*, 39 *Tax Law* 91, 91 (1985) (“There has been a pronounced shift from equity to debt financing in virtually all lines of business, in public as well as private companies.”). This trend may be reversing, however. See Lee A. Sheppard, *The Obstacles to Corporate Tax Integration*, 47 *Tax Notes* 1168, 1168 (1990) (“To the extent that overleveraging was a problem, the financial markets have corrected it.”).

⁴⁵ See Canellos, *supra* note 44, at 92 n.5 (listing sources of criticism).

⁴⁶ See, e.g., *id.* at 91; John D. Young, Jr., *Comment, Federal Income Tax Law: Who Really Bought RJR Nabisco?*, 25 *Wake Forest L. Rev.* 141, 141-42 (1990).

interest deductions were always offset by the tax liability incurred by interest recipients, it is argued, no incentive to leverage would exist.

The next sections point out, however, that interest deductions generated by corporate leveraging *are* matched by interest income inclusions; the problem lies in the fact that these interest inclusions often have little or no tax consequences for the recipients. Part II.A.1 explains how matching occurs and tax liability remains the same if corporate debt is held by tax-paying corporations. Part II.A.2 shows how the purchase of corporate debt by noncorporate investors, in contrast, reduces overall tax liability. Part II.B.1 shows how even greater reductions occur when tax-exempt entities purchase corporate debt. Because the apparent mismatch is thus a function of the tax characteristics of one of the parties to the transaction rather than of leveraging transactions in general, the focus of the dispute ought to be not on the presence or absence of an interest deduction, but on the justification for granting favored tax status to certain entities. The remainder of Part II explores those justifications and congressional moves to limit such entities' favorable tax treatment. In short, Part II demonstrates that situations that appear problematic because they violate the matching principle are in fact cause for concern—not for the fact of the matching principle's violation but for reasons best understood after its application.

A. Leveraged Takeovers

This Section applies the matching principle to leveraged takeovers. These transactions do not present matching problems in neutral circumstances—that is, when creditors are ordinary, tax-paying corporations. What at first appears to be a matching problem arises when creditors are noncorporate entities such as partnerships or proprietorships. Rather than a matching problem, however, the “problem” is better described as one of policing boundaries in an unintegrated tax system. Thus, the matching principle focuses the analysis on the proper policy question: whether corporations should be able to use leveraged takeovers to receive the favorable “one-tier” tax treatment that partnerships receive.

1. Neutral Circumstances

When a corporation finances its operations with debt rather than equity, it can distribute its "profits"⁴⁷ in the form of tax-deductible interest⁴⁸ rather than nontax-deductible dividends and avoid the corporate level income tax. No tax advantage results, however, if its creditors are ordinary, tax-paying corporations. The tax liability avoided by the debtor (First Corporation) is merely shifted to the creditor (Second Corporation), which has to pay tax on its interest income on a current basis.⁴⁹ The tax payable on Second's interest income should be approximately the same as the corporate income tax avoided by First's interest deductions.⁵⁰

In contrast, if Second held shares of stock in First instead of First's debt, Second's dividend income would be largely excludable from its taxable income because of the substantial intercorporate dividend exclusion.⁵¹ Moreover, what little tax Second would have to pay could be deferred, without an interest charge, by having First retain earnings rather than distribute its after-tax income each year.⁵² In

⁴⁷ For purposes of this Article, unless otherwise stated, the terms "profits" and "operating profits" are used to denote gross revenues less all costs other than interest expenses.

⁴⁸ Interest expenses incurred by a trade or business may be deducted from that business' gross income. See I.R.C. § 163(a) (1988).

⁴⁹ See id. § 61(a)(4) (including interest in the definition of gross income). Some tax savings are achieved if Second owns less than 80% of First. In such cases, a portion of the dividend distributions received by Second would be subject to tax in Second's hands, see id. § 243(a)(1) (allowing a 70% dividends-received deduction for dividends other than those received from electing, affiliated corporations), resulting in a limited amount of double taxation of that income. By receiving the dividends in the form of interest, the combination would eliminate that degree of double taxation. Thus, for example, assuming a 34% marginal tax rate, if First earned \$200 and distributed it in its entirety to Second as interest, Second would have to pay \$68 in income tax. If First were capitalized solely with equity, it would pay a tax of \$68 on that income, leaving \$132 to be distributed to shareholders. If all \$132 were distributed to nonaffiliated corporate shareholders, those shareholders would be liable for an additional \$13.46 of tax ($.34 \times (.30 \times 132)$).

⁵⁰ This statement assumes that First and Second have similar tax characteristics, an assumption that is not always borne out by the facts of a given situation. For a discussion of the problems that result when First and Second are in markedly different tax circumstances, see *infra* text accompanying notes 55-69, 80-84.

⁵¹ See I.R.C. § 243 (1988) (allowing corporations to deduct 70% or 100% of dividend income, depending on extent of ownership interest in dividend payer).

⁵² Except in the case of a few foreign corporations, see id. § 951(a)(1) (regarding controlled foreign corporations); id. § 1296 (regarding passive foreign investment companies), the Code does not require shareholders to recognize their share of a corporation's income until the corporation distributes the earnings to them outside of the corporate solution. See *Eisner v.*

short, the aggregate, after-tax income and income tax liability of the two corporations remains largely the same whether First is financed primarily by debt or by equity.⁵³ What changes is the identity of the corporation paying the tax. Hence, the decision whether to finance First with debt or equity should not be affected by tax considerations. In corporate finance terms, Modigliani and Miller's famous thesis regarding the irrelevance of a firm's debt-equity ratio⁵⁴ applies even in a world complicated by taxes.

2. *Nonneutrality: Mini-Matches and Integration*

The neutrality of the tax system collapses, however, when Second is taxed at less than the full corporate tax rate. In such cases, First and Second can generate tax savings through the transfer of income and the corresponding income tax obligation to Second by capitalizing First with debt rather than equity.⁵⁵ Such rate disparities may exist for a number of reasons. Second may be an individual or other noncorporate entity. The tax rates applicable to noncorporate taxpayers are lower than corporate tax rates in two respects. The maximum individual tax rate is lower (31%)⁵⁶ than the maximum corporate tax rate (34%).⁵⁷ Further, only corporate income is taxed twice—once in the hands of the corporation and again in the hands of its individual shareholders.⁵⁸ The judicious use of debt allows taxpay-

Macomber, 252 U.S. 189, 219 (1920) (rejecting argument that shareholders are taxable upon receipt of stock dividends).

⁵³ But see Lee A. Sheppard, *Should the Dividends Received Deduction for Portfolio Stock Be Increased?*, 47 *Tax Notes* 390 (1990) (discussing recent study alleging that recent decreases in the dividends received deduction were responsible for increasing the use of corporate debt).

⁵⁴ Franco Modigliani & Merton H. Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 *Am. Econ. Rev.* 261 (1958).

⁵⁵ The phenomenon is at one level just an assignment problem—which entity, First or Second, truly “earned” the income? That is, does First earn the income on its own equity, or is it attributable to Second’s equity, which has in turn been lent to First for use in First’s operations? The question has an air of unreality to it in light of the fact that First’s “own” equity in fact also belongs to Second, inasmuch as Second is First’s sole shareholder. Another way of looking at the difficulties of solving the problem is to realize that nothing prevents Second from carrying on First’s activities itself. Moreover, it would be possible for neither entity to exist but instead to have the individual shareholders of Second directly carry on both corporations’ activities.

⁵⁶ See I.R.C. § 1 (Supp. II 1990).

⁵⁷ See I.R.C. § 11 (1988).

⁵⁸ Dividend income is included in the Code’s definition of gross income. See *id.* § 61(a)(7). Corporate shareholders may deduct most or all of any dividend income received, depending on the extent of their ownership interest in the dividend payor. See *id.* § 243 (allowing

ers to avoid the double taxation scheme for corporate income, which is similar to the tax treatment of consumption expenditures, in favor of the friendlier one-tier, individual tax. It allows, in the words of one commentator, the “unrestricted ad hoc integration of corporate and shareholder taxation.”⁵⁹

The integration just described may not seem like much of a matching problem. After all, the interest deduction taken by First is “matched” by an offsetting income inclusion by Second. The interest payments, however, arguably are distributions of corporate profits that ought to be taxed twice. The taxpayers violate the matching principle by eliminating the inclusion at the corporate level through the use of the interest deduction. Of course, one could make exactly the same argument with respect to any expense deduction allowed First. Any time payments are made to noncorporate recipients, the effect is to reduce the amount of double-taxed corporate income.⁶⁰ Why should interest payments be singled out for special, disfavored treatment or be of special concern?

One might respond that interest, like dividends, constitutes payment for the corporation’s use of another’s capital. As functional equivalents, their tax treatment ought to be similarly equivalent. That argument proves too much, however, both because of the long history of different treatment of interest and dividends and because many other types of payments can be recharacterized as payments for one corporation’s use of another’s capital. Royalties, for example, may be characterized as payments for the use of another’s valuable asset—a patent or other form of protected information—and this value can be quantified in monetary terms. Royalties thus represent a return, be it called interest or dividends, on the monetized value of that asset. The fact that the money happens to be embodied in the form of a design or technical information rather than dollar bills prior to its transfer to the corporation does not change the fact that the corporation is essentially paying a return on the capitalized value of the transferred asset.

corporations to deduct 100% of dividends paid by a member of the same affiliated group of corporations and 70% otherwise). Individual shareholders have no comparable provision.

⁵⁹ Canellos, *supra* note 44, at 91.

⁶⁰ In fact, other countries have restricted the availability of non-interest deductions when attempting to protect their corporate income tax bases from erosion. See, e.g., *Proctor & Gamble Co. v. Commissioner*, 961 F.2d 1255, 1256-57 (6th Cir. 1992) (describing Spanish restrictions on payment and deductibility of royalty expenses by Spanish corporation to United States parent corporation).

Put differently, instead of obtaining a license for the transferred information and paying royalties on an ongoing basis, First Corporation could have borrowed money at interest from the licensor, used the loan proceeds to buy the information outright, and made interest rather than royalty payments. The royalty payments are economically equivalent to the interest payments that would have been made with respect to a loan equal to the value of the transferred information. Other types of corporate expenditures could be similarly recharacterized.

Indeed, it becomes clear that the real problem is defining the corporate tax base by differentiating the corporation's income from the income of other participants in the corporation's income-producing activities. In one sense, it is easier to perform that task for interest expenses than for many others. The fungibility of money makes the market value of money much easier to determine than the value of a patent or copyright. Overpayments of interest, unlike overpayments of royalties, are thus easy to identify. On the other hand, it is extremely difficult, if not impossible, to determine how much of a firm's capital, absent the income tax, should or would have been provided in the form of once-taxed debt rather than in the form of double-taxed equity.⁶¹ This problem is complicated by the fact that in many cases one can imagine the business as a whole being structured in noncorporate form, so that the debt-equity issue would never become relevant; one-tax treatment would be automatic.

Rather than a matching problem, then, the overleveraging "problem" is one of policing boundaries in an unintegrated tax system and, perhaps, of deciding whether such boundaries need to be policed at all. Not surprisingly, some commentators do not regard the creation of integration through leverage as a troubling phenomenon. Many believe that an integrated tax system is preferable to one that imposes two levels of tax on corporate income.⁶² These commentators can claim impressive allies; most of our major trading partners allow some

⁶¹ Though Congress authorized the Treasury Department to develop regulations differentiating between corporate debt and equity when it added § 365 to the Code in 1969, see I.R.C. § 385(a) (Supp. II 1990), Treasury has yet to issue such regulations. Indeed, after a drafting effort ended in failure in 1983, see Alvin C. Warren, Jr., *Recent Corporate Restructuring and the Corporate Tax System*, 42 *Tax Notes* 715, 718 n.18 (1989), Treasury abandoned the project entirely.

⁶² See, e.g., Charles E. McLure, Jr., *The Brookings Institution, Must Corporate Income Be Taxed Twice?* (1979); John K. McNulty, *Reform of the Individual Income Tax by Integration*

amelioration of the two-tax burden on corporate income, and some provide complete integration.⁶³

Even in the United States, Congress is best described as a partial supporter of tax integration, for it allows "unrestricted, ad hoc integration"⁶⁴ for certain types of joint business endeavors. For example, entities set up as partnerships are not subjected to income tax.⁶⁵ Their tax attributes flow through to their owners on a current basis.⁶⁶ Thus, to a very real extent, the worst that leveraged buyouts do is provide an alternate mechanism for achieving a tax status that Congress often considers a legitimate and acceptable alternative to the two-tax model for business income.

The fact that taxpayers are increasingly inclined to choose the one-tax over the two-tax model is not, in and of itself, necessarily a sign of a serious flaw in the tax system.⁶⁷ Nor is it evidence of nefarious behavior by the taxpayers involved.⁶⁸ What may be problematic,

of the Corporate Income Tax, 46 Tax Notes 1445, 1445 (1990); Alvin Warren, *The Relation and Integration of Individual and Corporate Income Taxes*, 94 Harv. L. Rev. 717 (1981).

⁶³ See Statement of Acting Assistant Treasury Secretary (Tax Policy) John Wilkins at Hearing on Leveraged Buyouts before House Ways and Means Committee, May 16, 1989, reprinted in *Daily Tax Rep. (BNA)*, May 17, 1989, at L-17, L-19:

Eight of the 12 European Community member countries use such an approach, as do Canada, Japan, Australia, New Zealand, and Finland. In Germany, Italy, Australia, and New Zealand, double taxation is completely eliminated by allowing the shareholder to receive credit for the full tax paid by the corporation. Several other countries substantially reduce double taxation; for example, in Belgium, France, Ireland, and the United Kingdom, the shareholder credit amounts to at least half the corporate tax. In Japan and Spain, the credit amounts to 10 percent of the dividends received.

⁶⁴ Cannellos, *supra* note 44, at 91.

⁶⁵ Partnerships are treated for tax purposes as conduits whose income passes through to the partners, who in turn report their respective shares of the firm's income or loss on their individual tax returns. 3 Bittker, *supra* note 4, ¶ 85.1.1, at 85-2; see I.R.C. §§ 701, 702 (1988).

⁶⁶ I.R.C. § 702 (1988).

⁶⁷ That is, unless one considers the maintenance of two, dissimilar taxing regimes for two quite similar sets of circumstances a serious flaw. One can just as easily, however, describe the situation as providing taxpayers with a choice of tax treatments, which they are free to choose between on whatever basis they desire.

⁶⁸ A recent article suggests that the imposition of a uniform, corporate level tax may solve an agency problem that arises whenever multiowner entities are treated as mere conduits for tax purposes. As different owners tend to have different tax characteristics, it is almost inevitable that at times their desires for the most tax-efficient operation of the entity will conflict—that is, one owner will desire a maximization of current income in a year in which another owner desires maximum deferral. Entity managers are then placed in the uncomfortable, but potentially profitable, position of determining which owner's tax agenda will be furthered. The separation of the entity's and owner's tax burden through the imposition of an independent corporate level tax obviates that conflict. Thus, both public and

however, is that taxpayers have selected a method of arriving at the one-level tax that is different from that intended and explicitly allowed by Congress.⁶⁹ This raises the possibility that the nontraditional method of achieving one-level taxation confers some advantages on the affected taxpayers that traditional, partnership treatment does not, and that Congress's intention is to offer these advantages at a price. It is important, therefore, to be clear as to the advantages of the corporate form.

3. *Advantages of the Corporate Form*

One traditional business advantage associated with the use of the corporate form is limited liability. But limited liability has for many years also been available for partnership investments. Limited partnerships must have at least one general partner, but nothing in the Uniform Limited Partnership Act or in the tax law prevents the general partner from being a corporate shell, with only a small investment in the partnership and with limited resources.⁷⁰ Thus, it is hard to argue convincingly that the extra layer of tax imposed on corporate income recompenses the government for the social costs of limited liability—namely, that some unpaid creditors may become entitled to government benefits or relief on account of a corporate default occur-

private purposes may be served by the establishment of a double tax system for corporate income. See Hideki Kanda & Saul Levmore, *Taxes, Agency Costs, and the Price of Incorporation*, 77 Va. L. Rev. 211 (1991). Nonetheless, nothing in this rationale for the maintenance of a two-tier tax system requires that adherence to it be mandatory. Avoiding managerial conflicts of interest is a worthy goal, but it hardly constitutes an inalienable one. Surely investors can intelligently decide for themselves whether the pursuit of such a goal is worth its price.

⁶⁹ This assumes that one regards the use of the interest deduction as somehow illicit, despite the inclusion of § 163 in the Code. See I.R.C. § 163 (1988 & Supp. II 1990). Many would doubtless argue that the continued existence of unlimited interest deductions under § 163 in most circumstances constitutes as explicit an authorization of the one-tier tax option as the relevant partnership provisions.

⁷⁰ Though the IRS and Treasury have attempted at various times to characterize such partnerships as taxable associations, they have lost each of the test cases brought on the issue. See 3 Bittker, *supra* note 4, ¶ 85.1.6, at 85-12 to 85-13. The Service recently provided a safe harbor for establishing that a limited partnership with one or more corporate general partners lacks limited liability. Revenue Procedure 89-12 states that a partnership lacks limited liability if the net worth of the corporate general partners equals at least ten percent of the total contributions to the partnership, has substantial assets, or will act independently of the limited partners. See Rev. Proc. 89-12, 1989-1 C.B. 798. For a fuller explication of this revenue ruling and related materials, see Susan P. Hamill, *The Limited Liability Company: A Possible Choice for Doing Business?*, 41 U. Fla. L. Rev. 721, 734-37 (1989).

ring in circumstances where noncorporate debtors could not so easily default. The limited partnership vehicle also offers a measure of two of the attributes traditionally associated with the corporate form—continuity of life⁷¹ and free transferability of interests.⁷²

Indeed, it seems that far from being advantaged compared to a traditional partnership, the highly leveraged corporate combination, in which Second is an individual, can be at a significant disadvantage. The primary business disadvantage is that interest payments, unlike either dividend or partnership distributions, must be made on a predetermined schedule regardless of business conditions.⁷³ This rigidity increases business risk and reduces managers' ability to respond quickly to changing business conditions. Nor is it clear that such combinations fare better than traditional partnerships from a tax perspective.

In fact, they may fare somewhat worse. For example, partnerships "pass through" all their income to their partners, who report and pay tax on those profits at their marginal rates. In a leveraged corporate structure, the interest payments distributed or deemed distributed are taxed currently to the creditors at their marginal rates. Any income that is not distributed, however, is taxed currently to the corporation at a rate higher than the highest individual marginal tax rate and subjected to tax once again in the year that it is distributed to individual shareholders.⁷⁴ In this way, some of the income earned by a leveraged corporation may be taxed at rates higher than those applicable to partnership income. Certainly any income retained for corporate expansion is so penalized. It must also be the case that corporate managers avoid interest obligations to the extent that defaults by the corporation threaten their own career stability.

On the other hand, a leveraged combination may also enjoy *more* favorable tax treatment than a partnership. Advantageous treatment occurs when the leveraged corporation uses corporate tax prefer-

⁷¹ See Hamill, *supra* note 70, at 727-28 n.34.

⁷² See *id.* at 738-39 nn.110-11.

⁷³ At least this is true whenever the debt instrument requires such payments, and the failure of a debt instrument to so provide may lead to its reclassification as equity.

⁷⁴ Any intervening corporate shareholder may deduct all or most of the dividend income pursuant to § 243 of the Code. See I.R.C. § 243 (1988); see also *supra* note 49 for an explanation of that provision's workings.

ences⁷⁵ in addition to the interest deduction to reduce its income, so that only a portion of its income is currently taxed. Although the untaxed income will eventually be taxed twice, the gains from postponing the imposition of any tax may outweigh the economic disadvantage of the eventual double tax burden. It is an empirical question, with no ready evidence, whether the amount of such disadvantaged corporate income exceeds or falls short of the income that is treated more favorably than partnership income. If such corporate tax advantages are substantial, however, the solution to the mismatch may be to cut back on those preferences rather than to restrict the interest deduction. One reason for the existence of those advantages, after all, is to mitigate the deleterious effects of the two-tier tax on corporate income. If the second tier is easy to avoid through the use of leverage, why should taxpayers be provided with yet another method of escape? Conversely, if the alternate escape method serves an independent purpose, why is it cause for concern if a taxpayer utilizes both leverage and corporate preferences?

One indication that limited partnership status is generally preferable to that of a leveraged corporate combination is that entities have migrated from the latter to the former. Indeed, Congress recognized and feared the effect of this migration on the corporate tax base.⁷⁶ Despite the fact that such transformations from the leveraged corporate form to an unleveraged partnership form would reduce, if not eliminate, the susceptibility of leveraged combinations to economic disaster—a susceptibility that is the foundation for most critics' con-

⁷⁵ It is not so much that corporations have preferences that individuals and partnerships do not, but rather that they are exempt from certain limitations on using those preferences that apply to individuals and partnerships. See, e.g., I.R.C. § 163(d)(1) (1988) (limiting deduction for investment interest “[i]n the case of a taxpayer other than a corporation”); id. § 469(a)(2) (applying disallowance to individuals, estates, trusts, closely held C corporations, and personal service corporations). Thus, corporations may reduce their taxable income below their economic income to an extent that other taxpayers may not, resulting in additional deferral of their income tax obligations.

⁷⁶ In a recent study, the Treasury Department noted a “significant[] increase[]” in the number of widely held partnerships, a phenomenon that it found “not surprising” and one that “will continue to grow.” See Treasury Department Study, *Widely Held Partnerships: Compliance and Administration Issues*, Submitted to Congress March 30, 1990, *reprinted in* 64 *Daily Tax Rep.* (BNA), Apr. 3, 1990, at L-1, L-3.

demnation of such deals⁷⁷—Congress recently made such transformations all but impossible by mandating the imposition of two-tier tax treatment on “publicly-traded partnerships.”⁷⁸ Inasmuch as it is unclear why public trading of ownership interests should lead to an increase in tax liability, it must be the case that Congress was primarily interested in stemming anticipated revenue losses.⁷⁹ The problem, however, is that the adoption of the constraint on partnerships may simply lead to the continuation of the leveraging trend—resulting in little revenue savings and generating serious bankruptcy costs.

B. Beyond Integration: Tax-Exempt Lenders

Although the use of debt to achieve integration, or one-tier taxation, may not violate any of the fundamental tenets of a sensible (even unintegrated) tax system, the use of debt to eliminate *completely* the tax on business profits seems to present a strong case for concern. This result would occur if all taxpayers leveraged to the limit and all debt were held by tax-exempt entities.⁸⁰ The matching principle sug-

⁷⁷ See Patricia L. Bryan, *Leveraged Buyouts and Tax Policy*, 65 N.C. L. Rev. 1039, 1041 (1987); Canellos, *supra* note 44, at 92 n.5 (listing articles describing concerns about business risks).

⁷⁸ See Revenue Act of 1987, Pub. L. No. 100-203, § 10211(a), 101 Stat. 1330 (codified as amended at I.R.C. § 7704 (1988)).

⁷⁹ Although one can plausibly argue that the existence of a two-tiered tax structure as an alternative in such cases makes sense, given the agency problem, see *supra* note 68, again the case for making such a structure mandatory seems less than overwhelming, particularly as applied to new accumulations of capital. Given the present rate structure with its much heavier taxation of corporate income, the identity of the alternative constituting the “lesser of two evils” is not obvious. Why should investors be deprived of the opportunity to make their own judgments on this matter?

⁸⁰ A corporation in the position of Second may not pay tax for a number of reasons. This Article discusses only one of these at length: where Second is a tax-exempt organization. For discussion of another variation, where Second is a foreign corporation, see Julie A. Roin, *Section 163(j): An International Tax Benefit Rule* (April 21, 1993) (unpublished manuscript, on file with the Virginia Law Review Association). Other possibilities that are mentioned in the literature are that Second may be a loss corporation, a bank, or an insurance company. The arguments for and against generous treatment of losses have been thoroughly discussed elsewhere. See, e.g., Mark Campisano & Roberta Romano, *Recouping Losses: The Case for Full Loss Offsets*, 76 Nw. U. L. Rev. 709 (1981); Richard L. Bacon & Nicholas A. Tomasulo, *Net Operating Loss and Credit Carryovers: The Search for Corporate Identity*, 20 Tax Notes 835 (1983); Mark Campisano & Roberta Romano, *On the Benefits of Loss Recoupment: A Response*, 21 Tax Notes 209 (1983); American Law Inst., *Federal Income Tax Project Subchapter C: Proposals on Corporate Acquisitions and Dispositions* 198-301 (1982). The “tax-free” status of banks is due to their heavy capitalization with debt—that is, they earn money through use of depositors’ funds. In a sense, banks are the original leveraged

gests that the existence of such a mismatch requires close investigation. However, such investigation reveals that here too the problem is not the lack of an offsetting income inclusion but rather the effect (or rather noneffect) of such an inclusion due to the nature of the recipient taxpayer. As the tax-exempt nature of such taxpayers results from deliberate congressional policy, the mismatch can be corrected only at the expense of that policy. As explained below, Congress has in the past appeared willing to compromise its policy of favoring tax-exempt entities in order to preserve tax revenues; a recently enacted piece of legislation appears to compromise it still further.⁸¹ Closer examination reveals that despite these appearances, little has been done to correct the "problem." Perhaps for good reason, Congress has decided to preserve the favorable treatment of tax-exempts despite its revenue implications.

1. *Aggregate Matching*

Congress has long exempted a variety of not-for-profit entities from the income tax.⁸² This exemption appears to violate the matching principle because payments that would be treated as income in the hands of ordinary recipients are "nonincome" in the hands of tax-exempt entities. Amounts deducted by payors as charitable contributions generate no corresponding, or matching, inclusions. To the extent that these transfers could be characterized as "consumption expenditures"—as they might in the case of dues paid to maintain one's place of worship—both the payor⁸³ and the recipient avoid being taxed. However, the deviations from established patterns may not be quite as complete as first appears.

combination. As long as the depositors' pay tax on their interest income, for the reasons stated in the text, it is folly to regard such arrangements as "tax-advantaged" or to consider banks to be tax exempt. Insurance companies pay little tax because of the generous rules for calculating reserves. To the extent that insurance company payouts are excluded from policyholders' income, interest payments do escape from tax. The implications of that escape are analogues to the implications for any tax exempt organization discussed in the next section.

⁸¹ See I.R.C. § 163(j) (Supp. II 1990); *infra* text accompanying notes 104-15 (describing that provision).

⁸² See I.R.C. § 501(c) (1988) (listing types of organizations qualifying for exemption from income tax). Probably the two most financially significant of these activities are public charities and pension funds.

⁸³ This assumes that the payor/transferor is entitled to a deduction under § 170, or § 404 in the case of contributions to an employee pension fund, for the amount transferred to the tax-exempt entity.

A match, albeit a remote one, occurs whenever the tax-exempt entity makes what would for taxable entities be considered "deductible" expenditures because the expenses of tax-exempt entities are not recognized as deductions any more than their revenues are taxed as income. The nondeductibility of expenditures by tax-exempt entities is often mismatched with the inclusion of these expenditures in the income of taxpayers on the receiving end of these expenditures. The overall treatment can therefore be described as one in which there are as many inclusions as deductions even though one set of deductions and income is skipped. In the aggregate the matching principle is maintained, and the total picture converges on the familiar one-tax business model.

Consider, for example, a college that raises funds to support student scholarships. A donor to this cause receives a deduction for contributions, and neither the first (the college), the second (the student), nor the third (the college, which then "collects" the scholarship money from the student) recipient includes the funds in its income. However, the employees of the college who are paid out of the tuition money generated by the scholarship pay taxes on their wages. There is, therefore, an initial deduction and an eventual inclusion, and the college and its scholarship students can be seen as harmless intermediaries between donors and instructors.

This treatment might be regarded as perfectly routine if all the transfers were labeled as "business expenditures." But the treatments seem preferential because many of the intermediate transfers more closely resemble consumption expenditures than they do business expenses. When students, or their parents, pay tuition out of earned taxable income, they are not entitled to deductions for these payments because education is generally treated as a consumption item.

Furthermore, rational, profit-maximizing businesses generally do not price their products at less than average cost, as the college granting the scholarship has done, so that the revenue foregone by the college, or transferred in the form of a scholarship, looks not like a cost of business but rather like some form of consumption. If the transactions are more consumption than business-like, then the overall picture should contain at least one more inclusion than deduction. Yet we have seen that the donor's deduction is ultimately offset only by one level of inclusion. The tax exemption available to colleges and other entities thus arguably affords consumption expenditures involv-

ing tax-exempts the more favorable tax treatment normally applied to business transactions.

In addition, tax-exempt organizations have an advantage over businesses with regard to the treatment of savings. Unexpended funds of tax-exempt entities can be accumulated and multiplied free of income tax, unlike the internally-generated capital earned by businesses. In both cases the savings are presumably intended for future expenses or expansion, but only tax-exempts can earn tax-free income on these savings without investing in tax-free municipal bonds. This advantage undoubtedly makes it easier for tax-exempt organizations to accumulate and retain capital.⁸⁴

2. *Congressional Limits on Tax-Exempt Income: The Unrelated Business Income Tax*

Congress has not, however, extended this preferential treatment to all income of tax-exempt entities. Profits derived from activities not directly related to the achievement of the entity's exempt function are subject to the unrelated business income tax, or "UBIT."⁸⁵ Under the UBIT rules, exempt organizations pay tax calculated at normal corporate income tax rates on all "unrelated business income."⁸⁶ The provision of funds for the support of an exempt function by a "feeder organization" is considered an unrelated activity. Therefore, profits from business activities otherwise unrelated to the entity's exempt function are taxed even if all of those profits ultimately finance the entity's exempt purposes.⁸⁷

The initial rationale for imposing such a tax was to prevent businesses owned by tax-exempts from deriving an unfair competitive

⁸⁴ Indeed, it was precisely the ease with which tax exempt entities could accumulate capital that led Congress to impose restrictions on their ability to accumulate capital through debt-financed investments. See S. Rep. No. 2375, 81st Cong., 2d Sess. 28 (1950), *reprinted in* 1950 U.S. Code Cong. Serv., 3053, 3081; Committee on Ways and Means, 89th Cong., 1st Sess., Written Statements by Interested Individuals and Organizations on Treasury Department Report on Private Foundations, 30, 45-52 (Comm. Print 1965). On the other hand, at least one commentator has argued that tax-exempt organizations need the tax subsidy to overcome the inherent disadvantages that they face when trying to raise capital for expansion of their tax-exempt activities. See Heury Hansmann, *The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation*, 91 *Yale L.J.* 54, 75 (1981).

⁸⁵ See I.R.C. § 511(a)(1) (1988) (imposing tax at regular rates on "unrelated business taxable income" of charitable organizations and trusts).

⁸⁶ *Id.*

⁸⁷ See *id.* § 502(a).

advantage over similar taxable businesses. Congress feared that the tax-exempt organizations would use their tax subsidies to aid their businesses, expanding them to the detriment of their competitors who are not tax-favored, rather than to finance their tax-exempt missions.⁸⁸ A subsidiary justification for withdrawing the exemption in certain cases was to protect the federal fisc from erosion through the transfer of business ownership to tax-exempts.⁸⁹

The UBIT does not, however, reach "passive" income, such as dividends, interest, royalties, and most rents.⁹⁰ Organizations can easily avoid the tax by investing their accumulated capital in assets generating those types of income rather than active business assets, often with no loss in economic return. The UBIT thus channels investments by

⁸⁸ The UBIT provisions were first enacted in 1950 in reaction to complaints about the New York University Law School's 1948 acquisition of the Mueller Macaroni Company. As N.Y.U. pleaded in court for its right under existing law to operate the macaroni company free of corporate income taxes, see *C.F. Mueller Co. v. Commissioner*, 190 F.2d 120 (3d Cir. 1951), owners of other macaroni companies pleaded with Congress to change the law to preserve their right to be free of "unfair competition" from businesses owned by tax-exempt entities. They were afraid that N.Y.U. would use its tax subsidy to create a macaroni monopoly rather than further its educational mission. Though the profits from the monopoly might eventually be used to support N.Y.U.'s educational activities, macaroni producers were afraid that the immediate consequence of Mueller's tax exemption would be the destruction of their own businesses. See Revenue Revision of 1950: Hearings Before the House Comm. on Ways and Means, 81st Cong., 2d Sess. 579-80 (1950) (statement of Rep. Dingell) ("[I]f something is not done . . . , the macaroni monopoly will be in the hands of the universities"); H.R. Rep. No. 2319, 81st Cong., 2d Sess. 36 (1950); S. Rep. No. 2375, supra note 84, at 28. Though N.Y.U. prevailed in its court case, see *C.F. Mueller Co.*, 190 F.2d at 123, its opponents prevailed in their congressional effort. See Revenue Act of 1950, Pub. L. No. 81-814, §§ 301, 331, 64 Stat. 906, 947-53, 957-59 (codified as amended at 26 U.S.C. §§ 502-514 (1988)). More recently, economists and other commentators have tried to evaluate the seriousness of the unfair competition claim. Most have concluded that it is overblown, if not totally inaccurate, because it makes more financial sense for the tax-exempt to invest in other ventures rather than to expand or to try to monopolize an existing business if the funds freed by the tax subsidy are not immediately needed to defray expenses incurred in its charitable mission. See, e.g., Boris I. Bittker & George K. Rahdert, *The Exemption of Nonprofit Organizations from Federal Income Taxation*, 85 *Yale L.J.* 299, 319-26 (1976); Henry B. Hansmann, *Unfair Competition and the Unrelated Business Income Tax*, 75 *Va. L. Rev.* 605, 609-12 (1989); Susan Rose-Ackerman, *Unfair Competition and Corporate Income Taxation*, 34 *Stan. L. Rev.* 1017, 1036-39 (1982); Comment, *Preventing the Operation of Untaxed Business by Tax-Exempt Organizations*, 32 *U. Chi. L. Rev.* 581, 591-92 (1965). At least one commentator, however, has come up with a convincing argument for the UBIT's retention on other grounds. See Hansmann, supra, at 614-23 (asserting that retention of UBIT promotes economic efficiency and preserves the corporate tax base).

⁸⁹ See S. Rep. No. 2375, supra note 84, at 31; H.R. Rep. No. 2319, supra note 88, at 36-37; Hansmann, supra note 88, at 622-23.

⁹⁰ See I.R.C. § 512(b) (1988).

tax-exempt entities into passive business interests more than it raises tax revenues. One explanation for the active-passive distinction is that passive investment creates less direct competition with for-profit entrepreneurs than does participation in active business assets. Another is that it works to dissuade tax-exempt organizations from actively managing business enterprises, because they would often be relatively inefficient and inexperienced managers of unrelated businesses.⁹¹

The law as originally written, however, imperfectly achieved the channelling function of the UBIT. For example, if the Second in a leveraged combination were a tax-exempt entity, neither First nor Second would pay any income tax on the earnings used to pay the interest due on the debt held by Second. First would get a deduction for interest paid, whereas Second would report no income on its receipt of this interest. Such income would simply drop out of the tax base altogether,⁹² even where the "debt" was functionally equivalent to "equity"⁹³ or the organization owned all the equity as well as the outstanding debt.

The best known example of a pre-UBIT "unrelated" investment is provided by the facts of *C.F. Mueller v. Commissioner*.⁹⁴ In that case, New York University could have continued to receive the income generated by the Mueller Macaroni Company, which the university owned, free of tax simply by recapitalizing the corporation to include substantial debt. If N.Y.U. held all of Mueller Macaroni's debt and equity, N.Y.U. would have received interest payments on the debt tax free, and Mueller Macaroni could have deducted the interest payments to N.Y.U.⁹⁵ This leveraged combination plan allowed a tax-exempt organization to reap the benefits of an unrelated business

⁹¹ See Hansmann, *supra* note 88, at 614-21 (outlining various efficiency objections to tax-exempt ownership of unrelated businesses).

⁹² If, however, the income was subsequently spent by the charity in a form in which it became taxable to the recipient, it will be retained in the tax base. See *supra* text accompanying notes 83-84.

⁹³ Exactly what the distinction between "debt" and "equity" means, as well as how to enforce it, has long been a subject of dispute in the tax arena. See *supra* note 61.

⁹⁴ 190 F.2d 120 (3d Cir. 1951).

⁹⁵ The scheme worked equally well if N.Y.U. "rented" the business to a "management group" for an amount equal to the group's total net profits from operation, taking into account a reasonable charge for salaries for members of the management group. This variation was, in fact, the one originally exploited by taxpayers. See H. Neil Beller, *Exempt Organizations: Taxation of Debt-Financed Income*, 24 Tax Law. 489, 490-91 (1971) (describing "bootstrap sales").

enterprise virtually free of income tax. Congress enacted the UBIT to eliminate this kind of arrangement.

Tax-exempt investors had other means of circumventing the original UBIT "one-tier tax" rule. The one-level tax on income derived from unrelated businesses could also be made to disappear when (1) the business generated "rents" for a tax-exempt Second;⁹⁶ (2) the business profits could be attributed to intellectual property owned by a tax-exempt Second and, hence, be distributed to it in the form of

⁹⁶ See I.R.C. § 512(b)(3) (1988) (excluding rents from real property from the definition of gross income derived by an organization from an unrelated trade or business). The predecessor to leveraged combinations utilized this statutory exemption. In a transaction called a *Clay Brown* or "bootstrap acquisition":

The exempt middleman purchases the selling corporation's stock, liquidates the corporation, and pays a stipulated amount of the liquidated assets to the sellers as a down payment. The exempt organization then forms a new "operating company" (typically with nominal capitalization) that is put under the control of either the sellers or trusted associates. The operating company leases the assets of the liquidated corporation from the exempt middleman in exchange for a "rental" that is based upon the net profits generated by the operating company (typically 80 percent). The exempt middleman in turn pays a fixed percentage of such "rent" (typically 90 percent) to the sellers in satisfaction of either a note bearing no interest or other similar obligation securing the purchase price of the stock.

Beller, *supra* note 95, at 491. The term *Clay Brown* originates from *Commissioner v. Brown*, 380 U.S. 563 (1965). Like leveraged combination arrangements, these transactions allowed most of the business's profits to be distributed to the tax-exempt party in a nontaxable form, with the distribution taking the form of rent rather than interest. However, *Clay Brown* conferred an additional advantage on the sellers—namely, that all the payments that the sellers received on their note would be treated as capital gains, which were taxed at favorable rates in that period. *Id.* at 491-92. Much of the advantage from capital gains treatment was eliminated by the addition to the Code in the early 1960's of depreciation recapture and imputed interest provisions. *Id.* at 496. Congress further cut back on the usefulness of the *Clay Brown* technique with a series of statutory changes in which it narrowed the UBIT rental exception. The rental exception now applies only if the amount of rent payable does not depend on the income or profits derived by any party from the leased property, see I.R.C. § 512(b)(3)(B)(ii) (1988), and if an "incidental" amount of the rents are attributable to personal, rather than real property. See *id.* § 512(b)(3)(A); Treas. Reg. § 1.512(b)-1(c)(2)(ii) (as amended in 1981) (defining incidental as no more than 10%); see generally 4 Bittker, *supra* note 4, ¶¶ 103.3-103.4, at 103-14 to 103-21 (discussing limitations placed by Congress on rental exceptions, and analyzing the inclusion of debt-financed income in the unrelated business income tax). The final blow came with enactment of § 514 of the Code, which includes an exempt organization's gross income from "debt-financed property" in its unrelated business income, whether the receipt is characterized as rent, interest, capital gain, or otherwise. See I.R.C. § 514 (1988); Beller, *supra* note 95, at 489. This provision reaches the elaborate variations on the *Clay Brown* theme that might otherwise escape the statutory net. See 4 Bittker, *supra* note 4, ¶¶ 103.3-103.4, at 103-21.

“royalties”,⁹⁷ or (3) the business profits could be donated to a tax-exempt Second after being earned by a taxable entity or individual, which then took a deduction for the value of the donation.⁹⁸ The leveraged combination technique was, however, by far the most powerful technique for avoiding tax. The other mechanisms succeeded only in limited factual situations or, in the case of mechanism (3), were constrained by limitations on the deductibility of charitable contributions.⁹⁹

In any event, Congress could not and did not allow such easy escapes from the UBIT. In 1969,¹⁰⁰ Congress amended the Code to provide that the passive income exception to the UBIT would not operate in the case of “interest, annuities, royalties, and rents” derived from any organization “controlled” by a tax-exempt entity.¹⁰¹

⁹⁷ Royalties, like rents, are excluded from the UBIT tax base. See I.R.C. § 512(b)(2) (1988) (excluding “all royalties (including overriding royalties) whether measured by production or by gross or taxable income from the property”).

⁹⁸ The Code limits charitable deductions to a set percentage of the taxpayer’s adjusted gross income. The precise percentage allowed depends on the type of taxpayer, the type of property donated, and certain characteristics of the charitable donee. See id. § 170(b) (detailing percentage limitations). Amounts donated in excess of this deductible amount may be carried forward and claimed as a charitable deduction in any of the five succeeding years, to the extent allowable under the limitation rules in effect for those years. See id. § 170(d). Taxpayers may not claim a deduction for any excess amounts that are not deducted within this five-year period, and such a taxpayer is treated as if it had never made such donations.

⁹⁹ Although individuals and corporations may donate as much of their income to charity as they please, deductions for those donations are limited to specified percentages of their adjusted gross income. See id. § 170(b) (establishing percentage limitations). Furthermore, although taxpayers may avoid taxes on the entirety of their business income if they have enough income from other sources, they may not use the charitable deduction to avoid the entirety of their income tax obligation.

¹⁰⁰ This is the same year in which Congress moved to shut down *Clay Brown* transactions. See supra note 96. This is not to imply that Congress had never before imposed restrictions on the tax-exempt privileges of tax exempt entities. An earlier, flawed version of the *Clay Brown* legislation (affecting certain rental income) had been enacted in 1950. See 4 Bittker, supra note 4, ¶ 103.4, at 103-16 to 103-18 (describing legislation and avoidance opportunities). Moreover, Congress had always included a limitation on the percentage of income a donor might deduct on account of charitable deductions, thus potentially subjecting larger donations to tax in the hands of the donor. See Don Fullerton, Tax Policy Toward Art Museums, National Bureau of Economic Research Working Paper No. 3379, at 10-11 (1990) (recounting American history of deductions for charitable contributions).

¹⁰¹ See Tax Reform Act of 1969, Pub. L. No. 91-172, § 121(b), 83 Stat. 487, 537-40 (codified at I.R.C. § 512(b)(13) (1988)). “Control” is defined by reference to the standards found in I.R.C. § 368(c). See I.R.C. § 512(b)(13) (1988). Hence, the exception to the passive income exception to the UBIT rules applies in the case of income paid by entities 80% or more of whose stock is held by the tax exempt entity. See id. § 368(c).

Specifically, the proportion of such income equal to the proportion of the payor's (First's) income that is unrelated business income is included in the payee's (Second's) "unrelated business gross income" if Second controls First.¹⁰² A tax-exempt Second may take appropriate deductions, but must then pay tax on the remaining income at regular corporate rates.

In the N.Y.U. case, for example, the proportion of the interest payments received by N.Y.U. from Mueller equal to the proportion of Mueller's income that constitutes "unrelated business income," presumably 100%, would be treated as unrelated business income in the hands of N.Y.U. With all of the interest income being subject to the unrelated business income tax in the hands of Second (N.Y.U.), there is no gain to N.Y.U. from holding any of Mueller's debt. Indeed, the tax liability remains about the same whether N.Y.U. holds only stock in Mueller¹⁰³ or simply owns and operates the assets of Mueller's directly. Furthermore, in both cases the tax bite is greater than if N.Y.U. passively invests the same sum in bonds issued by unrelated companies.

3. *Expanding Support for the UBIT: The Enactment of § 163(j)*

Twenty years after the 1969 UBIT reforms, Congress enacted another statute, codified as § 163(j), which seems to reinforce the UBIT. Coming as it did in the middle of the controversy over leveraged takeovers, this statutory reform may also be viewed as an attempt to curb tax-exempt entities' involvement in those transactions.¹⁰⁴ But like the original UBIT provisions, this new statute is

¹⁰² See *id.* § 512(b)(13).

¹⁰³ The exception to the UBIT passive income exception does not apply to dividend income, presumably because such income has already been subjected to one full level of corporate tax. Congress apparently determined that avoiding the second level of tax—that is, achieving integration—was acceptable.

¹⁰⁴ But cf. New York State Bar Association Tax Section Committee on U.S. Activities of Foreign Taxpayers, Report on Section 163(j) of the Internal Revenue Code, 47 Tax Notes 1495, 1496 (1990) (suggesting that § 163(j)'s application to tax-exempts was a Congressional attempt to avoid antidiscrimination provisions of international tax treaties yet target foreign taxpayers—the real purpose of the provision). Including domestic tax-exempts within the scope of the provision allowed Congress to argue that it was merely treating "similarly situated persons similarly," Revenue Reconciliation Act of 1989, Statement of the Managers, Standard Fed. Tax Rep., Nov. 22, 1989, at 67, after determining "which persons are similarly situated . . . by reference to the U.S. tax those persons do or do not bear on interest income from U.S. corporations." *Id.* at 68. This comparison convinced Treasury, which withdrew its opposition

unlikely to have much effect on tax revenues—or on the proclivity of tax-exempts to participate in corporate leveraging transactions.

Under § 163(j), certain corporations are denied deductions for “disqualified interest paid or accrued by such corporation during such taxable year.”¹⁰⁵ Only corporations with a debt to equity ratio in excess of 1.5 to 1¹⁰⁶ and “excess interest expense”¹⁰⁷—that is, a net interest expense in excess of 50% of adjusted taxable income¹⁰⁸—are affected by the disallowance. Most importantly, the disallowance, in turn, applies only to excess interest¹⁰⁹ paid to an entity “related” through a 50% or greater ownership stake¹¹⁰ and in whose hands the interest is exempt from income tax.

In one respect § 163(j) is more limited in its reach than the 1969 reforms because it affects only payments of interest¹¹¹ between related entities. Unlike the original statute, payments of annuities, royalties,

to the bill—or, at least, supported the claim that the statute was nondiscriminatory after its enactment. See Letter from Kenneth W. Gideon, Assistant Secretary (Tax Policy), U.S. Department of Treasury, to Keijiro Koyama, Managing Director, Keidanren (January 22, 1990) (on file with the Virginia Law Review Association). Others still have their doubts. See Richard L. Doernberg & Kees van Raad, *The Legality of the Earnings-Stripping Provision Under U.S. Income Tax Treaties*, 2 *Tax Notes Int'l* 199 (1990) (arguing that § 163(j) violates nondiscrimination provisions in tax treaties).

¹⁰⁵ I.R.C. § 163(j)(1)(A) (Supp. II 1990).

¹⁰⁶ Id. § 163(j)(2)(A)(ii); see also id. § 163(j)(2)(C) (defining “ratio of debt to equity”).

¹⁰⁷ Id. § 163(j)(2)(A)(i).

¹⁰⁸ Id. § 163(j)(2)(B). “Adjusted taxable income” means the taxable income of the taxpayer computed without regard to any deduction for net interest expense; any net operating loss deduction; or any depreciation, amortization or depletion expenses. Id. § 163(j)(6)(A). “Excess interest expense” is decreased by any “excess limitation carryforward,” id. § 163(j)(2)(B)(i)(II), which is the amount by which the corporation’s interest expense fell short of the “excess interest expense” cut-off in the three preceding years. Id. § 163(j)(2)(B)(ii)-(iii). For example, if Mueller Macaroni paid \$25 in interest on pre-interest earnings of \$100 in 1989 and \$75 in interest on pre-interest earnings of \$100 in 1990, it would have no “excess interest expense” in 1990 because its \$75 expense does not exceed 50% of \$100 plus the \$25 of “excess limitation carryforward” it is allowed from 1989.

¹⁰⁹ The disallowance applies to “disqualified interest” which, technically speaking, consists of any interest paid “to a related person if no tax is imposed by this subtitle with respect to such interest.” Id. § 163(j)(3)(A). However, § 163(j)(1)(A) also provides that “[t]he amount disallowed under the preceding sentence shall not exceed the corporation’s excess interest expense for the taxable year.”

¹¹⁰ Id. § 163(j)(4)(A) (cross-referencing §§ 267(b) and 707(b)(1)).

¹¹¹ The new rule takes effect only when the interest payor’s ratio of debt to equity (calculated in accordance with enumerated statutory rules) exceeds 1.5 to 1, see id. § 163(j)(2)(A)(ii), and only to the extent that the interest itself exceeds 50% of the payor’s adjusted taxable income “plus any excess limitation carryforward.” Id. § 163(j)(2)(B)(i)(II).

and rents are not addressed by § 163(j).¹¹² However, it is also more expansive than earlier law because it affects transactions between less closely related Firsts and Seconds. The pre-1989 restrictions applied whenever one of the entities “controlled” or owned at least 80% of the other entity.¹¹³ The new legislation applies whenever the entities are linked by a 50% or greater ownership interest.¹¹⁴ Also, unlike the 1969 reforms, § 163(j) has the effect of levying additional taxes on the interest payor (First) rather than the on the interest recipient (Second).¹¹⁵

These differences could have undesirable effects if § 163(j) were ever to apply to an actual tax-exempt entity. One side-effect of its peculiar structure, unlike the 1969 reforms, is to deflect some of the cost of the additional tax on to “innocent” co-investors in the enterprise.¹¹⁶ Because, by definition, § 163(j) comes into effect in the tax-exempt entity context only when substantial outside ownership interests in First exist, this side-effect can be substantial. If 20% or less of First is owned by shareholders who are unrelated to Second, payments of interest by First will be taxable in Second’s hands under the statutory rules enacted in 1969.¹¹⁷ The disallowance mandated by § 163(j) applies only to interest paid or accrued to a related person “if no tax is imposed by this subtitle with respect to such interest.”¹¹⁸ Thus, § 163(j) will never mandate a disallowance of an interest

¹¹² Cf. I.R.C. § 512(b) (1988) (excluding annuities, royalties, and rents).

¹¹³ Id. § 512(b)(13) (referencing § 368(c)).

¹¹⁴ The legislation applies to certain payments of interest made to a “related person.” See I.R.C. § 163(j)(3)(A) (Supp. II 1990). The term “related person” is defined by reference to §§ 267(b) and 707(b)(1) of the Code, both of which use 50% ownership as the test of relatedness between taxpayers. See id. § 163(j)(4)(A); I.R.C. §§ 267(b), 707(b)(1) (1988).

¹¹⁵ The operative provision prevents the interest payor from deducting any “disqualified interest.” See I.R.C. § 163(j)(1)(A) (Supp. II 1990). “Disqualified interest” is interest which: (1) is paid or accrued by the taxpayer to a related tax-exempt person, see id. § 163(j)(3)(A); (2) when added to the payor’s other interest expenses for the year, exceeds 50% of the payor’s adjusted taxable income, which is calculated without reference to the interest deduction and certain other allowable deductions, see id. § 163(j)(6)(A); and (3) is paid or accrued in a year in which the payor’s debt-equity ratio exceeds 1.5 to 1, see id. § 163(j)(2)(A). As a result, the payor’s taxable income becomes higher than it would be in the absence of the provision, leading to a higher income tax obligation. For an example of this section in operation, see *infra* text accompanying notes 119-34.

¹¹⁶ For a more complete discussion of this phenomenon, see Roin, *supra* note 80.

¹¹⁷ See I.R.C. § 512(b)(13) (1988).

¹¹⁸ I.R.C. § 163(j)(3)(A) (Supp. II 1990) (defining “disqualified interest”); id. § 163(j)(1)(A) (disallowing deduction of certain “disqualified interest”).

deduction unless more than 20% of First is held by unrelated shareholders. In such a case, more than 20% of the costs of the disallowance will be absorbed by innocent shareholders.

By way of illustration, suppose that N.Y.U. owned only 60% of Mueller and that 40% was owned by unrelated, taxable entities. Suppose also that two-thirds of Mueller's capital, say \$20,000, was provided in the form of debt bearing interest at 10% and held by its shareholders in proportion to their stockholdings. If Mueller's pre-tax, pre-interest gross income was \$3,000 in the year prior to enactment of § 163(j), the tax consequences would be as follows: Mueller would distribute \$2,000 of its \$3,000 earnings to its shareholders as interest and retain the remainder. Of the distributed \$2,000, N.Y.U. would receive \$1,200 net of tax, and the other creditors would receive \$528 after paying taxes of \$272.¹¹⁹ Of the retained \$1,000, \$340 would go to the government in taxes and \$660 would be left to be distributed to the shareholders, either in the form of dividends or additional proceeds on the sale of the underlying stock. Of this amount, \$396¹²⁰ would go to N.Y.U. and \$264¹²¹ would go to the other shareholders, who would be left with about \$237 after paying \$26.92 in additional taxes, assuming the distribution took the form of a dividend.¹²² Thus, N.Y.U. would enjoy \$1,596,¹²³ the other shareholders \$765,¹²⁴ and the Treasury \$639 of Mueller's earnings.¹²⁵

In contrast, after § 163(j)'s enactment, Mueller would be deemed to have \$500 of excess interest.¹²⁶ Thus, despite the fact that it will retain only the same \$1000 after paying its interest obligations, Muel-

¹¹⁹ $.34 \times \$800 = \272 . This assumes a 34% tax rate.

¹²⁰ $.60 \times \$660 = \396 .

¹²¹ $\$660 - \$396 = \$264$.

¹²² If the other shareholder were an unrelated corporation, it would be entitled to deduct 70% of the \$264 dividend ($.70 \times \$264 = \184.80) from its income. See I.R.C. § 243(a)(1). Thus, only \$79.30 would be included in the corporation's income from the dividend ($\$264 - \$184.80 = \$79.20$), generating a tax of \$26.92 ($.34 \times \$79.20 = \26.92).

¹²³ $\$1200$ (interest) + $\$396$ (dividends) = $\$1596$.

¹²⁴ $\$528 + \$237 = \$765$.

¹²⁵ $\$272$ (taxes levied on interest received by the taxable shareholders) + $\$340$ (corporate taxes levied on Mueller's taxable income) + $\$26.92$ (taxes on levied the dividends received by the taxable shareholders) = $\$639$.

¹²⁶ Five-hundred dollars is the amount by which Mueller's interest payments exceed one-half of its "adjusted taxable income," within the meaning of § 163(j)(6)(A). Under the assumed facts, Mueller also violates the 1.5 to 1 debt-equity safe harbor of § 163(j)(2)(A).

ler's taxable income would be \$1,500.¹²⁷ This income would generate a corporate tax liability of \$510,¹²⁸ leaving retained earnings of \$490.¹²⁹ Of this amount, \$294¹³⁰ would be attributable to N.Y.U. shares and \$196—about \$176 after shareholder taxes are taken into account—to the shares of other stockholders. N.Y.U.'s implicit tax obligation on account of § 163(j) would be \$102,¹³¹ while the other "innocent"¹³² shareholders would pay \$61¹³³ of the additional \$163¹³⁴ tax liability created by operation of § 163(j).

This problem of imposing a tax burden on innocent bystanders may merely be a transitional issue. The affected parties may be able to force the corporation either to reduce the leverage or to transfer ownership interests in the corporate debt to unrelated persons.¹³⁵ In some cases they may achieve a combination of these antidotes. In any event, a transfer of the debt to unrelated persons undoubtedly

¹²⁷ The interest disallowed as a deduction is the lesser of the amount of "disqualified interest," which in this case is \$1200, and the "excess interest" of \$500. See I.R.C. § 163(j)(1)(A) (Supp. II 1990).

¹²⁸ $.34 \times \$1500 = \510 .

¹²⁹ $\$1000 - \$510 = \$490$. This is the proper calculation because all but \$1000 will have been distributed as interest.

¹³⁰ $.60 \times \$490 = \294 .

¹³¹ $\$1596$ (total after-tax receipts of the year before enactment of § 163(j)) - $\$1494$ (receipts after enactment) = $\$102$.

¹³² The unrelated shareholders of Mueller are "innocent" because there is no more reason to believe that they profited from N.Y.U.'s tax exemption than to believe that Mueller Macaroni directly profited from N.Y.U.'s tax exemption after enactment of the UBIT. To escape both regular corporate tax and the UBIT, Mueller's profits had to be distributed to the tax-exempt shareholder, N.Y.U. The tax benefit—that is, the tax exemption—followed from the treatment of this income in N.Y.U.'s hands, not Mueller's. Though N.Y.U. could reinvest this tax-favored money in Mueller, no reason exists for it to do so in a manner directly benefiting other Mueller shareholders—not when N.Y.U. could obtain all the benefits itself through exchanging the additional sums for additional share or debt instruments of Mueller. Moreover, N.Y.U. has another, equally attractive option for investment of its money: it could invest its tax favored gains in other, unrelated companies, perhaps even as a portfolio investor. It would again enjoy the entirety of the tax benefit allowed with respect to the resulting income. Indeed, N.Y.U. would certainly follow this latter course if it had to share the benefits of its additional investments in Mueller with unrelated shareholders—unless Mueller, tax benefits aside, is super-profitable.

¹³³ $\$765 - \$704 = \$61$.

¹³⁴ $(.34 \times \$500)$ (additional taxes paid by Mueller) - $(.34 \times (.70 \times \$68))$ (decrease in dividend taxes paid by taxable shareholders on account of their reduced dividend) = $\$163$.

¹³⁵ An additional response may be for the tax-exempt entities to restructure the interest obligations as royalties or rents, neither of which are covered by § 163(j). Presumably, if this became a widely-used escape, Congress would amend § 163(j) to function like § 512(b)(13) and include all three categories of payments. See I.R.C. § 512(b)(13) (1988).

increases business risks,¹³⁶ which in turn may compel a decline in leverage in an effort to bring those risks down to a more acceptable level. Only such a reduction in leverage *necessarily* increases tax revenues. The effect of transferring the debt interests to unrelated persons depends on whether the unrelated purchasers of the debt are taxable or tax-favored entities.¹³⁷ If N.Y.U. sells its debtholdings in Mueller to Columbia University, for example, the interest on those bonds will continue to be both deductible to Mueller, eliminating its corporate tax liability, and nontaxable in the hands of the recipient (Columbia). The mismatch will remain.

Though tax revenues may not increase, the behavioral effects of § 163(j) may still prove advantageous for the same reasons that the UBIT is advantageous. The recent interest deduction disallowance, like the 1969 reforms, should reinforce the channeling effect of the UBIT by forcing an even wider dispersion of equity and debt interests in active businesses. Penalizing tax-exempt entities for owning both share and debt holdings in a single entity encourages them to diversify their holdings, resulting in a reduction of their control over each entity in which they invest. N.Y.U.'s control over Mueller would be weakened if Columbia held all of Mueller's debt. This dispersion of control may lead to third-party control, and this third party might be skilled in managing pasta rather than students. Such a result will not raise additional revenue for the government, nor will it advance the matching theme, but the change in control may lead to a better managed, and more competitive, firm.

Its advantages, however, would have to be compared to the disadvantages of increased business risk created by such diversification of interests. This same beneficial result could be achieved without running the risk of injuring innocent bystanders even temporarily by expanding the UBIT to cover interest payments received by related, highly leveraged entities. Any tax-exempt entity with enough shares

¹³⁶ Both the risk of default and the risks associated with the occurrence of default—strategic game-playing and its inevitable transactions costs—increase as the debtholders' interests diverge from those of the shareholders. Obviously, those interests are more likely to diverge when the shareholders and debtholders are different persons than when they are the same. The belief that debt levels are higher when the lenders and debtor are related is undoubtedly behind the earnings-stripping provisions as currently structured. However, the legislation affects much more than just this "higher" amount.

¹³⁷ Section 163(j) has no effect on the deduction allowed for interest payments to unrelated creditors, no matter how highly leveraged the interest payor is.

to fall within the definition of "related" would surely have access to the financial records of the business necessary to determine if the required degree of leverage existed.

Congress may, however, have intended not the dispersal of ownership of businesses but the raising of revenue by way of a reduction in the tax benefits provided to tax-exempt entities. If so, it is likely to be disappointed by the limited effects of these statutory changes. In order to raise revenue, Congress will have to go much further and amend the Code to levy UBIT on all interest, rents, and royalties paid to tax-exempt entities out of unrelated business income, regardless of whether there is a relationship between the payor and payee. Once it has done so, Congress will have to come to grips with the remaining impact of the deduction for charitable contributions contained in § 170.

If Congress makes all passive income of tax-exempts taxable as unrelated business income, the only way such entities will be able to receive unrelated business income tax free is through contemporaneous donations. Only in that situation will the profitable mismatch continue to exist. One profound effect of such a policy may be that tax-exempt entities will learn to emphasize yearly donations rather than contributions to endowments. The effects of such a change are difficult to predict or evaluate in normative terms,¹³⁸ but they surely would be significant.

In short, a Code that is true to the matching principle could have profound consequences for the structure and size of tax-exempt entities. On its own, however, § 163(j)'s limitation on interest deductions will not have any more of an impact than did the 1969 reforms because, once again, the problem is not the interest deduction. It is, rather, the specifics of the tax-favored status of certain taxpayers.

III. THE MATCHING PRINCIPLE AND INDIRECT CONTRIBUTIONS TO CHARITY

The allowance of a deduction for charitable contributions necessarily creates mismatches because such deductions are "matched" by income inclusions that, due to the identity of the recipient, are not

¹³⁸ This is particularly true in view of the fact that the reasons charitable entities maintain endowments is somewhat mysterious. See Henry Hansmann, *Why Do Universities Have Endowments?*, 19 *J. Legal Stud.* 3 (1990).

recognized by the tax system. These mismatches provide yet another congressional subsidy for qualifying organizations. As explained below in Part III.A., the boundaries of this mismatch must be policed to ensure that only qualified parties take advantage of it. Part III.B. examines a recent case that represents an attempt to do just that, *Davis v. United States*.¹³⁹ As explained in that Part, though the Court eventually arrived at the correct decision in the case, the Court seemed to do so out of an irrational objection to the mismatches themselves although these occur quite legitimately every day. In the process, it all but avoided discussing what should have been the central feature of the case. Part III.C. examines this issue—the benefits of intermediary control over charitable contributions—in detail before concluding that the outcome of the *Davis* case was indeed correct.

A. *Self-Interested Charitable Contributions*

The tax exemption provided to not-for-profit entities can also violate the matching principle by allowing consumption transactions to be taxed in accordance with the more favorable pattern that is generally reserved for business transactions. Because many of the consumption items provided by tax-exempt entities are regularly purchased on the private market with after-tax funds, it should come as no surprise that taxpayers sometimes misuse tax-exempt entities to obtain desired consumption items with pre-tax funds.

For example, instead of paying higher tuition to a private school, parents of students might periodically “donate” sums to meet “extraordinary” expenses incurred by the school.¹⁴⁰ Similarly, a taxpayer might contribute funds to be used to aid designated needy persons in the community—one of whom happens to be a retired domestic employee of the taxpayer and whom the taxpayer would otherwise feel morally obliged to assist.¹⁴¹ Moreover, donors may

¹³⁹ 495 U.S. 472 (1990).

¹⁴⁰ This ploy does not always work. See, e.g., *Fausner v. Commissioner of Internal Revenue*, 55 T.C. 620, 624 (1971) (holding that payments to parochial schools attended by taxpayer's children are not “acts of detached and disinterested generosity”), separate holding *aff'd.*, 472 F.2d 561 (5th Cir.), *aff'd.*, 413 U.S. 838 (1973); *Winters v. Commissioner*, 468 F.2d 778, 780-81 (2d Cir. 1972) (holding the same); Rev. Rul. 79-99, 1979-1 C.B. 108.

¹⁴¹ Again, the taxpayer who tries to do this may be challenged by the Service. However, at least one such taxpayer has prevailed in federal court. See *Havemeyer v. Commissioner of Internal Revenue*, 98 F.2d 706 (2d Cir. 1938) (holding that contributions to association for the benefit of elderly family retainers are deductible).

seek to influence operational decisions of a tax-exempt entity so that those operations fulfill the needs of the entity as well as pecuniary demands that would otherwise be imposed on the donor. A donor may try to donate money for an additional staff position on the condition that some unemployed relative be hired to fill it. It is equally unsurprising that tax law attempts to block such maneuvers. Congress is willing to give financial benefits to reward altruistic behavior that might otherwise be undersupplied, but it has no intention of granting tax benefits to reward essentially selfish behavior.¹⁴²

One way in which Congress has attempted to foil taxpayer plots designed to exploit the charitable deduction¹⁴³ has been to require that donations be made to registered charitable entities rather than to individual recipients of charitable beneficence or to defray particular expenses incurred by the organization.¹⁴⁴ This requirement utilizes

¹⁴² See H.R. Rep. No. 1860, 75th Cong., 3d Sess. (1938), *reprinted in* 1939-1 (Part 2) C.B. 728, 742:

The exemption from taxation of money or property devoted to charitable and other purposes is based upon the theory that the Government is compensated for the loss of revenue by its relief from financial burden that would otherwise have to be met by appropriations from public funds, and by the benefits resulting from the promotion of the general welfare.

If a taxpayer would have made the transfer in any case as a result of private considerations, no financial burden on the Government would have existed to be relieved, and the justification for the tax deduction disappears. See also 61 Cong. Rec. 5294 (1921) (statement of Rep. Green) ("The gifts must be made exclusively for public purposes."); *Thomason v. Commissioner of Internal Revenue*, 2 T.C. 441, 443-44 (1943) ("Charity begins where certainty in beneficiaries ends . . . Whenever the beneficiary is designated by name and his merit alone is to be considered, the bequest is private and not public and ceases to have the peculiar merit of a charity.").

¹⁴³ This term refers to the deduction allowed by § 170 of the Code. Technically, § 170 allows deductions for contributions to states, political subdivisions of states, or the federal government "for exclusively public purposes," organizations "organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes," veterans' organizations, and certain cemetery organizations. I.R.C. § 170(c) (1988).

¹⁴⁴ See *id.* (providing that "the term 'charitable contribution' means a contribution or gift to or for the use of" qualified organizations). The regulations back up this statutory command by requiring donors to maintain written records, which may be required to be attached to the donor's income tax returns, detailing:

The terms of any agreement or understanding entered into by or on behalf of the taxpayer which relates to the use, sale, or other disposition of the property contributed, including for example, the terms of any agreement or understanding which—

- (1) Restricts temporarily or permanently the donee's right to use or dispose of the donated property,
- (2) Reserves to, or confers upon, anyone (other than the donee organization or an organization participating with the donee organization in cooperative fundraising) any right to the income from the donated property or to the

the entities as monitors.¹⁴⁵ The necessity of the interposition of the charitable entity between donor and eventual recipient was recently reaffirmed by the Supreme Court in *Davis v. United States*.¹⁴⁶ The Court did so, however, for reasons that are at best misleading and at worst wrong. Though the erroneous reasoning did not prevent the Court from reaching the right result in the *Davis* case, similar errors might have harmful consequences in the future.

B. *Davis and Indirect Charitable Payments*

In *Davis*, the Supreme Court resolved an intercircuit dispute regarding the deductibility of payments made by Mormon¹⁴⁷ parents to support their children during a term of missionary service.¹⁴⁸ The

possession of the property, including the right to vote donated securities, to acquire the property by purchase or otherwise, or to designate the person having such income, possession, or right to acquire, or

(3) Earmarks donated property for a particular use.

Treas. Reg. § 1.170A-13(b)(2)(ii)(G) (as amended in 1990). Thus, should a donor try to earmark a contribution to be used to hire a hapless relative or support an indigent former employee of the donor, this condition would have to be disclosed. Such disclosure would presumably lead to the disallowance of the deduction. See also *Dohrmann v. Commissioner of Internal Revenue*, 18 B.T.A. 66 (1929) (deciding that gifts to needy persons are not deductible in the absence of an organized charitable institution); *Kluss v. Commissioner of Internal Revenue*, 46 T.C. 572 (1966) (disallowing donation to nonexempt foundation even though it financed work that benefited exempt charities); Rev. Rul. 80-77, 1980-1 C.B. 56 (allowing deduction for donations to the Red Cross, the local volunteer fire department, the Girl Scouts, and a home for the elderly by recipients of benefits from such organizations as long as no explicit tie exists between donation and receipt of benefits).

¹⁴⁵ The Supreme Court explained the monitoring phenomenon in *Davis v. United States*:

A qualified beneficiary of a bona fide trust for charitable purposes would have both the incentive and legal authority to ensure that donated funds are properly used. If the trust contributes funds to a range of charitable organizations so that no single beneficiary could enforce its terms, the trustee's duty can be enforced by the Attorney General under the laws of most States.

495 U.S. 472, 483 (1990); see also Wendy G. Shaller, *Tax Exemption of Charitable Organizations and the Deductibility of Charitable Donations: Dangerous New Tests*, 8 U. Bridgeport L. Rev. 77, 95 (1987) ("Because a qualified donee is already under scrutiny by the I.R.S., there is a greater likelihood that funds disbursed by these organizations will be used for exempt purposes.").

¹⁴⁶ 495 U.S. 472 (1990).

¹⁴⁷ This is the name commonly attached to the Church of Jesus Christ of Latter-Day Saints and its members.

¹⁴⁸ In the first case to reach this issue, *White v. United States*, 725 F.2d 1269 (10th Cir. 1984), the Tenth Circuit allowed parents to deduct their payment of travel and living expenses for their missionary son. Two years later, in *Brinley v. Commissioner of Internal Revenue*, 782 F.2d 1326 (5th Cir. 1986), the Fifth Circuit reversed the Tax Court and held that

Mormon Church operates a worldwide missionary program involving 25,000 persons each year, most of whom are young men between the ages of nineteen and twenty-two.¹⁴⁹ Under Mormon doctrine, morally worthy members of the Church are generally "called" to serve as missionaries when they reach the age of nineteen or twenty.¹⁵⁰ While on their mission, missionaries devote all their energies to fulfilling their missionary responsibilities.¹⁵¹ Financial support during the mission period is provided, whenever possible, by each missionary's own parents.¹⁵² The amount of such support is determined, however, by the Church's Missionary Department.¹⁵³ The Davis family had two sons who served as missionaries during the taxable years at issue in the case. The question presented in the case was whether the parents

taxpayers' payments sustaining their son while serving on a mission would be deductible if the Church were the primary beneficiary of the expenditure, see *id.* at 1331, or the Church maintained control over the expenditure by directing its amount and object. See *id.* at 1335. It then remanded the case to the Tax Court to allow the taxpayers the opportunity to present evidence of such use and control. *Id.* at 1336. In contrast, the Ninth Circuit held in *Davis v. United States*, 861 F.2d 558 (9th Cir. 1988), *aff'd.*, 495 U.S. 472 (1990), that amounts paid by taxpayers into their sons' bank accounts to support them while serving as missionaries would not constitute charitable contributions absent evidence that the Church controlled the disposition of the funds in the bank account. *Id.* at 562.

¹⁴⁹ *Davis*, 495 U.S. at 474.

¹⁵⁰ To be "called" is both a responsibility and a privilege. Before "calling" an individual, Church authorities must verify that the member has demonstrated adherence to the faith and doctrines of the religion by observing its standards and commandments, see Brinley, 782 F.2d at 1328, and is otherwise "spiritually, physically, and emotionally fit for missionary service." K.C. Jensen, Note, Tax Deductions for Payments to Mormon Missionaries, 4 B.Y.U. J. Pub. L. 115, 115 (1990).

¹⁵¹ During the missionary service, the mission president (leader of the mission) controls many aspects of the missionaries' lives, including the manner of dress and grooming. Missionaries are required to conform to a daily schedule which calls for at least 10 hours per day of actual missionary work in addition to study time, mealtimes, and planning time. Mission rules forbid dating, movies, plays, certain sports, and other activities; missionaries are not allowed to take vacations or travel for personal purposes. *Davis*, 495 U.S. at 474-75.

¹⁵² If the parents are unable or unwilling, as may be the case if the parents are not themselves members of the Church, to provide the necessary funds, the Church tries to locate another donor from the local congregation. As a last resort, it uses money donated to the Church's general missionary funds. *Id.* at 474. The Church relies on direct contributions to missionaries by specified individuals both because it "fosters the Church doctrine of sacrifice and consecration in the lives of its people" and because it reduces the administrative and bookkeeping requirements that would otherwise be imposed on the Church. *Id.* Further, "direct payments encourage frugality because the missionary is aware of the personal sacrifice by specific persons to assist the missionary work." *White*, 725 F.2d at 1270.

¹⁵³ *Davis*, 495 U.S. at 474.

were entitled to take a charitable deduction for the amounts they sent their children, in accordance with the Church's instructions, to support them in their missionary work.¹⁵⁴

Much of the case revolved around—and indeed, the eventual resolution of the case depended on—the correct interpretation of § 170's statutory language. In particular, the controversy centered on the literal meaning of the phrase “or for the use of” in the clause “the term ‘charitable contribution’ means a contribution or gift to or for the use of— . . . (2) A corporation, trust, or community chest, fund, or foundation— . . . organized and operated exclusively for religious purposes”¹⁵⁵ The taxpayers argued that the statutory language should be interpreted according to its ordinary meaning, so that any payments made that benefited the Church and furthered its activities, including the payments taxpayers made to support their sons' missionary services, should be considered charitable contributions “for the use of” the Church.¹⁵⁶

The government argued and the Supreme Court held that the clause “for the use of” conveyed “a similar meaning as ‘in trust for,’ ”¹⁵⁷ an interpretation that the Court found to be consonant with the traditions of the English common law¹⁵⁸ and the legislative history of the amendment to § 170.¹⁵⁹ Because the taxpayers gave the money directly to their sons without imposing any legal restrictions on the

¹⁵⁴ The Davises did not seek a deduction for amounts transferred in excess of the sums requested by the Church. See Brief of Petitioners at 6, *Davis* (No. 89-98) (“The charitable contribution deductions at issue in this case did not exceed the amounts set by the Church.”); *Davis v. United States*, 861 F.2d 558, 560 (9th Cir. 1988) (stating that taxpayers' second amended return reduced charitable deduction claimed to the “amount . . . requested by the Church”).

¹⁵⁵ See I.R.C. § 170(c) (1988); *Davis*, 495 U.S. at 478. The taxpayers argued in the alternative that the payments were deductible under Treas. Reg. § 1.170A-1(g) (as amended in 1990), which allows the deduction of “unreimbursed expenditures made incident to the rendition of services to an organization contributions to which are deductible.” *Id.*

¹⁵⁶ *Davis*, 495 U.S. at 479.

¹⁵⁷ *Id.* at 480-81.

¹⁵⁸ From the dawn of English common law through the present, the word “use” has been employed to refer to various forms of trust arrangements. See 1 G. Bogert, *Trusts and Trustees* § 2, p. 9 (1935); *Black's Law Dictionary* 1382 (5th ed. 1979) (“*Uses and trusts* are not so much different things as different aspects of the same subject. A use regards principally the beneficial interest; a trust regards principally the nominal ownership”). In the early part of this century, the word “use” was technically employed to refer to a passive trust, but less formally used as a synonym for the word “trust.”

Id. at 481.

¹⁵⁹ See *id.*

sons' use of the funds, the Supreme Court held that the taxpayers had not donated the funds in trust for the Church and, hence, had not donated the funds "for the use of the Church for purposes of § 170."¹⁶⁰

The Court made clear that policy considerations fueled this legal decision. Conceding at several points in the opinion that the taxpayers' interpretation of the statute was plausible,¹⁶¹ it expressed concern that "petitioners' interpretation would create an opportunity for tax evasion that others might be eager to exploit."¹⁶² Following the government's lead, the Court seemed particularly concerned about the difficulty of auditing and controlling deductions involving payments to specific individuals, particularly family members.¹⁶³ Both the Court and the government in its brief seemed convinced that the only way to justify a deduction for a payment to an individual missionary was to show that the individual expended all the money received on Church expenses, thus necessitating an audit of the recipient's expenditures to determine the correctness of the donation.

That concern seems misplaced. Even a donor's support of a missionary's *personal* expenses is of value to the Church, because such support relieves the Church of the necessity of paying that missionary a salary.¹⁶⁴ Payments to a missionary are analogous to a donor's direct payment of the salary of a professor, rather than donating the money to the college that pays the salary. As long as the professor treats the sum as salary for tax purposes there is no particular reason to inquire into the professor's *expenditures*. Indeed, one expects that the bulk of the professor's expenditures will be for personal, consumption items.

Put differently, *Old Colony Trust Co. v. Commissioner*¹⁶⁵ decided that an employer's payment of taxes directly to the federal government on behalf of an employee was constructive salary to the employee rather than a gift excludable from income under § 102 of

¹⁶⁰ Id. at 485-86.

¹⁶¹ See id. at 479, 484.

¹⁶² Id. at 485.

¹⁶³ Id.

¹⁶⁴ This assumes, of course, that the Church takes the donations into account when deciding the missionary's salary. Such account can only be taken if the Church is aware of the donation.

¹⁶⁵ 279 U.S. 716 (U.S. 1929).

the Code. The professor is thus on safe ground when the payment is reported as salary. The only fact that needs to be determined on audit is whether the payee actually rendered services on behalf of the college—or, in the case of the missionaries, the Church—a determination that would be required to be made if the payments were made directly by the tax-exempt organization as well.

The Court also expressed concern that “[p]arents and children might attempt to claim a deduction for the same expenditure” because the sums donated and deducted by the parents might be used by a missionary child to buy religious tracts for distribution, for example, for which the child would also claim a charitable deduction.¹⁶⁶ But the same double deduction treatment results when the Church steps in and functions as an intermediary. The parents enjoy a deduction for the contribution to the Church and the son includes the salary received from the Church, but this inclusion is partly offset by deductions for expenditures on religious items to be distributed, assuming the missionary itemizes deductions. Alternatively, the Church may pay the missionary a lower salary and then offer reimbursement for any expenditures incurred for religious items. Thus, the mismatch identified by the Court as the end of a “parade of horrors” is no disaster at all but merely represents the normal operation of the tax-exemption provided to religious/charitable organizations and activities.

C. *The Benefits of Intermediary Control*

Although the mismatches identified by the Court are not necessarily abusive, the intuition that the donative pattern at issue invited abuse was quite correct. The problem is not in the mismatch but in the process used for deciding which expenditures qualify for the favorable mismatch. There is little question that putting money directly in the hands of beneficiaries or “employees” substantially reduces the control exercised by the tax-exempt intermediaries that organize charitable fundraising and activities.¹⁶⁷ At the very least, such direct transmissions give donors greater control over the receipt of benefits. Leaving such decisions in a donor’s hands unquestionably

¹⁶⁶ See *Davis*, 495 U.S. at 488.

¹⁶⁷ See Note, *Does Charity Begin at Home? The Tax Status of a Payment to an Individual as a Charitable Deduction*, 83 Mich. L. Rev. 1428, 1442-43 (1985).

opens the way for abusive behavior. Although the Davis brothers may not have taken advantage of the lack of control by an independent intermediary,¹⁶⁸ the Court can hardly be faulted for refusing to set a dangerous precedent.

Even as the Court insists on the interposition of a tax-exempt entity between the charitable donor and the eventual beneficiaries, there remain several other methods of enjoying a charitable deduction yet avoiding the oversight of an intermediary tax-exempt entity. One is the allowance, by Treasury regulation, of charitable deductions for "unreimbursed expenditures made incident to the rendition of services to an organization contributions to which are deductible."¹⁶⁹ For example, a volunteer who spends a night away from home in the service of a charity may choose to stay in a luxury hotel for the night rather than a budget motel without having to answer to the charity (or imperiling her deduction for the cost of the hotel).¹⁷⁰

The other method of avoiding the oversight of the intermediary is the allowance of deductions for contributions of property to a qualified charity, including recently purchased property. A taxpayer may claim a deduction for the full cost of specially made prayer books bound at her brother's struggling bindery and then donated to a local church. Such a donation fills two goals, only one of which justifies the claimed deduction. In both of these situations, it is the taxpayer who claims the deduction and makes all decisions regarding the purchase, not the tax-exempt entity.¹⁷¹ Such purchases can be made from

¹⁶⁸ One cannot say the same for the Davis parents. They initially sought to deduct the entirety of the amounts sent to their sons and did not reduce their deduction to the amounts requested by the Church until filing their second amended return. See Brief of Petitioners, *supra* note 154, at 6-7. Though the case presented only the question of the deductibility of the amounts requested by the Church, the Court might well have noted the taxpayers' tendency to overfund their son's efforts (at partial government expense) in the absence of intermediary control.

¹⁶⁹ Treas. Reg. § 1.170A-1(g) (as amended in 1990).

¹⁷⁰ Because the value of the deduction only partially offsets the cost of the differential between hotel and camping prices, the volunteer must fund part of it herself. Nonetheless, the deduction lessens the differential, making the choice a closer one than it would have been had the volunteer been responsible for the entirety of her expenses.

¹⁷¹ Such decisions include the price to be paid for the item and the identity of the supplier. The price decision is limited by a "fair market value" standard, particularly when a donation of property is involved. The substantiation requirements demanded by the Service increase along with the value of the property donated. See Treas. Reg. § 1.70A-13(b) to -13(c) (as amended in 1990) (describing information required, including "qualified appraisal" for donations of property valued in excess of \$5000).

friends or relatives and can be tailored to fit the personal tastes of the purchaser, rather than the best interests of the tax-exempt organization. The questions then become whether those methods somehow avoid the dangers posed by the situation at issue in *Davis* and, if not, how those methods could be subjected to similar restrictions.

One safeguard that exists in these situations, but not in *Davis*, is that it would be quite difficult for all of the donor's contribution to be diverted to private benefit. To qualify for the deduction of unreimbursed expenses, the donor must provide some services,¹⁷² the provision of which necessarily exacts a personal toll on the provider.¹⁷³ Some of these costs must be for the property itself—such as paper, ink, and leather in the case of donated prayerbooks—and these will not enrich the person providing services. The existence of these extraneous costs limits abuse possibilities by making them less valuable; the personal costs imposed by the required transactions decrease the net gain from personally beneficial transfers. Looking at the problem in another way that is consistent with this Article's general theme, one could argue that a mismatch exists between the donor's personal expenditures and personal benefits. The greater the mismatch that exists, the more comfortable we should be with allowing a deduction for the expenditures involved.

I do not mean to suggest that no potential for abuse remains. If only a small amount of the donation is "misdirected," so that no personal benefit is generated, one has to wonder if the donation is motivated more by personal or private interests. If, for example, the donor donates a wooden pew, hand-carved by his aspiring artist-child, one wonders whether the major beneficiary is the parent who receives a tax deduction for what would otherwise be a nondeductible support payment or the church receiving the pew.¹⁷⁴ Similarly, an overnight trip on behalf of a charity probably does not justify the deduction of

¹⁷² The Supreme Court in *Davis* rejected the taxpayers' argument that they should be entitled to deduct the unreimbursed expenses of their sons, concluding that "§ 1.170A-1(g) does not allow taxpayers to claim a deduction for expenses not incurred in connection with the taxpayers' own rendition of services to a qualified organization." 495 U.S. at 488.

¹⁷³ This toll need not be immense, however. See, e.g., *McCollum v. Commissioner*, T.C.M. (P-H) ¶ 78,435 (1978) (holding that expenses incurred during voluntary services to National Ski Patrol deductible, even though taxpayer enjoyed skiing).

¹⁷⁴ Some control on this sort of misbehavior will be exercised by the limitation on the amount of the deduction to the fair market value of the property donated. See Treas. Reg. § 1.170A-1(c)(1) (as amended in 1990); 2 Bittker, *supra* note 4, ¶ 35.2.1.

the costs of the most expensive hotel room and meal in New York City. Some rule of proportionality between costs and benefits is needed. In fact, such a test is applied in the context of unreimbursed expenses, though it is usually denominated under the rubric of the "primary beneficiary" test.¹⁷⁵ That is, the court must agree that the "primary beneficiary" of the unreimbursed expense is the charity, rather than the supplier or consumer of the expenditure, or the deduction will be disallowed.

Needless to say, the determination of the primary beneficiary can be a difficult factual question, resulting in decisions of little precedential value. For example, in *Hamilton v. Commissioner*,¹⁷⁶ the Tax Court found that costs incurred by the taxpayer in transporting children to Girl Scout activities was nondeductible because the "primary beneficiaries" were the children transported, not the organization.¹⁷⁷ However, the children transported happened to be the taxpayer's own "and sometimes other children."¹⁷⁸ One wonders whether the Tax Court would have reached a different decision if the taxpayer had hired a bus at his expense and driven ten unrelated children as well as one of his own to a jamboree.

Moreover, in a set of other, superficially similar circumstances, even the imposition of a proportionality test seems questionable. For example, in the typical scenario involving a charity ball or benefit performance to which overpriced tickets are sold, one of the volunteer organizers may pay for the entertainment or catering out of his or her own pocket. This presents no matching problem if the purchasers of these tickets carefully deduct only the excess of the ticket price over the value of attending the event, a value that presumably has some relationship to the costs of staging it.¹⁷⁹ Thus, such expenditures are

¹⁷⁵ Deductions are denied for service-related expenses where it is clear that the primary beneficiary of the services or expenditures is not the charitable organization but the taxpayer or another person. See Note, *supra* note 167, at 1432 n.23, 1433-34 & n.35 (listing cases denying such deductions).

¹⁷⁶ T.C.M. (P-H) ¶ 79,186 (1979).

¹⁷⁷ *Id.* at 740.

¹⁷⁸ *Id.*

¹⁷⁹ The Service issued a revenue ruling that limits deductions to the excess of the purchase price over the fair market value of attending the fund-raising event. See Rev. Rul. 67-246, 1967-2 C.B. 104. Presumably, in the absence of information about fair market value, a donor-attende may use cost as a proxy for fair market value. When the fair market value exceeds the donor-provider's cost, there is a slight mismatch between the treatment of the provider and the attendee. This mismatch is not troubling because the inability of the attendee to claim a

taxed twice, in accordance with the consumption model. The only mismatch that may exist is the partial one arising out of the fact that the attendees, rather than the donor, include the costs in income. But even this problem is minor because the purchasers themselves tend to be in the same tax bracket as the donors, especially in light of contemporary, flat tax rates. Moreover, donors will find it hard to sell tickets if they fail to provide attendees with value for the nondeductible portion of the ticket price. In short, the market, as well as the tax-exempt entity, can act as a monitor in these situations.

The importance of policing access to the favorable pattern of taxation allowed tax-exempt entities is easily underestimated. The *Davis* decision should help the Service perform this necessary function by adding to its arsenal of monitoring devices. But the need for such monitoring should not be confused with an evaluation of the underlying tax advantage. The matching principle is in part a tool with which to identify areas of tax law that require careful study. In this case, the principle has allowed us to see that the tax exemption enjoyed by nonprofit organizations is a valuable creature with subtle effects and debatable attributes.

CONCLUSION

One of the hardest tasks in the implementation of the "real" tax benefit rule is determining its limits. Not all "inconsistencies" in treatment between taxable years require the reconciliation or correction that the familiar tax benefit rule suggests. Some apparent mismatches, when viewed in the context of the entire statutory scheme, turn out to be manifestations of purposeful legislative decisions.¹⁸⁰

deduction is offset by the failure of the charity or the provider to recognize gain on the value added, or the excess of market value over cost.

¹⁸⁰ See, e.g., *Hillsboro National Bank v. Commissioner*, 460 U.S. 370, 391-95 (1983) (refusing to apply the tax benefit rule to refunds of property tax paid directly to shareholders); *Rojas v. Commissioner*, 90 T.C. 1090, 1108-09 (1988), aff'd 901 F.2d 810 (9th Cir. 1990) (refusing to apply the tax benefit rule to corporate liquidation of appreciated assets); Rev. Rul. 85-186, 1985-2 C.B. 84 (deciding that the tax benefit rule does not require the recapture of previously deducted research and development costs upon the sale of an invention). See generally Louis A. Del Cotto & Kenneth F. Joyce, *Double Benefits and Transactional Consistency Under the Tax Benefit Rule*, 39 Tax L. Rev. 473, 478-95 (1984) (asserting that proper question to be asked in each case is "whether the allowance of the second benefit is . . . 'fundamentally inconsistent' with the allowance of the first benefit"); Carolyn Ells Cheverine, Note, *Rojas v. Commissioner: How Far Should The Tax Benefit Rule Go?*, 9 Va. Tax Rev. 173

The same is true of the “systemic tax benefit rule,” or matching principle, described in this Article. All taxpayers are not treated equally; Congress has determined that some should be treated more favorably than others. It is therefore not surprising that deviations from “normal” patterns of taxation appear. Nevertheless, unqualified acceptance of such deviations threatens the revenue-raising capacity of the income tax system. I have tried to show that a systemic analysis is required in order to assess the acceptability of deviations from the norm. Narrower analysis tends to lead to “reforms” that are ineffective if not largely counterproductive. In the end, much as the familiar tax benefit rule is less a rule than a useful tool for exploring realization and other inclusionary aspects of our tax system, the matching principle provides a useful means of thinking about deductions, exemptions, and their systemic effects.

(1989) (arguing that the tax benefit rule has been properly ruled inapplicable when expensed materials are fully consumed before liquidation).

