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Alvin C. Warren Jr.

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# TAXING CORPORATE INCOME IN THE U.S. TWENTY YEARS AFTER THE CARTER COMMISSION REPORT: INTEGRATION OR DISINTEGRATION?<sup>\*</sup>

BY ALVIN C. WARREN, JR.<sup>\*\*</sup>

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## I. INTRODUCTION

Twenty years ago the Carter Commission recommended integration of the Canadian individual and corporate income taxes.<sup>1</sup> Although modest initial programmes of integration were proposed by

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<sup>1</sup> Canada, Royal Commission on Taxation, *Report*, vol. 4 (Ottawa: Queen's Printer, 1966) (Chair: K. LeM. Carter).

the U.S. Treasury in 1984<sup>2</sup> and adopted by the U.S. House of Representatives in 1985,<sup>3</sup> the final version of the massive *Tax Reform Act of 1986* did not include any steps in that direction. In other respects, however, the 1986 legislation profoundly affected the relationship between corporate and individual American income taxes, most likely requiring significant further changes in the *Internal Revenue Code*.

This paper examines the current situation in the United States in three parts. Part I begins by briefly reviewing the principal conceptual models for taxing corporate income. Part II analyzes in detail the impact of the 1986 legislation on the relationship of individual and corporate income taxes in the United States. Finally, Part III briefly suggests possible directions for future legislation and the continuing relevance of the Carter Commission recommendations.

## II. TAXING DISTRIBUTIONS OF CORPORATE INCOME

### A. *Current Conceptual Models*

There are six major models of corporate income taxation that have received recent attention in the United States: (1) Haig-Simons accrual taxation, (2) current taxation of corporate earnings to shareholders, (3) classical double taxation of dividends, (4) Carter Commission integration, (5) cash flow taxation, and (6) an intermediate proposal developed by the American Law Institute's Federal Income Tax Project.

#### 1. Haig-Simons accrual taxation

Under the most widely accepted definition of income, a model income tax would tax individuals on changes in the value of

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<sup>2</sup> United States Treasury Department, *Tax Reform for Fairness, Simplicity, and Economic Growth* vol. 2 (Washington, D.C.: U.S. Treasury Dept., 1984) at 134-44 [hereinafter *Treasury Tax Reform Study*].

<sup>3</sup> H.R. 3838, 99th Cong., 1st Sess., § 311 (partial deduction for dividends paid).

their assets, including shares of corporate stock.<sup>4</sup> Such accrual taxation would reflect in the individual income tax base income earned by corporations resulting in increased stock values. Although implementation of such a regime for at least publicly-traded shares has long been discussed,<sup>5</sup> concerns about liquidity and valuation have kept such proposals from gaining wide acceptance. The rationale for adopting such a regime would be that the income tax should reflect changes in the wealth of individuals as accurately as possible, and that corporations do not possess independent tax-paying capacity.

## 2. Current taxation of corporate income to shareholders

In lieu of taxing shareholders currently on increases in the value of their shares, corporations could continue to compute income, which would be attributed to shareholders and taxed in the year earned. Partnerships have long been pass-through entities under U.S. tax law,<sup>6</sup> and corporations can elect such treatment if they are closely-held and have relatively simple capital structures.<sup>7</sup> Pass-through status for all corporations has generally been rejected on the grounds that it would be too difficult to attribute corporate earnings in complicated capital structures and that it would be unfair to tax shareholders who did not receive distributions of corporate earnings.

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<sup>4</sup> The classic formulation of what is generally referred to as the Haig-Simons definition of income is by Henry Simons:

Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question.

H. Simons, *Personal Income Taxation* (Chicago: University of Chicago Press, 1938) at 50.

<sup>5</sup> See, for example, D. Slawson, "Taxing as Ordinary Income the Appreciation of Publicly Held Stock" (1967) 76 Yale L.J. 623; D.J. Shakow, "Taxation Without Realization: A Proposal for Accrual Taxation" (1986) 134 U. Pa. L. Rev. 1111; B. Wolfman, "Subchapter C and the 100th Congress" (1986) 33 Tax Notes 669 at 673-74.

<sup>6</sup> U.S. *Internal Revenue Code* 26 USCS §§ 701-761 [hereinafter *IRC*].

<sup>7</sup> *IRC*, *ibid.* §§ 1361-379. Electing corporations are generally known as "subchapter S corporations" after the applicable portion of the *Internal Revenue Code*.

### 3. Classical double taxation of dividends

The model that is usually said to characterize the traditional U.S. regime is the "classical" system, under which corporations are taxed as income is earned by the entity, and shareholders are also taxed when that income is distributed in the form of dividends. Hence the return on corporate equity capital is said to be subject to a "double" tax. This characterization does not apply to the return on corporate capital provided in the form of debt or leased property, because interest and rent payments are deductible by the paying corporation. The rationale for this regime is that whatever the ultimate incidence of the corporate tax is, corporate income, as defined by the return to equity capital, should bear a tax burden in addition to the burden imposed on capital income generally, perhaps as a fee for the benefits of operating in corporate form.<sup>8</sup>

### 4. Integration of the individual and corporate income taxes

The fourth model of corporate taxation eliminates the double burden of the classical system, by means of either a corporate deduction for dividends paid or a shareholder credit for corporate taxes paid.<sup>9</sup> The Carter Commission developed a sophisticated version of shareholder credit integration that was intended to retain for Canada a tax on corporate income flowing to foreign investors from Canadian enterprises.<sup>10</sup> The rationale for adopting an integrated regime was that the corporate income tax should function as a withholding mechanism for an individual income tax collected on a realization, rather than an accrual, basis.

The Carter Commission's innovative suggestions included setting the corporate tax rate equal to the highest individual rate and allowing deemed distributions in a shareholder-credit system of

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<sup>8</sup> See R. Good, *The Corporation Income Tax* (New York: Wiley, 1951) at 26-40.

<sup>9</sup> See C.E. McLure, Jr., *Must Corporate Income Be Taxed Twice?* (Washington: Brookings Institution, 1979); A.C. Warren, Jr., "The Relation and Integration of Individual and Corporate Income Taxes" (1981) 94 *Harv. L. Rev.* 717.

<sup>10</sup> *Carter Commission Report*, *supra*, note 1 at 49-70.

integration. Because it would generally be in the shareholders' interest for corporations to deem the corporate earnings distributed each year in order to make available refunds due to the shareholder credit, such a system could ultimately bring about current shareholder taxation of corporate income, as described above.

## 5. Cash flow taxation

In recent years there has been renewed interest in a regime under which corporations would deduct not only current business expenses, but also capital costs, such as the cost of machinery and equipment.<sup>11</sup> Such a tax would be a corporate correlative of a personal consumption tax,<sup>12</sup> would continue to collect taxes on income produced by assets already in corporate solution, and would allow the government to share in the excess of the return on future corporate assets over the rate of interest on government borrowing.

This last function of a corporate cash flow tax can be illustrated with an example. Suppose the Treasury could borrow at an annual interest rate of 10 percent. Deductible corporate investment of \$200 would require the government to forgo \$100 of revenue as a result of the deduction if the corporate tax rate were 50 percent, increasing government borrowing by \$100. If, after a year, the corporate investment were liquidated in exchange for \$300, the Treasury's share would be \$150, of which it would retain \$40 after repaying its \$100 of borrowing plus \$10 in interest. As a result, the Treasury would have shared in the excess of corporate profits over the relatively riskless rate of return on government borrowing. Canadian scholars have demonstrated how this profit-

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<sup>11</sup> For example, Institute for Fiscal Studies, *The Structure and Reform of Direct Taxation* (London: George Allen & Unwin, 1978) (Chair: J.E. Meade) at 228-45 [hereinafter *Meade Committee Report*]; R.W. Boadway, N. Bruce & J.M. Mintz, "Corporate Taxation in Canada: Toward an Efficient System" in W.R. Thirsk & J. Whalley, eds *Tax Policy Options in the 1980s* (Toronto: Canadian Tax Foundation, 1982).

<sup>12</sup> A personal consumption tax would reach only the consumption portion of the Simons definition of income set forth in note 4, *supra*, and could be levied on a cash-flow basis. For differing views regarding implementation of such a tax, see W.D. Andrews, "A Consumption-Type or Cash Flow Personal Income Tax" (1974) *Harv. L. Rev.* 1113; M.J. Graetz, "Implementing a Progressive Consumption Tax" (1979) *92 Harv. L. Rev.* 1575.



sharing function of a corporate cash flow tax could be combined with the withholding function of integration.<sup>13</sup>

#### 6. American Law Institute federal income tax project

In 1982, a study published by the American Law Institute suggested enactment of a corporate deduction for dividends paid, with the deduction limited to dividends earned on amounts contributed to corporate enterprises after the date of enactment ("new equity").<sup>14</sup> The deductible amount would be further limited to a specified rate, similar to the return on corporate debt. This proposal was intended, like integration, to avoid the double tax on the return to corporate equity, but without a windfall gain to current shareholders, the price of whose shares presumably reflects the anticipated corporate tax on assets already in corporate solution ("old equity"). Because the deduction for returns to new equity would be limited to a specified rate, this proposal can also be interpreted as an attempt to reach profits on new corporate investments in excess of that rate, with an effect similar to that of a cash-flow tax.

#### B. *Implementation of the Models*

Although these models provide conceptual guidelines for designing corporate tax systems, the models are generally not fully implemented in particular national systems. Canada, for example, adopted a form of partial shareholder-credit integration after the *Carter Commission Report*, but the system as enacted does not

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<sup>13</sup> For example, R.W. Boadway, N. Bruce, J.M. Mintz, "The Role and Design of the Corporate Income Tax" (1984) 86 *Scand. J. of Econ.* 286.

<sup>14</sup> American Law Institute, *Federal Income Tax Project, Subchapter C: Proposals on Corporate Acquisitions and Dispositions, and Reporter's Study on Corporate Distributions* (Philadelphia, Pa.: ALI, 1982) at 356-400. This volume contains both the Institute's proposals regarding corporate acquisitions [hereinafter *ALI Acquisition Proposals*] and its Reporter's study regarding corporate distributions [hereinafter *ALI Reporter's Study*]. Only the former carry the imprimatur of the Institute.

always accomplish integration.<sup>15</sup> Indeed, shareholders can under certain circumstances obtain credits for taxes that have not been collected from the distributing corporation, a phenomenon sometimes known as "superintegration."<sup>16</sup> Many other developed nations have also adopted a partial form of integration in recent years, usually opting for the shareholder-credit method, in part to preserve taxation of corporate income paid to foreign shareholders.<sup>17</sup>

In the United States, the full rigours of the classical system of double taxation could be mitigated in a variety of ways before the *Tax Reform Act of 1986*, including the conduct of business through partnerships or special categories of corporations.<sup>18</sup> When business was conducted in regular corporate form, the burden of the corporate tax could be reduced by supplying capital as debt or leased property. In addition, a 1935 Supreme Court decision, *General Utilities & Operating Co. v. Helvering*,<sup>19</sup> had come to mean that corporations were not taxed on the previously unrealized appreciation on corporate assets when those assets were distributed to shareholders, creating another opportunity to avoid one level of tax. Even when two taxes were collected, the shareholder tax could be substantially reduced if the distribution of corporate earnings was accomplished in a transaction, such as repurchase of shares by the corporation, that gave rise to a capital gain, which was taxed substantially less heavily than ordinary income.<sup>20</sup> The effective tax

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<sup>15</sup> *Income Tax Act*, S.C. 1971, c. 63, ss 82, 121.

<sup>16</sup> See, for example, D.P. Jones, "Corporations, Double Taxation, and the Theory of Integration" (1979) 27 *Can. Tax J.* 405; D.P. Jones, "Further Reflections on Integration: The Modified Small Business Deduction, Nonqualifying Businesses, Specified Investment Income, Corporate Partnerships, and Personal Service Corporations" (1982) 30 *Can. Tax J.* 1; G. Bale, "A Call for Fundamental Tax Reform from the U.S. Treasury: Some Implications for Canada" (1985) 33 *Can. Tax J.* 269 at 287-96.

<sup>17</sup> See generally, International Fiscal Association, *Imputation Systems - Objectives and Consequences* (Deventer: Kluwer, 1983).

<sup>18</sup> See *supra*, notes 6 and 7.

<sup>19</sup> 296 U.S. 200 (1935).

<sup>20</sup> *Internal Revenue Code*, *supra*, note 6 as am., § 1202 (providing for a 60 percent deduction of net long term capital gains prior to the *Tax Reform Act of 1986*).

rate on certain new capital investments could also be substantially reduced by the capital recovery provisions, which made available deductions and credits with a present value equal to expensing, the standard result under cash flow taxation.<sup>21</sup> Finally, the highest corporate tax rate was historically lower than the highest individual tax rate, so that the "double" tax could often be advantageous for taxpayers, because earnings could compound in corporate solution at a higher after-tax rate of return than they would in the hands of individual shareholders.

In addition to a complex set of rules and distinctions governing distributions of corporate income to shareholders, U.S. corporate tax law prior to 1987 had developed a highly articulated system governing corporate mergers and other re-organizations. In general, the statute, cases, and rulings attempted to distinguish between taxable sales and non-taxable reorganizations on the basis of continuity of investment.<sup>22</sup> The basic idea was that corporations and shareholders should be taxed where there was a change in the substance, but not the form, of their investment. These provisions were often criticized for their awesome complexity.<sup>23</sup> In addition, some observers argued that shareholder taxability should not depend on the same criteria as corporate taxability and that the corporate-level results were often effectively elective for sophisticated practitioners.<sup>24</sup> Finally, a troublesome, unsettled issue of statutory

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<sup>21</sup> See *Meade Committee Report, supra*, note 11; A.C. Warren, Jr., "Accelerated Capital Recovery, Debt, and Tax Arbitrage" (1985) 38 Tax Law. 549.

<sup>22</sup> See generally, M.A. Levin & M.D. Ginsburg, "Taxing Corporate Acquisitions – A Summary of the Agonizingly Complex State of Current Law" in American Bar Association Tax Section and New York Bar State Association Tax Section, *Proceedings of a Conference on Subchapter C* (forthcoming, 1987) [hereinafter *Subchapter C Conference Proceedings*].

<sup>23</sup> *Ibid.*

<sup>24</sup> See the discussion *infra* at 336.

design was the extent to which net operating loss carryforwards should be transferable in mergers and acquisitions.<sup>25</sup>

In general, the U.S. implemented the double tax model for U.S. corporations on a worldwide basis with a credit for foreign taxes paid.<sup>26</sup> The separate corporate identity of subsidiaries was generally respected for these purposes, making the income of foreign branches of U.S. companies taxable in the year earned, while deferring taxation of the income of foreign subsidiaries until repatriated to the subsidiary's U.S. parent company.<sup>27</sup>

### III. EFFECTS OF 1986 TAX REFORM ON U.S. CORPORATE INCOME TAX STRUCTURE

We now turn to the effects of the 1986 legislation on the relationship between individual and corporate income taxes in the United States. After briefly reviewing the most important changes, some of the corporate tax design issues implicated by those changes will be considered in detail.

#### A. *Major Changes Affecting the Relationship between Corporate and Individual Income Taxes*

Three aspects of the 1986 legislation will have a major impact on the tax consequences of corporate distributions. First, Congress repealed the *General Utilities* doctrine, assuring that the corporate tax will apply to distributions of appreciated corporate

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<sup>25</sup> Congress had adopted new limitations in the *Internal Revenue Code of 1954*, but those limitations were widely criticized and replaced with new provisions in the *Tax Reform Act of 1976*, which were, in turn, controversial and never went into effect. See U.S. *Internal Revenue Code, supra*, note 6 at § 382 (as enacted in 1954 and amended in 1976).

<sup>26</sup> *IRC, supra*, note 6 at §§ 901-906.

<sup>27</sup> *Ibid.* at §902 provides a credit for foreign taxes paid by the subsidiary with respect to repatriated earnings. See note 94, *infra*, for provisions limiting the availability of deferral.

assets.<sup>28</sup> Implementation of this change was deferred until 1989 for certain closely-held corporations worth less than \$5 million.<sup>29</sup>

Second, the preferential treatment of capital gains was eliminated.<sup>30</sup> After the change is fully effective, the only advantage of a capital gain over ordinary income is that the former can be used to fully offset capital losses, whereas only \$3000 of ordinary income can be offset by capital losses annually.<sup>31</sup> Continuation of limited deductibility for capital losses prevents taxpayers from realizing their capital losses in order to reduce taxes on ordinary income, while retaining assets on which there is unrealized capital gain.

Third, the historic relationship between individual and corporate tax rates was reversed, so that, when fully phased in, the maximum corporate rate will be 34 percent and the maximum shareholder rate will be 28 percent.<sup>32</sup> Immediately before the legislation, the maximum corporate rate was 46 percent, and the maximum individual rate was 50 percent. Before 1981, the maximum corporate rate was 48 percent, and the maximum individual rate was 70 percent.

The only major structural change enacted with respect to corporate mergers and other reorganizations was the adoption of a new set of limitations on net operating loss carryforwards.<sup>33</sup> After a significant shift in stock ownership, annual deductions for loss carryforwards by the corporation will now be limited to the value of the corporation before the change in ownership multiplied by a long-term tax-exempt rate of return. This limitation is intended to

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<sup>28</sup> *Ibid.* at §§ 311, 336.

<sup>29</sup> *Tax Reform Act of 1986* H.R. 3838, 99th Congress, 2nd session §633(d). The transitional relief is phased out for corporations worth between \$5 million and \$10 million.

<sup>30</sup> *IRC, supra*, note 6 at § 1202.

<sup>31</sup> *Ibid.* § 1211. The excess can be carried forward indefinitely. *Ibid.* at § 1212.

<sup>32</sup> *Ibid.* at §§ 1, 11. Lower rates and certain other tax benefits are phased out as income rises, so that the total marginal rate of tax may be higher during the phase-out.

<sup>33</sup> *Ibid.* at § 382.

restrict use of the loss carryforwards to approximately the income that could have been generated by the corporation without a change in ownership.<sup>34</sup>

The major 1986 innovation regarding international corporate income was the imposition of a Canadian-type branch profits tax on U.S. branches of foreign companies in addition to the regular income tax.<sup>35</sup> The rationale for the additional tax is that the double U.S. tax applicable to corporate subsidiaries of foreign companies (which are taxed once when income is earned, and again when dividends are paid), should also apply to foreign companies operating in the United States through branches.<sup>36</sup>

### B. *Current Issues in Corporate Tax Design*

The 1986 legislation raises issues for corporate tax design in four major areas: (1) the scope of the corporate tax base, (2) the treatment of shareholders on receipt of corporate distributions, (3) mergers, acquisitions, and liquidations, and (4) international income flows.

#### 1. Scope of the Corporate Tax Base

The reversal of the historic rate relationship between individual and corporate taxes, the elimination of the *General Utilities* doctrine, and the repeal of the capital gains preference have substantially increased the tax cost of doing business in corporate form in the United States. As a result, the months since adoption of the *Tax Reform Act of 1986* have been characterized by intensive activity and discussion by tax practitioners focused on minimizing the double tax by removing assets from corporate solution. As a result, some practitioners have issued dire warnings about the coming

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<sup>34</sup> U.S. Congress, Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (Washington: U.S. Government Printing Office, 1987) 295-96. These limitations derived from the *ALI Acquisition Proposals*, *supra*, note 14 at 237-90.

<sup>35</sup> *IRC*, *supra*, note 6 at § 884. *Cf. Income Tax Act*, *supra*, note 15 at Part XIV.

<sup>36</sup> *General Explanation of the Tax Reform Act of 1986*, *supra*, note 34 at 1036-38.

"disincorporation" of America.<sup>37</sup> Three basic techniques are involved.

First, increased use may be made of forms of business organization that are not subject to the corporate tax. In particular, large publicly-traded partnerships, known as "master limited partnerships," are now pushing the limits of the extent to which an entity can display corporate attributes without being characterized as a corporation for tax purposes.<sup>38</sup> Similarly, many closely-held American businesses have, or will, elect to be taxed under subchapter S of the *Internal Revenue Code*, which passes through taxable income to the shareholders currently and does not impose a separate corporate income tax.<sup>39</sup>

Second, corporations that cannot make use of the partnership or subchapter S provisions can effectively reduce the size of the corporate tax base by substituting debt for equity in their capital structures, so that corporate income is distributed in the form of deductible interest, rather than nondeductible dividends. In the simplest form of transaction, a corporation might borrow funds, after which it would purchase its own shares on the stock market. A more sophisticated transaction is the "leveraged buy-out" which has attained great popularity in recent years as a means of taking public companies private. Such buy-outs typically result in a highly leveraged capital structure and a substantially reduced tax base. Similarly, corporate acquisitions that are not intended to take a public company private have sometimes used high-interest-rate "junk bond" financing, which generates interest deductions in lieu of the

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<sup>37</sup> See L.S. Freeman, "Some Early Strategies for the Methodological Disincorporation of America After the Tax Reform Act of 1986: Grafting Partnership Onto C Corporations, Running Amok with the Master Limited Partnership Concept, and Generally Endeavoring to Defeat the Intention of the Draftsmen of the Repeal of *General Utilities*" (1986) 64 *Taxes* 962; W. Friedrich, "The Unincorporation of America" (1987) 15 *J. Corp. Taxation* 3; P.C. Canellos, "Corporate Tax Integration: By Design or By Default" in *Subchapter C Conference Proceedings*, *supra*, note 22.

<sup>38</sup> See *Treasury Tax Reform Study*, *supra*, note 2 at 146-49 (proposing that large limited partnerships be taxed as corporations.)

<sup>39</sup> Other pass-through entities under current law include regulated investment companies, real estate investment trusts, and real estate mortgage investment conduits. *IRC*, *supra*, note 6 at §§ 851-860G.

dividend payments previously made to the shareholders of the target corporation. Finally, "leveraged recapitalizations" have recently been developed on Wall Street as a way of substituting debt for equity where there is a substantial body of continuing shareholders.<sup>40</sup>

Third, even where assets currently in corporate solution will continue to bear the corporate tax, techniques are being developed to insulate future business prospects from that tax. For example, instead of raising capital and pursuing a business idea itself, a corporation might enter into a joint venture with a widely-held partnership to pursue the project.<sup>41</sup> By using this form of business organization, the share of business earnings directed to non-corporate partners would escape the corporate tax completely.

A number of these techniques, such as the substitution of debt for equity, involve the complication that no tax may ever be collected on the capital income earned through corporate enterprise, because the supplier of capital may be a non-taxable foreign lender or an exempt institution or pension fund.

In general, these techniques can be thought of as varieties of do-it-yourself integration in a system that supposedly rejects the integration model in favour of the classical double tax. Under the current regime, some corporate income is thus subject to the double tax, while other, arguably corporate income is subject to effective integration, perhaps with non-taxable suppliers of capital. Most of the opportunities described above are not new, but the 1986 legislation increased the incentive to avoid the corporate tax. Additional taxpayer activity along these lines will presumably require a clearer articulation of when the classical double tax will apply. In particular, Congress or the Treasury will have to decide whether publicly-traded partnerships are to be classified as corporations; whether the single-tax regime of subchapter S should be expanded or contracted; and whether interest deductions should be available on debt substituted for equity.

Because of the pressure placed on the corporate tax base by the 1986 reversal of the historic relationship between corporate and

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<sup>40</sup> See Canellos, *supra*, note 37.

<sup>41</sup> See Freeman, *supra*, note 37.



individual rates, Congress will also have to decide whether it should restore a corporate rate that is not significantly higher than, or is below, the maximum individual rate. If the new rate structure is continued, consideration will have to be given to whether there is still any need for the penalty taxes that are designed to discourage the accumulation of corporate earnings and the formation of personal holding companies to avoid individual taxation.<sup>42</sup>

## 2. Taxation of distributions to shareholders

A second area in which the 1986 legislation dramatically changed the federal income tax stakes involves the taxation of shareholders on the distribution of corporate earnings. Before 1987, a dividend received was ordinarily income if the distributing corporation had current or accumulated earnings and profits, historically a measure of corporate earnings.<sup>43</sup> If, on the other hand, earnings were distributed by means of a corporation repurchasing its shares, and the repurchase was not re-characterized as a dividend,<sup>44</sup> the selling shareholders would be taxed on the excess of the amount received over their cost basis,<sup>45</sup> with that excess usually eligible for capital gains treatment. Such distributions of corporate earnings at capital gains rates were generally known by the colourful name of "bail-outs". This advantageous treatment was available not only for redemptions, as the *Internal Revenue Code* styles share repurchases, but also for qualifying complete and partial liquidations and for certain purchases by corporations of shares from individual stockholders.<sup>46</sup>

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<sup>42</sup> *IRC, supra*, note 6 at §§ 531, 541.

<sup>43</sup> *Ibid.* at §§ 301, 312, 316.

<sup>44</sup> The basic test for dividend equivalence involves an inquiry into whether shareholders have experienced a diminution in their proportionate interest in the corporation, on the theory that dividends are typically *pro rata*. See *ibid.* § 302(b).

<sup>45</sup> *Ibid.* at § 1001.

<sup>46</sup> *Ibid.* at § 331 (complete liquidations), § 302(b)(4) (partial liquidations). *IRC* § 304 provides that purchases of stock by a related corporation may be re-characterized as dividends.

Similarly, certain stock dividends would not be taxed currently, but could give rise to capital gains on a later sale or other disposition.<sup>47</sup> Certain spin-offs of the stock of corporate subsidiaries to shareholders of a parent corporation would also not cause immediate shareholder taxation, but would benefit from capital gains treatment when those shares were later sold.<sup>48</sup> To complete the treatment of sales of corporate stock, the "collapsible corporation" provisions would convert the usual capital gain on sale or liquidation of corporate shares into ordinary income where corporate-level realization was avoided.<sup>49</sup>

This array of provisions can be generalized with the statement that the *Internal Revenue Code* distinguished between dividend and non-dividend distributions of corporate earnings in three significant ways before the *Tax Reform Act of 1986*. First, a dividend was generally fully taxed as ordinary income, while a non-dividend distribution might benefit from the capital gains preference. Second, dividends and non-dividend distributions had different measuring rods for the recovery of capital that is necessary to identify income in the sense of gain. Dividends required corporate earnings and profits, whereas non-dividend distributions were generally taxed if the amount realized exceeded shareholder basis. Third, because dividends are typically *pro rata*, all shareholders would generally be taxed on dividends; whereas in non-dividend distributions only shareholders receiving cash or other property would be taxed. For example, the repurchase of stock by a corporation from some of its shareholders would have no tax consequences for non-selling shareholders, even though the

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<sup>47</sup> *Ibid.* at § 305(a) provides that certain stock dividends are non-taxable, but there are a number of exceptions. For example, *IRC* § 305(b) may require current taxation of stock dividends when other shareholders receive something else of value. *IRC* § 305(c) provides the Treasury with authority to extend that treatment to other transactions involving changes in shareholder's proportionate interest in the corporation. *IRC* § 306 taints certain preferred stock dividends, so that they will be denied capital gains treatment on later sale or disposition.

<sup>48</sup> *Ibid.* at § 355 generally conditions non-taxability on the distribution of control, the presence of active businesses in the distributing and distributed companies, and the absence of a device to distribute earnings and profits.

<sup>49</sup> *Ibid.* at § 341.

redemption could be re-characterized as a dividend to all shareholders followed by sales of stock among those shareholders.<sup>50</sup>

The 1986 *Act* changed the stakes dramatically for the distinction between dividend and non-dividend distributions of corporate earnings, by eliminating the preferential treatment of capital gains. The current regime is unnecessarily complicated and sometimes requires distinctions that no longer matter. Accordingly, just as the 1986 changes and the taxpayer response to them require refinement of the scope of the corporate tax base, so those changes suggest that further refinement of the provisions for taxing shareholder distributions is in order.

There are at least three possible responses to the current situation regarding distributions. First, one might take the view that repeal of the capital gains preference is not necessarily stable; so that the existing regime should be left in place because it would have to be reintroduced if the capital gains preference were restored.<sup>51</sup>

A second response is that redesign of the corporate tax should take advantage of capital gains repeal to simplify the taxation of distribution. In this view, the main pre-1986 difference in treatment between dividends and non-dividend distributions was the possibility of capital gains status for the latter. The other differences could be reduced by repealing the earnings-and-profits concept for domestic purposes and adopting a uniform method of recovering shareholder basis that would apply to all forms of corporate distribution.<sup>52</sup> The post-1986 function of the capital gains concept in limiting the category of income against which capital losses can be fully deducted could be more directly accomplished by

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<sup>50</sup> M.A. Chirelstein, "Optional Redemptions and Optimal Dividends: Taxing the Repurchase of Common Shares" (1969) 78 Yale L.J. 739.

<sup>51</sup> Even on this view, however, the collapsible corporation provisions could be eliminated if the target of those provisions was thought to be avoidance of the corporate tax by taking advantage of the *General Utilities* doctrine.

<sup>52</sup> The earnings and profits concept has long been criticized. See, for example, W.D. Andrews, "Out of its Earnings and Profits: Some Reflections on the Taxation of Dividends" (1956 Harv. L. Rev. 1403; W.J. Blum, "The Earnings and Profits Limitation on Dividend Income: A Reappraisal" (1975) 53 Taxes 68.

limiting the deductibility of losses to a narrower category of gains, such as those on publicly-traded assets.<sup>53</sup> Finally, in the interest of simplicity, this approach would ignore the remaining difference between dividend and non-dividend distributions — that all shareholders are usually taxed on dividend distributions, whereas non-dividend distributions result in the taxation of only those shareholders who receive cash or other property.

The third, and final, possible response to repeal of the capital gains preference attacks this remaining difference. The premise of this third approach is that corporations should not be able to distribute their earnings at a substantially reduced tax cost by replacing dividends with non-dividend distributions, even after the elimination of the capital gains preference. The resulting tax cost would be especially reduced if the only shareholders electing to be taxed by, for example, selling stock back to the corporation are those who are effectively non-taxable, either by status or because shareholder basis has been stepped-up by a testamentary transfer.<sup>54</sup>

If the opportunity to avoid taxation by not taking cash or property in a non-dividend distribution is considered significant, how could the corporate tax be redesigned to eliminate or reduce that possibility? There are at least two choices. First, the existing modest statutory provisions that impute dividend treatment to shareholders who experience an increase in their proportionate interest in the corporation could be expanded.<sup>55</sup> Alternatively, the American Law Institute study mentioned earlier proposed that a special excise tax be collected from any corporation making a non-dividend distribution.<sup>56</sup> This excise is intended to compensate for the lower tax cost of such distributions to shareholders. The scope of this approach is perhaps broader than is at first obvious, because

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<sup>53</sup> See, for example, M.D. Ginsburg, "Reexamining Subchapter C: An Overview and Some Modest Proposals to Stimulate Debate" in *Subchapter C Conference Proceedings, supra*, note 22.

<sup>54</sup> *IRC, supra*, note 6 at § 1014 provides that the basis of an asset received from a decedent is its value as of the decedent's death.

<sup>55</sup> *Ibid.* at § 305(c).

<sup>56</sup> *ALI Reporter's Study, supra*, note 14 at 401-86.

the purchase by corporation A of unrelated corporation B's stock from individual shareholders is, in effect, a non-dividend distribution by corporation A to individual shareholders. Accordingly, full implementation of this approach would require application of the excise tax to corporate purchases of stock from unrelated individuals.<sup>57</sup>

To recapitulate, repeal of the capital gains preference dramatically changes the stakes in the taxation of corporate distributions to shareholders. If that repeal is thought likely to be permanent, the distinction between dividends and non-dividend distributions could be greatly simplified by reducing the remaining differences in tax cost for the various methods of distributing corporate earnings to shareholders. Complete elimination of those differences would, however, require adoption of the excise tax or something like it.

### 3. Mergers, acquisitions, and liquidations

Another area that is ripe for legislative change is the set of provisions concerning corporate mergers, acquisitions, and liquidations. The *Internal Revenue Code* has long drawn a basic distinction between sales, which are taxable events, and corporate reorganizations, which are non-taxable for both shareholders and corporations.<sup>58</sup> The distinction derives from the realization concept and is clear at the extremes. For example, sale of corporate assets or stock for cash has been considered a significant enough change in position to impose income taxation on the selling party.<sup>59</sup> On the other hand, merger of one company into another with the shareholders of the merged company receiving only stock of the surviving company has not been thought to involve the kind of change in position generally required for taxation for either the

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<sup>57</sup> *Ibid.* at 473. For small investments in corporate stock, a roughly comparable result could be achieved by denying the intercorporate dividend exclusion with respect to such stock. *Ibid.* at 487-513.

<sup>58</sup> *IRC*, *supra* note 6, §§ 354, 358, 368, 361, 362.

<sup>59</sup> *Ibid.* at § 1001.

merging corporations or their shareholders.<sup>60</sup> Although the distinction is clear in extreme cases, its implementation in the United States has required a maddingly complicated statute,<sup>61</sup> a variety of additional judicial requirements (such as a continuity of propriety interest, business purpose, and continuity of business enterprise) for reorganization status,<sup>62</sup> and a massive volume of judicial decisions and administrative rulings to enforce the oft-repeated proposition that the substance of the transaction, not its form, determines the tax consequences.

a) *Elective corporate taxation of acquisitions*

In 1982, the American Law Institute proposed a fundamental reformulation of the corporate reorganization provisions under which the traditional realization-based approach would be replaced by elective treatment at the corporate level.<sup>63</sup> Shareholder taxation would be determined separately on the basis of the consideration received by particular shareholders.<sup>64</sup> In 1985, the staff of the Senate Finance Committee made similar proposals.<sup>65</sup> While this approach was not adopted by the 1986 *Act*, it is very much on the current reform agenda. The argument for its adoption involves five steps: (i) that corporate acquisitions should be recategorized on the basis of a functional distinction between carryover and cost-basis acquisitions; (ii) that the current system is already effectively elective between these two types of acquisitions in many cases; (iii) that simplicity and the role of the corporate income tax would be served

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<sup>60</sup> *Ibid.* at § 368(a)(1)(A).

<sup>61</sup> See Levin & Ginsburg, *supra*, note 22.

<sup>62</sup> See B. Wolfman, *Federal Income Taxation of Business Enterprise*, 2d ed. (Boston: Little, Brown, 1982) at 621-50.

<sup>63</sup> *ALI Acquisition Proposals*, *supra*, note 14 at 22-150.

<sup>64</sup> *Ibid.* at 151-97.

<sup>65</sup> U.S. Congress, 99th Sess., 1st Sess., Staff of the Senate Committee on Finance, *The Subchapter C Revision Act of 1985* (S. Prt. 99-47, 1985) [hereinafter *Senate Staff Proposals*].

by making the election explicit; (iv) that although certain discontinuities addressed by this approach were eliminated by the 1986 *Act*, others were created; and (v) that the design implications of the election are more acceptable than the alternatives.

(i) Carryover- versus cost-basis acquisitions

The 1982 American Law Institute recommendations suggest that the controlling legal concepts be formulated not in terms of the traditional distinction between sales and reorganizations, but in terms of a more functional distinction between two kinds of corporate acquisitions said to be implicit in current law: first, carryover-basis transactions in which the transferor of corporate assets is not taxed, and the acquiring corporation takes a carryover basis in the acquired assets, and second, cost-basis transactions in which the transferor of corporate assets is taxed, and the acquiring corporation takes a cost basis in the acquired assets.

This distinction does not depend on the consideration transferred by the acquiring corporation, nor on the form of the corporate transaction. Thus, acquisitions of either corporate assets or stock, paid for with either cash or stock of the acquiring company could be either carryover-basis or cost-basis transactions at the election of the taxpayers, as long as the corporate parties reported the acquisitions consistently.

(ii) Effective electivity

The next step in the argument is that the current system is already effectively elective between carryover-basis and cost-basis acquisitions in many cases. As a consequence of the repeal of the *General Utilities* doctrine, stock purchases for cash are currently subject to explicitly elective treatment.<sup>66</sup> Hence, an acquiring corporation can purchase the stock of a target corporation for cash and, if nothing more is done, the target's basis in its assets will remain unchanged and the target will pay no taxes. If, on the other hand, the acquiring corporation so elects, it can step up the target's

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<sup>66</sup> IRC, *supra*, note 6 at § 338.

basis in its assets as long as the target corporation recognizes gain as if it had sold those assets.<sup>67</sup> Stock acquisitions made with stock of the acquiring corporation can achieve carryover-basis treatment under the reorganization provisions,<sup>68</sup> cost-basis treatment of such acquisitions can be obtained if the requirements of a reorganization are not satisfied.

Asset purchases for cash will result in taxation of the selling (target) company and a cost basis for the purchasing corporation if no further action is taken. Carryover-basis asset acquisitions for cash require several transactional steps, such as the acquiring corporation buying stock of the target and then liquidating the target to receive its assets with the target's previous basis.<sup>69</sup> Asset acquisitions with stock of the acquiring corporation can achieve carryover-basis treatment under the reorganization provisions;<sup>70</sup> cost-basis treatment of such acquisitions can be obtained if the requirements of a reorganization are not satisfied.

The argument is not that sophisticated tax practitioners can necessarily accomplish every result desired by corporate parties, but that every desired result can be accomplished by some form of corporate transaction. There may, however, be valid non-tax reasons for not adopting a particular transactional form, so some results may be precluded for legitimate business reasons. For example, the

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<sup>67</sup> The cost-basis election was introduced in 1982 and replaced the previous requirement that the acquiring company liquidate the newly acquired subsidiary to receive a cost basis in the target's assets. *Internal Revenue Code, supra*, note 6 at § 334(b)(2). The statutory opportunity to take a cost basis in the target corporation's assets after a stock acquisition, either by liquidation or election, derives from the availability of a cost basis if the assets of the target are purchased either from the target or from the target's shareholders after the shareholders have liquidated the target. Before this opportunity was made available by statute, the courts had to distinguish acquisitions in which the acquiring corporation sought the target's assets from those in which the acquiring corporation sought the target's stock. The former would give rise to a cost basis in the target's assets, while the latter would yield a carryover basis. See, for example, *Kimbell-Diamond Milling Co. v. Commissioner* (1950), 14 T.C. 74.

<sup>68</sup> For example, *IRC, supra*, note 6 at § 368(a)(1)(A)&(B).

<sup>69</sup> *Ibid.* at § 332 provides that liquidation of a controlled subsidiary is non-taxable to the parent corporation; *IRC* § 337 provides that it is non-taxable to the subsidiary; and *IRC* § 334(b) provides that the parent takes the subsidiary's basis in the transferred assets.

<sup>70</sup> For example, *ibid.* at § 368(a)(1)(C).



carryover-basis asset acquisition described in the last paragraph requires the acquiring corporation either to exchange its stock for the desired assets or to take the target corporation's environmental and other liabilities, as a result of the target's liquidation. The argument for elective treatment on this view of current law is that making the election between carryover-basis and cost-basis acquisitions explicit would both simplify the taxation of acquisitions and separate the tax consequences from the availability of various corporate procedures.

(iii) Role of the corporate tax

The view that taxpayers should be able to freely elect cost- or carryover-basis treatment, no matter whether the transaction would be classified as a sale or a reorganization under current law, is related to conceiving of the corporate tax as having two functions.<sup>71</sup> First, it implements the double tax on the current operating income of corporations. Second, it functions as a substitute tax on non-operating income of corporations when that income is not taxed currently to shareholders. This refinement of the classical view of the corporate tax suggests that the double tax need not apply to the realization of gain on corporate assets outside the usual course of business if shareholders are currently taxed.

Allowing corporate acquisitions to achieve either carryover-basis or cost-basis treatment is consistent with this view of the corporate tax, as long as a corporation transferring assets in a carryover-basis asset acquisition cannot retain the consideration received for the assets in order to avoid current shareholder taxation. Accordingly, the proposals generally limit the availability of an election for carryover-basis treatment of two types of asset acquisitions: (1) mergers or consolidations that do not involve consideration that would be taxable if distributed to shareholders; and (2) asset acquisitions in which the corporation transferring the assets distributes the consideration received for the assets to its

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<sup>71</sup> *ALI Acquisition Proposals, supra*, note 14 at 15-19.

shareholders in a taxable transaction.<sup>72</sup> Thus, in every cash acquisition of assets there would be at least one tax collected: from the shareholders of the selling corporation if the cash is distributed to them, and from the selling corporation if it is not so distributed.

(iv) Discontinuities

Before the repeal of the *General Utilities* doctrine, the acquiring corporation could obtain a cost basis without any correlative taxation of the transferring corporation.<sup>73</sup> This discontinuity was one of the principal defects of *General Utilities* for many of its opponents.<sup>74</sup> The 1986 repeal eliminated that possibility, but introduced some additional discontinuities. Consider, first, the sale of stock by individual shareholders to an acquiring company versus the sale of corporate assets to that company. As described above, the *Code* currently allows explicitly elective treatment on stock, but not asset, acquisitions.<sup>75</sup>

Now consider the sale by a corporate parent of stock in a wholly-owned subsidiary. If the corporate parent sells the subsidiary stock to an acquiring corporation for cash and distributes the proceeds to the corporate parent's individual shareholders, there will be a corporate tax due on the sale, but the acquiring corporation will not receive a correlative step-up in corporate asset basis unless gain is recognized on the subsidiary's assets.<sup>76</sup> That is, carryover-basis treatment is not available even though individual shareholders of the selling corporation pay a current tax. Under these

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<sup>72</sup> *ALI Acquisition Proposals*, *ibid.* at 73-74; *Senate Staff Proposals*, *supra*, note 65 at 50.

<sup>73</sup> Prior to the *Tax Reform Act of 1986*, § 338 of the *Internal Revenue Code* provided that the target was taxed as though it had sold its assets pursuant to a plan of liquidation, but such sales were generally not taxable. See *Internal Revenue Code*, *supra*, note 6 at § 337 (as amended prior to 1986).

<sup>74</sup> *Senate Staff Proposals*, *supra*, note 65 at 42-44, 59-61.

<sup>75</sup> *IRC*, *supra*, note 6 at § 338.

<sup>76</sup> *Ibid.* § 338(h)(10) provides a special election to have the gain recognized on the subsidiary's assets, rather than on the sale of the subsidiary stock.

circumstances, the parties may be subject to "triple" taxation, because another corporate tax will be levied if the acquired subsidiary sells its assets. This problem derives from the possibility that a corporation's basis in the stock of a subsidiary can differ from the subsidiary's basis in its assets.

There are some tax-planning responses to these discontinuities, but their validity is uncertain.<sup>77</sup> In addition, these discontinuities may put further pressure on the provisions of the *Internal Revenue Code* that are designed to distinguish taxable dividends from non-taxable corporate divisions.<sup>78</sup> For example, corporate assets could be transferred to a subsidiary, the stock of which is transferred to individual shareholders, who would later sell the subsidiary stock for cash to an acquiring corporation, which liquidates the acquired subsidiary. If the form of that transaction were respected, the purchasing corporation would have achieved a carryover-basis asset acquisition with only one tax, paid by selling shareholders. Such a series of steps would, however, have to run the gamut of provisions designed to re-characterize transactions that are essentially substitutes for dividends.<sup>79</sup>

(v) Implications for corporate tax design

There are three possible statutory responses to the discontinuities between asset and stock acquisitions under current law: (1) adoption of the American Law Institute and Senate Finance Committee staff proposals to extend elective treatment to asset acquisitions, (2) elimination of the election currently available in stock acquisitions, and (3) tolerance of the inconsistency between asset and stock acquisitions. Each of these alternatives requires the articulation of distinctions that may not easily be implemented.

The first response, adoption of elective treatment for asset acquisitions, is consistent with the refined classical view of the

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<sup>77</sup> See, for example, J.A. Baker III, "Letter" (1986) 33 Tax Notes 1073.

<sup>78</sup> *IRC*, *supra*, note 6 at § 355.

<sup>79</sup> *Ibid.*

corporate income tax described above in (iii), but would involve a number of new concepts. To begin with, acquisitions eligible for the election would have to be defined. In general, the American Law Institute and Senate Finance Committee staff proposals are applicable to stock acquisitions in which 80 percent of the target's stock is obtained, and to asset acquisitions involving either statutory mergers or the transfer of substantially all the assets of the target corporation, followed by a liquidation of the target.<sup>80</sup>

The most difficult design issue in implementing this general approach would be specification of when the election is available on acquisitions of less than all the assets of a corporation or affiliated group of corporations.<sup>81</sup> At one extreme, transfer of any asset, other than sale of an item of inventory in the ordinary course of business, could be subject to the election if the selling corporation distributed the sale proceeds to shareholders, on the ground that the asset could have been separately incorporated and that the articulated role of the corporate tax would be served because shareholders would be taxed currently. Alternatively, a transfer of substantially all the assets of a corporation or an affiliated group, or perhaps the transfer of a pre-existing subsidiary, might be required. Another, intermediate, solution would be to require the transfer of an active business, as is now necessary for non-recognition treatment of corporate divisions.<sup>82</sup> Once the scope of the election was determined, a correlative decision would be required on whether consistency rules for corporate transferors or transferees would be necessary to protect the election from expansion by tax planning.<sup>83</sup>

Sometimes it is suggested that there should be special elections available for land, goodwill, and other non-amortizable intangibles, because a cost basis would not provide the acquiring corporation with additional depreciation deductions even though the

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<sup>80</sup> ALI *Acquisition Proposals*, *supra*, note 14 at 43, 73-74, 145-46; Senate Staff *Proposals*, *supra*, note 65 at 50.

<sup>81</sup> ALI *Acquisition Proposals*, *ibid.* at 92-101.

<sup>82</sup> IRC, *supra*, note 6 at § 355.

<sup>83</sup> Cf. *ibid.* at § 338(f) (consistency provisions applicable to stock acquisitions under current law).

corporate seller is taxed.<sup>84</sup> Thus, a carryover-basis treatment might be permitted for transfers of goodwill in a transaction otherwise considered a cost-basis acquisition.

Finally, proposals for elective treatment would generally conform a corporation's basis in the stock of its subsidiary to the subsidiary's basis in its assets,<sup>85</sup> but a special problem arises on a carryover-basis stock acquisition, followed by resale of the acquired subsidiary's stock within a relatively short time. Arguably, the corporate parent should be able to compute gain or loss using the cost of the stock for at least some limited period. Otherwise, there might be another corporate tax due where there was no additional economic gain.

The second response to the inconsistency in current law between asset and stock acquisitions is to achieve consistency with the result in asset transfers by requiring taxation at the corporate level when there is a significant transfer of stock to an acquiring corporation.<sup>86</sup> The rationale for this result is that a significant transfer of corporate assets should be a taxable event at the corporate level, whether accomplished by acquisition of the target company's assets or its stock. The main implementation issue implicated by this approach is to define when there is a significant enough shift in share ownership to trigger corporate taxation.<sup>87</sup>

The third, and final, possible response is to tolerate inconsistent treatment of stock and asset acquisitions by continuing the election for cost-basis or carryover-basis stock acquisitions without extending the election to asset acquisitions. The rationale for this result would be that acquisition of the assets of a corporate business should be considered a corporate realization event under the classical system even if acquisition of a corporation's stock is

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<sup>84</sup> *ALI Acquisitions Proposals, supra*, note 14 at 120-33; *Senate Staff Proposals, supra* note 65 at 54-55.

<sup>85</sup> *ALI Acquisition Proposals, ibid.*; *Senate Staff Proposals, ibid.* at 54-55.

<sup>86</sup> In terms of the structure of current law, this would require a mandatory election under *IRC, supra*, note 6 at § 338.

<sup>87</sup> *Cf., ibid.* at § 382(g) (defining shifts of stock ownership for purposes limiting loss carryforwards).

not. The major design issue under this approach would be to distinguish between stock and asset acquisitions.<sup>88</sup>

b) *Other merger, acquisition, and liquidation issues*

Although the proposal for elective treatment of asset acquisition has been the most widely discussed potential change in this area, there are other important issues to be resolved with respect to mergers and acquisitions. Four will be briefly identified here.

(i) Shareholder taxation

Should the criteria for taxation of a particular shareholder be developed separately from those governing corporate treatment and the treatment of other shareholders, as suggested by the American Law Institute and the Senate Finance Committee staff? Non-taxability of shareholders under these proposals would depend strictly on the consideration received by that shareholder.<sup>89</sup>

(ii) Refinement of the current regime

If the elective approach for corporate taxation is rejected and the basic distinction in current law between taxable sales and non-taxable reorganizations is maintained, could the governing provisions be substantially simplified by reducing the discontinuities among different types of reorganizations?<sup>90</sup>

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<sup>88</sup> Cf. *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945) (sale of assets); *United States v. Cumberland Public Service Co.*, 338 U.S. 451 (1950) (sale of stock).

<sup>89</sup> *ALI Acquisition Proposals*, *supra*, note 14 at 151-97; *Senate Staff Proposals*, *supra*, note 65 at 52-53.

<sup>90</sup> See, for example, American Bar Association Section of Taxation, Committee on Corporate Stockholder Relationships, "Recommendation No. 1981-5" (1981) 34 Tax Law 1386.

(iii) Incorporation provisions

In recent years, taxpayers have attempted to achieve non-recognition treatment in some acquisitions that would be taxable under reorganization concepts by arguing that the non-recognition provisions dealing with incorporation transactions can also be applied to mergers and acquisitions.<sup>91</sup> A design decision will thus be required on how the reorganization and incorporation provisions of the *Internal Revenue Code* should be interrelated.

(iv) Net operating loss carryforwards

Finally, as described above,<sup>92</sup> the 1986 legislation includes a new set of limitations on loss carryforwards, designed to limit the value of such carryforwards after a merger or acquisition to the value that the losses would have had to the company transferring the losses. The extent to which those proposals will accomplish that goal in practice, and whether the goal is desirable, remain open questions.

#### 4. International issues

The 1986 rate reduction is also likely to lead to reconsideration of certain aspects of the U.S. regime for taxing international income flows. International issues have not yet received the same attention as those involving the scope of the corporate tax base, distributions, and acquisitions,<sup>93</sup> so we will simply identify the major questions that have to be addressed.

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<sup>91</sup> See, for example, Rev. Rul. 84-71, 1984 C.b. 106 (reconsidering previous ruling that incorporation provisions were inapplicable in certain acquisitive transactions).

<sup>92</sup> See text at 316-17.

<sup>93</sup> United States Treasury Department, *Outline of Issues for the Treasury Study of Subchapter C* (9 April 1987) indicates that the Treasury will give substantial consideration to international issues.

a) *U.S. investment abroad*

Domestic rate reduction and repeal of the capital gains preference raise three major issues. First, should the United States reconsider its traditional systems of taxing worldwide corporate income with a credit for foreign taxes paid, because U.S. rates are now lower than those imposed by many of its trading partners? Alternatives include an exemption for foreign income and a deduction for foreign taxes.

Second, should the distinction in the treatment of a U.S. company's foreign branches (income taxed currently) and foreign subsidiaries (income not taxed until repatriated) be reconsidered? If the current system of deferral remains in place, there will certainly be scrutiny of the provisions designed to limit opportunities for deferral.<sup>94</sup>

Third, reconsideration of the earnings-and-profits concept will necessarily include the special function of that concept in the international context, where it is used to measure the U.S. tax base of foreign subsidiaries and to identify the foreign income related to foreign taxes paid.<sup>95</sup>

b) *Foreign investment in the United States*

Many countries, including the United States, impose a withholding tax on certain categories of income, such as corporate dividends, flowing out of the country to foreign investors.<sup>96</sup> Reduction of domestic tax rates raises the question of whether the withholding rates, which were intended to approximate net taxation on certain items of gross income, should now also be reduced. In addition, the growth of do-it-yourself integration may lead to

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<sup>94</sup> For example, *IRC, supra*, note 6 at § 482 (reallocation of income and deductions among related parties); *IRC* § 367 (relating to certain transfers in and out of the U.S.); *IRC* §§ 951-964 (requiring the current taxation of the income of certain controlled foreign corporations).

<sup>95</sup> For example, *ibid.* at §§ 902, 952.

<sup>96</sup> *Ibid.* at §§ 871(a), 881, 1441, 1442.



reconsideration of the current exemption from withholding for certain categories of corporate interest payments.<sup>97</sup>

Repeal of the capital gains preference for U.S. taxpayers raises the question of whether the virtual exemption of foreign investors from U.S. taxation of capital gains on stock in U.S. corporations (other than those sufficiently related to U.S. real estate) can be maintained.<sup>98</sup>

Finally, current issues include whether the new branch-profits tax will accomplish its intended goal of implementing the classical double tax for foreign corporations operating in the United States, and whether that goal is desirable.

### C. Summary of the Current Situation

The current corporate tax regime in the United States can be characterized as unstable in the areas we have considered. First, the 1986 *Act* creates new pressures on the scope of the double tax, with taxpayers likely to move aggressively to adopt do-it-yourself integration in order to take advantage of relatively lower individual tax rates. Second, for those corporate assets that remain subject to the classical double tax, the current system is not designed for a world with no capital gains preference and a corporate tax rate that is higher than the individual rate. Third, the provisions governing corporate reorganizations, which were not generally addressed by the 1986 legislation, contain many unresolved design issues, with some new questions raised by the repeal of the *General Utilities* doctrine. Fourth, the 1986 changes raise a number of questions about how the United States taxes international corporate income.

## IV. FUTURE DIRECTIONS

As a result of the 1986 *Act* and prior proposals, the current situation is ripe for significant changes in the U.S. corporate income

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<sup>97</sup> For example, *ibid.* at § 871(h) (exemption for interest received on portfolio debt investments).

<sup>98</sup> *Ibid.* at §§ 864(b), 871(a)(2), 897.

tax, in spite of the passage of major tax bills in 1981, 1982, 1984 and 1986. The 1986 legislation mandated a comprehensive study of corporate taxation by the Treasury Department, which is due to appear by the end of the 1987.<sup>99</sup> The American Law Institute Federal Income Tax Project is reappraising its 1982 proposals in the light of the recent changes, and various professional groups have begun their own studies.

Although the six models described at the beginning of this paper all describe theoretically possible directions for future legislation, four of those models — accrual taxation, current shareholder taxation of corporate income, cash flow taxation, and the American Law Institute study proposals on distributions — have not as yet generated much widespread interest in the United States.

If recent Congressional action is any guide, the most likely future direction is probably further refinement of the classical double tax system to prevent the disintegration of the corporate tax base predicted by some tax practitioners. With regard to the scope of the corporate tax, that would probably mean clarification of the taxation of publicly-traded partnerships, reconsideration of the role of subchapter S, and, perhaps, an attempt to classify as equity any debt issued in exchange for outstanding equity. With regard to distributions on equity, this approach would mean elimination of at least some of the remaining differences in the taxation of dividend and non-dividend distributions, if full taxation of capital gains is thought to be stable. This approach might also suggest reluctance to adopt full electivity for corporate acquisitions, on the grounds that corporations, like individuals, should pay taxes in accordance with a realization concept, rather than an election. Finally, the implications of recent Congressional action for future legislation in the international area are less clear, although refinement of the classical system could lead to a more rigorous implementation of the double tax with regard to international income, perhaps reducing opportunities for deferral.

My own preference would be for a different approach, which would begin movement toward integration of the individual and the

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<sup>99</sup> *Tax Reform Act of 1986, supra*, note 29 at § 634. The Treasury has released an outline of issues to be studied. See *supra*, note 93.

corporate income taxes. Pressures against that result in the immediate future include revenue consideration and the feeling on the part of many observers that Congress rejected the integration alternative in 1986. On the other hand, uncertainty about the economic effects of the double tax system, the spread of integrated regimes in other developed countries, and whatever opportunities remain for do-it-yourself integration after the next round of legislation, may ultimately move the United States in the direction of integration. In that case, the work done by the Canadian Carter Commission more than twenty years ago will remain an important standard against which future U.S. corporate tax legislation will be measured.

