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Issues in the Taxation of U.S. Entities”**

**Keynote Address: “Corporate Tax Reform,
Business Tax Reform, or Capital Income Tax
Reform?”**

Edward D. Kleinbard

The following is a lightly-edited transcription of Professor Edward D. Kleinbard’s oral remarks at the 2014 *Chapman Law Review* Symposium.*

INTRODUCTION OF PROFESSOR EDWARD D. KLEINBARD BY
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It is my distinct pleasure to introduce to you Edward D. Kleinbard from USC Law School. Ed has an interesting background. He got his BA in Medieval and Renaissance Studies, and he also has an MA in History, both from Brown University. Those of you who think there is a good preparation for tax in taking something like Economics, no. Tax is obscure and arcane. Medieval and Renaissance studies is where you get the background. He has his JD from Yale Law School, and he was a partner with Cleary Gottlieb in New York for two decades. When he left Cleary Gottlieb, he became Chief of Staff for the U.S. Congress Joint Committee on Taxation, and he has been at the University of Southern California Gould School of Law and a fellow at the Century Foundation since 2009. He is a prolific scholar of a wide range of tax policy issues, including: stateless income, tax expenditures in a tax base, proposals from presidential candidates and Capitol Hill, and a dual income tax with different rates for capital income and labor income. Join me in extending a warm welcome to Ed Kleinbard.

* His keynote address was accompanied by a presentation available at <http://www.chapman.edu/law/publications/chapman-law-review/annual-symposium/2014-symposium/>.

KEYNOTE ADDRESS OF EDWARD D. KLEINBARD, PROFESSOR OF
LAW, UNIVERSITY OF SOUTHERN CALIFORNIA GOULD SCHOOL OF
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Michael, thank you very much and thank you all for being here. Since this is a business tax symposium, it seemed to me worthwhile, before we figure out how to do business tax reform, to think about what it is we want to reform and why. In particular, I wish to ask the question, "Are we reforming the corporate income tax, the business income tax, or capital income taxation?" Calls for business tax reform are all around us, but we have to remember that in the United States, businesses and corporations are not synonymous. Meanwhile, there is a deeper level to the question of what it is we might want to think about, and that is the idea of capital income.

There are only two meaningful kinds of income: labor income and capital income. Those of you who have taken Tax I might have the impression that tax practice is all about discovering a stash of cash in a second hand piano. Cases involving this, record-setting home run baseballs, or treasure trove turn out to be a very small part of the typical practice. For our purposes of approximation, income is either from labor, or as a return on capital.

Capital income means all returns to savings and investment, not just capital gains. For example, capital income would include interest income, rents, or dividends. It would also include net business profits, because the labor inputs to business, in an ideal world, have already been accounted for through the deduction for wages. In a public corporation in particular, where if you want to get the returns to your labor paid out to you, you take them in the form of wages, what is left is some kind of return to capital.

Why is it that we want reform? One obvious answer is that the corporate headline rate, the 35% statutory rate, is uncompetitive. That is true in the sense that the U.S. headline rate is now substantially higher than the statutory rate in many other jurisdictions. Alternatively, do we want to engage in business tax reform to capture incremental economic efficiency gains? Again, it is certainly true that economically similar kinds of returns to capital are taxed at wildly different rates. That, in turn, leads to misallocation of investments. The most conspicuous example, of course, is homes, where by virtue of the heavy subsidization of home ownership, U.S. households have disproportionately invested in housing rather than in productive business capital.

Or do we want to pursue reform to advance distributional goals? One of the differences between rich people and other people is that rich people have more money. They have more capital, and as a result, they have more capital income. How you tax capital income therefore has a huge distributional implication. It is much more heavily top-weighted than our distributions of labor income.

Finally, what about revenue? Are we trying to reform business taxation in order to collect more revenue because we are short of our revenue needs?

Let's try and disentangle all these. Here I am going to keep peeling back layers of the onion. Is the corporate rate really uncompetitive? Yes, of course the statutory rate is, but we know for a fact that the effective real-life tax rate—the real-life burden—on foreign income of U.S. multinationals is in the single digits. Domestic effective tax rates are very different. Corporate effective tax rates in the United States, which you would think would be our first priority, get amazingly little attention in public discourse. If you look at the effective tax rate on a firm's next investment, its marginal investment—unincorporated businesses are a little bit lower-taxed than corporates; maybe 25% for corporations and 21 or 22% for unincorporated entities.

If we truly want a more economically efficient environment, the resulting tax system will require radical overhaul, as we will see in a minute. That is going to require thinking much more comprehensively about the different instances of capital income and how we can link them in some useful way.

Remember also that if economic efficiency is your goal, there is a classic problem: the usual base-broadening and rate-lowering intuition is said to reward old capital. That is, old investments would simultaneously enjoy the benefits of old accelerated depreciation methods and new lower rates. Why should we reward old investment through classic base broadening and rate lowering? I personally think that this issue is somewhat overstated, since old capital and new capital tend to go hand-and-glove. Firms that have old capital tend to continue and make new investments. But nonetheless, the efficiency is not easy to capture. Distributional goals are generally thought to conflict with efficiency goals because, from a distributional point of view, you might want to have a significant tax on capital incomes since they are so top-weighted. From an efficiency point of view, we want to encourage investment because ultimately that leads to greater productivity, greater GDP in the United States.

Revenue goals are the most fraught of all as a political matter. The reason tax reform in a broad sense cannot happen is that there is no agreement—or in my view, possibility—of agreement on the fundamental question of how large government should be and therefore how much we should finance. Those of us who think about tax tend to ask the questions in the wrong order. We start by asking, “How should we reform taxation?” But the government of the United States is not in business for the purpose of collecting taxes. The government of the United States, like all governments, is in business to *spend money*. The first question, the ultimate question, and the question dealt with at length in my new book *We Are Better Than This: How Government Should Spend Our Money*, is: What should we be spending our money on, and only then, how should we finance that spending? Frankly, tax policy is much, much easier than spending policy, but we have muddled the two, and so we indirectly argue about how much we should be spending under the guise of arguing about how much tax revenue we should be collecting. This is a backwards way of phrasing the question. Instead, we need to ask, “What should we be spending on, and then, can we afford to finance that?” It is really a fundamentally different perspective. That is one of the reasons why public debates on tax reform are so unproductive, because we are really arguing about government spending, and we are doing so through the guise of arguing about the tax system.

Let’s peel off another layer: Do we wish to reform corporate income, or business income? The United States is really unique among large economies in having half of its domestic business income in the unincorporated sector. You cannot treat partnerships, LLCs, and the like as some kind of a rounding error. Now, that number is somewhat overstated, as there are incentives to muddle labor and capital income for firms with the classic owner-entrepreneur; in other words, the closely held firm with an owner-entrepreneur. The result is that there is, in fact, a lot of implicit labor income in the United States that is being presented as net business profits of closely held firms. If you look at capital intensiveness, the number is probably closer to 70/30. That is, corporations probably have 70% of the capital investment, and that is just a rough-and-ready rule of thumb.

But remember that when you start down the path, whichever path you take, there are weird overlap issues. If you want to do corporate tax reform and pay for it through closing business tax expenditures, like accelerated depreciation, you are asking the unincorporated sector to pay for lower corporate rates. And conversely if, like Dave Camp, you propose a large-scale

reform where individual rates are lowered, businesses are asked to pay more, as we will see. In fact, the tax burdens on unincorporated entities in a proposal like Dave Camp's involve two things moving in opposite directions: after reform, they would face higher business taxable income tax, and they have lower rates on that business income. Thus, when thinking about the Camp proposal, we in fact have to think not just about how much business will be paying through base broadening, but also how much unincorporated entities are receiving through lower rates.

If we really want to have serious reform, we have to think much more radically, and we would want a system in which capital income is taxed at consistent rates, regardless of the form of financial investment. First, why do we care so much whether something is called debt or equity? Why should the effective tax rate vary so much? Second, it turns out that depreciation is not just for accountants. It turns out that depreciation *is* in fact the way that you measure returns to real financial investment. (When economists say "real," they mean investment in greasy machinery and the like, as opposed to financial investments.) Depreciation and amortization of intangibles are essential to whether you are accurately measuring capital income from real investments. Third, you would have rules that would get the same results without regard to the form of business organization.

I recognize that it is fun to have clients come in to your law office, and to recommend an S Corporation for one client, and an LLC for another. But if reform is your goal you want to take a big step back and think about a system that treats capital income consistently; you would not have different rules for different forms of business organization. If you really want to pick up these efficiency gains from taxing capital income more coherently, you need to tax all business enterprises identically. You need to rethink "debt versus equity" kinds of distinctions. And you would need to tease apart labor and capital income in a closely held firm through what I call a "labor-capital income centrifuge" so that you are applying the right rules to the right kind of income.

Very quickly, we can say with certainty that we are doing an okay job with labor income, we really are. If labor income were all that we cared about, and we are not that far off the mark. However, we do a horrific job at taxing capital income.

CBO did a great study a few years ago which found that the effective tax rates, the marginal investment by a corporation, could swing from 36% to -6%, depending on how it is financed, the depreciation rules, and so on. That is a 42 percentage point

swing in effective tax rate. When you look at investments that are debt-financed and have accelerated depreciation, and someone says, "That has a negative effective marginal tax rate," what they are saying is that all of us are paying money to that company to make that investment, which is a very odd thing to ask of us in a world that is supposed to be market-driven.

If you want to think these sorts of radical thoughts about capital income, what rate should we apply? There are all kinds of capital income: there is the dull, plodding returns, from return to waiting; there is the so-called normal returns; there is the returns from taking on risk; and there are economic rents, which are the super-sized returns, because you have a special angle, you have a patent, and you have a unique position that you can exploit. There is no reason to believe that those three kinds of income should be taxed the same, and there is certainly no reason to think that, as a logical matter, they ought to be taxed the same as labor income. It would be true only by coincidence.

What I am suggesting is that capital income reform is a great aspirational goal. It turns out to be technically possible, but it requires very radical rethinking: treating all business enterprises alike, treating all kinds of financial investments alike, separating labor from capital income, and having a coherent theory about which kinds of capital income are taxed at which rate. Capital income reform is too large a topic to tackle today, however I have an idea for a solution called the "dual business enterprise income tax," and it is the subject of my book *We Are Better Than This*.

Let us return our focus to more traditional corporate reform and business reform. When you start thinking about business reform today, you cannot avoid the central importance of how international income is taxed. This is a corporate issue. Unincorporateds have very little international incomes. We can all agree that it is critically important both to the firms themselves—multinational firms themselves—and to any tax reform initiative.

I think we can all agree as well that the current law is just immensely flawed. Corporations are quick to say that they face an uncompetitive business environment. Their idea of "competitiveness" requires what I call a "toothless territorial tax system." These complaints are largely fact free. In fact, if you look at the effective tax rates on major U.S. multinationals today, they are under foreign income. Whether you look at a Microsoft, an Apple, a Google, or a General Electric, their effective tax rates on their foreign income is in the single digits. There is no country in the world in which they actually do business that has tax rates

as low as their worldwide effective rate on their non-U.S. income. General Electric just reported \$13 billion of income for the last year, on which they had a *worldwide* effective tax rate—including the United States—of 4.2%.

Very quickly, the U.S. international tax system today really becomes an ersatz kind of territorial system. If you look at cash taxes that are actually paid, yes, some money comes back. The money that comes back, comes back with full foreign tax credit. I talked about this at length in the article *Stateless Income*. So the actual taxes paid on repatriated earnings today is close to nil. We do have the cost of the so-called “lock-out phenomenon” in which income must be held nominally in the ownership of the foreign subsidiary.

Competitiveness is therefore not the issue. Current law, however, does have extraordinary behavioral distortions. For example, the famous “lock-out effect” allows firms to have trillions of dollars of earnings that are owned by their foreign affiliates in order to take advantage of gaming current law. And because of arbitrage opportunities, in particular the opportunity to leave all of your interest expense in the United States and let your foreign income accumulate at very low rates, the U.S. domestic corporate tax base is at risk. It is at risk to an extent that is not fully appreciated.

My stateless income papers in effect try to develop the following: it always understood that U.S. tax system had incentives for firms to distort their results, i.e., to book as foreign income—income that arguably was really earned in the United States, and possibly to make foreign investments in low tax countries. However, it turns out that if you look a layer deeper at how international taxation actually works, we are incentivizing U.S. firms to invest in high-tax foreign countries because it is then extremely easy for them to move the income from a starting point in Germany, via Freedonia, to Bermuda, where it finally comes to rest. The result is a perverse incentive to invest outside the United States, not necessarily just on some island that is barely above high tide, but to invest in real foreign countries and then to shift those profits to those tax-haven atolls. And that is exactly how U.S. firms actually operate.

The consequences of and the explanation for the urgency that U.S. firms bring to the debate today about their competitiveness is not that they in fact face a high foreign effective tax rate; it is that they are hoist by their own petard. They have earned so much low tax income that they now have \$2 trillion of earnings outside the United States in a nominal sense, owned by their foreign subsidiaries. They would sincerely

like to use that money to prop up the share price of their companies. That is their goal, but they cannot. That is the only thing they cannot do. The money instead is invested in U.S. Treasuries, it is in U.S. bank deposits, it is in the United States, but it is not propping up share price, and that is troublesome for companies. That is what is really going on today. There is no material tax or GAAP-drag from current law. The result is this very distortive environment in which U.S. firms have an incentive to invest outside the United States. There is an efficiency cost in all the resources, they have to be devoted. Lost opportunities for Americans are a social cost. And the "lock-out phenomenon" does lead to sub-optimal investment decisions. Finally, there is the base erosion point domestically.

There are only three problems in doing better on the international side. First, what exactly is a U.S. company? What do we mean when we say, "This is a U.S. company subject to certain rules?" Second, figuring out the source of income—where is it really earned—is even more difficult, and I would argue in fact, rises to the level of impossibility. Third, the politics are made much more difficult by what I called "tax mercantilism," which is when countries have gone out of the business of explicit export subsidies, but try to achieve analogous goals through the tax system. We no longer engage in explicit trade wars—that is one of the things GATT, the General Agreement of Trades and Tariffs, and the World Trade Organization has done for us. Instead, countries have switched their subsidy programs to the tax arena. The United Kingdom, for example, has gone into the business of trying to attract European multinationals to re-headquarter in London and provide them a lower tax rate on their non-UK income than would be true if they stayed in their home countries. When you have countries competing on that basis, the international environment becomes very difficult.

Let us talk about where tax reform is today. The President has said that he wants a lower corporate tax rate, perhaps 28%. He has not quite explained how that is going to happen. He has said that he wants to tax existing offshore permanently reinvested earnings. The President wants to tax that to collect about \$150 billion to invest in the United States infrastructure. And he wants to raise another \$250 billion by making the international tax regimes tougher.

Dave Camp, by contrast, has a really big comprehensive bill, and there are a lot of good aspects to the bill. It is designed to be revenue-neutral over the ten-year budget window, the official window of time that Congress looks at, and to do so by having, in the aggregate, lower tax revenues on personal income. He

proposes a corporate rate of 25%. The individual rate—the highest bracket—would go down to 35%, but on a broader base than current law, so many high income individuals actually might pay more. On the international side he would move to a territorial system funded in part by a \$170 billion transition tax on those same permanently reinvested offshore earnings. If you were to look closely at the Joint Committee's revenue estimates for what this bill would mean, it shows \$590 billion more of business taxes in the next ten years, and \$590 billion less in personal income taxes, but as I'll explain in a minute, for unincorporated business owners, this accounting is misleading, as it is only the net of the two moves that is relevant.

Can we get to a deal? The Camp bill, unlike the President's observations, is comprehensive, it is detailed, and you can actually talk about it. There are a lot of points in common. Everyone agrees that the headline rate on corporate income has to come down. Everyone agrees that the international system is unstable and that the lock-out effect—the idea that foreign subsidiaries must retain their low tax foreign earnings to get lower effective tax rates and have a tax penalty if they repatriate too much to United States—is unwise.

There seems to be some confusion about the idea that business tax reform should be revenue-neutral because Camp imposes more tax on the business sector. I would have thought there would have been consensus. But we will dissect that in a minute. It remains the case that there is no chance whatsoever of consensus on this larger issue of how much overall revenue should be collected, because that is really the stalking horse for how big government should be. That means that if we are going to see business tax reform anytime in the next several years, we must look at it as a separate piece of legislation.

The current Camp Bill has to crash and burn and then, phoenix-like, a business-only legislation has to emerge. That is the only scenario that I can ever see working. That in turn has its own complexities. A number of people, including the President, are very unenthusiastic about breaking out business tax reform. There are a number of technical issues in doing so, and very different views about what to do about international income.

The Camp bill is a piece of serious legislative drafting, fully scored by the JCT. We should talk about how it is that a Republican Chairman of the Ways and Means Committee would produce legislation that would impose \$590 billion more tax on businesses, notwithstanding the lower rate. That seems very odd. The answer is in part that this overlooks the netting that goes on

within the unincorporated sector. That is, the Camp bill broadens the business income base, but individual rates are going down. The JCT staff scored the former as "more business taxes" and the latter as "lower individual taxes," even though the two are netted against each other on the tax return of an unincorporated firm. If you make a few sensible assumptions, that really what is going on is \$250 billion or so is being used from the corporate sector to finance the personal sector, once you net all the unincorporated business stuff.

The JCT, a wonderful group, presents things to some extent in ways that they were told. Nonetheless, it is a fair criticism of the long and detailed revenue estimates that were prepared that you cannot answer the question how much the corporate sector's tax burdens are rising compared to personal income tax returns. That is a normal question to ask; that is a question we ought to be able to answer. But because of the way they present all of business in one lump and then all of the consequences of personal rate reduction over on different tables, you cannot answer these very straightforward questions. I find that to be very frustrating. I would also hypothesize that there is a piece of paper with that answer. This is what Chairmen of Ways and Means Committees do, so that when an important constituent who has an unincorporated business comes into see you, you say, "Here, let me show you the picture," and there is a piece of paper somewhere that says, "This is how much net corporates are bearing, this is how much net the personal side is bearing."

The numbers themselves—even once you get past this question of how much is really being shifted from business to personal side—are quite fuzzy, as often is the case. It turns out that doing what everyone wants, reducing the corporate tax rate to 25%, is very expensive: \$680 billion over ten years. In fact the real number is greater, because Camp phases in the lower rate over five years. We don't even have a full ten-year cost for a 25% tax rate. Then we have these other two personal income items that basically wash out against each other. If these were fully phased in, you would be looking at \$800 billion more in revenue, lost through reducing personal tax rates. That is a big hole to fill.

There also is a lot of frontloading and backloading that goes on in the bill. The phase-in of the lower rate for corporation is an example of backloading the cost of the legislation. Slower depreciation and amortization rules tend to effectively frontload the revenue pick up from those changes. The international provisions of the Camp bill would raise about \$70 billion over ten years, but that turns out to be entirely fictitious. It is because of a one-time \$170 billion tax on the existing stock pile of of

permanently reinvested earnings. If you take that out, the Camp bill would reduce burdens on international income by another \$100 billion. You take income that today is taxed at a single-digit effective rate and say, "You know what, let's all throw another hundred billion dollars your way." It is not the call I would have made.

Finally, some of the revenue pick ups are unrealistic even to me, like rules requiring you to capitalize and amortize advertising expenses and rules that would require you to capitalize and amortize research and development rather than expense it, as we do currently. These are very, very large numbers, which is why I mentioned them, and not very likely ones.

What to do, what to do? Well of course, what you want to do right now is stand up and shout, "But surely dynamic analysis will fill the gap." This requires a visit from the growth fairy, and it also turns out that this dynamic estimating stuff is very difficult. When the JCT does a revenue estimate, the revenue estimate is dynamic in the sense that it does take behavior into account. It does not however, assume that GNP (Gross National Product) will be affected—it has a fixed GNP constraint. So-called "dynamic analysis" or macroeconomic analysis says, "What will this tax legislation do for the economy as a whole?"

The JCT macro analysis of the Camp bill suggests under some circumstances that there could be some growth in GDP over the next ten years. But every point needs to be asterisked. Macro analyses do not predict compounded growth in perpetuity. In fact, if you think about it, revenue-neutral legislation should not have huge macro effects because what one person is getting, another person is losing. Thus, the extent of growth effects would be limited to some modest efficiency gains.

We therefore should be very suspicious of a revenue-neutral legislation that is said to have huge macroeconomic consequences. Most interestingly, the real lesson to take from the JCT macro study of the Camp bill is that the effective tax rate on capital income appears to be going up, because they are predicting lower capital investment in the future or break-even capital investment in the future. All of the GDP pick up from the Camp bill comes from more consumption. It comes from the fact that individuals whose income is primarily labor income have lower taxes. Therefore, they will spend more, and that leads to a larger economy. But it does not do so forever. You do not in fact grow simply by spending more; you have to invest more to grow more. The real irony of the Camp bill is that it is at best

lukewarm, and arguably hostile, to investment through all of the changes it proposes.

Finally, it is worth taking a minute to talk about the JCT conclusion because it is so important. The JCT's macro conclusions have been widely misunderstood in the press. In fact, Dave Camp did misspeak a couple of times in public media that were to the advantage of the point he wanted to make. So I think I should, on his behalf, correct the record. The JCT macro study of the Camp tax bill found, in the best possible case they could conceive of, that GDP would grow by 1.6% in the aggregate over the next ten years. That is not the same as saying that the *growth rate* of the economy would increase by 1.6 percentage points a year for the next ten years. The economy is predicted to grow about 2.5% a year for the next ten years; this misreading would mean that the economy will grow at 4.1% a year instead. That would be nice but it is not what he said. What JCT said was, "Instead of having \$233 trillion of aggregate GDP over the next ten years, we will have \$237 trillion—maybe—in the best possible case that we could conceive of." That is not the same thing. If you do the arithmetic, it implies that instead of a 2.5% growth rate, we would have maybe a 2.8% growth rate in the best possible scenario.

Even a small increase in GDP growth would be nice if it were true, but it is not sustainable in perpetuity if in fact investment is not keeping pace, which I think is consistent with the JCT staff's conclusions. And it requires some heroic assumptions in the model about human nature, among other things, because it assumes that individuals basically, in effect, live forever and have perfect foresight as to the future. That is effectively what the model assumes about human beings. It makes the *modeling* easier; it just makes the results inherently spurious. The results have nothing to do with life as it is lived in the world that we actually know.

Even on its own terms, the Camp bill is revenue challenged. It is not a sustainable revenue-neutral legislation. I think actually a point of order might lie against it in the Senate for that reason. Even without regard to the Byrd Rule, there is a newer point of order that I think would lie against it for this reason. What are we going to do about that? What is the case for \$100 billion of lower tax on international income? What is the case for shifting \$250 or more billion net to the personal side and having a significant tax hike on corporations at least for the next ten years? It is not at all clear what the business case is for those fundamental directions that the Camp bill is going in, notwithstanding all of the good ideas that are in it.

Finally, let us remember what we are really talking about. If you really want to fill the revenue hole, this entire conversation is nonsensical, because the Fiscal Cliff tax deal of January 2013 destroyed our budget. In 2012, the official CBO baseline basically showed us growing out of deficit problems. It showed us raising about 21% of GDP in tax revenues, and it showed deficits going down to 1% or so of GDP, which means we would actually be paying down our national debt, because if the economy is growing significantly faster than that, the result is that national debt as a percentage of GDP would be declining. We were in a very good place from a budget point of view in January 2012.

In January 2013, we reversed course and made permanent all of the Bush tax cuts except for those individuals earning over \$450,000 which is the reverse of the assumption that CBO made in 2012, because it followed the law which contemplated that all of those would expire. Thus, the result is that \$4.6 trillion of new deficits appeared, plus additional interest. Those numbers now show a total deficit prediction of \$8 trillion over the next ten years. Eight trillion dollars? That is half of 2014 GDP. That should focus the attention of young people in the room, who will not doubt be affected by this, and who should think seriously about these issues.

Slashing spending is in fact an exercise in magical thinking. Even if you want to seriously limit entitlement spending, the fact is that doing so must be phased in slowly. The last time we adjusted Social Security, for example, we did it over a thirty-year horizon. In the meantime, the deficits have to be financed. You cannot run the economy of the United States on revenues of 18.5% of GDP. The United States in 2012, and it is predicted again in 2014, is in fact the lowest taxed country in the OECD as a percentage of GDP. We are not a high-taxed country. You are not unfairly put upon. This is a low-taxed paradise. The bankers of Zurich wish only that they could only endure the tax rates that we think are so punitive.

So in sum, the Camp bill is too soft on international, clearly, too hard on capital investment, too soft on labor income, and where is the money going to come from to fund the trillion dollar deficit?

Let us close by coming back to the international side, since that is where the big bid-ask spread difference is on corporate reform. Territorial solutions would say that international income should be taxed only where the income is earned abroad once. This works if you can have perfect confidence that the income around the world is, from a tax point of view, being attributed to the jurisdiction with the closest economic nexus to that income. If

we could do that, a territorial system makes perfect sense. The trouble is, it is impossible. It is completely impossible to pin down income to say that this is the jurisdiction with the strongest nexus case.

Why do we have multinationals? We have multinational enterprises because there are global synergies and lower internal transactions costs to doing business in this form, because they can conduct their business seamlessly across borders. All of that, in effect, should signal that it will be impossible to imagine a world in which we can predict with confidence the economic nexus of income. And because we cannot get very close at all to determining the geographic nexus of income, a territorial system in effect starts to fall apart. Everything else is like trying to hold back the sea with a broom—for example the current so-called “BEPS project”—because it begins with unsustainable premises.

There is one success story in this nexus world. Section 954(h) was designed by the Treasury to allow financial services firms to earn banking-type income—financial income—outside the United States, and it is ferocious. And it works. It is one of the great myths of some writing in this area that banking income is easy to move around. It is exactly the opposite. Actually, banks are the only ones who in fact have to prove nexus in every case. No one is volunteering for more 954(h).

The other direction is some kind of minimum tax as a safety net on international taxation or Baucus Option Z, which I think is sort of the worldwide true tax consolidation that I propose, combined with a split rate, a somewhat lower rate on international income than on domestic income.

I prefer a true residence-based worldwide tax consolidation regime. This in effect would address the issue of nexus by saying, “It is impossible,” and instead give a great deal of weight to residence of the company. In effect, my preferred approach would say, “If a company is a U.S. firm, that has meaning, and we’re going to tax it at a rate that is within the norm of developed country rates—which would mean mid-twenties—and we are going to treat that worldwide income as logically within the scope of the U.S. tax net.”

Why? What would be the policy justification for that? I think it comes out to a two-step analysis. The first step is: Why do we have a corporate tax at all? I think that the best answer is that a corporate tax is simply a non-refundable withholding tax on the income of owners. It is too hard to measure the income at the owner level. So the corporate tax really is a tax on owners in which the firm is just a proxy for owners. If you then assume that

the vast bulk of U.S. firms are ultimately owned by U.S. persons, then the idea of taxing U.S. firms on their worldwide income is not perfect—but it is good enough.

The standard Treasury data say 85 to 90% of U.S. firms are U.S. owned. A recent article suggested that that overstates things. The answer is yes, it is not perfect, but the number is not 45% either; if the number is 80 instead of 85, the basic claim that a U.S. firm is a pretty good proxy for U.S. investors still holds up. Given the impossibility of a territorial system, given the impossibility of the nexus of income, you need some other form of solution, and whether you call it a minimum tax, or a split rate on a worldwide income, in all of those cases, you have to recognize that what you are doing is in fact affirmatively embracing a residence-based tax system. I have tried to offer you a theory as to why doing so has some coherence. With that, I will stop, and I am delighted to take any questions.

QUESTION AND ANSWER

Audience Member: You indicate that there is not a competitive problem in the current system for internationals. Yet, in order to achieve that low rate of tax, they have to jump through hoops in a way that is entirely from the moon in terms of the transactions that they do, and if the IRS had more resources in terms of economists and auditors, much of that would be shut down. My thesis would be that that is why we have a low tax rate effectively on international income.

Kleinbard: I do not actually agree with that. We have a low rate on international income because the United States has aided and abetted it through the CFC look-through rules, through the check-the-box rules. We are a pariah among sensible countries in that respect. Yes, there are a lot of arm's-length pricing questions where people simply misprice relationships within the multinational group, but an awful lot of the income shifting that goes on is straight down the middle of the transfer pricing fairway.

The result is driven by the nonsensical idea of treating foreign subsidiaries as independent actors with their own capital structure. So even if we had perfect transfer pricing, we would still have low effective foreign tax rates. The problem is deeper and more structural than can be solved through litigation. Nonetheless, you are absolutely right that there is a lot of fertile ground for litigation. Frankly, the IRS should reach out to the private sector more and bring in more private help on these big ticket litigation items.

Audience Member: Thanks, very simple question. I am very sympathetic to your presentation. On your last point though, my question is, how does a worldwide tax system with a lot of pressure on residence of the corporation solve the problem, whereas to the obvious response is, "Okay, well, we will incorporate in Cayman or we will incorporate in Bermuda." Are you going to have some kind of attribution regime?

Kleinbard: Yes. A residence-based system requires more sophisticated residence rules than we have today. It requires, in effect, an either/or test. It is like Lloyd Doggett's bill that he introduces every year in which basically either you are incorporated in the United States or mind and management is in the United States. So if Mark Zuckerberg thought, "Geez, I am going to make a billion dollars or more, I should start life as a Cayman Islands company," the mind and management of Facebook would still be in the United States; it would still be a U.S. company. There would be an occasional case that slips through. But government has to move on, and the advantage of this is that it is much simpler; it does not have the transfer pricing consequences that we just discussed because in the end, the money could be taxed somewhere at 25%. And if all the executives of Mark Zuckerberg's firm actually decamp for the Cayman Islands, then I will take the risk of losing an occasional company.

Audience Member: Thanks, you mentioned the ten-year budget window that Congress looks at, and in particular, denying deductions for IRAs and all kinds of other pension changes that would shift cost out into the future.

Kleinbard: I do not know if everyone really understands what the questioner is saying. He is saying that another really good example of the backloading gimmicks going on is changing the way the IRAs work in ways that ultimately cost the government more money on present value terms if the IRAs do well, but which have the apparent effect of raising money inside the ten-year budget window and paying it out in forms of lower tax revenues in a more distant future.

Audience Member: The question is really, do you have any thoughts about how to fix the ten-year? If we looking at it the wrong way, how can that be fixed? I think you mentioned a Senate point of order.

Kleinbard: That is a really good question. I think that the right answer is that legislation needs to be scored on a present value basis, as well as the ten-year window basis. If we did a present value calculation, making some straightforward

assumptions, legislation like your example of the IRA switching game would be seen as radically not revenue-neutral. You would do that as an additional check on the process. In the Senate, my recollection, I'm not a parliamentarian, but my recollection of the new point of order is that the JCT has to certify to the Senate whether the legislation is predicted to lose more than \$100 million, I think, in any decade in the second, third, or fourth decade, and this legislation clearly would. So I think that there might be a point of order issue in the Senate. No one has said otherwise because nobody thinks that this legislation will ever get that far, but I can send to anyone that is interested a reference to the Senate point of order I have in mind.

Audience Member: Thanks so much. Just a hypothetical: General Motors has a subsidiary that makes a car in Germany, it competes with the Volkswagen model made by Volkswagen in Germany. Under your proposal of the tax going with the United States jurisdiction, assume for a moment, again, all of these are hypotheticals, that the U.S. tax rate is higher than the German tax rate, why is that not a competitive issue?

Kleinbard: There are a lot of levels to that answer. What you implicitly point out is that one of the consequences of relying on a residence-type approach to international taxation is that you lose some control over your tax rate. You cannot be that out of line with Germany's rate and France's rate because if you are, then you have this issue. That is sort of answer 1. Answer 2 is that worldwide tax systems, as we currently understand them, allow you to blend. So if in Fredonia your rate is lower than the German rate, you would blend—effectively for U.S. purposes—the two, which would get you down to the U.S. rate. Now, an economist would say, "That just means you are compelling someone to invest in Freedonia as well as in Germany." But multinationals tend to be everywhere, so the blending kind of works naturally for the large multinationals. Third, even if a U.S. individual invested directly in Volkswagen, we would expect her to pay tax on her worldwide income to bear whatever the U.S. tax cost is on top, so that if you think of a U.S. firm, again, recognizing it is not perfect; it is a rough-and-ready proxy for U.S. ultimate individual owners. The extra tax is in effect as one that should be imposed in that case.

Audience Member: On the third point, the taxation on the corporate entity, it is undoubtedly higher if you follow your rule for the American entity. Your first point of course, is because we have chosen that, and obviously that is a policy call. It is kind of a libertarian answer which happens to warm my heart because you are saying, you choose America under this rule, this is the

consequence of your having a higher corporate high tax rate than your competitor. I did not hear you say that my point was wrong as much as that it is a consequence of what policy a government might choose.

Kleinbard: I think that that is fair. Remember, however, my second point about blending. My basic response remains what I meant about losing control of our tax rate. When you go down this road, there has to be a concomitant commitment to a tax rate that is in the middle of the pack, so we do lose control of our tax rate to that extent. I acknowledge that.

Audience Member: I am thinking about the last point. If there is a materially lower rate in Germany than in the U.S., and the tax system is working right, then that raises the question: Why is that the case? Why would it be that, in Germany, the rate on German enterprises is 20% and in the U.S., it is 30%? There ought to be pressure to bring the U.S. tax rate down in that case. Maybe that sort of goes back to your first point, but probably the answer is, it is not going to be lower as a real matter. In fact, if you look at OECD countries, real effective tax rates do not actually vary all that much, which is one reason why territorial worldwide would not be that big of a problem if you did not have the stateless income problem.

Kleinbard: Exactly.

Audience Member: But then you also have these other problems you pointed to, which is: Where does the income arise in all of that?

Kleinbard: Which is why I get to residence, but it absolutely means you lose control, and you had to have a rate in the middle of the pack. Okay, with that, thank you very much.

The Emerging Consensus for Cutting the Corporate Income Tax Rate

By Jordan M. Barry*

INTRODUCTION

Contemporary tax policy circles are characterized by healthy debates on a range of policy measures. However, a consensus has emerged among tax policy experts on one point: the United States should lower its statutory corporate income tax (“CIT”) rate.¹ Doing so would produce a number of benefits, both internationally and domestically. This short Article summarizes some of the chief benefits that are driving the consensus for a reduced CIT rate. It also describes the surprising degree of political agreement that has quietly emerged on this point.

I. INTERNATIONAL TAX BENEFITS

Much of the consensus surrounding the value of cutting the U.S. CIT rate derives from concerns about U.S. competitiveness.

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¹ See, e.g., Karen C. Burke, *Is the Corporate Tax System “Broken”?*, 28 VA. TAX REV. 341, 363–66 (2008); Karen C. Burke, *Passthrough Entities: The Missing Element in Business Tax Reform*, 40 PEPP. L. REV. 1329, 1329 (2013); Peter R. Merrill, *Competitive Tax Rates for U.S. Companies: How Low to Go?*, 122 TAX NOTES 1009 (2009), available at taxprof.typepad.com/files/tn1009.pdf; David M. Schizer, *Fiscal Policy in an Era of Austerity*, 35 HARV. J.L. & PUB. POL’Y 453 (2012); Joseph J. Thorndike, *The Durability of a Dysfunctional Tax: Public Opinion and the Failure of Corporate Tax Reform*, 21 KAN. J.L. & PUB. POL’Y 347, 350 (2012); John Diamond & George Zodrow, *The Case for Corporate Income Tax Reform*, AM. ACTION F. (May 29, 2013), <http://www.americanactionforum.org/research/the-case-for-corporate-income-tax-reform>; Dan Maffei & Ryan McConaghy, *The Case for Corporate Tax Reform*, THIRD WAY 1 (Aug. 2011), http://content.thirdway.org/publications/434/Third_Way_Policy_Memo_-_The_Case_for_Corporate_Tax_Reform.pdf; *Tax: Fundamentals in Advance of Reform: Hearing Before the S. Comm. on Fin.*, 110th Cong. 20–21 (2008) (statement of Michael J. Graetz, Professor of Law, Yale Law School), available at <http://www.finance.senate.gov/hearings/hearing/?id=dd061d06-e1ba-5190-a38-f6bf4c8dab2e>; PETE DOMENICI & ALICE RIVLIN, BIPARTISAN POLICY CTR., *RESTORING AMERICA’S FUTURE: REVIVING THE ECONOMY, CUTTING SPENDING AND DEBT, AND CREATING A SIMPLE, PRO-GROWTH TAX SYSTEM* 17 (2010), available at <http://www.bipartisanpolicy.org/projects/domenici-rivlin-debt-reduction-task-force>; see also Dylan Matthews, *Everyone Wants to Lower Corporate Tax Rates. Here’s How You Do It.*, WASH. POST (Sept. 26, 2012), <http://www.washingtonpost.com/blogs/wonkblog/wp/2012/09/26/everyone-wants-to-lower-corporate-tax-rates-heres-how-you-do-it/> (“Everyone wants to cut the corporate income tax rate. That’s one of the few areas of real common ground in American tax policy . . . All three major bipartisan tax reform plans—Bowles-Simpson, Domenici-Rivlin and Wyden-Coats—include a corporate rate cut.”).

Reducing the statutory CIT rate would make the United States a more attractive business environment by lowering the tax cost of doing business in the United States. At the margin, this would help encourage more businesses to open and operate in the United States.

The argument laid out above can be made for any country that imposes a CIT. However, there is a sense among many that the United States is in particular need of a CIT rate cut. The basic argument is as follows: Over the last twenty-five years, business has become increasingly mobile. This has fueled an increase in tax competition among jurisdictions, which have cut their statutory CIT rates to attract businesses.² The United States has not participated in this rate cutting and has kept its statutory CIT rate relatively steady at a little below 40%.³ In 1990, a 40% CIT rate was slightly below the OECD average.⁴ However, by 2010, the average CIT rate of non-U.S. OECD countries had fallen to approximately 25%.⁵ Thus, the United States, by maintaining the same CIT rate, has found itself changed from a low-CIT-rate country to the nation with the highest statutory CIT rate in the OECD.⁶

Tax policy experts know that the story described above is accurate, but incomplete.⁷ Focusing on the effective tax rates that U.S. companies actually pay paints a more complicated picture. U.S. CIT revenues, as a percentage of GDP, have been below the OECD average almost every year since 1981.⁸ For example, in

² See, e.g., Bert Brys, Stephen Matthews & Jeffrey Owens, *Tax Reform Trends in OECD Countries* (OECD Ctr. for Tax Policy and Admin., Working Paper No. 1, 2011), available at <http://www.dx.doi.org/10.1787/5kg3h0xxmz8t-en>; Merrill, *supra* note 1, at 1009–10.

³ See Merrill, *supra* note 1, at 1010. This number includes both the federal corporate tax rate and state- and local-level corporate income taxes. *Id.*

⁴ At that time, the average CIT rate of non-U.S. OECD countries was a little over 41%. See, e.g., *OECD Corporate Income Tax Rates, 1981-2013*, TAX FOUND. (Dec. 18, 2013), <http://www.taxfoundation.org/article/oecd-corporate-income-tax-rates-1981-2013> (reporting statistics corresponding to a 41.2% average CIT rate across non-U.S. OECD member countries in 1990). The GDP-weighted average tax rate of non-U.S. OECD member countries was even higher. *Id.*

⁵ See *id.* (reporting statistics corresponding to a 25.2% average CIT rate across non-U.S. OECD member countries in 2010).

⁶ See, e.g., Kyle Pomerleau & Andrew Lundeen, *The U.S. Has the Highest Corporate Income Tax Rate in the OECD*, TAX FOUND. (Jan. 27, 2014), <http://www.taxfoundation.org/blog/us-has-highest-corporate-income-tax-rate-oecd> (identifying the U.S. CIT rate, including both federal and state-level CITs, as 39.1%, and the next-highest CIT rate as Japan's 37.0%).

⁷ See, e.g., Edward D. Kleinbard, *Stateless Income*, 11 FLA. TAX REV. 699, 759 (2011) (“[T]he gap between U.S. and world corporate [statutory] tax rate[s] . . . is sometimes overstated.”).

⁸ *Revenue Statistics - Comparative Tables*, OECD STATEXTRACTS, <http://stats.oecd.org/Index.aspx?DataSetCode=REV> (last visited July 11, 2014). In 1994 and 1995, the U.S. percentage was 0.1% above the OECD average, and in 1996 the U.S. percentage and

2009, U.S. CIT revenues constituted less than 2% of U.S. GDP, one of the smallest proportions in the OECD.⁹ From this perspective, the United States could be seen as a low-CIT nation.

Nonetheless, the general sense that the United States is a high-tax environment for corporations seems to have set in, and the impression seems to be a powerful one. This may be because the statutory CIT rate is simply much more visible than most other information about the corporate tax system. To the extent that this perception drives investment behavior, this is a problem for U.S. competitiveness. If so, this suggests that there may be real benefits to reducing the corporate income tax rate—even if doing so did not have a large impact on effective tax rates.

II. DOMESTIC TAX BENEFITS

In addition to increasing U.S. competitiveness, lowering the statutory CIT rate would have a number of domestic benefits. Our corporate tax laws affect all manner of business decisions, including which legal entity to use, which types of business to pursue, and how to fund the business. Many of these effects are negative, and a lower CIT rate would help ameliorate them.

U.S. taxpayers can choose to operate their businesses through a number of legal entities, including many pass-through business entities that are not subject to entity-level tax. The menu of pass-through options includes S corporations, disregarded entities, and partnerships, as well as more specialized structures such as regulated investment companies (“RICs”) and real estate investment trusts (“REITs”).

The abundance of pass-through options is one of the reasons why the United States has the highest statutory CIT rate in the OECD, yet its CIT collects a smaller percentage of GDP than other countries do. Consider a 2007 OECD study that looked at the number of incorporated and unincorporated businesses with varying characteristics in OECD member nations. It found that, among U.S. businesses with annual income of \$500,000 or more, there were more than twice as many unincorporated businesses as incorporated businesses.¹⁰ In every other country, this ratio

the OECD average were equal. On average, from 1982 through 2012 (the most recent year for which data was available), the United States' figure was 79% of the OECD average; looking at medians gives a similar picture. *Id.*

⁹ See *id.* (indicating that, in 2009, U.S. taxes on corporate profits raised revenue equal to 1.7% of U.S. GDP, tied with Austria for the third lowest among OECD countries; the OECD average was 2.8%).

¹⁰ See ALFONS J. WEICHENRIEDER, OECD, SURVEY ON THE TAXATION OF SMALL AND MEDIUM-SIZED ENTERPRISES: DRAFT REPORT ON RESPONSES TO THE QUESTIONNAIRE 7–8 tbl.1 (2007), available at <http://www.oecd.org/tax/tax-policy/39597756.pdf> (reporting a

was reversed—there were at least two incorporated businesses for every unincorporated business at this income level.¹¹

The U.S. pass-through sector has seen pronounced growth since the 1980s. This growth seems tied to the tax reform bills of the era, which reduced statutory tax rates for individuals¹² and raised the tax burden on corporate income, making it more tax efficient to operate a business via a pass-through entity than through the corporate form.¹³ The subsequent changes in business entity choices, presumably due at least in part to these changes in tax incentives, have been dramatic.

For example, in 1980, C corporations filed slightly more federal tax returns than pass-through entities did, but the figures were comparable.¹⁴ By 2008, pass-through entities filed more than four times as many returns as C corporations did.¹⁵ In 1985, C corporations filed more than three times as many returns as S corporations;¹⁶ by 2008, that ratio had almost reversed itself.¹⁷ Looking at income earned, instead of at returns filed, tells a similar story: in 1980, C corporations earned over four times as much income as pass-through entities;¹⁸ by 2008, pass-through entities earned significantly more income than C corporations.¹⁹

total of 81,000 such unincorporated entities and 29,000 incorporated entities).

11 See *id.* The country with the next closest ratio is the United Kingdom, which had 2.1 incorporated businesses for every unincorporated business in this income range. *Id.*

12 The Tax Reform Act of 1986 reduced the marginal tax rate on the highest earners from 50% to 28%. See Tax Reform Act of 1986, Pub. L. No. 99-514, § 104(b)(8), 100 Stat. 2085, 2105.

13 In particular, the Tax Reform Act of 1986 repealed the *General Utilities* doctrine, which enabled corporations to distribute appreciated property to shareholders without triggering entity-level tax. This essentially enabled many corporations to avoid the corporate income tax. When this doctrine was repealed, more corporate income was subject to two levels of tax, once at the corporate level and once at the shareholder level, significantly raising the effective tax rate on corporate income. *Id.*

14 That year, there were 2,163,458 C corporation returns filed, and a combined total of 1,926,734 returns filed by S Corporations, RICs, REITs, and partnerships. These figures do not include the 8,931,712 returns filed by non-farm sole proprietorships. See *SOI Tax Stats – Integrated Business Data*, INTERNAL REVENUE SERV. tbl.1, <http://www.irs.gov/uac/SOI-Tax-Stats-Integrated-Business-Data> (last visited Sept. 24, 2014).

15 *Id.* (reporting the filing of 1,782,478 returns by C corporations and a combined total of 7,210,749 returns by S Corporations, RICs, REITs, and partnerships, not including the 22,614,483 returns filed by non-farm sole proprietorships).

16 *Id.* (reporting that C corporations and S corporations filed 2,549,091 and 724,749 returns, respectively; a ratio of 3.52:1).

17 *Id.* (reporting that C corporations and S corporations filed 1,782,478 and 4,049,944 returns, respectively; a ratio of 1:2.27).

18 *Id.* (reporting C corporation net income of \$288,701,762,000 and combined S corporation, RIC, REIT, and partnership net income of \$67,857,464,000; a ratio of 4.25:1).

19 *Id.* (reporting C corporation net income of \$1,078,770,113,000 and combined S corporation, RIC, REIT, and partnership net income of \$1,728,971,856,000; a ratio of 1:1.603).

If our tax laws are pushing U.S. businesses out of the corporate form and into pass-through entities, that is not a good thing. Essentially, this would mean that, when individuals are choosing how to structure their businesses, tax law is putting a thumb on the scale in favor of passthroughs and against C corporations. That means that some businesses that would be better managed as C corporations will not be conducted that way. By pushing these businesses out of the CIT base, we both reduce government revenue and reduce economic activity overall due to the less efficient management structure.

Similarly, there are several other features of pass-through entities that may also have negative economic impacts. For example, S corporations have significant limits on their capital structures, both in terms of the kinds of ownership interests that they can issue²⁰ and the shareholders that they are allowed to have.²¹ Partnerships generally have more complicated returns than corporations, increasing compliance costs. Incurring these costs to reduce one's tax bill may make perfect sense from an individual businessperson's perspective, but little sense from an overall policy perspective. Lowering the corporate tax rate would help to reduce the tax system's influence on entity choice decisions, reducing all of these costs.

In addition, U.S. tax laws provide many deductions and credits that reduce the size of the CIT base.²² From a policy perspective, this combination of a smaller base with a higher tax rate leaves much to be desired. These deductions and credits also tend to be fairly complicated, and are often industry-specific.²³ This makes it more difficult to understand the tax system, rendering the tax law more opaque. Such opacity makes it harder for constituents to understand and evaluate what their representatives have done, reducing political accountability and the force of popular opinion on policymaking.

An increase in the use of business tax expenditures also means that politically favored companies and industries are able to get tax breaks that others are not.²⁴ This disparate treatment

²⁰ See I.R.C. § 1361(b)(1)(D) (2012).

²¹ See I.R.C. § 1361(b)(1)(A)–(C).

²² This is a second reason why U.S. CIT revenues are much lower than the statutory rate.

²³ See, e.g., I.R.C. § 179C (allowing the expensing of certain capital purchases for refineries); I.R.C. § 179E (allowing the expensing of certain capital purchases for mine safety equipment); I.R.C. § 181 (allowing the expensing of certain costs for qualified film and television productions).

²⁴ See, e.g., Victor Fleischer, *Regulatory Arbitrage*, 89 TEX. L. REV. 227 (2010) (discussing same); see also Jordan Barry, Response, *On Regulatory Arbitrage*, 89 TEX. L. REV. SEE ALSO 69 (2011).

is unfair, as it treats similarly situated taxpayers differently.²⁵ Moreover, the tax system is once again putting its thumb on the scale in favor of certain businesses relative to others, producing a different outcome than market competition would otherwise produce. More colloquially, the tax system is picking winners and losers. This is likely to produce inefficient outcomes.

The combined effects of these deductions and credits have been quite significant. For example, in 2009, publicly traded biotechnology firms had an average effective CIT rate of 4.5%.²⁶ In contrast, publicly traded trucking firms had an average effective CIT rate of 30.9%.²⁷

Reducing the statutory CIT rate reduces the value of tax breaks. This both decreases the unfairness in treatment between favored and disfavored industries and the extent to which the tax system encourages certain types of economic activity over others.

Higher CIT rates also encourage capital structures with a higher percentage of debt relative to equity.²⁸ Because interest payments are deductible, money paid out to creditors is only subject to tax once, at the creditor level. In contrast, dividends paid to stockholders are subject to tax twice: First, the corporation pays tax when it earns the income. Second, the shareholder pays tax when she receives the dividend. The increased use of debt financing makes companies more brittle; in a downturn, a company funded with equity can reduce its dividend or suspend paying a dividend altogether. On the other hand, a company that cannot make interest payments on its debt faces the prospect of bankruptcy. This can potentially exacerbate business cycles, making recessions and depressions more severe and longer lasting.²⁹

²⁵ Another way to describe this phenomenon is that it constitutes a violation of the principle of horizontal equity.

²⁶ See Binyamin Appelbaum, *Corporate Tax Code Proves Hard to Change*, N.Y. TIMES (Jan. 27, 2011), <http://www.nytimes.com/2011/01/28/us/politics/28tax.html>; see also Mike Bostock et al., *Across U.S. Companies, Tax Rates Vary Greatly*, N.Y. TIMES (May 25, 2013), <http://www.nytimes.com/interactive/2013/05/25/sunday-review/corporate-taxes.html> (reporting effective CIT rates among S&P 500 companies by sector; the range was significant; utilities paid an average effective CIT rate of 12%, while retailers paid 34%).

²⁷ Bostock et al., *supra* note 26.

²⁸ See, e.g., Ruud A. de Mooij, *The Tax Elasticity of Corporate Debt: A Synthesis of Size and Variations* (Int'l Monetary Fund, Working Paper No. 11/95, 2011), available at <https://www.imf.org/external/pubs/ft/wp/2011/wp1195.pdf> (collecting and reviewing studies of the effect of the CIT on the use of debt financing). Tax rates can also affect corporate capital structures in more subtle ways. See, e.g., Jordan M. Barry & John William Hatfield, *Pills and Partisans: Understanding Takeover Defenses*, 160 U. PA. L. REV. 633, 658–59 (2012) (discussing how tax considerations can influence the structure of corporate mergers and acquisitions).

²⁹ See, e.g., Hilary J. Allen, *Let's Talk About Tax: Fixing Bank Incentives to Sabotage Stability*, 18 FORDHAM J. CORP. & FIN. L. 821, 839–44 (2013) (discussing the effect of the

III. POLITICAL AGREEMENT

The consensus for cutting the CIT rate also extends to the political arena. For example, during the 2012 presidential election, both Barack Obama and Mitt Romney advocated for a CIT rate cut.³⁰ More surprisingly, both advocated for nearly the same cut: Mitt Romney proposed a 25% federal CIT rate.³¹ Barack Obama proposed a 28% federal CIT rate, along with a deduction for manufacturers that would ultimately give them a 25% federal CIT rate.³² Considering the degree of polarization in contemporary politics and the 35% federal CIT rate currently in effect,³³ the size of the gap between these two policy positions seems quite small.

In addition, cutting the CIT rate could help reduce disagreement surrounding one of the tax policy questions on which Democrats and Republicans are most strongly divided: How should the United States tax income earned by U.S. corporations and their subsidiaries in non-U.S. jurisdictions?

Currently, U.S. corporations with foreign subsidiaries generally do not owe U.S. tax on income that those subsidiaries earn overseas until they repatriate those earnings.³⁴ This system has several negative effects: Most other companies' corporations are not subject to domestic tax on income that they earn in other countries. Because U.S. corporations investing abroad can face an additional level of tax, this can place them at a competitive disadvantage. Further, because income earned in foreign jurisdictions is not subject to U.S. tax until repatriated, it encourages U.S. businesses to move profits to lower-tax countries. Finally, because profits earned abroad are not subject

CIT deduction for debt on banks, and suggesting that the effect is much larger than the "too big to fail" subsidy enjoyed by the largest institutions).

30 See THE WHITE HOUSE & THE DEPT OF THE TREASURY, THE PRESIDENT'S FRAMEWORK FOR BUSINESS TAX REFORM 1 (2012) [hereinafter OBAMA PLAN], available at <http://www.treasury.gov/resource-center/tax-policy/Documents/The-Presidents-Framework-for-Business-Tax-Reform-02-22-2012.pdf>; BELIEVE IN AMERICA: MITT ROMNEY'S PLAN FOR JOBS AND ECONOMIC GROWTH 6 (2011) [hereinafter ROMNEY PLAN], available at <http://www.thepoliticalguide.com/Items/MittRomney/BelieveInAmerica-PlanForJobsAndEconomicGrowth-Full.pdf>.

31 See ROMNEY PLAN, *supra* note 30, at 6, 43–45. This proposal did not end with the Romney campaign, and remains favored in Republican circles. In February 2014, House Ways and Means Committee Chairman Dave Camp put forward a tax reform proposal that also includes a 25% CIT rate. See HOUSE COMM. ON WAYS & MEANS, 113TH CONG., THE TAX REFORM ACT OF 2014: FIXING OUR BROKEN TAX CODE SO THAT IT WORKS FOR AMERICAN FAMILIES AND JOB CREATORS 19 (2014), available at http://www.waysandmeans.house.gov/uploadedfiles/tax_reform_executive_summary.pdf.

32 See OBAMA PLAN, *supra* note 30, at 1, 9, 12.

33 This is a slight oversimplification. See I.R.C. § 11(b) (2012).

34 This is an oversimplification. Special rules apply to certain types of income, sometimes referred to as Subpart F income. See I.R.C. §§ 951–965.

to U.S. tax until they are returned to the United States, companies have an incentive to keep those profits overseas instead of bringing them back to the United States.

Democrats and Republicans have weighed these varying concerns differently. Democrats have tended to focus on reducing the incentive for U.S. businesses to move profits overseas. For example, President Barack Obama has proposed a minimum tax on foreign income at the time it is earned.³⁵ This would help reduce the relative benefits of earning income offshore instead of in the United States, but would make U.S. businesses competing abroad less competitive.³⁶ Republicans, in contrast, have focused more on the issue of U.S. competitiveness. Mitt Romney advocated switching to a territorial tax system, which would mean no U.S. tax on income earned abroad.³⁷ This would improve the competitive position of U.S. businesses operating abroad; however, it would also increase U.S. businesses' incentives to move profits overseas.³⁸

Regardless, cutting the CIT rate helps with all three of these concerns: It reduces the competitive disadvantage to U.S. corporations from being subject to the U.S. CIT. It narrows the tax differential between earning profits in the United States and earning them in low-tax jurisdictions, reducing the incentive to shift profits out of the country. It reduces the tax cost of repatriating foreign earnings, which will encourage more repatriation at the margin. Thus, cutting the U.S. CIT rate is both a point of agreement across both parties, as well as a policy measure that will help reduce the magnitude of existing political disagreements.

CONCLUSION

This Article recaps some of the chief factors that have fueled the emerging consensus in favor of a cut in the statutory CIT rate. That said, it bears emphasis that tax policy experts generally envision such a cut as part of a larger tax reform package—and there is considerable disagreement on what the rest of that package should look like.

³⁵ See OBAMA PLAN, *supra* note 30, at 14.

³⁶ Currently, the advantage of foreign profits is that U.S. tax on such profits is deferred until they are repatriated. *See id.* at 13. Under such a change, more tax would be due at the time the income is earned, reducing the amount of tax deferred. *Id.* at 14. Such a change would also help reduce taxpayers' incentives to leave foreign profits in foreign subsidiaries. *Id.*

³⁷ See ROMNEY PLAN, *supra* note 30, at 45–46.

³⁸ Currently, the advantage of foreign profits is that U.S. tax on such profits is deferred until they are repatriated. *See id.* at 46. Under this change, such profits would be exempt from U.S. taxation—a significantly larger advantage.

Many call for a CIT rate cut to be paired with base-broadening provisions that eliminate or pare down existing deductions and credits.³⁹ Commentators disagree on which deductions and credits to target, and to what extent. Some, concerned about budget deficits, believe that a CIT rate cut can only be enacted if accompanied by spending cuts, new revenue raised from individuals, or a combination of both. Other commentators worry that a CIT rate cut could reduce the progressivity of our tax system, exacerbating economic inequality,⁴⁰ and must be enacted along with other tax provisions designed to counteract this effect. On a more nuts-and-bolts level, a reduced corporate tax rate, coupled with capital gains treatment for dividends, could render income earned through the corporate form subject to less tax than income earned by individuals.⁴¹ This could open up an opportunity for tax avoidance and reduce the effectiveness of the individual income tax.

All of these are significant concerns for policymakers, and assembling a package that addresses them all will not be easy. Nor does it seem probable that such a package will emerge in the near future. But, given the broad support among commentators and policymakers for cutting the statutory CIT rate, such a cut does seem very likely to happen—eventually.

³⁹ See, e.g., OBAMA PLAN, *supra* note 30, at 9–10.

⁴⁰ The short version of this argument is as follows: The burden of the CIT is primarily borne by a combination of shareholders and executives. Both tend to be wealthier than the average American. Accordingly, reducing the corporate tax will reduce the tax burden on those with more income, rendering the tax system less progressive.

⁴¹ For example, a 20% CIT rate, coupled with a 20% capital gains rate on dividends would mean that shareholders keep 80% of 80% (=64%) of distributed corporate profits—in other words, the net tax rate on such income is 36%. This is less than the current top individual rate. Moreover, if profits grow as money is reinvested, deferring the payment of dividends and reinvesting at the corporate level subject to a lower tax rate can significantly magnify this advantage.

Historical Perspective on the Corporate Interest Deduction

Steven A. Bank*

INTRODUCTION

One of the so-called “Pillars of Sand” in the American business tax structure is the differential treatment of debt and equity.¹ Corporations may deduct interest payments on their debt, but may not deduct dividend payments on their equity. This “ancient and pernicious” feature is criticized because it distorts corporate financing choices and inevitably leads to line drawing problems as the government engages in a futile chase to catch up with the latest financial innovation.² In the past few years, both the Obama administration and new Senate Finance Committee Chairman Ron Wyden have proposed capping or substantially reshaping the deductibility of corporate interest to “reduce incentives to overleverage and produce more stable business finances.”³

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¹ DANIEL N. SHAVIRO, *DECODING THE CORPORATE TAX* 44, 48 (2009); Alvin C. Warren Jr., *The Corporate Interest Deduction: A Policy Evaluation*, 83 YALE L.J. 1585, 1585 (1974).

² Ilan Benshalom, *How to Live with a Tax Code with Which You Disagree: Doctrine, Optimal Tax, Common Sense, and the Debt-Equity Distinction*, 88 N.C. L. REV. 1217, 1219 (2010); SHAVIRO, *supra* note 1, at 48–49. The controversy over the differential treatment of debt and equity is long-standing. See, e.g., M. L. Seidman, *Deductions for Interest and Dividends*, in *HOW SHOULD CORPORATIONS BE TAXED?* 130 (1947); NAT’L INDUS. CONFERENCE BD., 2 *THE SHIFTING AND EFFECTS OF THE FEDERAL CORPORATION INCOME TAX* 138–41 (1930).

³ THE WHITE HOUSE & THE DEPT OF THE TREASURY, *THE PRESIDENT’S FRAMEWORK FOR BUSINESS TAX REFORM* 10 (2012) (“[R]educing the deductibility of interest for corporations could finance lower tax rates and do more to encourage investment in the United States.”); The Bipartisan Tax Fairness and Simplification Act of 2011, S. 727, 112th Cong. § 211 (2011) (describing the so-called “Wyden-Coats” reform plan, which indexed the interest deduction for inflation and excluded the inflation component from the deduction). For other proposals, see Robert C. Pozen & Lucas W. Goodman, *Capping the Deductibility of Corporate Interest Expense*, 137 TAX NOTES 1207, 1207, 1209 (2012) (proposing to limit nonfinancial companies to a deduction of 65% of gross interest paid and to limit financial companies to a deduction of 79% of gross interest paid); Calvin H. Johnson, *Corporate Meltdowns and the Deduction of Credit-Risk Interest*, 131 TAX NOTES 513, 513 (2011) (proposing to disallow the deduction of interest paid on debt in excess of the risk-free interest, since it reflects credit risk rather than true interest). Former House Ways and Means Committee Chairman Dave Camp and former Senate Finance Committee chair Max Baucus also recommended considering modification of the deductibility of interest expense as part of reform geared toward lowering the corporate tax rate. Pozen & Goodman, *supra*, at 1209.

Over the years, several commentators have attempted to make sense of the corporate interest deduction by examining its history or have used historical evidence to buttress their normative arguments.⁴ Most recently, Jonathan Talisman, a former Assistant Secretary for Tax Policy in the Treasury Department under the Clinton Administration, forwarded a historical argument that has not been raised before.⁵ Talisman noted that the corporate income tax was originally conceived of as a proxy for a tax on shareholders: "It was viewed as necessary to reach shareholders' intangible wealth and prevent them from avoiding tax by keeping profits at the corporate level."⁶ From this, Talisman infers that the corporate income tax was *not* intended to reach bondholder wealth, since "the corporation does not provide a deferral shield with respect to debt. Interest generally must be paid periodically Thus, there is no need for a corporate proxy tax for debt to prevent deferral."⁷

This Essay contends that although there may be appropriate arguments in favor of maintaining a full corporate interest deduction,⁸ the historical premise for the origins of the corporate income tax system is not one of them. Corporate interest was deductible both in 1894,⁹ when deferral was not a concern because corporations routinely distributed all of their profits each year,¹⁰ and in 1909,¹¹ when there was no individual income tax and therefore no tax incentive to retain earnings. Moreover, it is not that Congress was indifferent to reaching bondholder wealth; that was a major subject of the debates in both 1894 and 1909. Rather, other priorities—including the protection of leveraged domestic industries and concerns about the constitutionality of targeting bondholders—took precedence. The corporate interest deduction emerged because of expedience, not tax policy *per se*.

In fact, the early history of the deduction has more in common with modern proposals to cap the interest deduction

⁴ See, e.g., Katherine Pratt, *The Debt-Equity Distinction in a Second-Best World*, 53 VAND. L. REV. 1055, 1094–98 (2000); Marjorie E. Kornhauser, *Corporate Regulation and the Origins of the Corporate Income Tax*, 66 IND. L.J. 53, 111–12 (1990); Curtis Jay Berger, *Simple Interest and Complex Taxes*, 81 COLUM. L. REV. 217, 219–20 (1981).

⁵ Jonathan Talisman, *Do No Harm: Keep Corporate Interest Fully Deductible*, 141 TAX NOTES 211, 211 (2013).

⁶ *Id.* at 215.

⁷ *Id.* at 216.

⁸ Some of the arguments advocates of the deduction have raised include that it helps facilitate capital investment, reduces business costs, and increases returns to investors. See Marc Heller, *Corporate Interest Deduction Proves Sacred Amid Reformers: Taxes*, BLOOMBERG, (May 29, 2013, 3:00 AM), <http://www.bloomberg.com/news/2013-05-29/corporate-interest-deduction-proves-sacred-amid-reformers-taxes.html>.

⁹ Wilson-Gorman Tariff Act, ch. 349, § 32, 28 Stat. 509, 556 (1894).

¹⁰ See *infra* text accompanying notes 28–30.

¹¹ Tariff Act of 1909, ch. 6, § 38, 36 Stat. 11, 113.

than it does with the current system of full deductibility. In 1909, because of the fear that shareholders could easily shift their investment to bonds in order to disguise dividends as deductible interest payments, the corporate interest deduction was capped. Under the provision, interest on corporate indebtedness in excess of the aggregate value of the corporation's paid-up capital stock was made non-deductible. Business lobbying began to chip away at this limitation in the post-Sixteenth Amendment revenue acts. In 1913 and 1916, the cap on corporate interest deductions was raised to the value of the capital stock plus one-half the amount of outstanding debt.¹² The cap was not lifted entirely until 1918,¹³ when it was done so to offset the exclusion of debt from the definition of invested capital in the war and excess profits tax. Much like today, these early capped interest deduction provisions were an attempt to strike a balance between concerns about the inefficiencies of the debt/equity distinction and concerns about overburdening businesses in industries in which debt financing was a necessity.

Part I of this Essay will discuss the nineteenth century origins of the corporate interest deduction, adopted amid controversy over the nature of income in the early income tax statutes. Part II will focus on the adoption of a deduction in the 1909 corporate excise tax. It will explore the debates over reaching bondholder wealth, which eventually led to the insertion of a cap on the amount of the deduction. In Part III, the Essay will examine the continuation of the capped interest deduction in the first two post-Sixteenth Amendment revenue acts of 1913 and 1916, before the cap was ultimately lifted during World War I. The Essay will conclude by offering some reflections on the historical basis for modern proposals.

I.

The deductibility of interest on corporate debt was controversial as far back as the first attempt to impose an entity-level income tax on corporations in 1894. Although it is almost taken as a given today that interest is a deductible business expense, while dividends represent a non-deductible return on ownership,¹⁴ the matter was far less settled at the end

¹² Tariff Act of 1913, ch. 16, § 2(G)(b), 38 Stat. 114, 173; Revenue Act of 1916, ch. 463, § 12(a)(3), 39 Stat. 765, 768.

¹³ Revenue Act of 1918, ch. 18, § 234(a)(2), 40 Stat. 1057, 1077 (1919).

¹⁴ See Adam O. Emmerich, Comment, *Hybrid Instruments and the Debt-Equity Distinction in Corporate Taxation*, 52 U. CHI. L. REV. 118, 122 (1985) ("Apparently, the idea that interest payments are deductible as an ordinary business expense is so intuitively appealing that Congress has thought it unnecessary to explain section 163(a) or its predecessors.").

of the nineteenth century. According to contemporary economist Edwin Seligman, who has been described as one of the “pivotal historical figures” in nineteenth century American public finance,¹⁵ “the most advanced tax laws in America, as well as in Europe, permit an individual to deduct his indebtedness or the interest on his debts, while the corporation is assessed on both bonds and stock, or on both interest and dividends.”¹⁶ The reason for this, Seligman explained, is:

[T]here is a distinction between individual income and corporate income. In the case of individuals, true taxable property consists in the surplus above indebtedness. Net income can therefore be arrived at only by deducting interest on debts. But in the case of corporations the matter is somewhat different. Capital stock represents in many cases only a portion of the property, the remainder being represented by the bonded indebtedness. It is the stock and bonds together that represent the property and the earning capacity of the corporations.¹⁷

Such theoretical distinctions may have been influential, but there were practical considerations that favored denying a deduction for corporate interest. In his State of the Union address in 1893, President Grover Cleveland suggested levying “a small tax upon incomes derived from certain corporate investments” to replace revenues lost as part of tariff reform.¹⁸ It was clear that he intended to reach income from bonds as well as stocks when, in an address before Congress, Treasury Secretary John Carlisle subsequently proposed a tax on incomes “derived from investments in stocks and bonds of corporations and joint stock companies” in order to “most conveniently and justly” replace the shortfall caused by Cleveland’s proposed tariff reform.¹⁹

Eventually, Cleveland’s proposal morphed into a corporate income tax proposal as policymakers sought to harness the corporation as a mechanism for taxing income at the source.²⁰ This meant that both dividends and interest would be taxed at the source as well. Thus, noted lawyer and political economist Thomas Shearman testified before a House subcommittee in

¹⁵ AJAY K. MEHROTRA, *MAKING THE MODERN AMERICAN FISCAL STATE: LAW, POLITICS, AND THE RISE OF PROGRESSIVE TAXATION, 1877–1929*, at 98–99 (2013).

¹⁶ EDWIN R. A. SELIGMAN, *THE INCOME TAX* 513 (2d ed. 1914).

¹⁷ *Id.*

¹⁸ President Grover Cleveland, *First Annual Message*, in *A COMPILATION OF THE MESSAGES AND PAPERS OF THE PRESIDENTS, 1789–1897*, at 434, 460 (1899).

¹⁹ SIDNEY RATNER, *TAXATION AND DEMOCRACY IN AMERICA* 174 (1980) (quoting TREASURY REPORT 83 (1893)).

²⁰ This was partly a reaction to concerns about the inquisitorial nature of the administration of the income tax during the Civil War and Reconstruction. See, e.g., David A. Wells, *An Income Tax: Is It Desirable?*, 17 F. 1, 3 (1893); William L. Wilson, *The Income Tax on Corporations*, 158 N. AM. L. REV. 1 (1894).

favor of an entity-level tax on corporate dividends and interest, plus all net income from corporate monopolies.²¹ According to Shearman, one of the greatest virtues of a tax on corporations was that “dividends upon stock and interest upon the bonds of corporations, and, in general, all income which is in any way paid through corporations” can be ascertained and taxed “without requiring a single return from the persons receiving such income.”²² Shearman noted that “every government which collects an income tax at all makes it a prime object to collect that tax as far as possible through the medium of corporations, requiring them to deduct the tax from all dividends and interest paid.”²³ Not surprisingly given these origins, the House bill in 1894 did not permit a deduction for corporate interest.

A corporate interest deduction was only added in the Senate bill in 1894.²⁴ The bill’s sponsor, Senator George Vest, a Democrat from Missouri, explained that

[i]f the provision in the bill as it came from the other House had been retained, which put a 2 per cent tax upon the bonded indebtedness of corporations, we should have heard from the other side of this Chamber and from this side such a protest as never was heard before in Congress in regard to a tax law.²⁵

Apparently, the House bill had provoked much outrage on this point, with heavily leveraged railroads claiming that the inability to deduct the interest expense risked leaving them “in ruin.”²⁶ Nevertheless, Seligman argued that because of this concession, “the definition of ‘income’ was certainly an uneconomic one; and that whatever arguments apply to the advisability of making corporations responsible for the tax on dividends apply with equal force to the interest on indebtedness.”²⁷

Notwithstanding Seligman’s objections, the distinction between the treatment of debt and equity in the 1894 Act was likely not viewed to be very significant at the time. During this period, the notion that corporations would defer dividends to shield them from taxation would have been considered quite foreign. As Republican Senator William Boyd Allison of Iowa noted during the debates, “as to the great body of the corporations of our country they make dividends covering

²¹ 53 CONG. REC. 11, 12 (1893) (statement of Hon. Thomas G. Shearman before Ways and Means Subcommittee on Internal Revenue).

²² *Id.* at 7.

²³ *Id.* at 11.

²⁴ 26 CONG. REC. 6867 (1894) (statement of Sen. George Vest).

²⁵ *Id.*

²⁶ SELIGMAN, *supra* note 16, at 513.

²⁷ *Id.*

practically [all] their earnings each year.”²⁸ Similarly, William Ripley explained that outside of the railroad industry, “it was the common practice [in the nineteenth century] to divide all profits in sight and to finance new construction by the issue of securities. Such policies were fully sanctioned by the public opinion of the day.”²⁹ This was in part because, in the absence of robust stock markets or readily available financial information, dividends provided an important signal about the stability and value of a company, and they were the sole source of liquidity for most shareholders.³⁰ In such an environment, there would not have been concern about a corporate retained earnings deferral shield that would have necessitated an entity-level tax on dividends, but not interest.

II.

The controversy over the interest deduction continued when income taxation was revisited in 1909. The corporate excise tax was supposed to reach the “great accumulated wealth of the country, or its earnings, engaged in corporate enterprise,” which meant that it was a proxy for taxing shareholders *and* bondholders, rather than just the former.³¹ Therefore, the possibility that wealth represented by bond interests would be excluded from the tax was considered problematic. *The New York World* reported “[t]here were indications to-day of growing opposition to the corporation tax plan. This was chiefly because Senators believed bondholders might escape payment of the tax while the small holders of stock would contribute all the revenue.”³² The difficulty was that in the absence of an individual income tax as a backstop to the corporation tax, an interest deduction meant that “the ‘bloated bondholder’ . . . escapes altogether Multimillionaires like Mr. Carnegie, whose wealth is mostly in bonded investments, go free, while the owner of no more than one share of stock in any paying corporation is taxed.”³³ Similarly, insurgent Republicans argued that it was “manifestly unfair to single out corporations whose lists of

²⁸ 26 CONG. REC. 6869 (1894).

²⁹ WILLIAM Z. RIPLEY, *RAILROADS: FINANCE AND ORGANIZATION* 244 (1915); *see* STEVEN A. BANK, *FROM SWORD TO SHIELD: THE TRANSFORMATION OF THE CORPORATE INCOME TAX, 1861 TO PRESENT* 51 fig. 2 (2010) (the dividend payout ratio for public corporations was approximately 80% between 1871 and 1895).

³⁰ STEVEN A. BANK, *ANGLO-AMERICAN CORPORATE TAXATION: TRACING THE COMMON ROOTS OF DIVERGENT APPROACHES* 108–112, 117–18 (2011).

³¹ 44 CONG. REC. 3756 (1909) (statement of Sen. Francis Newlands, D-NV.).

³² *Taft's Corporation Tax Framed to Reach the Rich*, N.Y. WORLD, June 18, 1909, at 5B.

³³ *Is Corporate Taxation Just, and Will It Aid the Revenues?*, WALL ST. J., June 26, 1909, at 6.

stockholders include men of nearly every degree of poverty, while wealthy bondholders will be exempt.”³⁴ One constituent wrote a letter to Senator Joseph Bristow of Kansas asking, “[D]oes the proposition reach the very wealthiest citizens, such as Rockefeller and Carnegie, whose holdings are not in stocks of corporations, but in bonds?”³⁵ Senator Moses Clapp of Minnesota answered, complaining that it “absolutely exempts the man who has gone still further in the process of accumulation and has laid his accumulated savings in the form of bonds.”³⁶ Senator Albert Cummins of Iowa echoed this point, observing, “I do not wonder that a man like Harriman should favor this measure rather than the general income tax; because the part of his great fortune, which has been segregated from the corporations in which he is interested, lies beyond the operation of this law.”³⁷ There were complaints that this inequity would not only play out on the investor level, but on the entity level. As one individual complained in a letter to the editor of *The Washington Post*, “[H]eavily bonded concerns doing business in competition with those with little or no funded debt would practically escape taxation, an obviously inequitable advantage.”³⁸

Originally, it appears that the Administration and its supporters in the Senate had approached the problem as a drafting exercise, proposing to solve it through more precise language. According to one report, they used the phrase “net income,” rather than “net earnings” or “net profit,” in the statutory language to avoid the over-bonding issue.³⁹ Apparently, courts and businessmen had disagreed about the interpretation of the latter two phrases, leaving open the possibility that they would exclude from the tax base such “fixed charges” as interest on bonds and dividends on preferred stock.⁴⁰ *The New York World* reported that “the ‘net income’ of a corporation, as

³⁴ *Insurgents’ Fight Will Hold Congress*, N.Y. TIMES, June 28, 1909, at 2.

³⁵ 44 CONG. REC. 4036 (1909) (read by Sen. Joseph Bristow, R-KS).

³⁶ *Id.* (statement of Sen. Clapp); see *id.* at 4036 (statement of Sen. Bristow, R-KS) (favoring an income tax because “[i]t would then include the bondholders and those who have large fortunes that are not reached by this tax. It would more equitably distribute the burden as to population than this corporation tax.”).

³⁷ *Id.* at 4038 (statement of Sen. Cummins); see *The President Takes a Hand*, LAFOLLETTE’S WKLY. MAG., June 26, 1909, at 13, 14 (“They [Senators Borah and Bristow] could see no reason, however, for exempting from taxation the vast incomes of individuals like Carnegie and Rockefeller, only a part of whose fortunes are in the form of corporation stocks.”).

³⁸ Letter to the Editor, *Reaping the Whirlwind: Proposed Corporation Tax Strikes a Deadly Blow at Protection*, WASH. POST, June 21, 1909, at D6.

³⁹ See *Taft’s Corporation Tax Framed to Reach the Rich*, *supra* note 32.

⁴⁰ *Id.*; Editorial, *Earnings, Profit, Income*, N.Y. TIMES, June 23, 1909, at 6. Under the 1894 Act, corporations were taxed on their “net profits or income” and bond interest was explicitly made deductible. Act of Aug. 27, 1894, ch. 349, § 32, 28 Stat. 556. The text of the statute may be found in BANK, *supra* note 30, at 40.

interpreted by the president, Secretary Knox, Attorney-General Wickersham, Senator Root and Secretary Nagel, all lawyers of high standing, is all the money the corporation has made outside its operating expenses."⁴¹ The drafters distinguished, however, between operating expenses, which were deductible, and fixed charges, which were not. "For instance, the tax must be paid by a railroad before the railroad board sets aside any of the gross earnings for improvements, sinking fund, dividends on preferred stock or interest on its bonds."⁴²

Requiring corporations to pay interest with post-tax money, however, was also controversial. *The New York Times* reported that "[t]he important point, which threatens to cause a real division among the [Senate Finance] committee members, is the question of taxing that part of a corporation's earnings set aside for the payment of interest on bonds."⁴³ The dissension spilled outside the committee room. Thus, for example, Republican Senator Stephen Elkins of West Virginia reportedly spent more than an hour discussing the reasons for his opposition to the proposed corporation tax in a meeting with President Taft, including the inequity of failing to "distinguish between capital and capital stock, as some corporations raised all their capital by bond issues and had very little stock."⁴⁴ Similarly, a group of Progressive senators issued a statement declaring that "[t]here is no reason for exempting from this tax the vast incomes of individuals like Carnegie, Rockefeller, and others, a very large part of whose fortunes do not consist of corporation stock."⁴⁵ According to *The New York Times*, the dispute was largely along regional lines.

The division here, it is understood, is somewhat geographical, the Eastern Senators being as a general thing opposed to taxing any money connected with bonds, while the Westerners are said to be in favor of finding a way to tax such fortunes as that of Andrew Carnegie, which consists almost entirely of bond holdings.⁴⁶

Even among the provision's supporters there were concerns about the constitutionality of taxing bond interest. In part, this related to the so-called "tax-free covenants" on many corporate bonds, which had been utilized by railroads and many larger industrial corporations to assuage bondholder concerns about the effects of income taxation after their experience with the Civil

⁴¹ *Taft's Corporation Tax Framed to Reach the Rich*, *supra* note 32.

⁴² *Id.*

⁴³ *Taft Plan for Tax Splits Committee*, N.Y. TIMES, June 19, 1909, at 5.

⁴⁴ *Rush of Objections to Taft Tax Plan*, N.Y. TIMES, June 22, 1909, at 1.

⁴⁵ *Oppose Taft Plan*, WASH. POST, June 17, 1909, at 1F.

⁴⁶ *Taft Plan for Tax Splits Committee*, *supra* note 43.

War-era tax.⁴⁷ Under the 1864 Act, companies were required to pay a five percent tax on interest payments, but were authorized to deduct the tax from those interest payments.⁴⁸ In practice, however, most corporations chose to bear the tax on interest themselves and they were permitted to do so under the original Civil War-era provisions.⁴⁹ Bondholders sought to ensure the continuation of that practice by inserting tax-free covenants in their bonds. Under the covenants, corporations promised to pay principal and interest “without deduction for any tax or taxes which the company may be required or permitted to pay thereon, or to retain therefrom, under any present or future law of the United States or of any state, county or municipality therein.”⁵⁰

Given the existence of these tax-free covenants, one objection to the proposal to tax corporations without permitting a deduction for interest is that the entity-level tax would require that corporations reduce the amount of interest by the tax due, which could be construed as unconstitutionally impairing a contract.⁵¹ The response was that the interest could be distributed and then taxed to the bondholder, but this could violate the constitutional prohibition on income taxation in *Pollock*, which the proposed corporate excise tax had sought to elide.⁵² Moreover, if the interest was paid at the pre-set amount despite being subject to tax at the corporate level, there were objections that it would effectively

amount to a double tax. In the first place, the tax would be levied on the interest fund itself . . . [And in the second place, since] in order to replenish the interest fund by the amount paid to the government for taxation on it, the proportion of net income to be devoted to paying dividends to stockholders would be curtailed by the amount of the tax on the interest fund.⁵³

There was some thought given to trying to impose a more narrowly tailored withholding tax on interest paid to bondholders as a way to equalize the treatment of debt and equity, but

⁴⁷ SELIGMAN, *supra* note 16, at 695; A.C. Rearick, *Simplification of the Federal Income Tax*, PROC. ANN. CONF. ON TAX'N UNDER AUSPICES NAT'L TAX ASS'N, 1914, at 298, 303–05.

⁴⁸ Act of June 30, 1864, ch. 173, §§ 120, 122, 13 Stat. 223. The text of the statute may be found in THE STATUTES AT LARGE, TREATIES, AND PROCLAMATIONS, OF THE UNITED STATES OF AMERICA FROM DECEMBER 1863, TO DECEMBER 1865, at 283–85 (George P. Sanger ed., 1866).

⁴⁹ Edwin R. A. Seligman, *The Income Tax*, 9 POL. SCI. Q. 610, 628–29 (1894); Rearick, *supra* note 47, at 303–04.

⁵⁰ Rearick, *supra* note 47, at 303.

⁵¹ *Taft Plan for Tax Splits Committee*, *supra* note 43.

⁵² *Id.*

⁵³ *Taft is to Fix Tax*, WASH. POST, June 22, 1909, at 1F.

President Taft later conceded that this idea was scuttled because of constitutional concerns:

[T]he defect was fully recognized by those who drafted the corporation tax. They would have been glad if possible to impose a tax upon the bondholders who are only less interested in the earnings and success of the corporations than are stockholders, but the difficulty of including them and of collecting from the corporation before the payment of interest on the bonds an income tax proportionate to a percentage of interest to be paid on the bonds was that Congress could not use a corporation to recoup itself in the payment of such a tax from the interest to be paid, because thus to impose a tax on the bondholders proportioned to the interest he received would be in violation of the Constitution as interpreted by the Supreme Court as an income tax not apportioned among the States.⁵⁴

Given these obstacles, it was not surprising that *The Washington Post* reported that "[t]he proposition to tax corporation funds put aside for the purpose of paying interest on bonds has been abandoned."⁵⁵

Although taxing bond interest was off the table, the fight was not over. The concern was that because of the different treatment of debt and equity, corporations and investors would take advantage of the relative fungibility of the different instruments and evade the tax by substituting bonds for stocks.⁵⁶ Senator Augustus Bacon, a Democrat from Georgia, noted during the debates over the bill that it was a frequent occurrence that

the owners of a corporation owning stock convert that stock into bonds, and therefore under that conversion, instead of paying dividends upon stock they pay interest on bonds, and the exact amount which would have been paid upon dividends is diverted to the payment of the bonds, which stand in the place of the stock which has thus been converted.⁵⁷

Bacon noted, "I have seen in the papers, for instance, that one of our great transcontinental railroads is now engaged in that very process of converting stock into bonds."⁵⁸ Similarly, *The Wall Street Journal* reported that

⁵⁴ *Taft Defends Tax on Corporations*, N.Y. TIMES, Sept. 22, 1909, at 7.

⁵⁵ *Taft Is to Fix Tax*, *supra* note 53.

⁵⁶ ROY G. BLAKEY & GLADYS C. BLAKEY, *THE FEDERAL INCOME TAX* 46 (1940). The fact that the spread between stock yields and bond yields was relatively small may have contributed to the perception of fungibility, although the equivalence could also have been ensured through the drafting of the instruments. In 1909, the average yield of American railroad bonds varied between a low of 3.605 and a high of 3.727, while common stock yields (the actual dividends paid in a year divided by the average of the monthly stock values) averaged 4.31. See U.S. DEPT OF COMMERCE, *HISTORICAL STATISTICS OF THE UNITED STATES 1789-1945*, at 280 (1949).

⁵⁷ 44 CONG. REC. 4007 (1909) (statement of Sen. Bacon).

⁵⁸ *Id.*

the United States Steel Corporation converted \$250,000,000 of its preferred seven per cent stock into bonds bearing five per cent interest. It is argued that if this corporation would thus convert stock into bonds then it could do so now, and that other corporations existing under similar state laws and liberal charters could do likewise, and thus convert net earnings into fixed charges and avoid the payment of taxes on net earnings as contemplated in the recommendations of the President.⁵⁹

Because of this concern, at a dinner Taft held for members of the Senate Finance Committee to convince them to back the corporation tax, “the senators told the president that it would be necessary to find some way to prevent corporations from so manipulating their stocks and bonds as to evade their tax on earnings.”⁶⁰

The compromise to this thin corporations problem was to permit corporations to deduct interest, but to cap the amount of the deduction to an amount of bonds equal to the par value of the corporation’s capital stock.⁶¹ Senator Elihu Root, a Republican from New York who was one of the principal drafters of the bill, explained that

[a]s we found that the bonded indebtedness of the corporations of the country does not vary very much from the capital stock as it is now, we thought that the simplest and most efficacious way to prevent any abuse on any considerable scale would be to introduce into the measure the limitation . . . not permitting the corporation to deduct from its gross income any amount assignable to the payment of interest upon indebtedness in excess of the amount of its capital stock.⁶²

Root’s theory was that the cap would generally limit bonded indebtedness from growing beyond its existing one-to-one status with capital stock.

⁵⁹ *Taxation of Net Earnings*, WALL ST. J., June 19, 1909, at 8.

⁶⁰ *Taft Banquets Senate Finance Committeemen*, L.A. HERALD, June 21, 1909, at 1.

⁶¹ *Rush of Objections to Taft Tax Plan*, N.Y. TIMES, June 22, 1909, at 1; Berger, *supra* note 4, at 220; Michael Asimow, *Principle and Prepaid Interest*, 16 UCLA L. REV. 36, 63 n.130 (1968). According to Marjorie Kornhauser, there was no deduction for interest in the June 17 draft, but by the June 21 draft it had been added. Kornhauser, *supra* note 4, at 111. Some taxpayer corporations attempted to argue that the value of the deduction should be tied to the total amount paid to the corporation even if it was in excess of par value, but this was rejected by the courts. See *N.Y., New Haven & Hartford R.R. Co. v. United States*, 269 F. 907, 909 (2d Cir. 1920).

⁶² 44 CONG. REC. 4007 (1909) (Statement of Sen. Root). Recent empirical studies suggest that the cap was effective, insofar as the average amount of corporate debt financing did not appreciably change before and after the adoption of the corporate excise tax in 1909 and the individual income tax in 1913. See generally Leonce Barger et al., *Taxes, Investment, and Capital Structure: A Study of U.S. Firms in the Early 1900s* (Mar. 13, 2014) (unpublished manuscript), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2408490.

The cap also reflected Congress's concern about the practice of over-leveraging. For corporations that already had outstanding indebtedness in excess of the par value of their paid-up capital stock or were tempted to incur such sizable debt obligations, the cap would serve as a dividing line between legitimate and what might have then been considered excessive business debt. New York practitioner George Holmes offered this explanation in his prominent income tax treatise:

In limiting the amount of interest which a corporation could deduct under [the 1909 law,] Congress evidently had in view the fact that some corporations carry a current indebtedness exceeding the amount of paid up capital stock and with respect to such corporations intended to limit the interest deduction to so much of the indebtedness as did not exceed the capital. It appears that Congress deemed that where the indebtedness exceeded that capital it should no longer be treated as an incident, but should be considered as a principal object of the corporate activities, and that the operations of such a corporation were conducted more for the benefit of the creditors than of the stockholders.⁶³

In effect, this suggests that Congress viewed excessive amount of debt, or debt that exceeded a corporation's capital stock, as no longer constituting an ordinary and necessary incident of business as other deductible expenses.

There was some concern that corporations could evade this limitation by increasing their authorized capital stock with meaningless "watered stock," which prompted drafters to define the cap in terms of "paid-up capital stock" so as to make this evasion technique costly.⁶⁴ Thus, the bill provided that "[s]uch net income shall be ascertained by deducting from the gross amount of the income of such corporation . . . [i]nterest actually paid within the year on its bonded or other indebtedness not exceeding the paid-up capital stock of such corporation . . . outstanding at the close of the year."⁶⁵ Progressives and insurgents did not consider the cap to be a satisfactory compromise, with Senator Clapp calling the treatment of bonds under the corporate tax "badly defective"⁶⁶ and still complaining that it "exempts the man with the great fortune who has invested his millions in bonds,"⁶⁷ but it nevertheless passed in the final act.⁶⁸

⁶³ GEORGE E. HOLMES, *FEDERAL INCOME TAX* 855 (1920).

⁶⁴ 44 CONG. REC. 4008 (1909) (colloquy between Sens. Bacon and Root).

⁶⁵ *Corporate Tax Bill Laid Before Senate*, N.Y. TIMES, June 26, 1909, at 2.

⁶⁶ 44 CONG. REC. 4009-10 (1909) (statement of Sen. Clapp).

⁶⁷ *Id.*

⁶⁸ Tariff Act of 1909, ch. 6, § 38(3), 36 Stat. 11, 114. The cap on deductibility of corporate interest was subsequently challenged in court, but ultimately upheld. *Flint v.*

III.

A.

In 1909, there had been little concern about the deferral shield, or the possibility that earnings would be retained by the corporation to permit shareholders to evade the personal income tax, because there was no individual income tax. Starting with the enactment of the first post-Sixteenth Amendment income tax in 1913, however, this was theoretically a legitimate concern and one means of reconciling the differential tax treatment of debt and equity. Nevertheless, a cap on the interest deduction remained in place.

During the Senate Finance Committee Hearings on the proposed revenue bill in 1913, several interest groups submitted statements complaining about the retention of the cap on the deductibility of corporate interest that had been adopted in 1909. J.T. Clark, speaking on behalf of corporations owning real estate, argued that the cap systematically disadvantaged such corporations due to the fact that

real estate is mortgaged for two-thirds of its value Therefore, if its capitalization equals the amount of its equity in the property, which is most frequently the case, its capitalization is only one-half of the amount of its mortgage indebtedness, so that under the operation of the pending bill a company will be permitted to deduct only one-half of the actual interest it is obliged to pay during the year, because of this illogical provision in the bill.⁶⁹

Clark contrasted this with the situation in most other large interstate corporations where the capital stock generally exceeds the corporation's indebtedness.⁷⁰ Thus, "large corporations with millions of bonds outstanding are permitted to deduct all the

Stone Tracy, 220 U.S. 107, 151–52, 173–74 (1911) (upholding the corporate excise tax itself, but also commenting on the capped interest deduction: "Again, it is urged that Congress exceeded its power in permitting a deduction to be made of interest payments only in case of interest paid by banks and trust companies on deposits, and interest actually paid within the year on its bonded or other indebtedness to an amount of such bonded and other indebtedness not exceeding the paid-up capital stock of the corporation or company. This provision may have been inserted with a view to prevent corporations from issuing a large amount of bonds in excess of the paid-up capital stock, and thereby distributing profits so as to avoid the tax. In any event, we see no reason why this method of ascertaining the deductions allowed should invalidate the act. Such details are not wholly arbitrary, and were deemed essential to practical operation. Courts cannot substitute their judgment for that of the legislature. In such matters a wide range of discretion is allowed."); see also *Anderson v. Forty-Two Broadway Co.*, 239 U.S. 69, 73 (1915) (upholding the cap); *Realty Company Loses*, N.Y. TIMES, Nov. 9, 1915, at 19.

⁶⁹ Memorandum in Relation to Amendment Sought to Pending Income-Tax Bill: Hearing on H.R. 3321 Before the S. Comm. on Finance, 63d Cong. 2078–79 (1913) (statement of J.T. Clark).

⁷⁰ *Id.* at 2080.

interest which they pay on their bonds," while, according to Clark, the small corporation that owns the buildings leased by the large corporations, "is penalized by being unable to deduct from the rents paid it by the large corporations the full amount of the interest which it has been obliged to pay to its mortgagee."⁷¹

Walker D. Hines submitted a brief on behalf of a number of railroad interests that also argued against the interest deduction cap. Hines argued that the concern that corporations would evade the 1909 tax by heavily capitalizing themselves with debt no longer existed in 1913 because "under the income tax law, the persons who receive the interest will pay the tax thereon . . . and hence the loss of revenue which was anticipated under the corporation excise tax law will not be realized under the income tax law."⁷² Moreover, Hines contended that the possibility of using leverage to evade the income tax was minimal due to the bankruptcy risk of heavy leverage and due to the fact that

[a]t the present time no corporation can put forward any bond with the hope that it will be attractive unless the bond contains a provision supposed to mean that the interest will be paid free of any tax which may be required to be paid or deducted at the source.⁷³

At the same time, the issue of reaching bondholder wealth was still prominent in policy discussions. The bill's authors reportedly designed the measure to "reach the rich man and be effective in equalization of taxation."⁷⁴ At the time, Andrew Carnegie was in the news for reportedly retiring with \$213 million worth of bonds in the newly formed United States Steel Corporation, all of which would be exempt from taxation under New York state property law after paying a one-time recording tax.⁷⁵ Moreover, beyond the sensationalism of individual massive bond wealth was the reality that corporation bonds were an important part of corporate financing at this time, with the gross amount of corporate bonds outstanding equaling \$17.4 billion in

⁷¹ *Id.*

⁷² *Some Suggestions and Comments, on Behalf of Certain Railroad Companies, Relative to the Provisions of the Income Tax Section of H.R. 3321, Regulating the Ascertainment of the Net Income of Corporations: Hearing on H.R. 3321 Before the S. Comm. on Finance, 63d Cong. 2058-59 (1913) [hereinafter *Hearings*]* (statement of Walker D. Hines). Indeed, the existence of the income tax led Hines to point out that the cap would result in double taxation on the non-deductible portion of the interest. *Id.* at 2060; see also Letter to the Editor, *Double Income Taxation*, N.Y. TIMES, May 17, 1913, at 10.

⁷³ *Hearings*, *supra* note 72, at 2062.

⁷⁴ *Taxes Piled Up in Succession Under Operation of Income Bill*, WALL ST. J., June 20, 1913, at 1.

⁷⁵ *Financial News for the Investor*, AM. REV. REVIEWS, July-Dec. 1913, at 126. New York's so-called "secured debt" exemption only added to the confusion among investors trying to understand the tax consequences of holding bonds at this time. See *Bonds and Taxes*, MUNSEY'S MAG., Apr.-Sept. 1913, at 421, 423.

1913, compared to only \$5.6 billion in combined tax-exempt federal and state bonds.⁷⁶

Ultimately, Congress elected to raise the interest cap rather than eliminate it. In the Senate Finance Committee, the ceiling on deduction of interest was increased from an amount equal to the paid-up capital stock to an amount “not exceeding one-half of the sum of its interest bearing indebtedness and its paid-up capital stock outstanding at the close of the year.”⁷⁷ There was some confusion about the construction of this clause. Treasury initially interpreted this to mean that the capital stock and the debt should be added together and then cut in half to arrive at the amount of debt for which interest may be deducted.⁷⁸ Corporations were even instructed to calculate their interest this way on their returns.⁷⁹ Nevertheless, Treasury soon changed its stance and issued a ruling to explain that it would construe the language as the paid up capital stock, plus one-half of the outstanding debt.⁸⁰ This confusion only underscores the arbitrariness of the number chosen for the ceiling on the interest deduction. Seligman called it a compromise “more favorable to the corporations than was the excise tax,” but one that was “entirely arbitrary. Either there should have been no deduction at all, or the deduction should have been permitted on all the indebtedness which might be regarded as a result of purely consumption credit.”⁸¹

B.

After 1913, Congress was subjected to “several years of intensive lobbying by corporate interests” on the subject of the corporate interest deduction.⁸² Some argued that the interest cap was hard to justify in a post-Sixteenth Amendment world. Representative J. Swagar Sherley, a Democrat from Kentucky, asked Chairman Cordell Hull whether the Ways and Means Committee “had considered the simplification of the law by providing that the corporation should do as individuals do, and that all interest paid should be considered as an expense of doing business.”⁸³ As Sherley explained, “I can see why, when you do

⁷⁶ GEORGE E. LENT, *THE OWNERSHIP OF TAX-EXEMPT SECURITIES, 1913–1953*, at 10 tbl. 1 (1955).

⁷⁷ *Tariff Act of 1913*, ch. 16, § 2(G), 38 Stat. 114, 173; BLAKEY & BLAKEY, *supra* note 56, at 84.

⁷⁸ *New Income Tax Returns Necessary from Corporations*, WALL ST. J., Mar. 21, 1914, at 1.

⁷⁹ *Id.*

⁸⁰ *Id.* at 1, 7; T.D. 1960, 16 Treas. Dec. Int. Rev. 43 (1914).

⁸¹ SELIGMAN, *supra* note 16, at 685.

⁸² Berger, *supra* note 4, at 221 n.32.

⁸³ 53 CONG. REC. 10,656 (1916) (statement of Sen. Sherley).

not tax individuals but only tax corporations, you should have a particular provision touching interest payments. But now you are taxing both the corporation and the individual"⁸⁴ Railroad lawyer Alfred Thom echoed these sentiments in a brief he submitted to the Senate Finance Committee during the consideration of the 1916 Act:

It is difficult to appreciate the reason for any arbitrary limitation on interest in calculating net income as would be the case in any expense incident to the business, and no satisfactory reason has been assigned. The present provision has apparently been taken over from the old corporation excise law without consideration of the effect of the establishment of a net income tax on individuals.⁸⁵

One impetus for change was the continuing perception that the cap on the deductibility of interest payments was effectively hitting either common stockholders with a second or third layer of tax or consumers in the form of higher prices, rather than reaching bondholder wealth. This was partly due to the continued presence of tax-free covenants and other structural features of the bond instruments that prevented corporations from factoring in the deductibility cap into previously issued bonds. Harvard Economics Professor Charles Bullock wrote that "[a]t present the average corporation is obliged to assume payment of the ordinary tax upon bond interest It therefore comes about, if the tax is not shifted, that the holders of common stock may be taxed at two or three times the ordinary rate."⁸⁶ These tax-free covenants had expanded far beyond the original confines of those enacted as a result of the Civil War-era income tax:

The language of the typical "tax-free" clause, however, framed at the instance of creditors who demanded protection against every possible contingency in the premises, is, in its usual form, so broad as apparently to comprehend not only an excise tax upon the business of the corporation deductible against its security-holders but a tax like the present income tax which is levied, not upon the corporation, but upon the recipient of the interest, and which solely, as a means of collection, the corporation is required to withhold and to pay to the

⁸⁴ *Id.*

⁸⁵ *Brief of Alfred P. Thom in Regard to the Duplicate Taxation of the Holders of Common Stock by the Pending Revenue Act*, in BRIEFS AND STATEMENTS FILED WITH THE COMMITTEE ON FINANCE, UNITED STATES SENATE, 64TH CONG., 1ST SESS., ON H.R. 16763 75, 76 (1916).

⁸⁶ Charles J. Bullock, *Financing the War*, 31 Q.J. ECON. 357, 374 (1917); see W. Elliot Brownlee, *Wilson and Financing the Modern State: The Revenue Act of 1916*, 129 PROC. AM. PHIL. SOC'Y 173, 197 (1985) (describing practice of tax-free covenants). But see Roy G. Blakey, *Amending the Federal Income Tax*, 58 ANNALS AM. ACAD. POL. & SOC. SCI. 32, 38 n.4 (1915) (arguing that the tax burden was properly on corporations or shareholders because the tax burden was built in to the higher price the corporation received for the bond).

government The result has been a tax which Congress intended to levy upon the *income-receiver* has, in this case, been shifted to the *income-producer*. It thus falls not upon the “swollen fortune” which it is the professed purpose of this act particularly to reach, but primarily upon the corporation and finally upon the unfortunate “ultimate consumer” who was supposed already to be more than sufficiently taxed.⁸⁷

This meant that one argument for differentiating between the cap in 1909 and the cap post-1913—that the individual income tax would ensure that bondholders paid their fair share of tax on the interest payments—may not have been entirely accurate. In effect, permitting the corporation to deduct interest payments may have become a way to ensure the corporation (or its stockholders, customers, or whoever bore the ultimate burden) would not pay the tax twice, since its bondholders were already being spared one layer of tax as a result of the covenants.⁸⁸

In 1916, Congress was not ready to abandon the cap completely, but it was willing to further the effort begun in 1913 to raise it. Thus, a bill was introduced to permit corporations to deduct interest on an amount of debt equal to twice its capital stock. As Chairman Hull explained, this was once again a compromise relating to concerns about the fungibility of debt and equity:

[T]he original theory of the matter was that corporations could issue quite a lot of watered stock, transfer that into bonds, mortgage their property, and incur interest, and make a great many shifts in many ways that would result in avoiding the real purpose of the law. This bill allows them to deduct interest on an amount of indebtedness double their capital stock.⁸⁹

As Hull explained, “[t]he original provision was modified, but it was not thrown wide open.”⁹⁰

Congress did not adopt the same cap proposed in the House bill, but it did employ language to ratify the more generous interpretation employed by Treasury starting in 1914. Thus, under the Revenue Act of 1916, it revised the statutory language to make clear that corporations were permitted to deduct the interest on an amount of debt equal to the paid-up capital stock

⁸⁷ Rearick, *supra* note 47, at 304.

⁸⁸ The Senate Finance Committee in 1916 also sought to ameliorate the problem by prohibiting tax-free covenants for future bond issuances, but ultimately simply barred the deductibility of income tax payments made as a result of such guarantees. See Brownlee, *supra* note 86, at 201; see also Cedric A. Major, *The Revised Federal Income Tax Law*, 2 CORNELL L.Q. 73, 87 (1917).

⁸⁹ 53 CONG. REC. 10,656 (1916) (statement of Sen. Hull).

⁹⁰ *Id.*

and one-half the outstanding indebtedness.⁹¹ While this fell far short of the critics' arguments for repeal, it laid the groundwork for a push to eliminate the cap completely a few years later.

The entry of the United States into the war and the adoption of war and excess profits taxes in 1917 had complicated the question of the corporate interest deduction. In its definition of an "invested capital" base upon which to measure "excess profits" and "war profits" for purposes of levying a tax, Congress had omitted most borrowed funds.⁹² *The New York Times* argued that this was inequitable since "all funds used in business, and at the risk of business, are capital for that purpose in an economic sense."⁹³ The *Times* suggested that "[a] small step toward solving the problem would be to remove, or at least to enlarge, the limit upon the allowance deductible for interest before calculating the tax."⁹⁴ As George Holmes explained, the interest cap's

arbitrary limitation resulted in the creation of a fictitious income on which the corporation was taxed, and since such fictitious income not only was subject to a heavy income tax but entered very materially into the computation of an extraordinarily heavy excess profits tax, the provision operated with rank injustice in the case of corporations which had an indebtedness greatly in excess of their capital stock.⁹⁵

In 1918, the House Ways and Means Committee used similar reasoning in a report recommending a repeal of the cap⁹⁶: "Since borrowed money is not allowed to be included in computing invested capital for the purpose of the war profits and excess profits tax, it seems only fair to allow as a deduction in computing net income the whole amount of the interest paid during the year."⁹⁷ Under the Revenue Act of 1918, Congress adopted this logic and interest on corporate debt became fully deductible for the first time.⁹⁸ This move was considered momentous and hailed by businesses and practitioners, where the cap had not only limited deductibility, but also caused significant confusion for corporate taxpayers.⁹⁹ As *The Wall*

⁹¹ Revenue Act of 1916, ch. 463, tit. I, § 12(a), 39 Stat. 756, 768 ("The amount of interest paid within the year on its indebtedness to an amount of such indebtedness not in excess of the sum of (a) the entire amount of the paid-up capital stock outstanding at the close of the year, or, if no capital stock, the entire amount of capital employed in the business at the close of the year, and (b) one-half of its interest-bearing indebtedness then outstanding . . ."); see *Revenue Bill Amended*, N.Y. TIMES, Aug. 13, 1916, at XX2.

⁹² ROBERT H. MONTGOMERY, EXCESS PROFITS TAX PROCEDURE 108 (1920).

⁹³ *Taxation of Borrowed Capital*, N.Y. TIMES, June 17, 1918, at 12.

⁹⁴ *Id.*

⁹⁵ HOLMES, *supra* note 63, at 856.

⁹⁶ *Retains Taxation on Issues of Bonds*, N.Y. TIMES, Sept. 18, 1918, at 17.

⁹⁷ H.R. REP. NO. 65-767, at 12-13 (1918).

⁹⁸ Revenue Act of 1918, ch. 18, § 234(a)(2), 40 Stat. 1057, 1077 (1919).

⁹⁹ See, e.g., *Income Tax Allowance with Respect to Interest: Where Indebtedness Exceeds the Capital, Month to Month Variations Must Be Taken into Account*, WALL ST. J.,

Street Journal had commented when the repeal of the cap was before the Ways and Means Committee, “[h]alf-way concessions [on the interest deduction cap] . . . were made in the present law, but the new bill contains the first full measure of justice to corporations” on this issue.¹⁰⁰ Similarly, *The New York Times* hailed the change: “Considering that all interest paid by corporations is subject to tax as income of those to whom it is paid, the limitation in the old law likewise resulted in double taxation to the extent that a corporation was not permitted to deduct interest in arriving at net taxable income.”¹⁰¹

CONCLUSION

The capped origin of the corporate interest deduction contradicts the notion that a full interest deduction was part of the original design of the corporate income tax. Indeed, there was significant concern about bondholder wealth and tax evasion as a result of the fungibility of debt and equity in 1909, and this concern continued even after an individual income tax was enacted. The cap on the interest deduction, although criticized as “logically indefensible,”¹⁰² reflected a pragmatic compromise between those concerned that corporations would become over-leveraged to avoid the entity-level tax and those concerned that not permitting an interest deduction would unfairly disadvantage corporations that needed such leverage. It was only removed when the larger issue of taxing wartime profits made the tax treatment of heavily leveraged companies more problematic.

This historical context also provides perspective for modern advocates of a cap on the corporate interest deduction. For instance, Senator Wyden justifies the proposal contained in his bill with Republican Senator Dan Coats on similar grounds of over-leverage and the ease of shifting between equity and debt. According to the information statement on the bill, the cap is justified as necessary to “create[] a more even playing field between corporate debt and equity by cutting the value of inflation from a corporation’s interest deduction on debt.”¹⁰³ The statement continues to note that “[c]utting the value of this tax

June 10, 1918, at 4; *Answers to Inquirers; War Revenue Problems*, WALL ST. J., Feb. 15, 1918, at 2; *Borrowed Funds Allowable as Capital in Cases*, WALL ST. J., Feb. 14, 1918, at 4; ROBERT H. MONTGOMERY, *INCOME TAX PROCEDURE* 584 (1920).

¹⁰⁰ *The Revenue Bill*, WALL ST. J., Aug. 31, 1918, at 1.

¹⁰¹ *Shows Injustices of Revenue Bill*, N.Y. TIMES, Jan. 12, 1919, at 29.

¹⁰² ROBERT H. MONTGOMERY, *INCOME TAX PROCEDURE* 459 (1919).

¹⁰³ RON WYDEN & DAN COATS, *THE BIPARTISAN TAX FAIRNESS AND SIMPLIFICATION ACT OF 2011*, available at <http://www.wyden.senate.gov/imo/media/doc/Wyden-Coats%20Two%20Pager%20FINAL1.pdf>.

deduction will reduce a company's financial incentive to take on debt."¹⁰⁴

¹⁰⁴ *Id.*

Subchapter S: Vive le Difference!

*Roberta Mann**

No rational, reasonably well-informed tax professional would deliberately choose Subchapter S status over an LLC when there is a choice, and 99 percent of the time there is a choice The LLC is clearly the choice of the future if you are dealing with rational people, and most of the time we are dealing with rational people.¹

INTRODUCTION

From 1958 to 1996, S corporations were the only business form to combine limited liability with reliable pass-through tax treatment. In 1996, the Treasury and the Internal Revenue Service (IRS) promulgated the “check-the-box” regulations, and LLCs, taxed as partnerships, became the darlings of the tax world. Is Subchapter S² obsolete, or does it still serve a rational purpose in the economy? This Article will examine that issue, focusing on the comparison between S corporations and LLCs. The Article begins with a history of Subchapter S and the “check-the-box” regulations. Next, the Article will compare the arguments for and against repealing Subchapter S.

The chairman of the United States House of Representatives Ways and Means Committee, David Camp, published options for pass-through entity tax reform in March of 2013.³ One option (Camp Option 2) would repeal Subchapter S and replace it with a

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¹ Amy Hamilton, *S Corporations 'Most Popular Choice of Entity,' IRS Finds*, 88 TAX NOTES 157, 157 (2000) (quoting former Internal Revenue Service (IRS) Commissioner Donald C. Alexander).

² Subchapter S refers to the collection of provisions that govern the taxation of S corporations. I.R.C. §§ 1361–1379 (2012).

³ HOUSE COMM. ON WAYS & MEANS, 113TH CONG., DISCUSSION DRAFT ON TAX REFORM ACT OF 2013 (2013) [hereinafter WAYS & MEANS DISCUSSION DRAFT]; HOUSE COMM. ON WAYS & MEANS, 113TH CONG., TECHNICAL EXPLANATION OF THE WAYS AND MEANS COMMITTEE DISCUSSION DRAFT PROVISIONS TO REFORM THE TAXATION OF SMALL BUSINESSES AND PASSTHROUGH ENTITIES (2013) [hereinafter TECHNICAL EXPLANATION].

unified tax regime for pass-through business entities.⁴ This Article will examine Camp Option 2 with a view to informing the reader whether to praise or bury it. Statistics appear to show that the number of S corporation returns is still increasing.⁵ Why are S corporations still being used, and do those reasons justify its continued existence?⁶ Perhaps the answer is political: politicians love small businesses and S corporation stands for “small business.”⁷ Ultimately, the answer to these questions may depend on whether politicians’ favorable view of small business is justified.

I. HISTORY

A. Subchapter S

In 1958, Congress enacted the first version of subchapter S.⁸ Subchapter S created the first limited liability entity without an entity level tax. The term “small business corporation” has been part of subchapter S since its original enactment.⁹ President Eisenhower proposed subchapter S to help small businesses.¹⁰ The stated goals of the original legislation, as proposed by the Senate, were (1) to permit “businesses to select the form of business organization desired, without the necessity of taking into account major differences in tax consequences”; (2) to remove the “double” tax on distributed earnings; and (3) to benefit small businesses by allowing shareholders to use corporate losses.¹¹ The legislation limited the benefits of subchapter S to “small business” corporations by imposing a strict limitation on the

⁴ See *supra* note 3; see also Monte A. Jackel, *An Initial Look at Camp's Small Business Proposals*, 138 TAX NOTES 1363, 1363 (2013); George K. Yin, *Comments on the Taxation of Passthrough Entities*, 140 TAX NOTES 358, 358 (2013); Willard B. Taylor, *Subchapter S Out the Window? What's Going On?*, 139 TAX NOTES 1051, 1052 (2013).

⁵ See MARK P. KEIGHTLEY, CONG. RESEARCH SERV., R42359, WHO EARNS PASS-THROUGH BUSINESS INCOME? AN ANALYSIS OF INDIVIDUAL TAX RETURN DATA 9–10 (2012).

⁶ See John W. Lee, *Choice of Small Business Tax Entity: Facts and Fictions*, 87 TAX NOTES 417, 425 (2000).

⁷ Mirit Eyal-Cohen, *Down-Sizing the “Little Guy” Myth in Legal Definitions*, 98 IOWA L. REV. 1041, 1047 (2013); Mirit Eyal-Cohen, *When American Small Business Hit the Jackpot: Taxes, Politics and the History of Organizational Choice in the 1950s*, 6 PITT. TAX REV. 1, 1 (2008) [hereinafter Eyal-Cohen I]; Martin A. Sullivan, *When Should Small Businesses Get a Tax Break?*, 134 TAX NOTES 267, 267 (2012); Martin A. Sullivan, *Why Not Tax Large Passthroughs as Corporations?*, 131 TAX NOTES 1015 (2011).

⁸ Technical Amendments Act of 1958, Pub. L. No. 85-866, § 64, 72 Stat. 1606, 1650 (current version at I.R.C. §§ 1361–1379).

⁹ *Id.*

¹⁰ The President's budget message of January 13, 1958, stated, “There are certain technical tax revisions which will give substantial benefits to small business, with a minimum loss of revenue and with no changes in tax rates.” 104 CONG. REC. 388, 389 (1958), *reprinted in* 1958 U.S.C.C.A.N. 5360, 5364.

¹¹ S. REP. NO. 85-87, at 1008 (1983).

number of shareholders.¹² Originally, S corporations could have no more than ten shareholders,¹³ and that limit was strictly enforced by the Internal Revenue Service (IRS).¹⁴ In Revenue Ruling 77-220, three separate S corporations, each with ten shareholders, joined together in a partnership to operate a single business.¹⁵ The IRS found that the principal purpose for forming the three corporations was to avoid the ten-shareholder limitation and invalidated the S elections made by the three corporations.¹⁶ Revenue Ruling 77-220 has since been reconsidered by the IRS. In Revenue Ruling 94-43,¹⁷ the IRS decided that the separate S elections of the three corporations should be respected, stating that:

The purpose of the number of shareholders requirement is to restrict S corporation status to corporations with a limited number of shareholders so as to obtain administrative simplicity in the administration of the corporation's tax affairs [T]he fact that several S corporations are partners in a single partnership does not increase the administrative complexity at the S corporation level.¹⁸

Somehow, between 1977 and 1993, "small" changed meaning.¹⁹ But it is unclear whether "small" ever had a significant meaning in the statutory context of subchapter S. The definition of S corporation has never referred to the value of assets held by the corporation or the amount of contributed capital, unlike some other tax provisions.²⁰ Under current law, S corporations may have up to 100 shareholders, and members of a family may count as a single shareholder.²¹

¹² Technical Amendments Act of 1958 § 64.

¹³ *Id.*

¹⁴ Rev. Rul. 77-220, 1977-1 C.B. 263.

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ Rev. Rul. 94-43, 1994-2 C.B. 198.

¹⁸ *Id.*

¹⁹ The number of permitted shareholders increased to 15 in 1976 (Tax Reform Act of 1976, Pub. L. No. 94-455, § 902(a)(1), 90 Stat. 1520, 1608); to 25 in 1981 (Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 233(a), 95 Stat. 172, 250); to 35 in 1982 (Subchapter S Revision Act of 1982, Pub. L. No. 97-354, § 2, 96 Stat. 1669, 1669); to 75 in 1996 (Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1301, 110 Stat. 1755, 1777); and to 100 in 2004 (American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 232(a), 118 Stat. 1418, 1434) (current version at I.R.C. § 1361 (2004)).

²⁰ See, for example I.R.C. §§ 1202(a)(1), (d)(1) (2012) (allowing a 50% exclusion from gain recognized on the disposition of "small business stock"), defining "qualified small business" as a corporation with aggregate gross assets less than \$50,000,000, and I.R.C. §§ 1244(a), (c)(3)(A) (allowing an ordinary loss to be recognized on the disposition of "small business stock"), under which a corporation may only be treated as a "small business corporation" "if the aggregate amount of money and other property received by the corporation for stock, as a contribution to capital, and as paid-in surplus, does not exceed \$1,000,000."

²¹ I.R.C. § 1361(b)(1)(A), (c).

Professor Mirit Eyal-Cohen meticulously examined the history of the subchapter S provisions.²² She observed that there is no standard definition of “small business.”²³ Whether a business is considered “small” may depend on the number of employees, number of owners, value of total assets or annual sales.²⁴ Irrespective of the particulars of the definition, “[s]mall companies are the darlings of the business world. . . . [and] have semi-sacred status in the American political economy,” according to economist Martin Sullivan.²⁵ Prior to the original enactment of subchapter S, the welfare of small companies was considered to be “a key condition for prosperity.”²⁶ This view has only strengthened over time, as discussed by Eyal-Cohen.²⁷ She notes, “small business has been constantly portrayed as the source of innovation and change—firms that by their mere existence generate new value and novel ideas. Size has turned into a pivotal benchmark to indicate business novelty and positive contributions to the economy.”²⁸ Sullivan notes that “no politician of any persuasion wants to do anything but praise small businesses.”²⁹

B. Limited Liability Companies and Check-the-Box

The political attractiveness of small businesses that spurred the enactment of subchapter S attaches with equal fervor to a newer business entity, the limited liability company (LLC).³⁰ Like corporations, LLCs are creatures of state law.³¹ In 1977,

²² Eyal-Cohen I, *supra* note 7. However, most S corporations are held by three or fewer shareholders. S. REP. NO. 10-195, at 4 (2009).

²³ See Eyal-Cohen I, *supra* note 7, at 7; see also STAFF OF THE JOINT COMM. ON TAXATION, 112TH CONG., SELECTED ISSUES RELATING TO CHOICE OF BUSINESS ENTITY 7 (2012) [hereinafter JCT]. The JCT found that a majority of S corporations could be considered “small,” as defined by having less than \$100,000 in assets. *Id.* at 8.

²⁴ Eyal-Cohen I, *supra* note 7, at 7.

²⁵ Martin A. Sullivan, *The Myth of Mom-and-Pop Businesses*, 132 TAX NOTES 1085, 1085 (2011).

²⁶ *Needed: Talent, Training & Tax Cuts*, TIME, Nov. 12, 1956, at 98.

²⁷ See generally Mirit Eyal-Cohen, *Down-Sizing the “Little Guy” Myth in Legal Definitions*, 98 IOWA L. REV. 1041 (2013) [hereinafter Eyal-Cohen II].

²⁸ *Id.* at 1054 (footnotes omitted).

²⁹ Martin A. Sullivan, *Start-Ups, Not Small Businesses, Are Key to Job Creation*, 134 TAX NOTES 158, 158 (2012).

³⁰ “Small businesses are almost always passthrough entities—subchapter S corporations, partnerships, or sole proprietorships.” Sullivan, *supra* note 7, at 267. Until 2011, the Treasury Department’s Office of Tax Analysis included as a small business owner any individual who received flow-through income from a partnership or S corporation. See Matthew Knittel, Susan Nelson, Jason DeBacker, John Kitchen, James Pearce & Richard Prinszano, *Methodology to Identify Small Businesses and Their Owners*, 4 OFF. TAX ANALYSIS TECHNICAL PAPERS, Aug. 2011, at 2.

³¹ *E.g.*, ROBERT W. HAMILTON, JONATHAN R. MACEY & DOUGLAS K. MOLL, CASES AND MATERIALS ON CORPORATIONS INCLUDING PARTNERSHIPS AND LIMITED LIABILITY COMPANIES 136, 1183 (11th ed. 2010).

Wyoming was the first state to enact LLC legislation.³² At the time, the IRS decided how to tax business entities by applying the so-called *Kintner* regulations.³³ The regulations identified four corporate characteristics: (1) continuity of life, (2) centralized management, (3) limited liability, and (4) freely transferable interests.³⁴ If an entity had three corporate characteristics, it was taxed as a corporation.³⁵ If it had two or fewer corporate characteristics, the IRS would disregard it for tax purposes if it had a single owner, or tax it as a partnership if it had more than one owner.³⁶ The regulations intentionally made it more difficult to obtain corporate tax treatment. Until 1986, the corporate tax rate was significantly below the top marginal rate applied to individuals.³⁷ Thus, wealthy individuals used corporations as tax shelters, keeping personal assets in the corporations and deferring individual tax liability. LLCs combined the limited liability of a corporation with the ability to avoid tax classification of a corporation because of lack of transferability, no centralized management, and lack of continuity of life. LLCs taxed as partnerships allowed flow through of tax losses and avoided the two layers of taxation experienced by corporate owners receiving dividends.

Despite these advantages, LLCs were not particularly interesting to tax planners until the Tax Reform Act of 1986

³² Wyoming Limited Liability Company Act, ch. 158, 1977 Wyo. Sess. Laws 537.

³³ *Kintner v. United States*, 107 F. Supp. 976, 979 (D. Mont. 1952), *aff'd*, 216 F.2d 418 (9th Cir. 1954); Treas. Reg. § 301.7701-2(a)(1) (1960); see Heather M. Field, *Checking in on "Check-the-Box,"* 42 LOY. L.A. L. REV. 451, 459–60 (2009).

³⁴ Treas. Reg. § 301.7701-2(a)(1).

³⁵ See Treas. Reg. § 301.7701-2(a)(2)–(3).

³⁶ See *id.*

³⁷ Table derived from JEFFREY L. KWALL, *THE FEDERAL INCOME TAXATION OF CORPORATIONS, PARTNERSHIPS, LIMITED LIABILITY COMPANIES, AND THEIR OWNERS* 6–7 (4th ed. 2012).

Years	Maximum Corporate Tax Rate	Maximum Individual Tax Rate
1954–1963	52%	91%
1964	50%	77%
1965–1978	48%	70%
1979–1980	46%	70%
1981–1986	46%	50%
1987	40%	38.5%
1988–1990	34%	28%
1991–1992	34%	31%
1993–2000	35%	39.6%
2001	35%	39.1%
2002	35%	38.6%
2003–2012	35%	35%
2013	35%	39.6%

reduced the top marginal tax rate applied to individuals to below the corporate tax rate.³⁸ The Congressional Budget Office found that the reduction in the top individual rate and neutrality between individual and corporate tax rates “probably stimulated the growth of pass-through entities.”³⁹ The interest in subchapter S peaked at about the same time.⁴⁰ Florida was the second state to enact LLC legislation in 1982,⁴¹ but no other states followed suit until after the IRS ruled on the tax classification of LLCs in 1988.⁴² In Revenue Ruling 88-76, the IRS ruled that entities formed under the Wyoming LLC statute would be classified as tax partnerships because they lacked the corporate characteristics of continuity of life and free transferability of interests.⁴³ By 1997, all fifty states had enacted LLC legislation.⁴⁴

1996 marked the most significant change in entity classification for tax purposes: the promulgation of the “check-the-box” (CTB) regulations.⁴⁵ Whereas under prior regulations, the IRS determined the tax classification of a business entity by examining its corporate characteristics, the CTB regulations allowed non-corporate entities to elect their tax classification. The regulations solved problems for both the IRS and taxpayers. The IRS no longer needed to use resources to litigate or issue guidance on entity classification issues.⁴⁶ Theoretically, taxpayers could save on tax advice regarding entity classification issues.⁴⁷ Under the CTB regulations, all domestic entities that are not incorporated under state law are eligible to elect to be taxed as corporations.⁴⁸ The CTB regulations also provide default rules for entities that do not make an explicit election: a domestic eligible entity is taxed under partnership tax rules if it has two or more owners and is disregarded for tax purposes if it has only one owner.⁴⁹ LLCs

38 See Susan Pace Hamill, *The Story of LLCs: Combining the Best Features of a Flawed Business Tax Structure*, in BUSINESS TAX STORIES 295, 313 (Steven A. Bank & Kirk J. Stark eds., 2005) [hereinafter Hamill I] (“The rise of the LLC has been largely driven by tax considerations . . .”).

39 CONG. BUDGET OFFICE, TAXING BUSINESSES THROUGH THE INDIVIDUAL INCOME TAX 13–14 (2012) [hereinafter CBO].

40 *Id.* at 12–13 (“The number of S corporations rose by almost 37 percent between 1986 and 1987, the largest annual increase in such entities during the 1986–2007 period.”).

41 Florida Limited Liability Company Act, ch. 82-177, 1982 Fla. Laws 580.

42 Rev. Rul. 88-76, 1988-2 C.B. 360.

43 *Id.*

44 Susan Pace Hamill, *The Origins Behind the Limited Liability Company*, 59 OHIO ST. L.J. 1459, 1470, 1473–77 (1998) [hereinafter Hamill II].

45 Treas. Reg. § 301.7701-3 (1997).

46 See Field, *supra* note 33, at 464.

47 *Id.* However, as will be illustrated, the choice is still not all that simple.

48 Treas. Reg. § 301.7701-3(a) (as amended in 2006).

49 Treas. Reg. § 301.7701-3(b).

made up the majority of all partnerships (64.3%) in 2011.⁵⁰ The number of domestic general partnerships has declined 24.9% over the past ten years.⁵¹

The combination of the nationwide availability of the LLC entity form and the CTB regulations means that taxpayers can freely choose a business form that provides limited liability without the need for the formality of incorporation. The CTB regulations even allow taxpayers to choose S corporation taxation without incorporating under state law. The taxpayer need only form an LLC, then elect to be taxed as a corporation, then make another election to be taxed as an S corporation.⁵² Americans like choices, or at least we think we do.⁵³ But while the availability of these options makes the alternatives simpler to obtain, it does not make it simpler to make the right choice.⁵⁴ The next section will outline the differences between partnership and subchapter S taxation that taxpayers need to consider when choosing a business entity.

C. Comparison of Partnership and S Corporation Tax Provisions

I'm perfectly happy to say that anyone who puts in a structure that pays more tax than necessary is nuts.⁵⁵

Partnership tax provisions are flexible but complex to apply.⁵⁶ S corporation tax provisions are restrictive but simple to apply. Each has advantages and disadvantages in particular situations. The following paragraphs explore a dozen differences in the taxation of partnership and S corporations.

⁵⁰ Ron DeCarlo, Lauren Lee & Nina Shumofsky, *Partnership Returns, 2011*, STAT. INCOME BULL., 2013, at 5, 7 (2013).

⁵¹ *Id.* at 8.

⁵² Rev. Rul. 2009-15, 2009-21 I.R.B. 1.

⁵³ "The United States was founded on a commitment to individual freedom and autonomy, with freedom of choice as a core value." BARRY SCHWARTZ, *THE PARADOX OF CHOICE: WHY MORE IS LESS* 4 (2004). The book asked the question "Is [e]xpanded [c]hoice [g]ood or [b]ad?" and noted that choosing well is difficult, and that unlimited choice "can produce genuine suffering." *Id.* at 18, 47, 201.

⁵⁴ The premise of another excellent book, *Nudge*, is that people are not necessarily good at making choices and that governments can use "choice architecture" to improve people's chances of making the right decision. RICHARD H. THALER & CASS R. SUNSTEIN, *NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS* 11 (2008).

⁵⁵ Michael Moss & Kate Zernike, *The 2004 Campaign: The North Carolina Senator; Campaign Releases Edwards's Earnings*, N.Y. TIMES (July 10, 2004), <http://www.nytimes.com/2004/07/10/us/2004-campaign-north-carolina-senator-campaign-releases-edwards-s-earnings.html> (quoting Veranda Smith, a government affairs associate with the Federation of Tax Administrators).

⁵⁶ Indeed, some commentators consider the existing partnership tax regime to be completely dysfunctional. See Andrea Monroe, *Integrity in Taxation: Rethinking Partnership Tax*, 64 ALA. L. REV. 289, 291 (2012).

1. Maximum Number of Equity Interests

Entities taxed as partnerships have no limit on the number of equity holders, but certain publicly traded partnerships lose the benefits of subchapter K and are instead taxed under subchapter C.⁵⁷ S corporations can have a maximum of 100 shareholders, but members of a family, as defined, may be treated as a single shareholder.⁵⁸

2. Classes of Equity Interests

Entities taxed as partnerships have no limit on the types of equity interests—partners can be general, or limited, and can have special allocations for tax and distribution purposes, provided that tax allocations have substantial economic effect.⁵⁹ S corporations cannot have more than one class of stock, although voting rights may differ.⁶⁰ If the IRS finds that an S corporation has more than one class of stock, the corporation's S election is terminated.⁶¹ If a shareholder has made a loan to the corporation and the loan is treated as equity under general principles of tax law, the loan will constitute a second class of stock.⁶²

3. Eligible Owners

Entities taxed as partnerships may have foreign owners, tax-exempt owners, corporate owners, partnership owners, trusts as owners—there are no restrictions on what or who may own a partnership interest. S corporation ownership, in contrast, is limited to individuals, estates, certain trusts, and certain charities.⁶³ An S corporation cannot have a corporate shareholder or a foreign shareholder.⁶⁴

⁵⁷ I.R.C. § 7704 (2012). Publicly traded partnerships are unlikely to fall within the usual conception of “small business.” However, even publicly traded partnerships can avoid corporate taxation if 90% of the gross income for the year consists of “qualifying income,” which is defined in § 7704(d) as income from interest, dividends, real property rents, gain from the sale or other disposition of real property, or certain natural resources. *Id.*

⁵⁸ I.R.C. § 1361(b)(1)(A), as modified by § 1361(c)(1).

⁵⁹ I.R.C. § 704(b); Treas. Reg. § 1.704-1(b)(1)(i) (as amended 2013).

⁶⁰ I.R.C. § 1361(b)(1)(D), (c)(4).

⁶¹ See, e.g., I.R.S. Priv. Ltr. Rul. 200334017 (Aug. 22, 2003). The IRS, in its discretion, may waive the effect of the terminating event. I.R.C. § 1362(f).

⁶² Treas. Reg. § 1.1361-1(l)(4)(ii) (as amended 2008). The regulations also provide a safe harbor (under which the debt will not be treated as a second class of stock) for “straight debt,” defined as “a written unconditional obligation, regardless of whether embodied in a formal note, to pay a sum certain on demand, or on a specified due date.” Treas. Reg. § 1.1361-1(l)(5). The debt must not provide for interest conditional on corporate profits, cannot be convertible into equity, and must be held by an individual. *Id.*

⁶³ I.R.C. § 1361(b)(1)(B), (c)(2), (c)(3), (c)(6) (2012).

⁶⁴ I.R.C. § 1361(b)(1)(C) (2012).

4. Allocation of Income and Losses

Both partnerships and S corporations are “flow-through” tax entities. Neither a partnership nor an S corporation is liable for federal income tax—rather, the owners bear the tax liability for the activities of the entity. The income and loss generated by a partnership flows through to the partners in accordance with the partnership agreement, provided that the allocations have “substantial economic effect.”⁶⁵ If the IRS determines that the allocations under the agreement fail the substantial economic effect test, the IRS will reallocate the items according to the partner’s interest in the partnership.⁶⁶ Thus, partnership allocations are flexible, but not certain.

S corporation income and loss are allocated to the shareholders on a rigid, per share, per day allocation system.⁶⁷ The income and loss are allocated pro rata unless a shareholder transfers all of her shares at a time other than the last day of the tax year. In that case, the shareholder who sells stock and the shareholder who buys the stock may make a “closing of the books” election, which would allocate a share of the income actually earned during the period of the year when the stock was owned by each shareholder.⁶⁸ A closing of the books election may also be made when a single shareholder disposes of 20% or more of the issued stock of an S corporation during any thirty day period⁶⁹ or when the S corporation issues an amount of stock equal to at least 25% of its previously outstanding stock to one or more new shareholders during any thirty day period.⁷⁰

5. Limitation on Losses

Both the partnership tax and S corporation rules limit the owner’s ability to deduct losses to the owner’s basis in entity.⁷¹ This rule necessarily fits with the overall flow-through taxation scheme. When income is allocated to an owner, the owner’s basis in the entity increases by the amount of the income.⁷² When losses or deductions are allocated to an owner, the owner’s basis in the entity decreases by the amount of the deduction.⁷³

⁶⁵ I.R.C. § 704(b).

⁶⁶ Treas. Reg. § 1.704-1(b)(1) (as amended 2013).

⁶⁷ I.R.C. §§ 1366(a), 1377.

⁶⁸ I.R.C. § 1377(a)(2).

⁶⁹ Treas. Reg. § 1.1368-1(g)(2)(i)(A) (as amended 2006).

⁷⁰ Treas. Reg. § 1.1368-1(g)(2)(iii).

⁷¹ For the partnership limitation on losses, see I.R.C. § 704(d). For the S corporation limitation on losses, see I.R.C. § 1366(d).

⁷² For partnership basis adjustments, see I.R.C. § 705(a)(1). For S corporation basis adjustments, see 26 I.R.C. § 1367(a)(1).

⁷³ I.R.C. §§ 705(a)(2), 1367(a)(2).

However, a partner's basis in the partnership is also increased by the partner's share of partnership debt.⁷⁴ An S corporation shareholder can deduct losses up to his basis in the S corporation and his basis in any loan he has made to the S corporation.⁷⁵ Courts have interpreted this provision narrowly.⁷⁶

6. Contributions of Property to the Entity

Both partners and S corporation shareholders can make tax-free contributions of appreciated property to the entity.⁷⁷ However, S corporation contributions only qualify as tax-free if the transferors, in the aggregate, have control of the corporation.⁷⁸ If a partner contributes property with a built-in gain or loss, when the partnership disposes of the property, the built-in gain or loss is allocated to the contributing partner, irrespective of any allocations in the partnership agreement.⁷⁹ S corporation gain is allocated on a per share, per day basis, irrespective of who contributed the asset.

7. Distributions of Property

When an S corporation distributes appreciated property to a shareholder, gain is recognized as if the S corporation sold the property.⁸⁰ The gain will flow through to the shareholders under the "per share, per day" allocation rule. While the general distribution rules for partnerships allow tax-free distribution of property,⁸¹ complex "anti-mixing-bowl" rules apply when property contributed by one partner is distributed to another,⁸² or when cash or other property is distributed to a contributing partner. For example, consider Partnership ABC in which Alice, Bridget, and Charlie each own 1/3 of the capital and profits interests. Alice contributes Asset 1 with a value of \$100 and a

⁷⁴ I.R.C. § 752. The partner's increase in basis happens because § 752 treats an increase in partnership debt as a contribution to the partnership. I.R.C. § 722 provides that a partner receives basis for contributions to the partnership. The rules for allocating debt among the partners can be intensely complex, particularly in the case of non-recourse debt. See Treas. Reg. § 1.752-2 (as amended 2006) for partner's share of recourse liabilities, and Treas. Reg. § 1.752-3 (2000) for partner's share of nonrecourse liabilities.

⁷⁵ I.R.C. § 1366(d)(1)(B).

⁷⁶ See *Estate of Leavitt v. Comm'r*, 875 F.2d 420 (4th Cir. 1989) (denying a deduction for S corporation debt guaranteed by the shareholder).

⁷⁷ For partnerships, see I.R.C. § 721(a) (2012). For S corporations, see I.R.C. § 351(a).

⁷⁸ I.R.C. § 351(a). Control is defined in I.R.C. § 368(c) as 80% of all classes of stock entitled to vote plus 80% of all other classes of stock.

⁷⁹ I.R.C. § 704(c)(1). For example, if a partner contributes property with a basis of \$20 and a fair market value of \$100, if the partnership later sells the property for \$150, \$80 of the \$130 gain will be allocated to the partner, in addition to any gain allocated under the partnership agreement.

⁸⁰ I.R.C. §§ 1371(c)(1), 311(b)(1).

⁸¹ See I.R.C. §§ 731-733.

⁸² I.R.C. §§ 704(c)(1)(B), 707(a)(2)(B), 737.

basis of \$20. Bridget contributes \$100. Charlie contributes Asset 2 with a value of \$100 and a basis of \$60. If Bridget receives a distribution of Asset 1 in exchange for her partnership interest, Bridget recognizes neither gain nor loss and will take Asset 1 at a \$100 basis.⁸³ Alice, however, will recognize \$80 of gain.⁸⁴ If, in the alternative, Charlie receives a \$50 distribution from Partnership ABC within two years of contributing Asset 2, Charlie will recognize \$20 of gain,⁸⁵ even though under the usual rules of section 731, he would not recognize gain because the distribution is less than his basis in the partnership interest.

8. Transfer of Equity Interests

One of the most complex aspects of partnership taxation is the treatment of “hot assets.” When a partner sells a partnership interest (or in some cases, when the partner receives a distribution of partnership property), a portion of the gain recognized may be treated as ordinary income to the extent the property within the partnership is either unrealized receivables or substantially appreciated inventory.⁸⁶ Partnership tax also provides an election to adjust the “inside” basis of partnership assets when a new partner joins the partnership.⁸⁷ The section 754 election has the effect of reducing gain allocated to new partners upon the sale of existing partnership assets, as well as increasing depreciation deductions allocated to new partners with respect to existing partnership assets.

None of the foregoing applies to S corporations. Sales of S corporation stock or distribution of assets to S corporation shareholders do not affect the remaining assets in the S corporation. Sales of S corporation stock generally produce capital gain.⁸⁸ Distributions from S corporations are not taxed to the extent the distribution represents previously taxed income.⁸⁹ If the S corporation had previously operated as a C corporation, the rules are a bit more complex.⁹⁰

⁸³ I.R.C. §§ 731(a)(1), 732(b).

⁸⁴ I.R.C. § 704(c)(1)(B).

⁸⁵ I.R.C. § 707(a)(2)(B); Treas. Reg. § 1.707-3 (1992).

⁸⁶ I.R.C. § 751 (2012). For example, an unpaid bill owed to a doctor by a patient is an unrealized receivable. § 751(c). Substantially appreciated inventory, for example, could be Nerf Blasters with a \$45 value in a toy store that had paid \$30 for each Nerf Blaster. § 751(b)(3) (fair market value exceeds 120% of the basis).

⁸⁷ I.R.C. § 754.

⁸⁸ I.R.C. § 1221; *see* Ark. Best Corp. v. Comm’r, 485 U.S. 212, 223 (1988).

⁸⁹ I.R.C. § 1368(b).

⁹⁰ I.R.C. § 1368(c).

9. Transfer of Interest as Compensation for Services

As noted in paragraph seven above, owners of partnerships or corporations may transfer property in exchange for ownership interests without immediate tax consequences. However, services are not considered property.⁹¹ If an S corporation shareholder provides services in exchange for S corporation stock, the shareholder will have ordinary income in the amount of the value of the stock.⁹² The same is true for the receipt of a capital interest in a partnership.⁹³ But a partner may receive a profits interest in a partnership without immediate income recognition—because the profits interest is treated as having zero value.⁹⁴ A capital interest in a partnership gives the holder a share of the proceeds of the assets of the partnership if the partnership were to be liquidated.⁹⁵ A profits interest entitles the holder to a share of the profits of the partnership, if any.⁹⁶ This feature of partnership taxation is an essential part of the compensation of hedge fund and private equity managers.⁹⁷ The manager receives a profits interest in the fund as compensation for services. As the profits of the fund are mostly capital gains, the income is taxed at capital gains rates rather than as ordinary income.⁹⁸

10. Application of Employment Taxes

Partners must pay self-employment taxes on their share of net business income and guaranteed payments.⁹⁹ S corporation shareholder-employees receive wages, are not subject to self-employment taxes, and avoid employment taxes altogether on non-wage distributions.¹⁰⁰ The employment tax on an employee's wages (FICA)¹⁰¹ and the self-employment tax on net earnings from self-employment (SECA)¹⁰² are imposed at the same rate and with the same earnings cap, but with the liability

⁹¹ I.R.C. § 351(d).

⁹² I.R.C. § 83(a) (2012). If the stock is subject to transfer restrictions or substantial risk of forfeiture, then the timing of the income will be delayed until the restrictions or risk of forfeiture lapse, unless the shareholder makes an election to immediately include the value of the stock in gross income.

⁹³ Treas. Reg. §1.721-1(b)(1) (as amended 2011).

⁹⁴ Rev. Proc. 93-27, 1993-2 C.B. 343.

⁹⁵ *Id.*

⁹⁶ *Id.*

⁹⁷ See Alan D. Viard, *The Taxation of Carried Interest: Understanding the Issues*, 61 NAT'L TAX J. 445, 445 (2008).

⁹⁸ See Steven M. Rosenthal, *Taxing Private Equity Funds as Corporate 'Developers'*, 138 TAX NOTES 361, 362 (2013).

⁹⁹ Cherie J. Hennig, Blaise M. Sonnier, William A. Raabe & John O. Everett, *S Corp Taxation: Level the Playing Field*, 139 TAX NOTES 435, 436 (2013).

¹⁰⁰ *Id.*; see also Willard B. Taylor, *Payroll Taxes—Why Should We Care? What Should Be Done?*, 137 TAX NOTES 983, 987 (2012).

¹⁰¹ I.R.C. § 3101 (2012).

¹⁰² I.R.C. § 1401.

for FICA divided equally between the employer and the employee.¹⁰³ FICA is imposed on all wages received as remuneration for employment, while SECA is imposed on net earnings from a trade or business. The employment tax advantage of S corporations has been enjoyed by some prominent persons,¹⁰⁴ leading others to call it a “loophole.”¹⁰⁵ To achieve this loophole, the S corporation shareholder-employee would seek to minimize the amount received as “compensation.”¹⁰⁶

11. Real Estate Transactions

Property owners may hold property for investment and later decide to develop the property. To minimize tax liability, property owners seek to separate the investment function from the development function to recognize as long-term capital gain any portion of the gain attributable to the period for which they held the property for investment.¹⁰⁷ To accomplish this goal, the property is initially held in an investment entity, which then transfers the property to a development entity.¹⁰⁸ If the two entities have significant overlap in ownership, the development entity needs to be a corporation (including an S corporation) for the strategy to succeed. Partnership rules treat the gain on the transfer of property between related partnerships as ordinary income if the property would not be a capital asset in the hands of the transferee.¹⁰⁹

The foregoing clearly shows that there are differences between the taxation of LLCs and S corporations. However, it does not illustrate which type of entity would be best for small businesses. Assuming that Congress and policymakers will continue to support small business, that consideration should be paramount when assessing the effectiveness of tax reform. If S

¹⁰³ See STAFF OF THE JOINT COMM. ON TAXATION, DESCRIPTION OF THE SOCIAL SECURITY TAX BASE (2011).

¹⁰⁴ Former presidential candidates John Edwards and Newt Gingrich employed the S corporation strategy. Moss & Zernike, *supra* note 55 (Edwards); Paul Sullivan, *The Advantages and Risks of Gingrich's Tax Strategy*, N.Y. TIMES (Feb. 3, 2012), <http://www.nytimes.com/2012/02/04/your-money/advantages-and-risks-of-gingrichs-s-corporation.html> (Gingrich).

¹⁰⁵ See Stephen R. Looney, *Finding Loopholes in Closing S Corp Loopholes*, 141 TAX NOTES 895, 895 (2013).

¹⁰⁶ *Id.*; see, e.g., *Watson v. United States*, 668 F.3d 1008, 1017 (8th Cir. 2012), *aff'd* 757 F. Supp. 2d 877 (S.D. Iowa 2010); see also U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-10-195, TAX GAP: ACTIONS NEEDED TO ADDRESS NONCOMPLIANCE WITH S CORPORATION TAX RULES 25 (2009). In the 2003 and 2004 tax years, the net shareholder compensation underreporting equaled roughly \$23.6 billion, which could result in around \$3 billion in total employment tax underpayments.

¹⁰⁷ I.R.C. § 1221(a)(1). Capital asset does not include “property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.” *Id.*

¹⁰⁸ See *Bramblett v. Comm'r*, 960 F.2d 526, 534 n.2 (5th Cir. 1992).

¹⁰⁹ I.R.C. § 707(b)(2).

corporations are better for the type of small business that policymakers want to support, then Congress should not repeal subchapter S. The next section will review the arguments for and against retaining subchapter S.

II. ARGUMENTS FOR AND AGAINST RETAINING SUBCHAPTER S

S corporations have had detractors and defenders since before LLCs became popular.¹¹⁰ The rhetoric heated up considerably after the promulgation of the CTB regulations. In 1999, the prestigious American Law Institute issued a study on the taxation of private business enterprise, which advised requiring most non-publicly held business entities to be taxed under a modified partnership tax system.¹¹¹ While not specifically critical of subchapter S, Professor George Yin, one of the co-authors of the ALI study, explained that "[t]he elective tax treatment [of private firms under current law] undermines both equity and efficiency objectives for the income tax."¹¹² Yin explained that the ALI study did not use subchapter S as a model for conduit taxation "because of its entity tax features which seemed inconsistent with a conduit tax objective."¹¹³ Yin praised subchapter S as "a remarkably coherent version of a simplified conduit system."¹¹⁴

Other commentators were not so flattering. In 1996, Professor Walter Schwidetzky argued that the ready availability of LLCs meant that subchapter S was "ready for retirement."¹¹⁵ He opined, "An LLC has all the advantages of a partnership, and the potential simplicity of an S corporation. There is little about a

110 Compare Warren P. Kean, Comment, *After the Facelift, Is Subchapter S Any More Attractive?*, 46 LA. L. REV. 87, 131 (1985) ("The non-tax privileges of operating in the corporate form, as bridled by the restrictions in subchapter S, will in many instances be an insufficient counterpoise to warrant the small business corporation election."), with Ronald Freeman, *The Subchapter S Corporation Distributive System After the Subchapter S Revision Act*, 62 TAXES 773, 787 (1984) ("Both taxpayers and their tax advisors should welcome these changes to the intricate Subchapter S system.").

111 See George K. Yin, *The ALI Reporters' Study on the Taxation of Private Business Enterprises*, 85 TAX NOTES 91, 91 (1999).

112 George K. Yin & David J. Shakow, *Reforming and Simplifying the Income Taxation of Private Business Enterprises*, in STAFF OF THE JOINT COMM. ON TAXATION, STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986 at 220, 222 (2001).

113 George K. Yin, *The Future Taxation of Private Business Firms*, 4 FLA. TAX REV. 141, 172 (1999).

114 *Id.* at 173. Professor Phillip Postlewaite argued that the ALI study, while paying lip service to using subchapter K as a model, in fact created a modified subchapter S. Phillip F. Postlewaite, *I Come to Bury Subchapter K, Not to Praise It*, 54 TAX LAW. 451, 456 (2001).

115 See Walter D. Schwidetzky, *Is It Time to Give the S Corporation a Proper Burial?*, 15 VA. TAX REV. 591, 642 (1996).

plain vanilla LLC that makes it less foolproof than a plain vanilla S corporation.”¹¹⁶ Schwidetzky did not define a “plain vanilla LLC.” It may be that he was contemplating an entity without special tax allocations.¹¹⁷ However, even without special tax allocations, the Mom and Pop owners of the “plain vanilla LLC” would still be subject to the complex “anti-mixing bowl” provisions of Subchapter K, as well as the “hot asset” rules and the issue of how to determine allocations of basis with respect to LLC recourse and non-recourse debt.¹¹⁸ Thirteen years later, with subchapter S still stubbornly hanging on, Schwidetzky again urged Congress to pull the plug.¹¹⁹

Professor Jeffrey Maine, on the other hand, has been a staunch defender of subchapter S.¹²⁰ Maine agrees with Schwidetzky that the taxation of pass-through entities should be consolidated, but Maine prefers a single pass-through regime based on subchapter S rather than subchapter K.¹²¹ With respect to the ALI study’s choice of partnership tax as a model, Maine considers the study’s rejection of the S corporation model as a misreading of the theory of corporate taxation.¹²² Examining the history of the corporate tax, Maine concludes that the taxation of corporations as entities developed because of the statutory benefit of limited liability, rather than the conception of the corporation as a “natural entity.”¹²³ The incorrect adoption of an entity theory of taxation, in Maine’s view, doomed tax classification based on form and led inevitably to the CTB regulations.¹²⁴ Maine asked, “If federal tax law views a corporation as independent of its shareholders, then why does federal tax law abandon the entity view with respect to both the formation of all corporations via § 351 and the operation of more

¹¹⁶ *Id.* at 637.

¹¹⁷ This seems likely from Schwidetzky’s later article. See Walter D. Schwidetzky, *Integrating Subchapters K and S—Just Do It*, 62 TAX LAW. 749, 768 (2009) (footnote omitted) (“But now Mom and Pop can use an LLC and have the benefits of partnership taxation, while operating out of a single entity that in most states is less burdensome to keep straight than a corporation. Further, in these closely held entities, the complexities of Subchapter K are mostly held in abeyance, so that the LLC is also a fairly simple entity for tax purposes.”).

¹¹⁸ Schwidetzky, *supra* note 117, at 810.

¹¹⁹ *Id.* at 813.

¹²⁰ See Jeffrey A. Maine, *Evaluating Subchapter S in a “Check-the-Box” World*, 51 TAX LAW. 717, 763 (1998) (arguing on both practical and theoretical grounds that subchapter S has continuing utility in a check-the-box environment).

¹²¹ See Jeffrey A. Maine, *Linking Limited Liability and Entity Taxation: A Critique of the ALI Reporters’ Study on the Taxation of Private Business Enterprises*, 62 PITT. TAX REV. 223, 271 (2000).

¹²² *Id.* at 243.

¹²³ *Id.* at 244.

¹²⁴ *Id.* at 244–46.

than half of all corporations via Subchapter S?”¹²⁵ Maine advocates for entity taxation based on limited liability, rather than form.¹²⁶

While the scholars debate whether Subchapter K or Subchapter S is the best model of small business taxation, taxpayers and practitioners continue to choose the form that best suits the business model.¹²⁷ Clearly, S corporations continue to be a popular business entity. S corporations are the second most popular choice for businesses, after sole proprietorships.¹²⁸ In 2009, S corporation tax returns comprised more than 70% of all corporate tax returns.¹²⁹ There were almost a million more S corporation tax returns than partnership tax returns.¹³⁰ Moreover, S corporations are still popular with small businesses. In 2008, S corporations with less than \$100,000 in assets filed roughly 60% of the over 4 million total S corporation returns filed.¹³¹

Is it appropriate to eliminate taxpayers' choice of pass-through regime? Does having a single pass-through tax regime really make it easier for taxpayers and practitioners? It is axiomatic that tax reform should produce results that improve economic efficiency, fairness, and administrability.¹³² But these considerations can be viewed from a variety of perspectives. Any time a choice is available, resources must be used in determining which choice to make. Field notes that “when an election is available, there are necessarily multiple possible tax outcomes, and thus taxpayers must analyze (and often incur the costs to obtain advice regarding) which alternative is preferable.”¹³³ Schwidetzky agrees, stating that “[h]aving two pass-through regimes is inefficient.”¹³⁴ On the other hand, it may be more economically efficient for a particular business to operate in one or other taxing regimes; thus, losing the ability to choose may be inefficient from the perspective of the taxpayer. Schwidetzky further argues that having two pass-through regimes is unfair to taxpayers, because wealthy taxpayers are more likely to be

¹²⁵ *Id.* at 248.

¹²⁶ *Id.* at 271.

¹²⁷ See Stewart Karlinsky, *S Corporations: Let Me Count the Ways*, 134 TAX NOTES 335 (2012).

¹²⁸ JCT, *supra* note 23, at 3.

¹²⁹ *Id.* at 5.

¹³⁰ *Id.*

¹³¹ *Id.* at 5, 7–8.

¹³² See, e.g., Roberta Mann, *Waiting to Exhale?: Global Warming and Tax Policy*, 51 AM. U. L. REV. 1135, 1206 (2002) (“Classic evaluation of tax provisions involves consideration of equity, economic efficiency, and ease of administration.”).

¹³³ Field, *supra* note 33, at 474–75.

¹³⁴ See Schwidetzky, *supra* note 117, at 811.

well-advised and thus obtain the best tax results from their choice of entity.¹³⁵ Taking that advice to an extreme, a head tax would be the most fair tax of them all, because well-advised taxpayers would have no advantage. Yet few tax scholars would advocate for a head tax on fairness grounds.¹³⁶ Administrability could be viewed from the perspective of the government who needs to enforce the tax system or from the standpoint of the taxpayer who needs to comply with the system. The government may prefer to have a single pass-through tax regime, thereby saving resources in training, compliance, and enforcement efforts. On the other hand, taxpayers will weigh the savings in compliance costs against the loss of the ability to choose the best entity for their business, a choice that could save much more over the long term.

The government has identified compliance issues with both S corporations and partnerships. The Government Accountability Office (GAO) issued a report in 2009 outlining S corporation compliance issues.¹³⁷ S corporation shareholders understated income, overstated deductions, overstated basis, and understated shareholder-employee compensation.¹³⁸ The last issue resulted in \$23.6 billion in net underpaid wage compensation to shareholders for the 2003 and 2004 tax years.¹³⁹ S corporations have the ability to characterize business profits as either salary or shareholder flow-through income, allowing shareholder employees to “minimize their employment tax obligations by paying themselves low salaries.”¹⁴⁰ This so-called S corporation loophole made the hit list of tax targets for elimination in 2013.¹⁴¹ Reducing shareholder-employee compensation to avoid employment taxes has become even more popular since the 2010 health care reform law both increased the Medicare payroll tax and exempted S corporation business income from the tax.¹⁴² The

¹³⁵ *Id.*

¹³⁶ On efficiency grounds, yes.

¹³⁷ See GAO, *supra* note 106.

¹³⁸ *Id.* at 12.

¹³⁹ *Id.* at 25; see also TREAS. INSPECTOR GEN. FOR TAX ADMIN., REFERENCE NO. 2005-30-080, ACTIONS ARE NEEDED TO ELIMINATE INEQUITIES IN THE EMPLOYMENT TAX LIABILITIES OF SOLE PROPRIETORSHIPS AND SINGLE-SHAREHOLDER S CORPORATIONS 1–3 (2005).

¹⁴⁰ See Hennig et al., *supra* note 99, at 436; see also Richard Winchester, *Working for Free: It Ought to Be Against the (Tax) Law*, 76 MISS. L. J. 227, 227–28 (2006).

¹⁴¹ See Lindsey McPherson, *Democrats List Tax Targets for Elimination in Budget Talks*, 141 TAX NOTES 591 (2013).

¹⁴² *Id.*; I.R.C. § 1411; see Looney, *supra* note 105, at 895.

The critics of the purported S corporation loophole have generally focused on the fact that non-wage distributions from ‘personal service S corporations’ may be one of the few paths to receive income untouched

proposal was estimated to raise between \$10 billion and \$15 billion in increased tax revenue over ten years.¹⁴³ However, the budget compromise approved at the end of 2013 contained no tax provisions at all, so it is uncertain when, if ever, this proposal will become law.¹⁴⁴

Partnership tax compliance issues, on the other hand, are so vast and varied that this Article could not even begin to scratch the surface.¹⁴⁵ The peculiar flexibility of the partnership tax system, allowing flexible allocations of deductions, tax indifferent partners, allocations of deductions, and loss based on non-recourse debt, makes partnerships an essential part of many corporate tax shelters.¹⁴⁶ As Professor Lawrence Lokken wrote, "partnership allocations can be used to divorce tax consequences from economic consequences."¹⁴⁷

III. CHAIRMAN CAMP'S SMALL BUSINESS TAX REFORM: IN CONTEXT

Chairman Camp's small business tax reform discussion draft contains two options: Option 1 retains Subchapter S and Subchapter K, with tweaks. Option 2 replaces Subchapter S and Subchapter K with a unified pass-through regime.¹⁴⁸ Focusing on the more radical Option 2, I will summarize the provisions to facilitate the following discussion about why Congress wants to support small business and what type of small business Congress wants to support. Then we will be prepared to consider how best to meet those goals.

from the FICA tax, the self-employment tax, and on the new net investment income tax imposed under section 1411.

Id. at 896.

¹⁴³ McPherson, *supra* note 141, at 591.

¹⁴⁴ Marcella S. Kreiter, *The Issue: Budget Deal Moves to Senate; New Era of Compromise?*, UPI (Dec. 15, 2013, 4:30 AM), http://www.upi.com/Top_News/US/2013/12/15/The-Issue-Budget-deal-moves-to-Senate-new-era-of-compromise/UPI-31291387099800/.

¹⁴⁵ See Monroe, *supra* note 56, at 291–94; see generally Postlewaite, *supra* note 114.

¹⁴⁶ See, e.g., *ACM P'ship v. Comm'r*, 157 F.3d 231, 247–50 (3d Cir. 1998). See generally STAFF OF THE JOINT COMM. ON TAXATION, DESCRIPTION AND ANALYSIS OF PRESENT-LAW TAX RULES AND RECENT PROPOSALS RELATING TO CORPORATE TAX SHELTERS (Comm. Print 1999).

¹⁴⁷ Lawrence Lokken, *Taxation of Private Business Firms: Imagining a Future Without Subchapter K*, 4 FLA. TAX REV. 249, 264 (1999). The codification of the economic substance doctrine in 2010, as well as the regulatory partnership anti-abuse rule, have somewhat restricted the use of partnerships in tax shelters. I.R.C. § 7701(o); Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 1409(a), 124 Stat. 1029, 1067–68; Treas. Reg. § 1.701-2 (1995); see also Monte A. Jackel, *Tax-Motivated Transactions: The Black, the White, the Gray*, 139 TAX NOTES 449, 450–51 (2013) (discussing recent tax shelter cases).

¹⁴⁸ See WAYS & MEANS DISCUSSION DRAFT, *supra* note 3.

A. Option 2

The unified pass-through tax regime of Option 2 would apply to any partnership and any eligible corporation that elects to be treated as a pass-through entity.¹⁴⁹ Any corporation is eligible to make the election except for those which are (1) publicly traded, (2) a financial institution that uses the reserve method of accounting for bad debts, (3) an insurance company subject to tax under Subchapter L, or (4) a domestic international sales corporation (DISC) or former DISC.¹⁵⁰ The technical explanation follows this description with this statement: “Thus, a pass-through corporation does not include . . . ineligible corporations under present law subchapter S.”¹⁵¹ However, the current law’s definition of an eligible S corporation also provides that the corporation must be domestic.¹⁵² Under Option 2 as drafted, a foreign corporation could elect pass-through treatment.¹⁵³ Option 2 also requires that entity to withhold taxes from the owner’s distributive share of pass-through income.¹⁵⁴ The remainder of the analysis of Option 2 will attempt to follow the categories used in the prior discussion of the differences between Subchapter K and Subchapter S.

1. Maximum Number of Equity Interests

Option 2 does not limit the number of owners. Present law Subchapter S limits the number of shareholders to 100. Present law Subchapter K allows partnerships with over 100 partners to use a modified allocation system if the partnership makes an election.¹⁵⁵

2. Classes of Equity Interests

Like Subchapter K, Option 2 does not limit the number of classes of entity interests. Present law Subchapter S allows only one class of equity interest.

3. Eligible Owners

Like Subchapter K, Option 2 does not limit the eligible owners. For example, an eligible pass-through entity could have

¹⁴⁹ TECHNICAL EXPLANATION, *supra* note 3, at 42–43.

¹⁵⁰ *Id.* at 43. Present law treats certain publicly traded partnerships as corporations, disallowing pass-through taxation. I.R.C. § 7704 (2012).

¹⁵¹ TECHNICAL EXPLANATION, *supra* note 3, at 43.

¹⁵² I.R.C. § 1361(b)(1).

¹⁵³ WAYS & MEANS DISCUSSION DRAFT, *supra* note 3, § 703; TECHNICAL EXPLANATION, *supra* note 3, at 43.

¹⁵⁴ WAYS & MEANS DISCUSSION DRAFT, *supra* note 3, § 701; TECHNICAL EXPLANATION, *supra* note 3, at 42.

¹⁵⁵ I.R.C. §§ 771–776.

a publicly traded corporation or a non-resident alien¹⁵⁶ as an owner.

4. Allocation of Income and Losses

Here, Option 2 differs from both present law Subchapter K and Subchapter S. Under Option 2, the owner's distributive share of income and losses must be consistent with the owner's economic interest in the pass-through entity.¹⁵⁷ This appears to be an attempt to simplify the substantial economic effect test under section 704(b) and the voluminous regulations thereunder. As the draft specifies that the owner's economic interest is to be determined by all the facts and circumstances, it is unclear how much simplification this rule would provide.¹⁵⁸ The ownership agreement may not provide different distributive shares of pass-through items within a particular category to the same owner. The categories are (1) ordinary items, (2) capital gain rate items, and (3) tax credits. It is unclear whether this rule is intended to apply during the entire time the owner has an equity interest or year by year.¹⁵⁹ The draft directs the Treasury to write regulations preventing avoidance of this restriction, another potential source of intense complexity.

5. Limitation on Losses

Like present law Subchapter K and S, Option 2 limits the owner's ability to use pass-through losses to the owner's basis in the entity.¹⁶⁰ The owner's basis in the entity is determined in a manner similar to Subchapter K and Subchapter C.¹⁶¹ The draft is silent on how entity level debt is included in the owner's basis, but it appears to import principles similar to those in Subchapter K.¹⁶²

¹⁵⁶ Under present law, S corporations need not worry about section 1441 source withholding, as they may not have foreign owners.

¹⁵⁷ WAYS & MEANS DISCUSSION DRAFT, *supra* note 3, § 712; TECHNICAL EXPLANATION, *supra* note 3, at 45.

¹⁵⁸ "[I]n light of the uncertainties in applying the partners' interest in the partnership rule under current law, what makes the drafters of Camp's proposals think the concept of economic interests will be simple for small businesses to apply?" Jackel, *supra* note 4, at 1366.

¹⁵⁹ See Taylor, *supra* note 4, at 1054.

¹⁶⁰ WAYS & MEANS DISCUSSION DRAFT, *supra* note 3, § 712(e).

¹⁶¹ *Id.* § 713.

¹⁶² *Id.* § 752. See Jackel, *supra* note 4, at 1364 ("The discussion draft would extend to passthrough corporations the principles of section 752 regarding the allocating of debt to and from partnership and partners. However, the proposal does not explain how the shares of the entity's debt are allocated to the owners under the Option 2 system.").

6. Contributions of Property to the Entity

Option 2 allows tax-free contributions of appreciated property to the pass-through entity, like Subchapter K, and does not include a control requirement, like Subchapter S.¹⁶³

7. Distributions of Property

Option 2 adopts a Subchapter S approach with respect to the distribution of property to an owner of the entity. Like Subchapter S, Option 2 requires the recognition of gain in the amount of the difference between the entity's basis in the property and the fair market value of the property.¹⁶⁴ The owner will not recognize gain or loss (other than the owner's distributive share of the gain recognized in the previous sentence) if the owner's basis in the entity is more than the fair market value of the distribution. However, like Subchapter K, pre-contribution gain or loss will be allocated to the contributing owner. This rule seems to adopt the worst of both of Subchapter S and K. Like Subchapter S (and Subchapter C), appreciated assets can go in tax-free, but face a tax when removed from the entity. Like Subchapter K, owners must keep track of pre-contribution gain and face "mixing bowl" rules.

8. Transfer of Equity Interests

The draft adopts the Subchapter K rules on termination of a pass-through entity, which provide that the passthrough is terminated if the entity's operations cease, or if within a 12-month period there is an aggregate sale or exchange of at least 50% of the pass-through interests. Pass-through interests are generally treated as capital assets, but look-through rules similar to the "hot asset" rules of Subchapter K apply.¹⁶⁵

9. Transfer of Interest as Compensation for Services

The draft does not address this issue. Several commentators thought that the draft contemplated the continued availability of profits interests.¹⁶⁶

10. Application of Employment Taxes

The draft does not address this issue.¹⁶⁷

¹⁶³ WAYS & MEANS DISCUSSION DRAFT, *supra* note 3, § 721(a).

¹⁶⁴ See I.R.C. § 311(b)(1) (2012); see also I.R.C. § 1371(a).

¹⁶⁵ See Yin, *supra* note 4, at 361 (explaining that "[t]he discussion draft appears to retain the substance of § 751(b)" and "Section 751(b) is an extremely complicated provision" with a compliance rate of 2.5%); TECHNICAL EXPLANATION, *supra* note 3, at 55; I.R.C. § 751(b)(3).

¹⁶⁶ Jackel, *supra* note 4, at 1365; Taylor, *supra* note 4, at 1057.

11. Real Estate Transactions

Option 2 adopts the Subchapter K rule treating the gain on the transfer of property between related partnerships as ordinary income if the property would not be a capital asset in the hands of the transferee.

Option 2 does not cover all possible issues relating to pass-through entity taxation, which is unsurprising, as it is meant to be a starting point for discussion.¹⁶⁸ Commentators generally viewed the draft as a good start, but clearly there are many unresolved issues.¹⁶⁹ Practitioner Willard B. Taylor found that “[t]he great merit of option 2 is that in positing the elimination of subchapter S, it requires us to focus on whether the differences between subchapters S and K make any sense and on whether there are simpler ways to treat passthroughs than those in existing subchapter K.”¹⁷⁰ Professor George Yin has questioned whether the concept of a single tax system for pass-through entities makes sense. He noted,

Uniformity places considerable pressure on the specific rules selected and if there are broad differences in the taxpayers subject to the single set of rules, there is significant risk that the uniform system will produce an “unhappy combination: rules still too complicated for the less sophisticated and too imprecise and manipulable for the more sophisticated.”¹⁷¹

Yin argued that taxpayers should be able to choose to surrender “some economic flexibility in exchange for a simpler set of tax rules and reduced compliance costs.”¹⁷² While advocating for two tax systems for passthroughs, Yin advised that current law should be modified to limit differences between the two systems to those that relate to simplification and compliance.¹⁷³ Yin’s suggestions seem practical and consistent with the classic goals of tax reform. Moreover, even though Yin suggested eliminating

¹⁶⁷ See Taylor, *supra* note 4, at 1057.

¹⁶⁸ Press Release, House Comm. On Ways & Means, Strengthening the Economy and Increasing Wages by Making the Tax Code Simpler and Fairer for America’s Small Businesses (Mar. 12, 2013), available at http://waysandmeans.house.gov/news/document_single.aspx?DocumentID=323445 (“Camp urged stakeholders to review and comment on the discussion draft and to share feedback with their lawmakers . . .”).

¹⁶⁹ See, e.g., Jackel, *supra* note 4, at 1363 (“[T]he draft provides a good starting point for the tax reform debate.”).

¹⁷⁰ Taylor, *supra* note 4, at 1058.

¹⁷¹ George K. Yin, *Comments on the Taxation of Passthrough Entities*, 140 TAX NOTES 358, 359 (2013) (quoting GEORGE K. YIN & DAVID J. SHAKOW, TAXATION OF PRIVATE BUSINESS ENTERPRISES 115 (1999)).

¹⁷² *Id.*

¹⁷³ *Id.*

differences that solely create tax advantages, practitioners would likely approve of the trade-off.¹⁷⁴

Practitioner Stewart Karlinsky has observed that “[b]ecause the administrative burden and complexity of the tax system disproportionately affect small business, the ability to choose a simpler business entity form is an important nontax advantage.”¹⁷⁵ He cited two important simplification advantages of S corporations: the required per share, per day allocation rule for income and losses and the lack of built-in gain and loss rules which apply in partnership tax, which complicate the tracking of which assets are sold and to whom the gain or loss should be allocated.¹⁷⁶ Yin suggested the change that Karlinsky viewed as most significant for simplification: inclusion of entity level debt in owner’s basis.¹⁷⁷ Yin has also suggested eliminating differences in employment tax consequences and in the taxation of distributions.¹⁷⁸

B. Why the Focus on Small Business?

You wanna go where people know, people are all the same, you wanna go where everybody knows your name.¹⁷⁹

Chairman Camp’s discussion draft press release puts small business squarely in the picture. The purpose of the proposal is stated as “to help strengthen the economy by helping *small business* expand operations . . . and increase wages and benefits.”¹⁸⁰ The press release quoted Camp: “More Americans get their paycheck from *small businesses* than any other type of business or government. If we really want to strengthen our economy and put more money in the pockets of American workers, we must fix the tax code and how it treats *small businesses*” and “[t]he tax code ought to be easier to understand and less expensive for *small businesses* to comply with That is my goal for comprehensive tax reform – a simpler, fairer tax code that leads to more jobs and higher wages.”¹⁸¹ The two-page press release uses the term “small business” fifteen times.¹⁸²

¹⁷⁴ *Id.*

¹⁷⁵ Karlinsky, *supra* note 127, at 356.

¹⁷⁶ *Id.*

¹⁷⁷ Yin, *supra* note 4, at 359; Karlinsky, *supra* note 127, at 357.

¹⁷⁸ Yin, *supra* note 4, at 359.

¹⁷⁹ GARY PORTNOY & JUDY HART ANGELO, WHERE EVERYBODY KNOWS YOUR NAME (Argentum Records 1982) (theme song from the television show *Cheers*). *Cheers* ran from 1982 to 1993 on NBC. *Cheers*, IMDB, <http://imdb.com/title/tt008399/> (last visited Feb. 24, 2014).

¹⁸⁰ Press Release, House Comm. On Ways & Means, *supra* note 168 (emphasis added).

¹⁸¹ *Id.* (emphasis added).

¹⁸² *Id.*

The virtue of small businesses is a deeply held cultural belief. Professor Mirit Eyal-Cohen drew this picture: "We patronize them daily; they are builders, mechanics, and retail stores. They are the local laundry, the neighborhood hairdresser, and the corner bakery."¹⁸³ Small is beautiful, and big is scary.¹⁸⁴ In the view of Congress, "small business is the engine which drives our economy."¹⁸⁵ Still, the love expressed by Congress for small business fails to define small business. What does Chairman Camp mean by "small business"? Martin Sullivan has noted, with support from the Treasury, that "[i]t is common practice for politicians and the press to use the term 'small business' to describe pass-through businesses."¹⁸⁶

While it is true that most small businesses enjoy pass-through tax treatment,¹⁸⁷ it is not true that all pass-through entities are small businesses. The Office of Tax Analysis (OTA) of the Treasury Department found that 18% of partners own firms that are not small—defined as having gross receipts in excess of \$10 million.¹⁸⁸ Six percent of S corporation shareholders own shares in large businesses.¹⁸⁹ Using passthrough as a proxy for small business is hopelessly circular. Pass-through tax treatment has been justified as helping small business.¹⁹⁰ But if businesses that are eligible to receive pass-through tax treatment are per se small, "small" has no meaning.

Having logically eliminated eligibility for pass-through tax treatment as an appropriate definition for small business, the next question is what type of small businesses does Congress want to support. The Camp press release appears to equate small businesses with jobs.¹⁹¹ "[T]he unchallenged conventional economic wisdom is that small businesses are the source of most

183 Eyal-Cohen I, *supra* note 7, at 6. You can almost hear the theme song from the long-running television series *Cheers*.

184 Richard J. Pierce, Jr., *Small is Not Beautiful: The Case Against Special Regulatory Treatment of Small Firms*, 50 ADMIN. L. REV. 537, 538 (1998) (noting that the myth that small is good and big is bad is deeply rooted in our cultural beliefs).

185 *The President's Tax Proposals To The Congress For Fairness, Growth, and Simplicity: Hearings Before the H. Comm. On Ways & Means*, 99th Cong. 2742 (1985) (statement of Hon. James Sasser, Sen.).

186 See Sullivan, *supra* note 25, at 1085.; see also Knittel, *supra* note 30, at 2.

187 JCT, *supra* note 23, at 5, 7–8. In 2008, 60% of S corporations had less than \$100,000 in assets and almost half of partnerships had less than \$100,000 in assets. *Id.* at 5.

188 Knittel et al., *supra* note 30, at 17.

189 *Id.*

190 Small businesses have trouble accessing capital, therefore they must be relieved from the burden of double taxation. See Eyal-Cohen I, *supra* note 7, at 21 ("Taxes reduced their main source of financing, because small businesses did not enjoy easy credit and remained unable to fill their needs for growth and expansion through borrowing.").

191 See Press Release, House Comm. On Ways & Means, *supra* note 168.

job creation.”¹⁹² However, it is also untrue that most small businesses are job creators. When the data is controlled for the age of the business, it becomes clear that new businesses create jobs, not small businesses.¹⁹³ The researchers have concluded that “policies targeting firms based on size without taking account of the role firm age [plays] are unlikely to have the desired impact on overall job creation.”¹⁹⁴ Another study found that most small businesses, defined as firms with fewer than twenty employees, do not grow significantly, but rather start small and stay small.¹⁹⁵ Small businesses are mainly lawyers, doctors, real estate agents, shopkeepers, restaurants, and skilled craftspeople. Not only do these businesses not grow, they don’t want to grow.¹⁹⁶ Only a small fraction of businesses are started by founders who have a new idea, but those innovative businesses do seek expansion and create jobs.¹⁹⁷ The study found that businesses that seek venture capital are more likely to grow than other small firms.¹⁹⁸ These studies suggest a path forward for policymakers seeking to encourage job creation.¹⁹⁹ Rather than subsidize small business, Congress could focus its efforts on entrepreneurial business.²⁰⁰ But that advice is well beyond the scope of this Article, which seeks to determine whether Subchapter S should survive.

CONCLUSION

Perhaps Congress is wrong about small businesses being job creators and it should not seek to use scarce resources to help them. Nonetheless, Congress seems to want to help small businesses. Does Subchapter S help small businesses? Sullivan wrote, “If Congress really wants to help all small businesses, its best course of action would be to reduce compliance costs.”²⁰¹ Karlinsky argued, “[T]he simplicity of a small business doing

¹⁹² Martin A. Sullivan, *New Research Weakens Case for Small Business Tax Relief*, 134 TAX NOTES 54 (2012).

¹⁹³ John C. Haltiwanger, Ron Jarmin & Javier Miranda, *Who Creates Jobs? Small vs. Large vs. Young* 2 (Nat’l Bureau of Econ. Research, Working Paper No. 16300, 2010), available at <http://www.nber.org/papers/w16300> (“[F]irm births contribute substantially to both gross and net job creation.”).

¹⁹⁴ *Id.* at 29.

¹⁹⁵ Erik Hurst & Benjamin Wild Pugsley, *What Do Small Businesses Do?* 8 (Nat’l Bureau of Econ. Research, Working Paper No. 17041, 2011), available at <http://www.nber.org/papers/w17041>.

¹⁹⁶ *Id.* at 29–31 (noting that those who start a business for non-pecuniary reasons are less likely to want to grow, to want to innovate, and to actually innovate).

¹⁹⁷ *Id.* at 29–30.

¹⁹⁸ *Id.* at 5.

¹⁹⁹ Sullivan, *supra* note 25, at 55.

²⁰⁰ See Sullivan, *supra* note 7, at 270 (“Tax incentives should be targeted to the subset of small businesses that are fast-growing and innovative.”).

²⁰¹ *Id.*

business as an S corporation is part of its charm and utility.”²⁰² As we have learned, whether a business is eligible for pass-through tax treatment is not a good proxy for the size of the business. Although the rules of Subchapter S do not limit the size of the business, as defined by assets or income, most S corporations are small in terms of assets.²⁰³ Although S corporations can have up to 100 shareholders, the vast majority have three or fewer.²⁰⁴ Yin has concluded that a unified pass-through tax regime would risk failing to meet the needs of both sophisticated and unsophisticated taxpayers.²⁰⁵ While certainly not perfect, Subchapter S is significantly simpler than Subchapter K. While a simple LLC could avoid running afoul of partnership special allocation rules, it is hard to avoid the complexity of Subchapter K. If an owner contributes assets with pre-contribution gain or loss, the assets must be tracked.²⁰⁶ If the business has substantially appreciated inventory or unrealized receivables, and makes a distribution, then the taxpayers must attempt to comply with section 751, an extremely complicated provision known as the “Achilles heel of subchapter K.”²⁰⁷

From a tax administration perspective, Subchapter S has minimal abuse potential, except for employment taxes. Subchapter S already requires taxation of gain on the distribution of assets, as recommended by Yin. With stock ownership restricted to U.S. individuals, S corporations cannot participate in the sort of tax avoidance facilitated by multinational corporations’ use of hybrid entities.²⁰⁸

Subchapter S is a valuable and simple tax system for small businesses. Minor changes to the Subchapter S regime could improve compliance and make life easier for S corporation shareholders. The employment tax difference between partnerships and S corporations should be eliminated, either by imposing employment tax on all net business income allocated to

²⁰² Karlinsky, *supra* note 127, at 355.

²⁰³ See JCT, *supra* note 23, at 5, 7–8.

²⁰⁴ U.S. GOV’T ACCOUNTABILITY OFFICE, *supra* note 106, at 4.

²⁰⁵ Yin, *supra* note 171, at 359.

²⁰⁶ I.R.C. § 704(c)(1)(C) (2012).

²⁰⁷ Yin, *supra* note 171, at 361 (internal citation omitted).

²⁰⁸ See Martin A. Sullivan, *Let’s Promote the Competitiveness of All American Businesses*, 133 TAX NOTES 1175, 1176 (2011), available at <http://taxprof.typepad.com/files/133tn-2.pdf>; see also Harry Grubert & Rosanne Altshuler, *Fixing the System: An Analysis of Alternative Proposals for the Reform of International Tax* 66 (Apr. 1, 2013 draft) (unpublished manuscript) (on file with author) (“Check-the-box creates further opportunities for tax planning through use of hybrid entities in tax havens.”). A hybrid entity is treated as a branch for U.S. tax purposes but as a corporation for foreign tax purposes. See Lee A. Sheppard, *OECD BEPS Action Plan: Trying to Save the System*, 140 TAX NOTES 283, 285 (2013).

S corporation shareholders, or by allowing LLC members and limited partners to limit the income subject to employment taxes to reasonable compensation.²⁰⁹ S corporation shareholders should be allowed to increase their basis for loss deductions by debt within the S corporation. Because allocations of income and loss are based on ownership of a single class of stock, allocations of debt would be similarly simple under Subchapter S.²¹⁰

²⁰⁹ The first alternative would likely improve compliance, according to the GAO. See U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 106, at 33.

²¹⁰ Much of the complexity in section 752 relates to special allocations under section 704. See LAURA E. CUNNINGHAM & NOEL B. CUNNINGHAM, *THE LOGIC OF SUBCHAPTER K: A CONCEPTUAL GUIDE TO THE TAXATION OF PARTNERSHIPS* 1, 15 (3d ed. 2006) (explaining how section 752 relates to and complicates Subchapter K).

Integrating Subchapters K and S and Beyond

Walter D. Schwidetzky*

INTRODUCTION

This Article builds upon a similar, lengthier effort that I published in the *Tax Lawyer* in 2009.¹ While there is overlap, this Article contains much new material. Important case law and tax proposals from the House Ways and Means Committee have come out in the interim. Due to space limitations, unlike my *Tax Lawyer* effort, this Article attempts to avoid prolixity. It assumes the reader has good knowledge of both Subchapters S and K and the tax entity selection process. If you are not that reader, a review of my *Tax Lawyer* article or Professor Mann's article in this symposium edition² will fill in the gaps. Generally speaking, I recommend repealing Subchapter S, but integrating its more legitimate benefits into Subchapter K. I also make Subchapter K available to most nonpublic C corporations, putting most closely held businesses on a level playing field.

Part I of this Article provides some context and in a fairly summary fashion reviews the tax advantages that S corporations have over partnerships. Part II looks at income from services and capital and the use of S corporations to avoid self-employment taxes. Part III looks at the possibility of repealing Subchapter K instead of S. Part IV takes a brief look at the nuts and bolts of how my proposal would be implemented. Part V recommends that nonpublic corporations be also allowed to elect Subchapter K, albeit with some continued potential for double taxation in

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¹ Walter D. Schwidetzky, *Integrating Subchapters S and K—Just Do It*, 62 TAX LAW. 749 (2009) [hereinafter *Tax Lawyer* article].

² See Roberta Mann, *Subchapter S: Vive le Difference!*, 18 CHAP. L. REV. 65 (2014).

accordance with current sections 1368 and 1374, and Part VI looks at the pass-through reform proposals of the House Ways and Means Committee chaired by Congressman David Camp (“the Camp Proposals”) which came out in 2013 as well as the House Ways and Means’ massive Tax Reform Act of 2014 (“TRA 2014”) (hence the “and Beyond” part of the title).

While I will review the tax advantages of S corporations, I generally do not review the tax advantages of tax partnerships, a decidedly longer list. That said, I will make note of two advantages of Subchapter K that I believe are of special importance. One is special allocations, which play a very important role in structuring business transactions. Under section 704(b), partnerships are allowed to allocate items of income and deduction in a manner that is at variance with the underlying ownership of the partnership interests. Thus, someone who is otherwise a 10% partner could be allocated 50% of depreciation deductions. Or, more significantly, the “money partners” can be allocated all of the losses until some form of break-even and then, for example, divide income equally with the “brain partners.” Or, also importantly, large capital contributors may get a preferential return on their capital. The ability to make special allocations plays an important role in getting business deals off the ground. It might be reason by itself to prefer Subchapter K to Subchapter S (where such allocations are not possible). Some have proposed systems that would eliminate special allocations, because of validly perceived abuses that often occur in the special allocation system.³ But in my view, the answer is to reform section 704(b), not to kill it.⁴ Special allocations simply play too valuable a role in everyday business deals, and a lot of business would not get done without them.

The second advantage is section 752, which permits partner-level debt to increase owner-level basis. Subchapter S does not have a section 752 analog, and that creates major problems for business, as well as traps for the unwary. To end-run the problem, S corporation businesses need to have the shareholders borrow the money and contribute or lend it to the corporation. That is in and of itself a little clunky, but becomes a major problem if the debt needs to be secured by S corporation

³ See *id.*; GEORGE K. YIN & DAVID J. SHAKOW, AM. LAW INST., TAXATION OF PRIVATE BUSINESS ENTERPRISES 371–77 (1999) [hereinafter ALI REPORT].

⁴ One cogent reform would be to eliminate special allocations for related parties. See Emily Cauble & Gregg Polsky, Taxing Partnership Allocations Among Related Parties (Apr. 4, 2014) (unpublished manuscript) (on file with author).

assets, as is commonly the case. While resolvable, this creates significant secured transaction headaches.⁵

Having two pass-through tax regimes creates obvious administrative and other inefficiencies. There was a time when S corporations served a valuable purpose, particularly when taxpayers needed a fairly simple and foolproof pass-through entity that provided a liability shield. But limited liability companies ("LLCs"), which are usually taxed as partnerships,⁶ in most contexts make S corporations obsolete. LLCs too can be fairly simple and foolproof, while providing the superior tax benefits of the partnership provisions of Subchapter K.⁷ The advent and popularity of LLCs means that the inefficiency created by two separate pass-through tax regimes can no longer be justified.

It has been difficult to justify Subchapter S for some time. In 1996, I published my first article recommending the repeal of Subchapter S.⁸ It has been almost twenty years, and I am still at it. There has been the occasional moment of encouragement along the way. In a rather novel experience for a law professor, in 2004 there was a bill in the House of Representatives (H.R. 4137) that would have, among other things, enacted my proposal.⁹ The bill, however, never became law (or got much of anywhere in the House) and the tax system remains saddled with both tax partnerships and S corporations. H.R. 4137 is discussed in detail in my *Tax Lawyer* article, but not in this effort.

I. S CORPORATION PLUSES AND WHAT TO DO WITH THEM

S corporations offer a number of legitimate benefits not currently available to tax partnerships, and those benefits should be incorporated into Subchapter K. Some derive from the simple fact that the S corporation is a corporation. For example, parties who anticipate a public offering often use an S corporation, as it is a simple matter to convert it to a C corporation prior to the public offering. While there are publicly traded limited partnerships and LLCs, corporations are much more popular with investors, and the overwhelming majority of publicly traded entities are corporations.

⁵ See James A. Fellows, *Shareholder Basis in the S Corporation: Debt Guarantees and Loans from Commonly Controlled Entities*, 10 J. PASSTHROUGH ENTITIES 25, 25–33 (2007).

⁶ See Treas. Reg. § 301.7701-3(b) (as amended 2006).

⁷ See *Tax Lawyer* article, *supra* note 1, at 759–81.

⁸ Walter D. Schwidetzky, *Is It Time to Give the S Corporation a Proper Burial?*, 15 VA. TAX REV. 591 (1996) [hereinafter *S Corp Burial*].

⁹ H.R. 4137, 108th Cong. (2004).

A partnership can make the transition to a corporation, but it can be a hazardous process. The partnership must first incorporate and then make the public offering of the stock. There may be state law barriers, including transfer taxes. Generally, section 351(a) permits incorporations on a tax-free basis. An issue, however, is whether the requirements of section 351(a) and its 80% control are met. It would normally be met on the initial incorporation, but does the subsequent public offering have to be collapsed together with the incorporation, and if so, does that break the 80% test? The answer to the first question typically is yes, unless there is no binding agreement to engage in the public offering at the time of the incorporation. The answer to the second question is typically no, as long as sufficient public moneys flow into the corporation so that the 80% control test is still met.¹⁰ But other contexts are more problematic. An incorporation followed by a reorganization has been held to violate the section 351(a) requirement.¹¹ How can the needs of the parties making these and similar uses of S corporations be met in a world without Subchapter S? The solution I propose is twofold. One part of the solution is to make it easier for partnerships to incorporate under state law. States should cooperate in this regard by providing conversion statutes which permit parties to change entities through a legal, one-step conversion, without formally having to liquidate one entity and transfer the assets to another. This approach would, for example, avoid state income and transfer taxes. The other is to revise the Code so that non-cash out, post-incorporation transactions will not run afoul of sections 351(a) or 368.¹²

¹⁰ There was a common understanding that a binding agreement was necessary (to, for example, engage in a public offering) for the step transaction doctrine to be applied to collapse section 351 transfers, based on Revenue Ruling 78-294 (and particularly the holding in that ruling on a firm commitment underwriting that was not pre-sold). Rev. Rul. 78-294, 1978-2 C.B. 141. However, at the time of the regulatory amendment to section 351 in 1996, the IRS rendered obsolete Revenue Ruling 78-294, and some commentators have viewed that action as signaling that the IRS might now apply a more expansive step transaction test to post-incorporation transfers. See MARTIN D. GINSBURG & JACK S. LEVIN, *MERGERS, ACQUISITIONS, AND BUYOUTS* ¶ 608.3.3.4 (2014). Thanks to Professor Martin Schnall of Boston University Law School for his observations in this regard. See *Tax Lawyer* article, *supra* note 1, at 769-84; Treas. Reg. § 1.351-1(a)(3) (1996).

¹¹ See Rev. Rul. 70-140, 1970-1 C.B. 73. Note, however, that Revenue Ruling 2003-51 takes out some of the bite. Rev. Rul. 2003-51, 2003-1 C.B. 938. It both affirms and distinguishes Revenue Ruling 70-140, and surprisingly concludes that the control test of section 351(a) is met, notwithstanding a pre-incorporation binding agreement to dispose of the stock, if the taxpayer could have gotten to the same end result tax-free using a different series of steps.

¹² The section 368 reorganization provisions should be amended to make clear that they apply even if the participating corporation has recently incorporated. This amendment is necessary to deal with an attack from the other end of the transaction. While the focus of the rulings to date has been on section 351, there also could be an

Another advantage of an S corporation over a partnership is the so-called capital gain freeze technique. This normally presupposes a taxpayer who owns real estate that is a capital asset¹³ with substantial, inherent long-term capital gains. If the property is sold before development, these gains are taxed at favorable rates. In the case of raw land, for example, the rate commonly is 15%.¹⁴ If instead the taxpayer subdivides and develops the land, selling the lots individually, all of the gain on the sales is ordinary income, including the gain inherent in the property before development. Property held for sale in the ordinary course of a trade or business does not qualify as a capital asset, even if it was a capital asset in the hands of the taxpayer previously.¹⁵

There is currently a solution to this unhappy state of affairs. Before development, the taxpayer can sell the property to an S corporation the taxpayer (typically) controls. The S corporation then develops and sells the lots. The S corporation's gain on the sale of the lots is ordinary income, but the pre-development gain is locked in as long-term capital gain to the taxpayer by dint of the taxable sale to the S corporation.¹⁶ The S corporation takes a fair market value basis in the property upon purchase.¹⁷ It is very unlikely that the S corporation can be funded with sufficient cash to be able to pay for the property outright. Most likely the S corporation pays with promissory notes that are payable in the future as the S corporation collects revenues from the sale of the lots. Under the installment sale rules of section 453, normally the selling taxpayer only has to recognize his long-term capital gain

argument, for example, that the B reorganization stock-for-stock swap rules are not met if the stock comes from a recently incorporated partnership. The Service could argue the flip side of Revenue Ruling 70-140, that in substance the acquiring corporation is not swapping its stock for stock, but its stock for assets.

¹³ It is also possible for the property to be a section 1231 asset, which includes real property used in a trade or business. If a taxpayer's gains from section 1231 assets exceed his losses from those assets, all the gains and all the losses are generally characterized as long-term capital gains and losses. It is probably more common for the property pre-development to be a capital asset.

¹⁴ I.R.C. § 1(h)(1)(C) (2012).

¹⁵ See I.R.C. § 1221(a)(1); *Mauldin v. Comm'r*, 195 F.2d 714 (10th Cir. 1952). Section 1237 contains a fairly minor exception.

¹⁶ I.R.C. § 1001(c). Query whether section 269 could be applied to stop this technique. It seems unlikely. Section 269 appears to be mostly an anti-abuse rule. Here the taxpayer is just getting the same tax treatment he would have gotten on the sale to a third party. There is no tax arbitrage going on. Generally, the Code specifically regulates related party transactions, and if they are not regulated, I would think the presumption would be that they are allowed. Also, when the Code regulates them, it is, as in sections 1239 or 707(b)(2), to change the character, not ignore the transaction. Thanks to Professor Jay Soled of Rutgers University School of Law for bringing this issue to my attention.

¹⁷ I.R.C. § 1012.

as the notes are paid.¹⁸ A heavily indebted corporation with a high debt to equity ratio sometimes has to worry about the debt being reclassified as equity.¹⁹ This is not generally a problem in the S corporation context, however, as long as the debt meets the "[s]traight debt safe harbor."²⁰

A taxpayer cannot ordinarily achieve this result by selling the property to a tax partnership. Section 707(b)(2) treats a partner's gain as ordinary income if the partner sells property to a partnership which, in the hands of the partnership, is not a capital asset, and the partner directly or indirectly owns more than 50% of the capital or profits interest in the partnership.²¹ The selling partner, perhaps with other related parties, commonly controls the partnership, and the property in the hands of the partnership is not a capital asset as the partnership uses it in the business of development.²² Section 707(b)(2) is generally said to be designed to prevent the following tax arbitrage: The sale gives the partnership a fair market value basis in the property. The likely cost to the related partner seller is long-term capital gains taxed at low rates (but for section 707(b)(2)). Further, the partnership can now depreciate the property from the new, higher basis.²³ At times the tax benefits of the higher basis to the partnership offset the tax cost to the related selling partner. The risk of tax arbitrage is highly unlikely when the sale is of real property. The depreciation rates for improvements to real property are quite long—27.5 years for residential property and 39 years for commercial property.²⁴ Usually, only a mathematically-challenged partner accepts the tax burden of the sale gain today in exchange for a series of relatively small annual depreciation supplements to the partnership for many years in the future. Further, the real property involved in capital gain freezes probably is most often raw land, which is not depreciable at all. If the sale, on the other

¹⁸ See section 453(e) for limitations that do not usually pose problems.

¹⁹ See BORIS I. BITTKER & JAMES S. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 4.02 (7th ed. 2000).

²⁰ See I.R.C. § 1361(c)(5). The debt must be sum certain payable on demand or on a specified date, the interest rate cannot be contingent on profits or the borrower's discretion, the debt cannot be convertible into stock, and the creditor must be an individual, an estate or trust that is qualified to be an S corporation shareholder, or a professional lender.

²¹ The constructive ownership rules of section 267 apply for purposes of determining whether a partner meets the ownership test. These rules would, for example, attribute partnership interests owned by certain family members to the selling partners. See I.R.C. § 707(b)(3).

²² See I.R.C. § 1221(a)(2). The lots held for sale are also not capital assets. See I.R.C. § 1221(a)(1).

²³ Section 707(b)(2) overlaps with section 1239.

²⁴ I.R.C. § 168(c).

hand, is of an apartment building which the parties want to convert to condominiums, the gain equal to depreciation previously taken is typically taxed at a fairly high rate, 25%, making the tax arbitrage more uneconomical and more unlikely.²⁵

It is not apparent why existing, inherent capital gains should be converted to inherent ordinary income when the use of the property changes. It is appropriate that future appreciation be taxed in a manner that is consistent with the nature of the new use, but not past appreciation. This raises the question of whether an overarching solution should be found that would apply across the board and not just in the partnership context.²⁶ That is worth considering, though it is beyond the scope of this Article.

To bring some rationality to Subchapter K in this regard and further integrate Subchapters S and K, at a minimum, section 707(b)(2) should be amended to provide that it only applies to sales of personal property.²⁷ With this change, the capital gain freeze technique for real property could be implemented with a partnership.

S corporations are also often used to illegitimately reduce or eliminate Social Security and Medicare taxes. There is important new case law in this area which makes a bad problem potentially worse. Of course, the elimination of S corporations will end this abuse. I discuss this topic in detail next.

²⁵ See I.R.C. § 167; *Simon v. Comm'r*, 68 F.3d 41 (2d Cir. 1995); see also I.R.C. § 1(h)(1)(D).

²⁶ Why require any long-term capital gain that arose while property was held as an investment to be converted into ordinary income when the property is converted to a different purpose? Why require taxpayers to go through the fiction of a sale? Well, in truth, there could be practical problems. In the classroom, we can make our numbers up, but in the real world, it is hard to know with certainty what the value is at the time property is converted to another use. Also, how will the fisc know if property is truly being held for investment? The current rule effectively requiring a sale to an S corporation (and under my proposal, to a partnership) has the advantage of setting a heralding, reportable event that the Service can audit and upon which it can reach an independent judgment. Another possible solution that does not require a sale is to require a minimum holding period for the property during the investment phase where no significant development takes place, perhaps five years, with an appraisal to be done at the time of conversion by an independently licensed and unrelated appraiser. See I.R.C. § 1237.

²⁷ A conforming change would need to be made to section 1239.

II. INCOME FROM SERVICES, INCOME FROM CAPITAL, AND THE NESE DODGE

A. Some Background

Section 1401 imposes a tax on “net earning from self employment” (“NESE”). The tax has two components. One component is for “old-age, survivors, and disability insurance,” commonly known as Social Security. The tax is 12.4% of NESE. The maximum NESE to which it applies is \$117,000 in 2014.²⁸ The other component is for hospital insurance, commonly known as Medicare, and is 2.9% of NESE and applies to all of a taxpayer’s NESE. There is no dollar limit.²⁹ Additionally, the Affordable Care Act added section 1401(b)(2)(A), which imposes a 0.9% tax on NESE for persons earning over \$200,000 if they are single, or \$250,000 if they are married. The Affordable Care Act also added section 1411, which imposes a 3.8% tax on net investment income for persons with “modified adjusted gross income” in excess of those thresholds.³⁰ Importantly in the S corporation context, net investment income does not include income from an activity in which the taxpayer materially participates.³¹

NESE is defined as “gross income derived by an individual from any trade or business carried on by such individual, less the deductions . . . attributable to such trade or business, plus his distributive share . . . of income or loss . . . from any trade or business carried on by a partnership of which he is a member.”³² NESE does not include certain kinds of passive income, including portfolio income, capital gain, and similar income (“Excluded Income”).³³ I will discuss this in more detail below, but note that in this definition *all* partnership income other than Excluded Income is included in NESE.

The Social Security and Medicare taxes apply differently to employers and employees. They apply to “wages,” that is, compensation to an employee for services rendered.³⁴ The

²⁸ This amount is adjusted for inflation. See I.R.S. Notice 1036 (Dec. 2013).

²⁹ Individuals are entitled to a trade or business deduction equal to one-half of the self-employment tax. I.R.C. §§ 164(f), 62(a)(1).

³⁰ “Surviving spouses” fall under the higher threshold. I.R.C. § 1411(b)(1). Modified adjusted gross income is adjusted gross income after adding back in the section 911 exclusion. I.R.C. § 1411(d).

³¹ I.R.C. § 1411(c)(2).

³² I.R.C. § 1402(a).

³³ *Id.* Among the exclusions are certain rentals from real estate, most dividends, certain interest, and certain property gains (typically from the sale of capital assets). See *id.* Certain retirement payments are also excluded. See I.R.C. § 1402(a)(10).

³⁴ The statutory phrase is “remuneration for employment.” See I.R.C. § 3121(a).

employer and the employee each pay one-half of the Social Security and Medicare taxes. The total tax is the same as it is for the self-employed. Thus, the tax that the employer and employee each pay is 6.2% of wages for Social Security (up to the same maximum that applies to self-employment income) and 1.45% of wages for Medicare (without a maximum). The 0.9% Affordable Care Act tax applies to the employee on his or her wages above the noted thresholds.³⁵

A partner cannot be an employee of a partnership or receive wages from a partnership for services rendered.³⁶ Outside of Excluded Income, a general partner's distributive share of income is always NESE.³⁷ NESE does not include the distributive share of any limited partner other than guaranteed payments under section 707(c) for services rendered.³⁸ Note that a partner can hold both a limited and general partner interest, and section 1402(a) applies to each separately. The limited partner exception was added to prevent passive investors from obtaining Social Security coverage. Limited partners had originally been subject to Social Security and Medicare taxes to the same extent as general partners, but Congress was concerned that limited partnerships might be established as investment vehicles in order to obtain Social Security coverage, and therefore excluded limited partners in the late 1970s.³⁹ Who qualifies as a limited partner is not defined in the Code or Regulations, but it appears from the legislative history and the plain language of the statute that a state law limited partner is intended.⁴⁰ Thus, apparently all tax partners who are not state law limited partners, including LLC members, fall under the general NESE rule.⁴¹

To summarize, all income from a trade or business (other than Excluded Income) of any partner (other than a limited partner) is NESE, regardless of the partner's participation in the business, regardless of the capital invested in the business, and

³⁵ See I.R.C. §§ 3101, 3111; I.R.S. Notice 1036 (Dec. 2013); I.R.S. Notice 2007-92, 2007-47 I.R.B. 1036. Notwithstanding this division, there is evidence that employees bear the economic burden of the entire tax. They pay their own share directly and, in effect, the employer's share through reduced wages. See HARVEY S. ROSEN, PUBLIC FINANCE 285-86 (7th ed. 2005).

³⁶ Rev. Rul. 69-184, 1969-1 C.B. 256.

³⁷ I.R.C. § 1402(a).

³⁸ I.R.C. § 1402(a)(13).

³⁹ See Patricia E. Dilley, *Breaking the Glass Slipper—Reflections on the Self-Employment Tax*, 54 TAX LAW. 65, 85 (2000).

⁴⁰ See H.R. REP. NO. 95-702, pt. 1, at 40 (1977). At that time, only a state law limited partnership could have been intended, as LLCs and similar entities did not yet exist. See David C. Culpepper et al., *Self-Employment Taxes and Passthrough Entities: Where Are We Now?*, 109 TAX NOTES 211, 212 (2005). The Service might be authorized to expand that definition.

⁴¹ See Culpepper et al., *supra* note 40.

regardless of the character of the business. It is thus very possible for a partner (other than a limited partner) to have NESE that is unrelated to any services performed by the partner.

One might think that both wages and NESE would measure the same thing—income earned from the provision of services. The fact that this is not the case has much to do with the history of the Social Security tax. The Social Security tax structure was originally centered on the employer-employee relationship.⁴² In the early years, coverage extended only to limited groups of wage earners.⁴³ The self-employed were not covered.⁴⁴ Thus, originally it was clear that the Social Security tax (the Medicare tax had not yet been created)⁴⁵ applied only to income from services. The self-employed originally resisted coverage, but then in the 1950s acquiesced partly due to the fact that meaningful coverage could be had at what at the time was still a low rate of tax.⁴⁶ Congress had been concerned about the administrative feasibility of including the self-employed within the Social Security system, particularly with regard to obtaining accurate reports of their income.⁴⁷ These concerns were eventually laid to rest and the self-employed were included, but nothing in the legislative history suggests that Congress wanted the focus of the Social Security tax to move from a tax on income from services to a tax on income from services *and* capital. Further, at the time the self-employed were brought into the fold, much of the discussion seems to have centered on applying the Social Security tax to professionals such as doctors and lawyers, that is, service providers.⁴⁸ Thus, when Congress brought the self-employed within the Social Security tax system, it likely thought that NESE primarily focused on income from services. Further, by excluding certain passive income and later income of limited partners (historically, by definition, passive participants), Congress made some effort to exclude from NESE certain kinds of income that are not from services.

Finally, there would have been little logic to expanding the Social Security tax to include income from capital. Why should the type of income subject to Social Security and Medicare taxes for employees be different than that for the self-employed?

⁴² See Dilley, *supra* note 39, at 70.

⁴³ *Id.*

⁴⁴ *Id.* at 71.

⁴⁵ It was enacted in 1965. See Social Security Amendments of 1965, Pub. L. No. 89-97, 79 Stat. 286.

⁴⁶ See Dilley, *supra* note 39, at 71–74.

⁴⁷ S. REP. NO. 81-1669, at 11–12 (1950); see also *Yoder v. Harris*, 650 F.2d 1170, 1173 (10th Cir. 1981) (discussing the relevant legislative history).

⁴⁸ See Dilley, *supra* note 39, at 71–74.

Employers and employees are not being rewarded for using double-tax C corporations as S corporations, which can also have employees and are subject to the same employment tax rules as C corporations. S corporations have been on the scene since 1958 and conceptually since 1946.⁴⁹ Further, the Social Security benefits one receives are a function of what one pays in.⁵⁰ Why would Congress want the self-employed to have a larger base for benefits than employees? There is thus little logic in applying Social Security and Medicare taxes to income from capital. Further, there is no good reason why passive owners who are limited partners are not subject to self-employment taxes and passive owners who are LLC members are subject to self-employment taxes. In an increasing number of states, limited partners have increasing rights to participate in the affairs of the limited partnership in their capacity as limited partners,⁵¹ making their automatic exclusion from NESE dubious. The logic behind these dichotomies has not been apparent to the Service either.⁵²

B. Income From Capital Conundrum

In 1997, the Treasury proposed regulations in this area. This was one of several efforts I will outline that attempt to limit NESE to income from services, or at least reduce the amount of income from capital that is included in NESE. The Treasury faced a terminological challenge, in that it had to squeeze its regulations into the statutory general/limited partner structure. It did this by freeing the term “limited partner” in the tax statute from that term in state law statutes. Under the Proposed Regulations, a member of any state law entity that is classified as a partnership for federal income tax purposes can be treated as a limited partner for section 1402 purposes under some circumstances.⁵³ The Proposed Regulations also partially address the overarching issue of when income is from services and when from capital.

⁴⁹ See Act of Sept. 2, 1958, Pub. L. No. 85-866, 72 Stat. 1606. See generally RICHARD B. GOODE, U.S. DEP'T OF THE TREASURY, *THE POSTWAR CORPORATION TAX STRUCTURE* (1946).

⁵⁰ See Dilley, *supra* note 39, at 70.

⁵¹ See UNIF. LTD. P'SHIP ACT § 303 (2001).

⁵² Some older private letter rulings treat an LLC member's share of income as NESE. See, e.g., I.R.S. Priv. Ltr. Rul. 9525058 (June 23, 1995); I.R.S. Priv. Ltr. Rul. 9452024 (Dec. 30, 1994); I.R.S. Priv. Ltr. Rul. 9432018 (Aug. 12, 1994).

⁵³ Prop. Treas. Reg. § 1.1402(a)-2(h), 62 Fed. Reg. 1702, 1704 (Jan. 13, 1997). These were preceded by Proposed Treasury Regulation section 1.1402(a)-18, which focused more on LLCs as such. Prop. Treas. Reg. § 1.1402(a)-18, 59 Fed. Reg. 67253, 67254 (Dec. 29, 1994).

The laudable objective of the Proposed Regulations is to ensure that similarly situated individuals owning interests in entities formed under different statutes or in different jurisdictions are treated similarly.⁵⁴ The Proposed Regulations treat an individual as a limited partner unless the individual (1) has personal liability for the debts of or claims against the partnership by reason of being a partner; (2) has authority to contract on behalf of the partnership under the statute or law pursuant to which the partnership is organized; or (3) participates in the partnership's trade or business for more than 500 hours during the taxable year.⁵⁵ Note that if a state law limited partner meets one of the three criteria, he is not a limited partner for section 1402 purposes.

By statute, no member of any type of LLC has general liability for the obligations of the LLC in their capacity as members; thus test (1) of the Proposed Regulations could not apply to an LLC.⁵⁶ If an LLC is "member-managed," commonly all members have the apparent authority to contract on behalf of the LLC.⁵⁷ Consequently, usually no member of a member-managed LLC qualifies as a limited partner under the Proposed Regulations. In a "manager-managed" LLC, the managers have the exclusive authority to manage the LLC and typically have the authority to contract on behalf of the LLC. Members who are not managers normally do not have any apparent authority to contract.⁵⁸ Consequently, these non-managing members can qualify as limited partners as long as they do not fail the 500-hour test. In states that have adopted the Revised Uniform Limited Liability Company Act ("RULLCA"), members of both types of LLCs are not automatically agents of the LLC.⁵⁹ Consequently, in RULLCA-adopted states, the critical test will be whether or not the member participates over 500 hours per year.

⁵⁴ See Prop. Treas. Reg. § 1.1402(a)-2(h), 62 Fed. Reg. 1702, 1702 (Jan. 13, 1997).

⁵⁵ Prop. Treas. Reg. § 1.1402(a)-2(h)(2), 62 Fed. Reg. 1702, 1704 (Jan. 13, 1997). The 500-hour rule is derived from the regulatory definition of material participation under the passive loss rules of section 469. See Temp. Treas. Reg. § 1.469-5T(a)(1) (2013).

⁵⁶ A limited liability partnership ("LLP") is a general partnership with a liability shield. Thus, its partners are general partners, who in most states have the authority to contract to the same extent as general partners in general partnerships. Thus, they also would not qualify as limited partners under the Proposed Regulations, irrespective of whether they hold multiple classes of interests or not. See Culpepper et al., *supra* note 40; CARTER G. BISHOP & DANIEL S. KLEINBERGER, LIMITED LIABILITY COMPANIES: TAX AND BUSINESS LAW ¶ 1.05 n.754 (2012).

⁵⁷ See BISHOP & KLEINBERGER, *supra* note 56, ¶ 7.02[2].

⁵⁸ *Id.* ¶ 7.02[3].

⁵⁹ UNIF. LTD. LIAB. CO. ACT § 301 (amended 2006). The following states have adopted RULLCA: California, the District of Columbia, Florida, Idaho, Iowa, Nebraska, New Jersey, Utah, and Wyoming.

The Proposed Regulations contain a special rule for services partnerships, under the assumption that virtually everyone involved will be actively performing services. The Proposed Regulations provide that if substantially all of the activities of a partnership involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting, any individual who provides such services for the partnership cannot be classified as a limited partner,⁶⁰ and thus all of his or her income is NESE (other than Excluded Income).

The Proposed Regulations permit individuals to hold more than one class of interest in any partnership except a services partnership. A partner may bifurcate his interests, with some interests earning NESE, and other "limited partnership interests" not earning NESE.⁶¹ Thus, the treatment that is available today in a state law limited partnership the Proposed Regulations make available to all non-services tax partnerships.⁶² It is here that the Proposed Regulations make an initial attempt to tussle with the issue of when income is from services and when from capital. In effect, the Proposed Regulations are saying that for non-services partnerships (irrespective of the state law classification), it is permissible to create a class of limited partnership interests to which non-NESE income can be allocated. This income can be viewed as coming from capital and not from services. While the Proposed Regulations are hardly comprehensive, they take a step in the right direction.

The Proposed Regulations were generally well received,⁶³ but Congress imposed a moratorium, stating that they could not be

⁶⁰ Prop. Treas. Reg. § 1.1402(a)-2(h)(5), 62 Fed. Reg. 1702, 1704 (Jan. 13, 1997).

⁶¹ Under the Proposed Regulations, it is possible to qualify as a limited partner even if the partner participates over 500 hours and does not hold multiple classes of interest. For this rule to apply, limited partners (as normally defined under the Proposed Regulations) must own a substantial, continuing interest in the partnership, and the rights and obligations of the individual in question must be identical to those for the limited partnership class. The underlying presumption apparently is that the partner would be paid for her services, and the rest of any payment should be seen as return on capital. Note that the partnership would still have to have two classes of interest overall. See Prop. Treas. Reg. § 1.1402-2(h)(4), 62 Fed. Reg. 1702, 1704 (Jan. 13, 1997).

⁶² The Proposed Regulations, however, permit the bifurcation of interests only to the extent the individual's rights and obligations with respect to a limited partnership class of interest is identical to the rights and obligations of other partners in that class who (1) qualify as limited partners under the Proposed Regulations without regard to the bifurcation rules, and (2) own a substantial interest in the partnership. See Prop. Treas. Reg. § 1.1402(a)-2(h)(3) to (4), 62 Fed. Reg. 1702, 1704 (Jan. 13, 1997).

⁶³ See John R. Marquis, *Current Status of Limited Liability Companies and the Self-Employment Income Tax*, 77 MICH. B.J. 440, 441 (1998).

finalized before July 1, 1998.⁶⁴ That date has long come and gone without the Treasury taking any additional action on the Proposed Regulations, though they have not been withdrawn. Congress appears to have been concerned about the risk of existing state law limited partners being reclassified as other than limited partners for federal income tax purposes.⁶⁵ In fact, this risk was quite slight, as most limited partners doubtless fail all three tests.⁶⁶ Further, in those cases where reclassification might happen, it is likely justified. Political pressure, not for the first time, may have taken precedence over sound tax policy, and to date the Treasury has not had the intestinal fortitude to take another run at it.

The difficulty with the Proposed Regulations is that they do not tackle the income-from-capital versus income-from-services issues head on. On the other hand, the Service was bound by the limitations of the statute it was interpreting. The only "out" from NESE was the income allocated to a limited partner. Others have had a freer hand.

The American Institute of Certified Public Accountants ("AICPA") in 1998, in response to the Proposed Regulations, suggested a statutory change.⁶⁷ In broad outline, the AICPA's proposed amendment provides that partners in tax partnerships have NESE to the extent of the reasonable value of the services performed on behalf of the partnership. It contains a safe harbor for determining the reasonable value of services. If a partner's NESE varies from the safe harbor by more than 10%, the NESE is subject to reasonableness testing on the basis of facts and circumstances. The safe harbor NESE is the partner's distributive share of partnership income or loss *plus* the section 707(c) guaranteed payment for services *minus* a reasonable rate of return on the partner's capital account at the beginning of the year. The rate of return on the partner's capital account is deemed to be reasonable if the rate used is 150% of the

64 See Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 935, 11 Stat. 788, 882.

65 See Culpepper et al., *supra* note 40.

66 Congress itself partially acknowledged the truth of this in 1997. When discussing the passive loss rules, the Statement of Managers for the Taxpayer Relief Act of 1997 observes that limited partners usually do not materially participate in a partnership's activities. H.R. REP. NO. 105-220, at 661-62 (1997) (Conf. Rep.); see also Culpepper et al., *supra* note 40, at 220 n.58.

67 See Michael E. Mares, *AICPA Forwards Legislative Proposal on Self-Employment Taxes*, 98 TAX NOTES TODAY 39-34 (1998). H.R. 4137, 108th Cong. (2004) takes a similar approach to that of the AICPA (doubtless not by coincidence).

“applicable federal rate”⁶⁸ (“AFR”) at the end of the partnership’s tax year.

The proposal has several shortcomings. It does not except services partnerships, the most likely area of abuse, notwithstanding the fact that an objective review of most service partnerships would conclude that all or almost all of their income is NESE. What is worse, given the safe harbor, service partnerships have an incentive to inflate capital accounts to avoid NESE. This could be done by making cash contributions to the partnership and holding them in a money market account. Further, capital accounts⁶⁹ are usually not precise measures of the value of partners’ invested capital. While they can under some circumstances be “restated” to current value,⁷⁰ this is relatively uncommon. A partner’s capital account may lag far behind or move far ahead of the value of the partner’s partnership interest. Thus, a reasonable rate of return on the partner’s capital account may yield a meaningless number. Finally, while there is much to be said for bright, predicable lines, the 150% AFR standard is arbitrary. For some industries, the 150% rate could be far high or far low.⁷¹ The AICPA provides for additional fudge room by permitting partners to vary from the safe harbor by 10%. Of course, what the AICPA is likely trying to do is limit partners’ NESE as much as practicable.

In 2005, the Staff of the Joint Committee on Taxation (“JCT”) also proposed a statutory change.⁷² In 2006, the JCT proposed a modified version of its 2005 proposal.⁷³ I discuss these in detail in my *Tax Lawyer* article. Here I will cut to the chase. Under the modified proposal, all income except Excluded Income is NESE in the case of a partnership engaged in the performance of services in the fields of health, law, engineering, architecture,

⁶⁸ The Service sets short-term, mid-term, and long-term applicable federal rates monthly. See, e.g., Rev. Rul. 2008-43, 2008-31 I.R.B. 258. Curiously, the AICPA report does not specify which of these three applicable federal rates it would use.

⁶⁹ Under the Regulations, capital accounts must be increased for the fair market value of contributed property (net of associated debt), money contributed, and allocable partnership income. The capital accounts must be decreased for the fair market value of distributed property, money distributed, and partnership losses. See Treas. Reg. § 1.704-1(b)(2)(iv)(b) (as amended 2013).

⁷⁰ See Treas. Reg. § 1.704-1(b)(2)(iv)(f) (as amended 2013).

⁷¹ See STAFF OF THE JOINT COMM. ON TAXATION, 109TH CONG., ADDITIONAL OPTIONS TO IMPROVE TAX COMPLIANCE 34 (Comm. Print 2006) [hereinafter JCT 2006], available at <http://www.finance.senate.gov/newsroom/chairman/release/?id=196654d7-c5d3-4847-b6ed-0d6a3d5c3d56>.

⁷² STAFF OF THE JOINT COMM. ON TAXATION, 109TH CONG., OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES 1 (Comm. Print 2005), available at <http://www.gpo.gov/fdsys/pkg/CPRT-109JPRT98128/content-detail.html>. I do not discuss their S corporation proposals, as they are moot under my proposal.

⁷³ See JCT 2006, *supra* note 71.

accounting, actuarial science, or consulting ("professional services"). The 2006 effort did not contain a proposal for non-service partnerships.

The American Bar Association Tax Section has taken several runs at this issue. I will focus only on the most recent effort, if for no other reason than I participated in the task force that prepared the Section's comments.⁷⁴

In its comments,⁷⁵ which are fairly brief, the Tax Section objects to the "wholesale expansion" of the income treated as NESE. It is not clear to what expansion the Tax Section is referring. The real expansion is occurring because an unchanged section 1402 is applying to a broader range of businesses and thus a broader range of income, and it is not coming from the JCT. The Tax Section argues that for both service and non-service partnerships, the most appropriate rule is to treat as NESE only that portion of the net income of a partnership that represents reasonable compensation for services rendered. The Tax Section recommends that if the JCT approach for service partnerships is adopted, an exception for "de minimis service partners" be created for those who provide low amounts of services. Under the Tax Section proposal, NESE for de minimis service partners consists of guaranteed payments as well as the partners' distributive share of income generally, but in the latter case only to the extent it constitutes reasonable compensation for services rendered. With regard to non-services partnerships, the Tax Section argues "strongly" that NESE be limited to an amount that constitutes reasonable compensation, as income also will come from capital. Should that be considered to be administratively unworkable, the Tax Section recommends a complex proposal that includes guaranteed payments as NESE. Additionally, a "material participation partner's" distributive share of income (other than Excluded Income) is NESE to the extent of reasonable compensation for services. The Tax Section further recommends that there be a rebuttable presumption that guaranteed payments and the distributive share are NESE up to a "presumption amount"; the Tax Section suggests that the maximum income to which the Social Security tax is applied (\$117,000 in 2014) be that presumption amount. As I discuss below, it has become common for advisors to S corporations to

⁷⁴ See Paul J. Sax, *ABA Tax Section Suggests Legislative Fix for LLC Self-Employment Tax*, 99 TAX NOTES TODAY 133-23 (1999).

⁷⁵ See A.B.A. SECTION OF TAXATION, COMMENTS ON ADDITIONAL OPTIONS TO IMPROVE TAX COMPLIANCE PREPARED BY THE STAFF OF THE JOINT COMMITTEE ON TAXATION 7-9 (2006). I do not address the S corporation proposals, as they are mooted by my proposal.

recommend that shareholder employees only take the Social Security tax maximum as a salary and let the rest of the S corporation's income "flow through" as non-wage income. (Elsewhere in its comments, the Tax Section endorses this approach.) The Tax Section is attempting to obtain official sanction for a practice that likely commonly understates compensation. If the Social Security tax maximum is the presumption amount, it is a safe bet that only ill-informed partners will have compensation income in excess of that amount, and large amounts of what should be compensation income will escape Medicare (and for the more aggressive, Social Security) taxes. Congress and the Service should not entertain such an invitation to end-run the Social Security and Medicare tax system, particularly given the financial difficulties in which Social Security and Medicare find themselves.⁷⁶

I propose amending section 1402 to catch it up with the real world. I discuss my proposal in terms of partnerships, but would apply it to disregarded entities/sole proprietors as well. What the JCT and the Proposed Regulations do wisely, and will go a long way toward limiting abuse, is to carve out a special rule for partnerships primarily engaged in the performance of services. I agree with the JCT that all income of a services partnership (except Excluded Income) should be classified as NESE. While it is certainly possible that a given service partnership has a substantial investment in capital, allowing service partnerships to allocate earnings to capital opens the door wide for abuse. As I noted above, for the vast majority of service partnerships, capital is most likely not a large income-producing factor. Additionally, there may occasionally be partners in service partnerships who provide little in the way of services, but they likely once did if the partnership is allocating income to them. Further, the income that is being allocated to them is, most likely, from someone's performance of services. By the mere expedient of shifting income from active to inactive partners, Social Security and Medicare taxes should not be avoided. Treating all income (other than Excluded Income) from service partnerships as NESE will create little unfairness, while avoiding many shenanigans and reducing the enforcement burdens of the Service. The Proposed Regulations and the JCT, however, limit the rule for service partnerships to those engaged in the performance of professional services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting. Yet the underlying

⁷⁶ See *Social Security: Achieving Sustainable Solvency: Hearing Before the S. Comm. on Fin.*, 109th Cong. 1–17 (2005) [hereinafter *Senate Finance Hearing*].

policy issues apply to any service partnership, so I would apply my proposal to any service partnership, not just those engaged in the specified professions. My broader approach creates the need to formally define a services partnership. A reasonable definition is any partnership less than 20% of the gross income of which is attributable to non-human capital.

For non-service partnerships, I largely agree with the Tax Section. Anyone performing services for a non-services partnership should be required to be paid reasonable compensation for those services, and that amount should be NESE. I have no "presumption amount" which, as I noted above, will commonly lead to improper tax avoidance. I treat partnership income in excess of reasonable compensation as income from capital and not as NESE.

The reasonable compensation for services standard may seem unduly vague, and indeed will create administrative burdens, but in fact it has been one we have lived with for generations. It had been regularly applied in the C corporation context. Commonly there, shareholder employees had attempted to avoid the C corporation double tax by paying themselves a large salary. They argued that as salary, the payment is income to the recipient, deductible to the corporate payor, and thus (they hoped) subject to one level of tax.⁷⁷ Courts have analyzed these purported salary payments under various standards, and if they concluded the salary was unreasonably high, reduced it, with the excess being reclassified as a nondeductible dividend.⁷⁸ There have also been occasions where the courts have looked at whether a salary is too low, as I will discuss below.

Admittedly, allowing courts to resolve compensation issues creates inefficiencies and uncertainties. In a given set of circumstances, taxpayers will not be able to be completely certain if their allocation between compensation and a return on capital will be respected, and it might encourage some to play the audit lottery in the hopes that their abusive scheme will not be uncovered. But the reality is that a fixed rule often will be far off the mark. What is appropriate compensation varies greatly based on the amount of capital involved, the extent of the services provided, the nature of the industry involved, and doubtless a

⁷⁷ See I.R.C. § 162(a) (2012).

⁷⁸ *Owensby & Kritikos, Inc. v. Comm'r*, 819 F.2d 1315, 1323 (5th Cir. 1987) (applying a multiple-factor test); *Exacto Spring Corp. v. Comm'r*, 196 F.3d 833, 838 (7th Cir. 1999) (analyzing the reasonableness of the salary based on whether an adequate return was being paid to the shareholders on their investment); see also *Haffner's Serv. Stations, Inc. v. Comm'r*, 326 F.3d 1, 4 (1st Cir. 2003) (applying factors but acknowledging the legitimacy of the *Exacto Spring* decision).

host of other factors. The inequity of a fixed rule in the non-services partnership context argues for a more general standard. Further, the fact that all income (other than Excluded Income) of service partnerships is automatically NESE will ease the administrative burden on the Service and the courts, providing something of an offset.

C. The Scofflaw Gambit

The current definition of NESE means that a taxpayer who wants to avoid Social Security and Medicare taxes will not find the partnership soil very fertile. S corporations are a very different matter. While a partner may not be an employee of a partnership,⁷⁹ there is nothing to keep a shareholder from being an employee of a corporation, whether it be a C corporation or an S corporation. Employers and employees are only assessed Social Security and Medicare taxes on the compensation that is paid to the employee.⁸⁰ That fact gives rise to the following tax avoidance technique using S corporations. The S corporation pays a modest salary or perhaps no salary at all to its shareholder employees. The net income of the S corporation not used to pay salaries “flows through” under the regular S corporation section 1366 rules, arguably as non-compensation, and therefore arguably not subject to Social Security and Medicare taxes. For example, in 2014 a neurosurgeon with \$1 million of net S corporation income (before salaries) from her services might pay herself the Social Security income maximum of \$117,000 as a salary, and let the rest of the income flow through as non-compensation. She thus saves the Medicare tax of $2.9\% \times \$883,000 = \$25,607$.⁸¹ Some

⁷⁹ Rev. Rul. 69-184, 1969-1 C.B. 256.

⁸⁰ See I.R.C. §§ 3101, 3111.

⁸¹ Easily the most famous person to use this technique was former Senator, vice presidential nominee, presidential candidate, and bon vivant John Edwards. Over four years (from 1995 to 1998), on income of about \$27 million, he saved Medicare taxes of over \$590,000. See Michael Moss & Kate Zernike, *Campaign Releases Edwards's Earnings*, N.Y. TIMES, July 10, 2004, <http://www.nytimes.com/2004/07/10/us/2004-campaign-north-carolina-senator-campaign-releases-edwards-s-earnings.html>. The journalism on this news story left something to be desired. The technique was portrayed as a legitimate “tax shelter.” If challenged, a court most likely would have held almost all of the S corporation income to be compensation. The specifics: Edwards apparently incorporated midway through 1995. In that year he paid himself a salary of \$180,000 on income for the year (including pre-incorporation) of \$5 million. In 1996, the S corporation earnings were \$4 million and Edwards received a salary of \$360,000. In 1997, the S corporation earnings were \$11 million and Edwards received a salary of \$360,000. In 1998, his final year of law practice, the S corporation earnings were \$5.5 million with the same \$360,000 salary. See Tom Daley, Letter to the Editor, *Edwards's S Corp: Can We Get the Numbers Right?*, 104 TAX NOTES 1310 (2004). The total earnings reported in the Daley piece are somewhat less than in the *New York Times* article (\$25.5 million versus \$27 million). I have not found a source for this, but I have heard that the \$360,000 salary was based on what the average personal injury lawyer makes in North Carolina, the state where Edwards practiced law.

advisors are routinely telling their clients to pay the Social Security maximum to themselves as salary, and to treat the balance of the S corporation income as non-compensation.⁸²

This gambit has been going on for many years. Senator Wyden, an Oregon Democrat, calls those who make such inappropriate use of S corporations "Social Security scofflaws."⁸³ While it would be more fun to call the neurosurgeon example the "Scofflaw gambit," going forward I will call it the "NESE gambit." The loss to the fisc from this technique is not insubstantial. The underpayment of Medicare and Social Security taxes through the use of S corporations is estimated to be about \$6 billion per year for each tax, or about \$12 billion per year in total.⁸⁴

Taxpayers have used S corporations to avoid both Social Security taxes and Medicare taxes. Since Social Security taxes are only applied to limited amounts of compensation, S corporation shareholders have to pay themselves relatively low salaries or no salaries to save these taxes. And, in fact, they have done so. The Service has challenged the most piggish gambit users, those that have paid themselves little or no salary. The Service has won all of these cases. Courts have generally concluded that earnings of the S corporation constituted compensation to the shareholder-employees, either under a substance-over-form analysis or by concluding that the distributed earnings constituted reasonable compensation for the services rendered.⁸⁵ Curiously, the Service has never issued a

See Kip Dellinger, *Edwards's S Corp: The Revised Numbers Are Still Ridiculous*, 104 TAX NOTES 1456 (2004).

⁸² I have not come across written evidence of this, but it is often implied. See, e.g., Alan L. Olsen, *Ten Tax Planning Ideas for Small Businesses in 2009*, GROCO, http://www.groco.com/readingroom/tax_smallbusiness.aspx (last visited June 2, 2014).

⁸³ See *Senate Finance Hearing*, *supra* note 76, at 29–30.

⁸⁴ In 2005, the Treasury Inspector General for Tax Administration estimated that for 2006–2010, unless the law is changed, the Medicare and Social Security tax gap resulting from under-compensation of Subchapter S shareholder-employees would be \$30.2 billion and \$30.8 billion, respectively. *Id.* at 41 (statement of Hon. Russell George, Inspector General for Tax Administration, United States Department of the Treasury). The Government Accountability Office (GAO) issued a report in 2009 outlining S corporation compliance issues. See U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-10-195, TAX GAP: ACTIONS NEEDED TO ADDRESS NONCOMPLIANCE WITH S CORPORATION TAX RULES 25 (2009). It estimated \$3 billion in employment tax revenue losses over tax years 2003 and 2004—still substantial, but significantly less than the 2005 study. The studies apply to different time frames, which might explain much of the difference. The very substantial gap is still a little perplexing. Given the jump in the use of S corporations, I lean to the former over the latter.

⁸⁵ See *Veterinary Surgical Consultants, P.C. v. Comm'r*, 117 T.C. 141 (2001), *aff'd*, 90 F. App'x 669 (3d Cir. 2004); *Nu-Look Design, Inc. v. Comm'r*, 356 F.3d 290 (3d Cir. 2004); *Specialty Transp. & Delivery Servs., Inc. v. Comm'r*, 91 F. App'x 787 (2004); *Spicer Accounting, Inc. v. United States*, 918 F.2d 90 (9th Cir. 1990); *W. Mgmt., Inc. v. United States*, 45 Fed. Cl. 543 (2000); *Radtke, S.C. v. United States*, 712 F. Supp. 143 (E.D. Wis. 1989), *aff'd per curiam*, 895 F.2d 1196 (7th Cir. 1990); *Dunn & Clark, P.A. v. Comm'r*, 853

ruling involving the NESE gambit.⁸⁶ It has only issued a ruling where the taxpayer failed to take any salary.⁸⁷ Many practitioners are reluctant to advise clients to violate a revenue ruling, and the Service might have saved the fisc billions of dollars had it issued a ruling on the NESE gambit.

In a pure services S corporation, through which, for example, a doctor or a lawyer practices her profession, the NESE gambit is obviously abusive. In the closely-held corporation context, courts generally have required corporations to pay reasonable compensation to their shareholder-employees.⁸⁸ In the neurosurgeon example above, all of the income of the S corporation is attributable to her services. Therefore, normally reasonable compensation is all of the net income of the S corporation. Reasonable compensation must be based on the value of the neurosurgeon herself and not, say, the value of the average neurosurgeon. Otherwise the top neurosurgeon in a state making five times the average could argue that her compensation should be based on what the average neurosurgeon earns, or one-fifth of what she is actually earning. That would be an easy way to save Medicare and possibly Social Security taxes. But if that top neurosurgeon went to work for a bona fide employer, she would not accept the average wage—she would insist on being compensated for her actual worth. That is her reasonable compensation.

While there is no hard data, it is highly likely that for most service S corporations, all of the net income of the S corporation represents income from services. As noted earlier, there might be an argument in the occasional service S corporation that there is a sufficient capital investment so that a small percentage of the income is allocable to capital. But clearly what is usually going on is an effort to end-run the Medicare tax and in some cases even the Social Security tax systems. It is axiomatic that

F. Supp. 365 (D. Idaho 1994); *Joly v. Comm'r*, 76 T.C.M. (CCH) 633 (1998), *aff'd*, 211 F.3d 1269 (6th Cir. 2000). In these cases, the courts often focused on distributed earnings, and typically most or all of the earnings were distributed. Distribution should not change the analysis. If the S corporation earnings are indeed best classified as wages to the shareholder employees, whether or not they are distributed in a given year should not change the answer. Typically, the shareholder employees have full control over timing. See *Charlotte's Office Boutique, Inc. v. Comm'r*, 121 T.C. 89 (2003), *aff'd*, 425 F.3d 1203 (9th Cir. 2005).

⁸⁶ See H.R. 3970, 110th Cong. § 1211 (2007) (Congressman Rangel attacking the totality of the problem within the S corporation context).

⁸⁷ Rev. Rul. 74-44, 1974-1 C.B. 287. Thanks to Robert Rombro, Esq. of Baltimore, Maryland for bringing this revenue ruling to my attention.

⁸⁸ See *Exacto Spring Corp. v. Comm'r*, 196 F.3d 833 (7th Cir. 1999); *Joly*, 76 T.C.M. (CCH) 633.

substance controls form,⁸⁹ and for that to occur, in most cases all of the net income of a service S corporation should be subject to Social Security and Medicare taxes.⁹⁰

It was a long wait, but in 2010 there was finally an NESE gambit case. The taxpayer took a small, but not a de minimis salary from his S corporation. While the court did not accept the salary the taxpayer took, sadly it did not require all of the income of the S corporation to be treated as employment income. Indeed, the arguments I made above notwithstanding, the court accepted the argument that only what the average, similarly situated professional made was a measure of the appropriate salary, arguably opening the door wider for taxpayers who wish to avoid employment taxes on their services income. In *Watson v. United States*,⁹¹ the taxpayer, Watson, formed an S corporation of which he was the sole shareholder. The S corporation was a partner in an accounting firm partnership. The other partners were also one-person S corporations. In 2002, Watson's S corporation received profit distributions of \$203,651 from the partnership. In 2003, it received \$175,470 in profit distributions. In each of those years, the S corporation paid Watson a salary of \$24,000 per year, let the balance of the income "flow through" as non-compensation income, and paid that balance to Watson as a "dividend." The trial court and the Eighth Circuit in its affirmation concluded that Watson's salary and dividend payments were an effort to avoid federal employment taxes, and that the dividends paid to Watson were, in part, remuneration for services performed. The court did not conclude, as it should have, that all of the dividends paid were income for services and subject to federal employment taxes. An expert witness testified that fair market value of Watson's services for the years in question was about \$91,044 per year. Only the difference between that amount and \$24,000 was held to be subject to federal employment taxes, interest, and penalties. The fact that a similarly situated taxpayer in a partnership or working as an employee for a large accounting firm would have had to pay employment taxes on all of the net income earned from services seems to have escaped the trial court's attention, though not that of the Eighth Circuit, as I will discuss.

⁸⁹ *Frank Lyon Co. v. United States*, 435 U.S. 561, 573 (1978).

⁹⁰ A similar technique was tried unsuccessfully with a limited partnership. See *Renkemeyer, Campbell & Weaver, LLP v. Commissioner*, 136 T.C. 137 (2011), which admittedly involved a quite abusive fact pattern.

⁹¹ *Watson, P.C. v. United States*, 757 F. Supp. 2d 877 (S.D. Iowa 2010), *aff'd*, 668 F.3d 1008 (8th Cir. 2012). The Eighth Circuit cited my *Tax Lawyer* article, *supra* note 1, in the text of its opinion, but alas did not follow its reasoning.

Watson in the short run flings the door wide open for the NESE gambit. Provided taxpayers earn more than the “average,” they can often expect to avoid employment taxes on significant portions of their services income. If *Watson* were the law of the land, query whether it would be worth it to the Service to litigate a case where salaries equal to the Social Security tax maximum were paid, since it often will be likely that the fair market value of the services performed will be relatively close to that amount. Again, under the court’s reasoning in *Watson*, at issue is not the fair market value of the taxpayer’s own services, but those of an average, similarly situated taxpayer, whose services might be worth less than those of the taxpayer in question.

Hopefully the Tax Court⁹² and other circuits will not follow the reasoning in *Watson*. Actually, there was a bit of a waffle in the Eighth Circuit’s affirming opinion. After citing my *Tax Lawyer* article, it stated: “Nevertheless, although we think evidence of shareholder-employee billings and collections may be probative on the issue of compensation, in view of all the evidence presented to the district court in this case, we see no error.”⁹³ An optimistic reading of this language would be that the Eighth Circuit was affirming a finding of fact rather than one of law. Certainly, the Eighth Circuit left a door open to reach a different decision under similar facts, and taxpayers in the Eighth Circuit cannot be completely sanguine about their prospects.

The *Renkemeyer*⁹⁴ case also provides some hope that reason will ultimately prevail. *Renkemeyer* involved a similar, but more abusive effort than that in *Watson* with a law firm limited liability partnership.⁹⁵ There the Tax Court generally took the position that income from services is subject to self-employment taxes and cannot be avoided by structural fancy footwork. “The

⁹² The Tax Court followed the reasoning of *Watson* in *McAlary Ltd. v. Commissioner*, No. 21068-11S, 2013 WL 4052429 (T.C. Aug. 12, 2013) (summary opinion), an S case, that is, a small tax case that cannot be cited as precedent. Likely the Tax Court did not realize the significance of the case when it accepted the taxpayer’s request to designate it an S case. Thanks to Professors Jensen, Lederman, McMahon, and Todd who brought me up to speed on S cases.

⁹³ *Watson*, 668 F.3d at 1019.

⁹⁴ *Renkemeyer*, 136 T.C. 137.

⁹⁵ *Renkemeyer* involved a law firm of tax lawyers organized as an LLP (not a limited partnership). To oversimplify the facts a bit, in 2004 the partners recapitalized the LLP into “general managing partner partnership units” and “investing partnership units,” with the general managing partner partnership units having full authority to act on behalf of the partnership. The vast majority of the income was allocated to the investing partnership units. The partners tried to claim that these should be treated as limited partnership interests and be free from self-employment taxes. The court rejected this approach and held that all of the partnership income was subject to self-employment taxes. *Id.*

legislative history of section 1402(a)(13) does not support a holding that Congress contemplated excluding partners who performed services . . . in their capacity as partners (i.e., acting in the manner of self-employed persons), from liability for self-employment taxes.⁹⁶ It is hard to see why the Tax Court would not reach a comparable conclusion for the NESE gambit with S corporations.

As long as S corporations can be used to avoid employment taxes, I believe the political hurdles to repealing Subchapter S will be too great. But if this benefit is taken away, the political prospects improve substantially, though one must never forget that the S corporation bar is politically powerful. While there is no data to prove this, I and others believe that the NESE gambit drives the use of S corporations. It is difficult to otherwise explain the substantial popularity of S corporations. My *Tax Lawyer* article goes into this issue in depth. Also, eliminating this benefit for S corporations in and of itself might strike a major blow for pass-through entity reform. It would make S corporations less popular and its erstwhile proponents less averse to reform. Indeed, without the NESE gambit, S corporations might wither on the vine.

III. REPEAL SUBCHAPTER K INSTEAD?

Much ink has been spilled on the problems with Subchapter K.⁹⁷ It is surely true that abuses can happen. Subchapter K and its regulations are an extraordinarily complex area of tax law. Of just one piece of this puzzle, the special allocation rules of section 704(b), Professor Lawrence Lokken famously wrote: “[They are] a creation of prodigious complexity . . . essentially impenetrable to all but those with the time, talent, and determination to become

⁹⁶ *Id.* at 150. Section 1402(a)(13) excludes income allocated to a limited partnership interest from self-employment taxes. Thus, even if the taxpayers had formed an actual limited partnership and allocated income to the limited partnership interests, the Tax Court’s language indicates that the limited partner status would not have been respected and self-employment taxes would not have been avoided.

⁹⁷ A partial list: Lawrence Lokken, *Taxation of Private Business Firms: Imagining a Future Without Subchapter K*, 4 FLA. TAX REV. 249 (1999); Rebecca S. Rudnick, *Enforcing the Fundamental Premises of Partnership Taxation*, 22 HOFSTRA L. REV. 229 (1993); Mark P. Gergen, *Reforming Subchapter K: Special Allocations*, 46 TAX L. REV. 1 (1990); Curtis J. Berger, *Whither Partnership Taxation?*, 47 TAX L. REV. 105; Noël B. Cunningham, *Commentary, Needed Reform: Tending the Sick Rose*, 47 TAX L. REV. 77 (1991); William D. Andrews, *Inside Basis Adjustments and Hot Asset Exchanges in Partnership Distributions*, 47 TAX L. REV. 3 (1991); Philip F. Postlewaite et al., *A Critique of the ALI’s Federal Income Tax Project—Subchapter K: Proposals on the Taxation of Partners*, 75 GEO. L.J. 423 (1986); William S. McKee, *Partnership Allocations: The Need for an Entity Approach*, 66 VA. L. REV. 1039 (1980); see also Darryll K. Jones, *Towards Equity and Efficiency in Partnership Allocations*, 25 VA. TAX REV. 1047 (2006); Karen C. Burke, *Partnership Distributions: Options for Reform*, 3 FLA. TAX REV. 677 (1998).

thoroughly prepared experts on the subject.”⁹⁸ Professors George Yin and David Shakow, as Reporters for the American Law Institute, produced an impressive study that was critical of Subchapter K. In it they proposed “an optional tax system” for the simple private business firm grounded in Subchapter K, but “with a strong resemblance to Subchapter S.”⁹⁹ Professors Yin and Shakow did not launch a full frontal assault on Subchapter K, perhaps cognizant of the political perils of such an effort. In addition to the private business firm proposal, they proposed to keep Subchapter K, though with substantial changes.¹⁰⁰

I actually think that Subchapter K has much to commend it. The flexibility it offers promotes economic efficiency. Yes, abuses can happen, but I have yet to see any data suggesting that they are a large part of the partnership pie. Professors Yin and Shakow have argued that the complexity of Subchapter K argues for the creation of an alternative, simpler entity.¹⁰¹ But the complexity of Subchapter K is to a large extent voluntary. It is perfectly possible to have a simple tax partnership, and there are many. Further, S corporations, with their rigid qualification rules, particularly the one class of stock requirement and the lack of a section 752 analog, are simply unsuitable for many complex business undertakings where income is often allocated in tranches to different owners. But in some ways, this debate is a waste of time. The reality is that repealing or dramatically changing Subchapter K is a political nonstarter. Perhaps the best evidence of that fact is that Professors Yin and Shakow were not able to persuade the American Law Institute, a reform-oriented—and in the view of some, moderately progressive—organization, to adopt their views, notwithstanding that they did not even go so far as to recommend repeal of Subchapter K. Repeal of Subchapter K has never been given serious consideration by Congress. Further, some kind of partnership taxation will always have to be with us if for no other reason than taxpayers can inadvertently find themselves in

⁹⁸ Lawrence Lokken, *Partnership Allocations*, 41 TAX L. REV. 545, 621 (1986).

⁹⁹ See ALI REPORT, *supra* note 3, at 125. This would have been an elective system. For example, it would have in some cases severely restricted special allocations and would have required gain recognition (as well as loss recognition in the case of a liquidation) on the distribution of assets. See *id.* at 183 (Proposal 4-2(1)(a)); *id.* at 215 (Proposal 4-5(1)(a)); *id.* at 300 (Proposal 5-1(1)(a)); *id.* at 129 (Table 1); see also Jeffery A. Maine, *Linking Limited Liability and Entity Taxation: A Critique of the ALI Reporters' Study on the Taxation of Private Business Enterprises*, 62 U. PITT. L. REV. 223 (2000).

¹⁰⁰ See ALI REPORT, *supra* note 3, pt. 5, at 273.

¹⁰¹ Professor Yin has not changed his mind. See George K. Yin, *Comments on the Taxation of Passthrough Entities*, 140 TAX NOTES 358 (2013).

a state law partnership.¹⁰² They cannot inadvertently end up in an S corporation. So, if we cannot repeal Subchapter K, surely we should repeal Subchapter S. As noted above, the legitimate benefits of Subchapter S are relatively few in number and can either be incorporated into Subchapter K or be achieved by some adjustments to Subchapter C. Having two pass-through regimes is inefficient. Similarly situated taxpayers are taxed differently, to the advantage of those with skilled advisors, and often to the disadvantage of those with unskilled advisors. This violates principals of vertical equity. Well-advised taxpayers can effectively choose, albeit within limits, how much tax to pay. Taxpayers will exploit the differences between their regimes for their benefit. A classic example is using S corporations for the NESE gambit.¹⁰³ Further, the Service is required to train personnel in two different pass-through regimes.

That said, Subchapter K is a far from perfect taxing regimen. The ALI Report and others have pointed out its deficiencies and made many intelligent recommendations for improvement. Reform of Subchapter K should continue. But the fact that Subchapter K is in need of reform is not a reason to continue a parallel pass-through regime in Subchapter S. One of the two systems needs to go. It won't be Subchapter K; therefore it should be Subchapter S. Indeed, the existence of Subchapter S impedes the reform of Subchapter K. Having two systems in play can prevent policy makers and the Service from becoming fully focused on one. It spreads limited human resources thin. Likely, the pace of reform of Subchapter K will pick up once Subchapter S is off the playing field.

IV. LET NONPUBLIC CORPORATIONS COME TO THE PARTY

It seems fair to permit nonpublic¹⁰⁴ state law corporations to elect Subchapter K (or become disregarded entities if they have a single shareholder). As I discuss below, the cost of permitting nonpublic C corporations to do so may now not be large. I would exclude corporations that are currently ineligible for Subchapter S from making this election.¹⁰⁵

¹⁰² See ALAN R. BROMBERG & LARRY E. RIBSTEIN, BROMBERG AND RIBSTEIN ON PARTNERSHIPS § 2.01(a) (Supp. 2014).

¹⁰³ See ALI REPORT, *supra* note 3, at 45.

¹⁰⁴ As did H.R. 4137, so too do I define a nonpublic C corporation as a domestic corporation, no stock of which is readily tradable. See H.R. 4137, 108th Cong. (2004).

¹⁰⁵ As did H.R. 4137. Generally, a pass-through regime is highly awkward for these types of entities. See section 1361(b)(2), which lists corporations that are ineligible to elect to be taxed under Subchapter S. Included are financial institutions which use the reserve method of accounting for bad debts described in section 585 (e.g., many banks), insurance companies subject to tax under Subchapter L, corporations to which an election under

C corporations can have highly complex stock and debt structures. In many cases, those structures may make the switch to Subchapter K impractical. But usually, Subchapter K will be up to the challenge. Many partnerships have highly complex ownership and debt structures, but thrive in Subchapter K.¹⁰⁶

State and federal governments are regularly changing the ground under business owners' feet. An owner who twenty years ago rationally chose a C corporation, might not have done so if he had known of the impending LLC revolution. The tax benefits that he may have gleaned by using a C corporation are, given the overall double tax burden, unlikely to have been so great as to justify locking him into a now outdated choice. Further, why should different nonpublic business entities be taxed differently? Closely held businesses should at least have the option of playing on the same field, making for greater horizontal equity. Other countries have taken a uniform approach.¹⁰⁷ I recommend that the United States also take a more uniform approach, though I would not make the election of Subchapter K mandatory for C corporations. As I discussed above, it would be very difficult for nonpublic entities to get by wholly without Subchapter C. As I discuss briefly below, and in more detail in my *Tax Lawyer* article, I recommend that C corporations be allowed to switch to Subchapter K on a taxpayer-friendly basis.¹⁰⁸

V. THE NUTS AND BOLTS IN BRIEF

In my *Tax Lawyer* article, I discuss in detail how to get from here to there. I will briefly summarize my discussion.

A. S Corporations

A first step toward repeal is to prohibit any further S elections, as of the effective date of any relevant act.¹⁰⁹ Existing S corporations are given the option of electing Subchapter K or C

section 936 applies (relating to Puerto Rico and possession tax credit), and domestic international sales corporations. See JAMES S. EUSTICE & JOEL D. KUNTZ, *FEDERAL INCOME TAXATION OF S CORPORATIONS* ¶ 3.05 (4th ed. 2001).

¹⁰⁶ See, e.g., Karen T. Lohnes, John Schmalz & Craig Gerson, *Value Equals Basis and Partners' Distributive Share: Stuffing, Fill-Ups, and Waterfalls*, 105 J. TAX'N 109 (2006).

¹⁰⁷ Germany, for example. See Michael J. Munkert, *Fallstricke der neuen Thesaurierungsbegünstigung*, 10-07 STEUERCONSULTANT 34 (2007).

¹⁰⁸ One might think that permitting C corporations to continue to elect Subchapter S during the ten-year death watch might be a way of facilitating the transition to Subchapter K, but in fact that often, perhaps usually, will not be the case. The S corporation one-class-of-stock rule of section 1361(b)(1)(D) will make Subchapter S unavailable to many existing C corporations. Also, section 1374 will take away much of any tax benefit that Subchapter S provides.

¹⁰⁹ See Small Business Tax Modernization Act, H.R. 4137, 108th Cong. (2004); *S Corp Burial*, *supra* note 8, at 643.

for ten years. If they do neither, they automatically fall under Subchapter K at the end of the ten years.

Generally, an S corporation that shifts to Subchapter K is deemed to liquidate for tax purposes and reform as a tax partnership. This process is necessary (1) to establish capital accounts for the partners correctly;¹¹⁰ (2) for section 704(c), section 707(a)(2)(B), and section 737 to apply properly; and (3) to establish the owner's bases in the assets properly if the S corporation becomes a disregarded entity. The regular S corporation rules apply until the liquidation, deemed or actual, takes place, with one modification. I apply my recommended reform of Social Security and Medicare taxes to S corporations during the transition period. Thus, all income of an S corporation primarily engaged in the performance of services is subject to Social Security and Medicare taxes. For capital-intensive S corporations, on the other hand, reasonable compensation for services rendered must be paid, but only that compensation is subject to Social Security and Medicare taxes.¹¹¹

Generally I recommend that Subchapter K apply to the liquidation of the S corporation as well as, of course, the formation of the tax partnership. Under the current rules of Subchapter S, the liquidating S corporation must generally recognize any gain or loss inherent in its assets.¹¹² It seems inappropriate, however, to apply the current S corporation rules and require gain (or permit loss) recognition on the termination of S corporation status.¹¹³ The taxpayers are being forced to use another entity, making gain recognition unfair. Typically, no real disposition is being made. Most owners will continue the same business.¹¹⁴ This makes loss recognition inappropriate. I therefore recommend that S corporations and their shareholders be allowed to move to partnerships or disregarded entities using Subchapter K.

Sufficiently creative taxpayers can find ways of inappropriately taking advantage of these generous rules for

¹¹⁰ See Treas. Reg. § 1.704-1(b)(1)(iv), (b)(2)(ii) (as amended 2013).

¹¹¹ Perhaps the easiest way to accomplish this is to bring S corporations under the self-employment rules, as opposed to continuing their current coverage under sections 3101, 3111, and related provisions. See STAFF OF THE JOINT COMM. ON TAXATION, 110TH CONG., TAX REFORM: SELECTED FEDERAL TAX ISSUES RELATING TO SMALL BUSINESS AND CHOICE OF ENTITY 68 (Comm. Print 2008); H.R. 3970, 110th Cong. § 1211 (2007).

¹¹² I.R.C. § 336(a) (2012).

¹¹³ See I.R.C. §§ 331(a), 336(a).

¹¹⁴ They may want to actually liquidate the S corporation and form, for example, an LLC. See *S Corp Burial*, *supra* note 8, at 616. Or they may want to continue using the state law corporation, which either is disregarded for tax purposes if it has a single owner, or is taxed under Subchapter K if it has multiple owners. *Id.* at 611; I.R.C. § 701.

liquidation of S corporations. To stop or at least impede this, I recommend Congress authorize the Service to adopt an anti-abuse rule that applies to this process.¹¹⁵

Note that under my proposal, S corporations do not have the option of liquidating under the current S corporation rules. This is to prevent taxpayers from cherry-picking tax treatment, that is, using Subchapter S for S corporations with net losses in their assets and Subchapter K for S corporations with net gains. It is appropriate, however, to have a brief transition period of perhaps one year where S corporations are allowed to actually liquidate under either Subchapter K or S. Taxpayers planning to liquidate in fact should not be caught unawares by the statutory change. While cherry-picking can happen during the one year, the associated revenue losses are not likely to be great given the limited time frame. Further, S corporation losses and deductions, including depreciation deductions, generally flow through to the shareholders.¹¹⁶ In other words, the losses have often already been recognized by the shareholders. As a consequence, it is not likely that there are a large number of S corporations with large amounts of losses inherent in their assets, though there will be some with economic losses that have not yet been taken into account for tax purposes.¹¹⁷

While it is difficult to predict with certainty in the absence of hard data, it seems doubtful that permitting largely tax-free liquidations of S corporations will generate unacceptable revenue losses for the fisc. Under the current rules, S corporations can avoid distributing assets that contain significant amounts of appreciation. Instead, they commonly retain the property in corporate solution, depriving the government of a recognition event. In addition, Social Security and Medicare tax revenues will no longer be lost, creating a substantial offset, indeed likely a net revenue increase.

What if the S corporation has earnings and profits or unrecognized section 1374 gains? The equities in this regard are not as strong as the equities in favor of allowing non-recognition of the (non-section 1374) gains and losses inherent in the S

115 One example: A and B own all of the stock of an S corporation. A individually owns asset X and B individually owns asset Y. They wish to exchange these assets with each other. The assets do not qualify for like-kind exchange treatment under section 1031. To avoid gain recognition, they could each contribute the assets to the S corporation. The contribution would be tax free under section 351(a). As part of a subsequent liquidation of the S corporation under Subchapter K, the S corporation could distribute asset Y to A and asset X to B, potentially tax free. See I.R.C. § 731.

116 I.R.C. § 1366.

117 A drop in the value of land, for example, would normally only be recognized in the case of taxable disposition, as land is not depreciable. See I.R.C. § 1001.

corporation assets. The earnings and profits and section 1374 gains originated with a C corporation, and avoiding any tax consequence also avoids what would have been part of the Subchapter C double tax system, and Subchapter C is not being recommended for repeal. Here I depart from my *Tax Lawyer* article and follow the lead of the Camp proposals discussed below. The accumulated adjustments account¹¹⁸ with the relevant section 1368 potential dividend treatment and the section 1374 treatment carry over from the erstwhile S corporation to the new entity, be it a tax partnership or a disregarded entity, with credit given for that portion of the ten-year section 1374 time period that elapsed while an S corporation. Further, during the transition period, current rules apply to the section 1374 gains.

Should the proposed act contain continuity of business enterprise and ownership interest tests? Should the business of the erstwhile S corporation be required to be continued for some period of time? Should the erstwhile shareholders be required to stay on as partners for some period of time?¹¹⁹ Should a special rule be applied to S corporations that actually liquidate and discontinue the business? While the failure to address these issues may mean that some owners will be able to convert corporate assets to personal use without an income tax effect,¹²⁰ on the whole, the better answer to the question is not to apply continuity of interest standards or special rules for actual liquidations and discontinuance of the business. Because S corporations are being forced out of existence, the equities favor an owner-friendly set of rules. Also, aside from the possibility of converting business assets to personal use, which will likely be uncommon, the relevant tax consequences after the conversion are similar to, or even worse than, those before the conversion. Some examples: a sale of stock in the S corporation usually generates a capital gain or loss; the sale of a partnership interest may generate ordinary income (i.e., worse off in a partnership);¹²¹ the gain or loss on the sale of business assets generally flows through to the shareholders for S corporations and to partners for partnerships (i.e., treatment unchanged). Also, determining whether the continuity tests are met will create additional

¹¹⁸ I.R.C. § 1368(e).

¹¹⁹ These rules apply to corporate reorganizations. See BITTKER & EUSTICE, *supra* note 19, ¶¶ 12.21, 12.61[2].

¹²⁰ This could not happen with an S corporation, since the distribution of property by an S corporation to its shareholders causes gain and possibly loss to be recognized under sections 311(b) and 336. On the other hand, a distribution of property by a partnership to a partner is generally not recognized to either party. See I.R.C. § 731. *But see* I.R.C. §§ 707(a)(2)(B), 704(c)(1)(B), 737, 751(b).

¹²¹ See I.R.C. § 751(a).

complexity that does not seem worth the statutory effort. Numerous questions will arise. How long should the business be operated? What if the assets are used in a different business? How much of an ownership change is permitted? Many of these issues have been addressed in the corporate context. But in the case of S corporations being forced out of existence, the courts might address these issues differently.¹²² Further, if continuity provisions are enacted, most owners likely will continue the business long enough to pass muster, so little revenue will be raised.

B. C Corporations

For newly formed C corporations electing to be taxed under Subchapter K, rules will need to be developed that track the section 704(b) allocation rules with the multiple classes of stock possible in a C corporation. Other special issues may arise, but they should be manageable. A separate question arises for existing nonpublic C corporations wishing to elect Subchapter K (or disregarded entity status). How should they get from here to there? Assuming it does not create undue fiscal burdens, I recommend taking the same approach as for S corporations (including section 1368 accumulated adjustment accounts and section 1374). As Subchapter C would be continuing, I do not make this approach mandatory as I do for S corporations. It would be almost impossible to keep track of C corporations liquidating for independent reasons and those liquidating to continue under Subchapter K. Thus, C corporations have the option of liquidating under the current rules, which they will prefer if overall it generates losses.¹²³ An anti-abuse rule should be created so that C corporations cannot switch to the new rules and then promptly formally liquidate to avoid double taxation. They might be required to continue the business for two years, for example. For the reasons noted above for S corporations, however, I would not apply other continuity of interest rules.

Some will view my proposal as an unduly liberal give-away. And indeed, as I discuss below, its cost may be too high. But there are also economic inefficiencies that are created when some taxpayers are forced to operate within an outdated form and others are not. New businesses forming LLCs have a competitive advantage over older businesses trapped in C corporations. Electing S corporation status may not be available

¹²² See BITTKER & EUSTICE, *supra* note 19, ¶¶ 12.21, 12.61[2].

¹²³ It is not out of the question they will prefer it in a gain situation, as it means a basis step up. See I.R.C. § 732.

if their ownership structure does not permit a single class of stock. Leveling the playing field should make for a more efficient economy.

If the costs to the fisc of my proposal for existing C corporations are too high, a simple solution, and probably as reasonable as any, is simply to leave the current rules for liquidating C corporations in effect with one adjustment: existing nonpublic C corporations may, during the ten-year window, elect Subchapter K or disregarded entity status, but if they do so they are deemed to liquidate under Subchapter C, recognizing the gains and possibly the losses per its rules.¹²⁴ To limit the tax pain, any taxes owed are payable over five years. Again, an anti-abuse rule should apply to prevent C corporations from electing Subchapter K and then liquidating soon thereafter to take advantage of the five-year payout.

Whichever of these rules are used for existing C corporations, they should only apply during the ten-year window. To allow these tax benefits for C corporations that liquidate after the ten-year window is to permit them to have their cake and eat it too, using Subchapter C when it is beneficial and switching to Subchapter K when it is not, indefinitely.

Assuming a favorable environment in which qualifying C corporations can elect Subchapter K at a low tax cost, will the LLC revolution be reversed or at least slowed? Rather than forming LLCs, will taxpayers form corporations and elect Subchapter K? While this is not necessarily a bad thing, it is not a likelihood for non-tax reasons. State LLC statutes have more modern, flexible statutory architectures in comparison to typical corporate statutes.¹²⁵ Indeed, many who prefer for whatever reason to operate as C corporations for tax purposes often form LLCs and then check the box to be taxed as C corporations to take advantage of the greater state law flexibility LLCs offer.¹²⁶

VI. CAMP PROPOSALS AND TRA 2014

In March of 2013, the Chairman of the United States House of Representatives Ways and Means Committee, David Camp, published options for pass-through entity tax reform.¹²⁷ “Option

¹²⁴ Of course, a C corporation can always actually liquidate and form a partnership with all the attendant tax consequences. See I.R.C. §§ 346, 332.

¹²⁵ See BISHOP & KLEINBERGER, *supra* note 56, ¶ 1.02.

¹²⁶ LLCs can also elect to be taxed as S corporations. See INTERNAL REVENUE SERV., FORM 8832 (2013), available at <http://www.irs.gov/pub/irs-pdf/f8832.pdf>.

¹²⁷ HOUSE COMM. ON WAYS & MEANS, 113TH CONG., DISCUSSION DRAFT ON TAX REFORM ACT OF 2013 (2013), available at http://waysandmeans.house.gov/uploaded_files/final_sm_bus_passthrough_legislative_text_03.12.13.pdf; HOUSE COMM. ON WAYS

1” keeps Subchapters K and S, but makes recommendations for reform. In general, these are more taxpayer friendly for S than for K. “Option 2” repeals Subchapters K and S and replaces them with a new Subchapter K which departs from the current version at times in dramatic fashion. Option 2 would automatically apply to tax partnerships. Option 2 would allow corporations to elect the new Subchapter K, provided they are not publicly traded. Insurance companies, DISCs, and most banks could not make that election. I briefly discuss Option 1 and Option 2 below.

But things get still more dramatic. In February 2014, the House Ways and Means Committee proposed the Tax Reform Act of 2014¹²⁸ (“TRA 2014”). This massive proposal contains some provisions of significant relevance to this Article, and is also discussed briefly below.

A. Option 1

Option 1 contains a diverse series of changes. There does not seem to be any main theme, but rather a desire to make a number of independent fixes. Some are laudable, some not, and some are hard to get excited about one way or the other. I will not attempt a blow-by-blow review, but a few of the changes are worthy of special note.

Option 1 would repeal section 707(c) guaranteed payments. Thus, payments to a partner would either have to fall under the third party rules of section 707(a) or the regular rules for distributions to partners of section 731. Section 707(c) has always been a bit of an odd duck, trying to split the difference between sections 707(a) and 731, and it is a code provision Subchapter K can live without. So this is a change that makes sense.

Section 736 would also be repealed. This is perhaps my least favorite code section in all of Subchapter K. It works very awkwardly and under limited circumstances permits quick deductions for payments for goodwill. “[T]ime has passed section 736 by, and, rather than serve its initial purpose, section 736

& MEANS, 113TH CONG., TECHNICAL EXPLANATION OF THE WAYS AND MEANS COMMITTEE DISCUSSION DRAFT PROVISIONS TO REFORM THE TAXATION OF SMALL BUSINESSES AND PASSTHROUGH ENTITIES (2013) [hereinafter TECHNICAL EXPLANATION], *available at* http://waysandmeans.house.gov/uploadedfiles/final_sm_bus_passthrough_technical_explanation_03_12_13.pdf.

¹²⁸ See HOUSE COMM. ON WAYS & MEANS, 113TH CONG., TAX REFORM ACT OF 2014 DISCUSSION DRAFT SECTION-BY-SECTION SUMMARY (2014) [hereinafter TRA 2014], *available at* http://waysandmeans.house.gov/uploadedfiles/ways_and_means_section_by_section_summary_final_022614.pdf.

survives as an anachronism preventing the coherent evolution of the Code.”¹²⁹ This is another laudable change.

Less laudable is the provision that would make section 754 elections mandatory, with a few twists in the case of their application of section 734(b). Mandatory section 754 elections, while more theoretically pristine, can pose a large burden on business, especially small business. At a minimum, small partnerships should be excluded.

Option 1 would also eliminate the current seven-year window for mixing bowl transactions under sections 704(c)(1)(B) and 737. This would pose a major recordkeeping burden, perhaps an impossible one, on partnerships, especially small partnerships. It is also very difficult to justify on policy grounds. The seven-year window is already quite long and should stop almost all mixing bowl tax games. This provision of Option 1 fixes a non-problem.

B. Option 2

If one wanted to come up with an option that would make no one happy, be opposed by almost everyone, and have no chance of ever being enacted, it would be hard to do better than Option 2. A respected commentator has called it a “good starting point for the tax reform debate.”¹³⁰ I fear that this view is too optimistic. It is hard to get a debate going when the House Ways and Means Committee comes out with a proposal most of which hardly anyone will want. Any serious counterproposal would be substantially different, making compromise very difficult.

Option 2 often refers to its new Subchapter K entity as a “passthrough,” and I will use the same nomenclature. Option 2 has many Subchapter K-like provisions. There are equivalents or near equivalents to sections 704(c), 704(d), 705, 706, 707(a) and (b), 708, 721,¹³¹ 722, 723, 724, and 751. Option 2 eliminates special allocations, as I noted above, a valuable benefit to legitimate business undertakings. It requires a partner’s distributive share to be fixed within each of three categories: ordinary items, capital items, and tax credits (it does

¹²⁹ Philip F. Postlewaite & Adam H. Rosenzweig, *Anachronisms in Subchapter K of the Internal Revenue Code: Is It Time to Part with Section 736?*, 100 NW. U. L. REV. 379, 380 (2006).

¹³⁰ Monte A. Jackel, *An Initial Look at Camp’s Small Business Proposals*, 138 TAX NOTES 1363, 1363 (2013).

¹³¹ Note that inasmuch as Option 2 follows current section 721, owners do not have to meet section 351-like control requirements when contributing assets to a partnership. See TECHNICAL EXPLANATION, *supra* note 127, at 48.

not have to be the same across the categories).¹³² An owner's distributive share must be consistent with the owner's economic interest. The owner's economic interest is to be determined under all facts and circumstances. One might think that without special allocations, owners likely would usually have straightforward, fixed allocation percentages that would not impose large compliance problems. But owners might try to end-run the rules by having allocations vary from year to year. Further, it is unclear how a service partner receiving a future profits interest would calculate his economic interest. Thus, we could expect some fairly complex regulations on determining an owner's economic interest.¹³³ Option 2 does not address capital accounts. They likely would still be necessary to determine an owner's economic interest.¹³⁴ Further guidance will be necessary in this regard. How does the taxpayer determine her capital account when an entity converts from, for example, Subchapter S to new Subchapter K? In my proposals, I address this by having the electing entity go through a deemed liquidation/reformation process. The bottom line, though, is that eliminating special allocations is likely a deal killer.

Option 2 adopts the equivalent of current sections 301(b)(1), (c)(2), (c)(3), and 311. Thus, as would be the case in a distribution from an S or C corporation, the passthrough recognizes a gain, but not a loss, on the distribution of property. The owner recognizes a capital gain if the fair market value of the distributed property exceeds her basis in the ownership interest (subject to the equivalent of section 751(b)). A loss could be recognized on liquidation of the ownership interest. In the case of a gain asset, the owner typically takes a fair market value basis in the distributed property. In the case of a loss asset, the owner typically takes a carryover basis. As under current section 732(a)(2), the owner cannot take a greater basis in the distributed property than she had as an outside basis in the ownership interest plus any gain recognized by the owner on the distribution. Logically, the outside basis is reduced by the basis taken in the distributed property, but not below zero. In fairness, requiring gain recognition would eliminate some "game playing" that takes place now and much of the need for mixing bowl rules. Indeed, Option 2 contains no analog to sections 704(c)(1)(B) or

¹³² *Id.* at 45. Exceptions are made for contributed property, to which the equivalent of section 704(c) will apply, and section 751-like rules designed to preserve a partner's share of ordinary income. *Id.* at 45–47; see also I.R.C. § 751(a) (2012).

¹³³ See Jackel, *supra* note 130, at 1366.

¹³⁴ See Willard B. Taylor, *Subchapter S Out the Window? What Is Going On?*, 139 TAX NOTES 1051 (2013).

737, though it has a version of section 707(a)(2)(B). The requirement that gain be recognized on a distribution will be very unpopular, though perhaps not the deal killer that eliminating special allocations likely is.

Option 2 makes what is now a section 754 election mandatory. Again, this would be very burdensome for, and unpopular with, small business and could evolve into a major recordkeeping headache. Option 2 reconfigures the equivalent of section 734(b) in a way that makes it more accurate than the current version, albeit in a highly complex way.¹³⁵ Of course, this additional complexity will make life just that much harder for small business.

In what appears to be a major, but sad, nod to current S corporation users, Option 2 may be continuing the ability to avoid self-employment taxes. I say may be, because the language is cryptic and at dramatic disjuncture with the position TRA 2014 takes. Option 2 states: "The [new section 707(a)] also applies when an owner performs services for the passthrough and is paid reasonable compensation, including wages, by the passthrough for such services." If indeed this language is meant to continue self-employment tax avoidance, it would go a long way to appeasing current S corporation users, but for the reasons noted above, would constitute terrible tax policy. Also, there are likely many in Congress, especially on the Democratic side of the aisle, who would resist this approach. So while it adds allies, it also adds opponents. It is also not clear how this effort, without more, would work. How would Option 2 passthroughs be treated under section 1402? Section 1402 does not contemplate them, of course, and without amendments to section 1402, it is not an inevitability that the pass-through "wage payments" would be respected for self-employment tax purposes to the extent wage payments from S corporations may be. A court might conclude that the passthrough should be treated as a partnership under section 1402. It would be thus necessary to amend section 1402. That would have the benefit of bringing the issue to a head. But that likely is exactly what current users of S corporations do not want, as it would be very difficult to justify the avoidance of self-employment taxes. Thus, what looks like a provision S corporation users might support could end up being one that also causes them to oppose Option 2. However, perhaps the implied nod to self-employment tax avoidance was unintended, because TRA 2014 addresses this issue directly and very differently, as I discuss below.

¹³⁵ See Jackel, *supra* note 130, at 1366.

Option 2 has the equivalent of current section 707(b)(2). Thus, the capital gain freeze technique discussed above that is currently available with S corporations would no longer be available. This would endear the new provisions to almost no one (with the possible exception of a few law professors).

It adds the equivalent of current section 752, albeit one that is short on details.¹³⁶ As noted, its absence from Subchapter S had at times been a major problem for S corporation shareholders. So this would be a plus for them, but neutral to those operating under Subchapter K.

Option 2 permits most non-publicly traded C corporations¹³⁷ to elect the new Subchapter K. There are few other limits. In contrast with current Subchapter S, there is no limit on the number of shareholders, classes of ownership interest, or who may be a shareholder. Indeed, there is not even a requirement that the corporation be domestic. This election must be counted as a plus, as is the way it addresses existing double taxation issues, following current sections 1368 and 1374. An electing C corporation's earnings and profits would carry over to the new entity, which would be required to keep an accumulated adjustment account. Distributions in excess of that account would be treated as dividends to the extent of erstwhile earnings and profits. If the corporation sells assets it held while a C corporation within five years of election of the new Subchapter K, it must recognize a corporate level gain (and pay tax on that gain at the highest corporate tax rate) to the extent of the net gains inherent in corporate assets at the time of the election. If an S corporation elects the new Subchapter K, and current section 1374 applied to the S corporation, the new Subchapter K's section 1374 equivalent will apply. But the new passthrough gets credit against the five years for so much of that time period as applied while under the old rules. (Note that Option 2 reduces the current ten-year section 1374 window to five years.)

Option 2 continues current section 1375 and assesses a corporate level tax at the highest rate on excess passive investment income, if the passthrough has earnings and profits from its C corporation days. However, the current law threshold of 25% of gross receipts is increased to 60%.

Strikingly, Option 2 does not discuss the receipt of an ownership interest for services. Generally, currently the receipt

¹³⁶ See *id.* at 1364.

¹³⁷ Insurance companies, current or former domestic international sales corporations, and most banks may not make the election. See TECHNICAL EXPLANATION, *supra* note 127, at 43.

of a pure, future partnership profits interest for services is not income, while the receipt of stock in an S corporation is.¹³⁸ This is a highly controversial area, and certainly any new Subchapter K would need to address this issue.

Last, but far from least, Option 2 assesses a withholding tax on the passthrough based on an owner's distributive share of net ordinary income and net capital gains. The withholding percentage is not specified and can be different for ordinary income and capital gains if the owner's distributive shares are different. This would likely only come in second to eliminating special allocations for unpopularity. It is doubtless a well-intended measure to increase compliance, and indeed, improving compliance is a laudable objective. But there is a limit to how many unpopular measures you can load into a given tax act and expect to succeed. Option 2 is way past that limit.

Most current nonpublic C corporations that cannot qualify for current Subchapter S will find something to cheer about in Option 2. But there is little in Option 2 which would enthruse either a current Subchapter K or current Subchapter S supporter. Under those circumstances, it is difficult to see how Option 2 ever gets off the dime. But, as I noted above, it also constitutes a major impediment for other systemic reform proposals which likely would be at substantial variance with Option 2.

C. TRA 2014

A law professor could spend several years writing law review articles about this massive legislative proposal which takes no prisoners. Luckily, here I can be fairly brief. One overarching comment: While there is much I do not agree with in TRA 2014, one cannot fairly claim the drafters just played favorites. They took on some of the sacred cows of the wealthy. Also note that TRA 2014 retains both Subchapters K and S with changes and makes no attempt to implement Option 2.

One of the sacred cows that TRA 2014 takes on is the use of S corporations to avoid self-employment taxes. At the same time, the drafters make an attempt to address the problem of distinguishing income from services from income from capital. Under TRA 2014,¹³⁹ self-employment taxes would apply to general and limited partners of a partnership (including limited

¹³⁸ See I.R.C. § 83 (2012); Rev. Proc. 93-27, 1993-2 C.B. 343; Prop. Treas. Reg. § 1.83-3(e), 70 Fed. Reg. 29,675, 29,680 (May 24, 2005); Treas. Reg. § 1.83-3(e) (as amended 2014).

¹³⁹ TRA 2014, *supra* note 128, § 1502, at 32–33.

liability companies), as well as to shareholders of an S corporation to the extent of their distributive share of the entity's income or loss (except for Excluded Income). Partners and S corporation shareholders who materially participate¹⁴⁰ in the trade or business of the partnership or S corporation would treat 70% of their combined compensation and distributive share of the entity's income as net earnings from self-employment (and thus subject to self-employment taxes), and the remaining 30% as earnings on invested capital not subject to those taxes. For partners and S corporation shareholders who do not materially participate in the trade or business (TRA 2014 calls them, not always correctly, passive investors), none of the income would be subject to self-employment taxes.

The TRA 2014 Discussion Draft states that this distinction between net earnings from self-employment and other income reflects the fact that over the last several decades, the portion of GDP attributable to labor has remained remarkably constant at approximately 70%, while the portion of GDP attributable to capital has held steady at roughly 30%.

I believe that the drafters are to be commended both for taking on the use of S corporations to avoid self-employment taxes, and for attempting to distinguish income from services from income from capital. An across-the-board 70% / 30% split certainly has the advantage of setting a bright line. But, as I discussed above, for most service businesses, almost no income will come from capital, yet 30% will not be subject to self-employment taxes. For capital intensive businesses, 30% may be wildly low. A bright line that, likely more often than not, is at great disjuncture from reality, cannot be justified. The more nuanced approach like the one I suggest above is more likely to get to the right answer more often.

TRA 2014 also contains changes for tax partnerships and S corporations. For the most part, the TRA 2014 changes track Option 1 discussed above. One startling departure, however, is that TRA 2014 would repeal section 708. "Thus, [a] partnership would be treated as continuing even if more than 50 percent of the total capital and profits interests of the partnership are sold or exchanged, and new elections would not be required or permitted" (as they are currently).¹⁴¹ No explanation was given

¹⁴⁰ This term is taken from section 469, containing the so-called "passive loss rules." See I.R.C. § 469(c)(1)(B). Material participation is defined in Treasury Regulation section 1.469-5T in various ways. See Treas. Reg. § 1.469-5T(a) (1996). One way to materially participate is to participate in an activity over 500 hours per year.

¹⁴¹ TRA 2014, *supra* note 128, § 3619, at 119.

for this change, and it could be accused of fixing something that is not broken. It makes little sense to bind a partnership to elections it made when it had an entirely different set of partners. Indeed, repealing section 708 would often make it difficult to find parties to buy partnership interests. It is true that Option 1 eliminates some elections, but hardly all, and it is difficult to see this change as anything other than mystifying.

Another substantial, and vastly more defensible, addition to Option 1 is a new rule for carried interests. Fully engaging this topic would require a separate article, but suffice it to say that currently, partners performing services for investment partnerships are often able to have income from their services classified as capital gains. TRA 2014 takes on this sacred cow and classifies the income as ordinary in many circumstances.¹⁴²

TRA 2014 has no chance of ever being enacted. But, unlike Option 2, which as noted above might stifle discussion and reform, the boldness of TRA 2014 and its willingness to play hardball may indeed encourage discussion of important tax issues. With a little luck, TRA 2014 may jump-start genuine, large-scale tax reform.

CONCLUSION

While neither Option 2 of the Camp proposals nor TRA 2014 is politically realistic, the repeal of Subchapter S is likely possible if the use of S corporations for self-employment tax avoidance is stopped. The repeal of Subchapter S will make the U.S. tax system more efficient. The country does not need two pass-through business entity tax regimes, and only the repeal of Subchapter S is politically realistic. A few relatively modest Code changes permit the important, defensible benefits of Subchapter S to be retained. The repeal of Subchapter S allows the Service to make better use of its personnel. It also makes for readier reform of Subchapter K. The Treasury and Congress, their attention no longer divided between two tax systems, and their limited human resources no longer spread as thin, can bring greater focus to that task. Finally, the time has come to allow nonpublic C corporations to elect Subchapter K as well, ideally on a taxpayer-friendly basis. Shareholders should not be trapped with an antiquated choice.

¹⁴² *Id.* § 3621, at 120; see also Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1, 3–7 (2008). See generally Adam H. Rosenzweig, *Not All Carried Interests Are Created Equal*, 29 NW. J. INT'L L. & BUS. 713 (2009); David A. Weisbach, *The Taxation of Carried Interests in Private Equity*, 94 VA. L. REV. 715 (2008).

A Hitchhiker's Guide to Outbound International Tax Reform*

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INTRODUCTION

This Article will discuss operating principles for accomplishing international tax reform regarding U.S. persons (i.e., “outbound” international income tax reform). It also will discuss some specific reform proposals that we recommend be included in an international tax reform bill.

I. SOME SUGGESTED OPERATING PRINCIPLES FOR INTERNATIONAL TAX REFORM OF OUTBOUND TRANSACTIONS

A. International Tax Reform Should Be Part of an Integrated Reform Effort

Because the U.S. tax rules for international transactions involving U.S. persons do not operate in a vacuum, fundamental international tax reform needs to be part of a broad-scale reform of the U.S. tax system, rather than an independent project. To be specific, it is not possible to properly design the U.S. international tax rules for outbound transactions without knowing such things as whether fundamental corporate integration reform will be adopted, whether a capital gains preference will be retained and to what extent it will be broadened or narrowed, the general tax rate structure that will be adopted (including the top marginal rates on individuals and corporations, if corporations continue to be treated as separate taxpayers), how foreign persons will be defined and taxed, and

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how the tax system will treat complex financial products and intellectual property transactions (more generally as well as in the international tax rules). Resolution of these and other broadly foundational issues will have an important effect on any re-design of the U.S. international tax rules.

B. The International Tax Part of Tax Reform Should Not Lose Revenue

Given our large (although recently much-reduced) budget deficits, as well as many important and worthy competing direct government programs that need to be funded, the international component of tax reform should not result in a net reduction in tax revenues and probably needs to result in a net revenue increase. So, for example, a move to a territorial tax system that does not have serious anti-tax base erosion provisions (particularly with respect to intellectual property income) should be a non-starter since such a system would result in a net revenue decrease (and a potentially significant one). As another example, so-called simplification measures in the international area that lose significant revenue, such as those relating to the foreign tax credit and the anti-deferral regimes, as applied to large multinational corporations, should be non-starters in this era of budget austerity.

C. International Tax Reform Is Important to Perceived Fairness of the Tax System Overall

It is important that the international tax aspects of tax reform not undermine the actual and perceived fairness of the tax system. Public support for the tax system is indispensable in our self-assessed tax regime, and tax "reform" provisions that appear to substantially reduce, if not eliminate, the U.S. income tax on foreign income of U.S. multinational corporations ("MNCs") are likely to be perceived by the press and public as "special interest" provisions that result from well-funded lobbying efforts. Thus, although such provisions may involve relatively small amounts of revenue as compared with other features of the income tax system, such as the home mortgage interest deduction or the tax-deferred treatment of various healthcare and retirement savings vehicles, they are likely to undermine public support for the tax system.

D. International Tax Reform Should Not Extend or Enhance Tax Incentives to Shift Business and Investment Activities or Income Abroad

The international tax system should not be restructured in such a way as to create or enhance tax incentives to shift business and investment activities from the United States to low-tax or no-tax foreign countries. Such incentives strip the U.S. tax base of badly needed revenue and may result in loss of domestic jobs (although the economic evidence on this point is inconclusive).¹ Moreover, economic efficiency is undermined if taxpayers choose tax-favored foreign investments producing lower pre-tax returns over domestic investments with higher pre-tax returns that are fully subject to U.S. tax. This is one of our major concerns with territorial systems for taxing international income because those systems do encourage this inefficient behavior.²

E. Competitiveness Claims Have Been Largely Overstated and Unsubstantiated

Commentators who oppose making the current worldwide system into a real worldwide system and instead propose replacing the current U.S. international tax system with a territorial system often have argued that such a change is necessary to enhance the competitiveness of U.S. MNCs.³ The two of us, together with a third co-author (Stephen Shay), have taken the position that this advocacy is in substance an attempt to argue for a competitiveness subsidy provided through the tax

¹ It is clear, however, that in recent years the de facto territorial system of the United States has been correlated with substantial growth in the foreign employment of U.S. MNCs. See Sudeep Reddy, *Domestic-Based Multinationals Hiring Overseas*, WALL ST. J., Apr. 29, 2013, <http://online.wsj.com/news/articles/SB10001424127887324763404578430960988848252>; Martin A. Sullivan, *U.S. Multinationals Cut U.S. Jobs While Expanding Abroad*, 128 TAX NOTES 1102 (2010); Scott Thurm, *U.S. Firms Add Jobs, but Mostly Overseas*, WALL ST. J., Apr. 27, 2012, <http://online.wsj.com/news/articles/SB10001424052702303990604577367881972648906>.

² See, e.g., Jane G. Gravelle, *Foreign Tax Provisions of the American Jobs Act of 1996*, 72 TAX NOTES 1165, 1166 (1996).

³ See, e.g., STAFF OF THE JOINT COMM. ON TAXATION, THE IMPACT OF INTERNATIONAL TAX REFORM: BACKGROUND AND SELECTED ISSUES RELATING TO U.S. INTERNATIONAL TAX RULES AND THE COMPETITIVENESS OF U.S. BUSINESSES 5 (2006); R. Glenn Hubbard, *Tax Policy and International Competitiveness*, 82 TAXES 213, 242 (2004); Pamela F. Olson, Peter Merrill, Michael Mundaca, Michael Reilly & Jaime Spellings, *Staking New Ground: Exploring a Potential Territorial System of Taxation*, 90 TAXES 53, 60, 64–66 (2012); Phillip R. West, *Across the Great Divide: A Centrist Tax Reform Proposal*, 130 TAX NOTES 1025, 1040 (2011). For a commentator who supports adoption of an exemption system on the grounds that it would increase worldwide economic efficiency, rather than on competitiveness grounds, see Terrence R. Chorvat, *Ending the Taxation of Foreign Business Income*, 42 ARIZ. L. REV. 835 (2000).

system for the foreign business and investment activities of such U.S. corporations.⁴

In our work, we have pointed out numerous flaws in this competitiveness argument.⁵ Our most basic critique objects to defining competitiveness in terms of improving the after-tax profitability of already successful U.S. MNCs instead of defining it in terms of improving the living standard of American individuals.⁶ In our view, the appropriate focus of international and other tax reforms is on the effect of such reforms on the living standard for U.S. individuals, and the proponents of competitiveness theory/territorial taxation have failed to establish how this living standard will be enhanced by providing U.S. tax subsidies to U.S. MNCs with respect to their foreign business and investment activities.

Moreover, even if one were to define competitiveness with reference to its effect on the profitability of U.S. MNCs, the supporters of low or zero U.S. tax on the foreign-source income of those entities have never convincingly established with strong empirical evidence that U.S. MNCs need a tax subsidy to

⁴ For explanations of the subsidy effect of an exemption system, see J. Clifton Fleming, Jr. & Robert J. Peroni, *Reinvigorating Tax Expenditure Analysis and Its International Dimension*, 27 VA. TAX REV. 437, 528–41, 547–51 (2008) [hereinafter Fleming & Peroni, *Reinvigorating Tax Expenditure Analysis*]; J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Perspectives on the Worldwide vs. Territorial Taxation Debate*, 125 TAX NOTES 1079, 1091 (2009) [hereinafter Fleming, Peroni & Shay, *Worldwide vs. Territorial*]. Professor Edward Kleinbard has aptly opined that the competitiveness argument in favor of a territorial system “is indistinguishable from a call for export subsidies, on the grounds that other countries offer export subsidies.” Edward D. Kleinbard, *The Lessons of Stateless Income*, 65 TAX L. REV. 99, 129 (2011). For a leading commentator arguing that a territorial system, as is typically enacted, is a prohibited export subsidy under the General Agreement on Tariffs and Trade, see Reuven S. Avi-Yonah, *Tax, Trade, and Harmful Tax Competition: Reflections on the FSC Controversy*, 21 TAX NOTES INT’L 2841, 2843 (2000).

⁵ See Fleming, Peroni & Shay, *Worldwide vs. Territorial*, *supra* note 4, at 1085–86; J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Worse than Exemption*, 59 EMORY L.J. 79, 106–10 (2009) [hereinafter Fleming, Peroni & Shay, *Worse than Exemption*]; J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Designing a U.S. Exemption System for Foreign Income When the Treasury is Empty*, 13 FLA. TAX REV. 397, 456–59 (2012) [hereinafter Fleming, Peroni & Shay, *Designing a U.S. Exemption System*].

⁶ For example, the World Economic Forum defines competitiveness more broadly as “the set of institutions, policies, and factors that determine the level of productivity of a country.” WORLD ECON. FORUM, *THE GLOBAL COMPETITIVENESS REPORT 4* (2013), available at http://www3.weforum.org/docs/WEF_GlobalCompetitiveness_Report_2013-14.pdf. This Report focuses on twelve factors, which it terms “pillars,” in measuring each country’s competitiveness, including its institutions, infrastructure, macroeconomic environment, health and primary education, higher education and training, goods market efficiency, labor market efficiency, financial market development, technological readiness, business sophistication, innovation, and market size. Using this approach to measure competitiveness, the Report ranked the United States seventh overall in 2012–2013 and fifth overall in 2013–2014. See *id.* at 15; see also STAFF OF THE JOINT COMM. ON TAXATION, *PRESENT LAW AND ISSUES IN U.S. TAXATION OF CROSS-BORDER INCOME* 88 (2011) (noting this alternative approach to defining competitiveness).

compete successfully in the global marketplace.⁷ Indeed, a recent study by a leading public finance economist has concluded that the competitiveness argument “does not seem to have much empirical support.”⁸ This same study found an absence of strong empirical support for the argument that low U.S. tax burdens on U.S. MNCs’ foreign-source income increases U.S. domestic investment,⁹ another claim sometimes made by advocates for territorial taxation. In addition, another prominent public finance economist noted that the competitiveness argument conflicts with standard economic theory, stating: “It can generally be shown that the United States would still be better off, or at least no worse off, if it taxes foreign and domestic investments by its firms at the same rate, even if other countries do not.”¹⁰

Finally, even if one could establish that U.S. MNCs needed a subsidy funded through the U.S. international tax system, this subsidy, like other tax expenditures, should have to undergo a rigorous cost-benefit analysis in which it competes against other meritorious programs for the currently inadequate U.S. revenue stream.¹¹ Such a subsidy should be continued and broadened by Congress only if it survives this scrutiny.

F. Fairness Concerns About International Tax Reform Do Matter

We currently have a hybrid income tax system that is “heavily grounded on a fairness notion—that taxpayers should contribute to the cost of government in relationship to their comparative economic well being or ability-to-pay.”¹² Thus, if we

⁷ See U.S. DEPT OF THE TREASURY, THE DEFERRAL OF INCOME EARNED THROUGH U.S. CONTROLLED FOREIGN CORPORATIONS 56–57, 61 (2000), available at <http://www.treasury.gov/resource-center/tax-policy/Documents/subpartf.pdf>.

⁸ Harry Grubert, *Foreign Taxes and the Growing Share of U.S. Multinational Company Income Abroad: Profits, Not Sales, Are Being Globalized*, 65 NAT’L TAX J. 247, 268 (2012).

⁹ *Id.* at 257.

¹⁰ JANE G. GRAVELLE, CONG. RESEARCH SERV., R42624, MOVING TO A TERRITORIAL INCOME TAX: OPTIONS AND CHALLENGES 17 (2012) [hereinafter GRAVELLE, OPTIONS AND CHALLENGES], available at www.fas.org/sgp/crs/misc/R42624.pdf; see also ERIC TODER, TAX POLICY CTR., URBAN INST. & BROOKINGS INST., INTERNATIONAL COMPETITIVENESS: WHO COMPETES AGAINST WHOM AND FOR WHAT? 2 (2012), available at www.taxpolicycenter.org/publications/url.cfm?ID=412477.

¹¹ See Fleming & Peroni, *Reinvigorating Tax Expenditure Analysis*, *supra* note 4, at 439.

¹² J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Fairness in International Taxation: The Ability-to-Pay Case for Taxing Worldwide Income*, 5 FLA. TAX REV. 299, 350 (2001) [hereinafter Fleming, Peroni & Shay, *Fairness in International Taxation*]; see also AJAY K. MEHROTRA, MAKING THE MODERN AMERICAN FISCAL STATE: LAW, POLITICS, AND THE RISE OF PROGRESSIVE TAXATION, 1877-1929, at 8–15

are going to retain this hybrid income tax as a primary source of revenue at the federal government level (instead of, for example, shifting to a cash-flow consumption tax base), we must consider the impact of various international tax reform proposals on the distribution of the tax burden based on ability-to-pay. International tax reform proposals, such as many versions of territorial tax systems, which undermine the fair allocation of the income tax burden by removing most foreign-source active income from the tax base, should be enacted only if their demonstrable efficiency and simplification benefits outweigh their costs in terms of fairness. Although applying ability-to-pay fairness analysis to the international tax area is complicated by the facts that so much of the income is earned through C corporations and that foreign countries have competing claims to tax this income, fairness concerns should play an important role here as they do in other areas of tax reform.¹³ In our view, in the international tax area, fairness concerns have not received the attention they deserve in crafting specific reform proposals or in analyzing the tax policy efficacy of the various proposals.

G. Simplification Concerns Do Matter but May Have to Give Way to Efficiency and Fairness Concerns

The U.S. international tax system has many complex provisions and some (perhaps many) of those provisions could be substantially simplified without undermining their basic purpose. Needlessly complex tax provisions, including those in the international tax area, create a deadweight loss for society by increasing the costs of compliance for both taxpayers and the government, without achieving any offsetting economic benefit. Increased compliance costs can result in higher prices in goods and services for consumers and less capital being available for investment in productive businesses of the taxpayer.¹⁴ Increased administrative costs may lead to a less efficient collection of revenue by the government and fewer resources for worthy direct government programs. Therefore, simplification of the federal income tax, in general, and the international income tax provisions, in particular, is an important goal of any tax reform effort. However, it is important to remember that most foreign-source income is earned by sophisticated corporate taxpayers who have highly competent tax advisors to help them

(2013) (tracing the rise of the ability-to-pay concept as a fundamental principle of taxation in the United States).

¹³ See Fleming, Peroni & Shay, *Fairness in International Taxation*, *supra* note 12, at 354.

¹⁴ See U.S. DEPT OF THE TREASURY, INTERNATIONAL TAX REFORM: AN INTERIM REPORT 1 (1993) [hereinafter U.S. DEPT OF THE TREASURY, INTERIM REPORT].

navigate the complexity of the U.S. international tax rules. In fact, in many cases, these taxpayers voluntarily elect into complexity by structuring intricate transactions primarily to attain significant tax benefits (often in more than one country through tax arbitrage).¹⁵ Moreover, many international transactions are inherently complex; thus, the tax rules that govern them are likely to have a substantial and unavoidable amount of complexity as well. And the important competing considerations of efficiency and fairness may work at cross-purposes with simplicity concerns when constructing international tax reform proposals. Finally, compromise among competing objectives itself breeds complexity;¹⁶ coherent, principled systems are typically less complicated than hybrid systems resulting from compromise, but such coherence is difficult, if not impossible, to achieve in the give and take of the political process as legislation works its way through Congress. Thus, although tax simplification is an important aspect of tax reform, it is not likely to be the major focus of serious international tax reform efforts, particularly with respect to taxation of foreign business activities. Stated differently, whatever international tax rules emerge from the tax reform process are likely to be somewhat complex in nature (i.e., they may be simpler than current law but not simple), and other competing norms, such as economic efficiency and fairness concerns, are likely in many important specific cases to trump simplification concerns.

II. SOME SPECIFIC SUGGESTED INTERNATIONAL TAX REFORMS IN THE BUSINESS/INVESTMENT AREA

A. Making the Current U.S. System a Real Worldwide System (The First-Best Solution)

1. Introduction

The United States purports to have a worldwide system for taxing the income of U.S. persons; i.e., U.S. citizens, resident aliens, and domestic corporations are subject to tax on their worldwide incomes, regardless of source. To mitigate international double taxation, a foreign tax credit is allowed for qualifying foreign income taxes. The foreign tax credit is subject to a number of limitations. The most important of these are in section 904, which limits the total foreign tax credits in a taxable

¹⁵ See Robert J. Peroni, *A Hitchhiker's Guide to Reform of the Foreign Tax Credit Limitation*, 56 SMU L. REV. 391, 394 (2003) [hereinafter Peroni, *A Hitchhiker's Guide*].

¹⁶ See, e.g., U.S. DEP'T OF THE TREASURY, INTERIM REPORT, *supra* note 14, at 1.

year to the pre-credit U.S. tax liability on the foreign-source portion of a taxpayer's worldwide taxable income. Section 904 also prevents a taxpayer from offsetting (i.e., cross-crediting) high foreign taxes on non-passive foreign-source taxable income against the U.S. tax liability on passive foreign-source taxable income.¹⁷ However, the current U.S. international tax system has two important defects that undermine its potential as a true worldwide system—deferral and cross-crediting. Fundamental international tax reform needs to deal with those two defects and make the U.S. system a real worldwide system.

2. End Deferral by Enacting a Pass-Through Regime for U.S. Shareholders of Foreign Corporations or Some Other Full-Inclusion System

The first major defect (deferral) is that under current U.S. tax law, if a U.S. person invests abroad directly or through an unincorporated branch or pass-through entity, the U.S. person pays tax currently on the income earned abroad, subject to a foreign tax credit. By contrast, if the U.S. person earns foreign-source income through a separate foreign corporation, then the U.S. tax on the foreign-source income is generally deferred until it is repatriated to the United States through a distribution or until the U.S. person sells the foreign corporation's stock at a price that reflects the accumulated foreign income.¹⁸ This deferral privilege is subject to two principal exceptions (i.e., anti-deferral regimes), the controlled foreign corporation ("CFC") provisions of Subpart F in the Code (sections 951–965)¹⁹ and the passive foreign investment company ("PFIC") provisions (sections 1291–1298).²⁰ These highly complex anti-deferral regimes provide some restraint on the deferral privilege but are outdated and do not reflect the nature of modern global commerce. They are filled with loopholes and have not been restructured to address contemporary deferral tax-planning strategies. Thus, they do far too little in limiting deferral.

This deferral privilege operates as a tax subsidy accorded to U.S. taxpayers who locate their business and investment activities in low-tax or no-tax foreign countries, a tax subsidy

¹⁷ See I.R.C. § 904(a), (d)(1) (2012).

¹⁸ See, e.g., CHARLES H. GUSTAFSON, ROBERT J. PERONI & RICHARD C. PUGH, *TAXATION OF INTERNATIONAL TRANSACTIONS* 25, 303, 485–86 (4th ed. 2011).

¹⁹ I.R.C. §§ 951–965. For a detailed discussion of the Subpart F provisions, see 1 JOEL D. KUNTZ & ROBERT J. PERONI, *U.S. INTERNATIONAL TAXATION* ch. B3 (1992 & Supp. 2013).

²⁰ I.R.C. §§ 1291–1298. For a detailed discussion of the passive foreign investment company provisions, see 1 KUNTZ & PERONI, *supra* note 19, at ch. B2.

that would not survive rigorous cost-benefit scrutiny under a tax expenditure analysis.²¹ This deferral privilege also violates the tax policy goal of locational neutrality by encouraging U.S. corporations to shift business and investment activities to low- or zero-tax foreign countries and to engage in aggressive cross-border tax planning strategies that shift income (particularly from highly mobile intangible property) to low-tax foreign countries.²² Moreover, according to the most recent tax expenditure estimates by the Staff of the Joint Committee on Taxation, the deferral privilege results in the loss of about \$273.1 billion of revenue for fiscal years 2013–2017.²³ This foregone revenue could be better used for other purposes, including an across-the-board corporate tax rate reduction.

We have developed a proposed solution to this first defect (the untoward consequences of deferral). In a series of articles, we have recommended that deferral be ended by the United States enacting a pass-through system with respect to U.S. shareholders' shares of income earned by foreign corporations, at least with respect to 10-percent-or-more U.S. shareholders.²⁴ Such shareholders would be able to obtain direct foreign tax credits for any creditable foreign taxes paid with respect to the foreign income that passes through from the corporation. Thus, the indirect credit provisions of sections 902 and 960 would be repealed because they would no longer be necessary. Because deferral would be ended completely with respect to 10-percent-or-more U.S. shareholders of foreign corporations under this proposal, the Subpart F income provisions, with all of their complicated exceptions and operating rules, would be repealed. Previously taxed income rules would be retained to

²¹ See J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Deferral: Consider Ending It, Instead of Expanding It*, 86 TAX NOTES 837, 846 (2000) [hereinafter Fleming, Peroni & Shay, *Consider Ending Deferral*]; Robert J. Peroni, *Deferral of U.S. Tax on International Income: End It, Don't Mend It—Why Should We Be Stuck in the Middle with Subpart F?*, 79 TEX. L. REV. 1609, 1615 (2001) [hereinafter Peroni, *End It, Don't Mend It*]; Fleming & Peroni, *Reinvigorating Tax Expenditure Analysis*, *supra* note 4, at 528–41, 547–51.

²² See, e.g., GUSTAFSON, PERONI & PUGH, *supra* note 18, at 486, 488–89; Fleming, Peroni & Shay, *Worse than Exemption*, *supra* note 5, at 85–86, 96–97.

²³ See STAFF OF THE JOINT COMM. ON TAXATION, ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2012–2017 30 (Comm. Print 2013) [hereinafter STAFF OF JOINT COMM. ON TAXATION, ESTIMATES OF TAX EXPENDITURES].

²⁴ See Robert J. Peroni, *Back to the Future: A Path to Progressive Reform of the U.S. International Income Tax Rules*, 51 U. MIAMI L. REV. 975, 986–94 (1997) [hereinafter Peroni, *Back to the Future*]; Robert J. Peroni, J. Clifton Fleming, Jr. & Stephen E. Shay, *Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income*, 52 SMU L. REV. 455, 507–19 (1999) [hereinafter Peroni, Fleming & Shay, *Getting Serious*]; Fleming, Peroni & Shay, *Consider Ending Deferral*, *supra* note 21; Peroni, *End It, Don't Mend It*, *supra* note 21; Robert J. Peroni, *The Proper Approach for Taxing the Income of Foreign Controlled Corporations*, 26 BROOK. J. INT'L L. 1579 (2001).

ensure that income when distributed by the corporation to the shareholders is not taxed again at time of distribution. Transition rules would need to be carefully crafted to ensure that untaxed earnings deferred under prior law are subject to U.S. tax. A number of approaches to taxing such deferred earnings would need to be considered.

As a less drastic reform, but one that would still substantially improve the anti-deferral rules of current law, a new category of Subpart F income could be created for low-taxed foreign income.²⁵ The new category would not have exceptions for same-country income or for manufacturing income.²⁶

3. Substantially Restrict Foreign Tax Credit Cross-Crediting by Enacting a Per-Country Limit or Expanding the Number of Basket Limitations

The second major defect of the U.S. international income tax system (cross-crediting) is that under current U.S. tax rules, a U.S. taxpayer has substantial opportunities to essentially eliminate the residual U.S. tax (i.e., the U.S. tax remaining after allowance of the foreign tax credit) on foreign-source income that is subject to low or no foreign taxes by cross-crediting high foreign taxes on some types of active business income against the residual U.S. tax on other types of business income earned in low-tax or zero-tax jurisdictions, including many types of intellectual property income that are highly mobile and often lightly taxed. This means that the foreign tax credit is going beyond its primary function of preventing double taxation from discouraging efficiency-enhancing cross-border transactions. Instead, the foreign tax credit is being used by U.S. taxpayers to ensure that certain foreign income is not taxed anywhere.

The foreign tax credit limitations in section 904²⁷ have been substantially weakened by recent legislative developments, particularly the 2004 American Jobs Creation Act.²⁸ The 2004 legislation essentially gutted the foreign tax credit limitations by reducing the number of limitation categories in section 904 to two: the passive category income limitation and the general

²⁵ See J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Formulary Apportionment in the U.S. International Income Tax System: Putting Lipstick on a Pig?*, 36 MICH. J. INT'L L. (forthcoming 2014) [hereinafter Fleming, Peroni & Shay, *Putting Lipstick on a Pig*].

²⁶ See *id.*

²⁷ I.R.C. § 904 (2012). For a detailed discussion of the foreign tax credit limitation provisions in Section 904, see 1 KUNTZ & PERONI, *supra* note 19, at ch. B4.

²⁸ For our critique of the 2004 Jobs Act provisions, see J. Clifton Fleming, Jr. & Robert J. Peroni, *Eviscerating the Foreign Tax Credit Limitations and Cutting the Repatriation Tax—What's ETI Repeal Got To Do With It?*, 104 TAX NOTES 1393 (2004).

category income limitation.²⁹ In addition, the look-through rules in section 904(d)(3) that apply to royalties and other deductible payments from a controlled foreign corporation to its U.S. shareholders essentially place such payments in the same limitation basket as high-taxed foreign business income, where the U.S. residual tax on such payments is eliminated through foreign tax cross-crediting even though these payments are usually deductible and therefore untaxed in the jurisdiction in which the foreign corporation is organized.³⁰ Loose limitations on foreign tax cross-crediting provide a strong incentive for U.S. taxpayers with profitable, active businesses in high-tax foreign countries to locate other business and investment activities in low-tax or zero-tax foreign countries to exploit cross-crediting opportunities that reduce the U.S. residual tax on the lightly taxed foreign income.³¹ This is a violation of well-established economic efficiency norms.

We have also developed a proposed solution to this defect. In a number of articles, we have argued that our current international tax system needs to be made into a true worldwide system by enacting more serious limitations on cross-crediting.³² Our preference would be for Congress to enact a per-country foreign tax credit limit, with separate single-country basket limitations for both passive income and all other income arising within each individual country.³³ No other categories or baskets based on type of business income should be necessary under a per-country limit. The per-country limit does a better job of restricting cross-crediting than even the multi-basket foreign tax credit limitation enacted as part of the Tax Reform Act of 1986 and thus helps ensure that the foreign tax credit provisions accomplish their core purpose of ameliorating international double taxation, instead of creating untaxed foreign income. We believe that criticisms of the per-country limitation as being too

²⁹ See I.R.C. § 904(d)(1) (2004) (after enactment of the 2004 Jobs Act).

³⁰ See, e.g., Fleming, Peroni & Shay, *Worse than Exemption*, *supra* note 5, at 142–44.

³¹ See, e.g., Peroni, *A Hitchhiker's Guide*, *supra* note 15, at 393.

³² See Robert J. Peroni, J. Clifton Fleming, Jr. & Stephen E. Shay, *Reform and Simplification of the U.S. Foreign Tax Credit Rules*, 101 TAX NOTES 103 (2003) [hereinafter Peroni, Fleming & Shay, *Reform of the U.S. Foreign Tax Credit Rules*]; Peroni, *Back to the Future*, *supra* note 24, at 994–1000; Peroni, *A Hitchhiker's Guide*, *supra* note 15, at 394–95; Stephen E. Shay, J. Clifton Fleming, Jr. & Robert J. Peroni, *The David R. Tillinghast Lecture "What's Source Got to Do With It?": Source and U.S. International Taxation*, 56 TAX L. REV. 81 (2002) [hereinafter Shay, Fleming & Peroni, *Source and U.S. International Taxation*]; Fleming, Peroni & Shay, *Putting Lipstick on a Pig*, *supra* note 25.

³³ See Peroni, Fleming & Shay, *Reform of the U.S. Foreign Tax Credit Rules*, *supra* note 32, at 121–23; Peroni, *Back to the Future*, *supra* note 24, at 995–96; Peroni, *A Hitchhiker's Guide*, *supra* note 15, at 394–95; see also Shay, Fleming & Peroni, *Source and U.S. International Taxation*, *supra* note 32, at 153.

complex and unadministrable³⁴ are overstated and that it is possible to construct an administratively practicable per-country limitation.

As an alternative, we would recommend that the foreign tax credit baskets for certain types of lightly taxed and highly mobile business income be reinstated, e.g., the separate basket limitations for shipping income and financial services income. Even better, thought should be given to creating a separate basket limitation for low-taxed business income.³⁵

4. Other Reforms: Changes to the Source Rules

Source rules serve different purposes in international tax law. In the inbound foreign tax area governing the U.S. taxation of foreign persons, the source rules serve to help define the extent and limits of the U.S. income taxation of such persons. In the outbound context, they mainly serve to help define the amount of the foreign tax credit limitation. Yet the Internal Revenue Code often uses the same source rules for both functions.

Our view is that the source rules in the Code should be revised to reflect the purpose for which they are being used. So, in the foreign tax credit area, the source rules should be revised to generally treat income as foreign-source income for foreign tax credit limitation purposes "only if it is subject to a substantial tax by a foreign country that is consistent with international norms for asserting source-based taxing jurisdiction."³⁶ Thus, using this proposed approach, various types of income of U.S. residents that are typically not subject to taxation in a foreign country, such as space and ocean income, or international communications income, should be treated as U.S.-source income for foreign tax credit limitation purposes. Similarly, income that is exempt from U.S. tax by reason of a tax treaty between the United States and the country in which the income arises should be treated as U.S.-source income for foreign tax credit limitation purposes.³⁷ Finally, the inventory export source rule in sections 861(a)(6) and

³⁴ See, e.g., AM. LAW INST., FEDERAL INCOME TAX PROJECT: INTERNATIONAL ASPECTS OF UNITED STATES INCOME TAXATION 323-26, 328 (1987).

³⁵ See Fleming, Peroni & Shay, *Putting Lipstick on a Pig*, *supra* note 25. For discussion of earlier proposals to separate the general income limitation into a high-tax limitation basket and a low-tax limitation basket, see Michael J. McIntyre, *Separate Basket Limitations in Theory and in Practice*, 70 TAX NOTES 1393, 1398 (1996); Peroni, *Back to the Future*, *supra* note 24, at 999-1000.

³⁶ Peroni, *A Hitchhiker's Guide*, *supra* note 15, at 396; see Shay, Fleming & Peroni, *Source and U.S. International Taxation*, *supra* note 32, at 149-51.

³⁷ See Peroni, *A Hitchhiker's Guide*, *supra* note 15, at 396. Alternatively, such treaty-protected income could be placed in its own foreign tax credit limitation basket to prevent cross-crediting. See Julie Roin, *Rethinking Tax Treaties in a Strategic World with Disparate Tax Systems*, 81 VA. L. REV. 1753, 1775 (1995).

862(a)(6) results in export sales income being treated as foreign-source income by reason of the seller of inventory goods passing title to them abroad even though this income is usually not subject to foreign tax by reason of the foreign tax law itself or under a U.S. income tax treaty. This means that the U.S. seller/exporter can eliminate the U.S. residual tax on such export sales income through cross-crediting with foreign taxes on other highly-taxed foreign business income. This source rule makes little policy sense. Thus, under revamped source rules, income from inventory sales should be treated as U.S.-source income, unless the taxpayer has a foreign office or fixed place of business to which the inventory sale is attributable and which results in the taxpayer incurring a significant foreign income tax on such income.³⁸

5. Other Reforms: Expand and Revamp Earnings Stripping Rules in Section 163(j)

The earnings stripping rules in section 163(j) are designed to protect the U.S. tax base by disallowing interest deductions for U.S. tax purposes in situations where the recipient of the interest is exempt from U.S. income tax by reason of a tax treaty or otherwise. However, the provision is triggered only if a specified debt-equity ratio is exceeded and other rules substantially narrow its scope and reduce its effectiveness. Our view is that these rules should be broadened to cover other deductible payments such as royalties and service payments and that the trigger and other rules for calculating the limitation need to be substantially revised to broaden the impact of these limitations. We are currently working on another article in which we develop this thesis.

6. Other Reforms: Formulary Apportionment is No Panacea

U.S. MNCs might be expected to regard the present U.S. international income tax system as perfectly satisfactory³⁹ because, as discussed above, it creates ample opportunities to achieve a zero U.S. tax, and even a negative U.S. tax in certain cases.⁴⁰ However, the system relies on the highly complex

³⁸ See Peroni, *A Hitchhiker's Guide*, *supra* note 15, at 396; see also Shay, Fleming & Peroni, *Source and U.S. International Taxation*, *supra* note 32, at 151.

³⁹ Indeed, a major association of U.S. MNCs has expressed a preference for maintaining the current U.S. system while enlarging its loopholes. See Nat'l Foreign Trade Council, Inc., *The NFTC's Report on Territorial Taxation*, 27 TAX NOTES INT'L 687 (2002).

⁴⁰ See generally Fleming, Peroni & Shay, *Worse than Exemption*, *supra* note 5.

arm's-length method⁴¹ to allocate income between domestic parent corporations and their foreign subsidiaries, it is very complex in additional ways,⁴² it raises little revenue, it causes taxpayers to incur high tax-planning and transaction costs in order to create favorable results, and it imposes large administrative costs on the Internal Revenue Service ("IRS").

A U.S. exemption or territorial system would limit the United States to taxing only business income earned within its borders and foreign-source business income would be exempt from U.S. income taxation. Such a system would be simpler and would involve lower costs than the present U.S. system with regard to tax planning and enforcement. The current U.S. international income tax system indirectly creates virtually the same end result as an exemption system (no U.S. tax on foreign business income) through deferral and cross-crediting. Consequently there has been considerable interest in replacing the current system with an explicit territorial or exemption system that would directly, and more simply, impose a zero U.S. tax on foreign-source business income.

There are two types of explicit exemption systems: traditional territoriality and formulary apportionment. Traditional territoriality uses source rules and the above-mentioned arm's-length approach to distinguish between domestic-source business income that is subject to tax and exempt foreign-source income. This arm's-length approach⁴³ is widely criticized because it is highly complex, readily manipulable, very expensive for taxpayers to comply with and for the IRS to administer, theoretically incoherent,⁴⁴ and quite ineffective in dealing with the shifting of intangible property income to low-tax foreign countries.

The second type of territoriality is formulary apportionment. Instead of using the arm's-length method, it distinguishes between taxable domestic income and exempt foreign income by combining the worldwide incomes of a U.S. MNC and its foreign

⁴¹ The arm's-length method seeks to ascertain the prices that would be charged in transactions between related parties if they were independent entities dealing at arm's length and then to determine tax consequences as if those arm's-length prices had been used by the related parties. See I.R.C. § 482 (2012); Treas. Reg. §§ 1.482-1–1.482-9 (1994). For a detailed discussion of the arm's-length method and the provisions of section 482 and the regulations issued thereunder, see 1 KUNTZ & PERONI, *supra* note 19, at ch. A3.

⁴² For example, computation of the credit allowed by the United States for foreign taxes can be very complicated, as are the anti-deferral rules of Subpart F, as discussed above.

⁴³ See *supra* note 41 and accompanying text.

⁴⁴ The arm's-length method is theoretically incoherent in that it does not take into account the economic efficiencies of related-party business integration and probably cannot do so.

subsidiaries and then allocating this income to the United States (taxable income) and to foreign countries (exempt income) in proportion to the amounts of certain factors of production of the U.S. MNC and its subsidiaries that are located in the United States and in foreign countries. For example, if 75% of the relevant production factors of a U.S. MNC and its subsidiaries were located in foreign countries, 75% of the combined worldwide income would be exempt foreign-source income and the remainder would be domestic-source income taxable by the United States.

Both forms of territoriality are a poor second-best to real worldwide taxation because both forms require the revenue-constrained United States to give up a residual tax on business income earned in low-tax foreign countries, and both encourage U.S. MNCs to locate real business activity and the related employment in low-tax foreign countries where the resulting income is excluded from the U.S. tax base. The United States would do much better to follow our recommendations above, and adopt real worldwide taxation.⁴⁵

Territoriality advocates, however, push back against that recommendation and argue in favor of formulary apportionment as the way to achieve territoriality without the problems of the arm's-length method. The most often-discussed production factors that would be used by a formulary system in place of the arm's-length method to distinguish exempt foreign income from taxable domestic income are assets, payroll, and sales. Assets are a substantial proxy for business operations and payroll is an indisputable proxy for jobs. Thus, formulary apportionment clearly creates an incentive for U.S. MNCs to move their business operations and jobs, as well as their sales, to low-tax foreign countries because to the extent they do so, they shift their combined worldwide income into the exempt foreign category. The negative effect on the U.S. tax base and U.S. employment is clear.

Some formulary advocates have argued that sales are significantly immobile and cannot be shifted into a low-tax country. Thus, these advocates maintain that a formulary apportionment system that allocates the income of a U.S. MNC between the United States and foreign countries exclusively in proportion to U.S. sales and foreign sales will not result in the U.S. tax base migrating to low-tax foreign countries.⁴⁶

⁴⁵ See Fleming, Peroni & Shay, *Putting Lipstick on a Pig*, *supra* note 25.

⁴⁶ See Reuven S. Avi-Yonah, Kimberly A. Clausing & Michael C. Durst, *Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split*, 9 FLA. TAX REV. 497 (2009).

The validity of this argument depends on how the location of a sale is identified. If the longstanding U.S. title-passage rule is used in a formulary system with respect to sales of goods,⁴⁷ it will be easy to locate all sales of goods in low-tax countries, outside the U.S. tax base, by arranging sale terms so that title passes in low-tax locations.

Consequently, some have suggested locating sales of goods where the first sale to an independent buyer occurs.⁴⁸ If that test is used, then MNCs will move their sales out of the United States by selling their products to independent foreign distributors who sell into the United States. By imposing contractual performance and conduct standards on the foreign distributors, the U.S. MNCs can preserve most of the vertical integration advantages of doing their own distributing. And if sales of services are located where the work is done, the work can be performed in low-tax countries with delivery being made over the Internet.⁴⁹

The sales location approach to formulary appointment does have the salutary effect of ending the game of locating foreign intangibles in low-tax foreign countries and then creating low-tax foreign income by paying deductible royalties from subsidiaries in high-tax countries to intangible licensing subsidiaries in low-tax countries. This is because intra-group payments are irrelevant under a formulary system with combined reporting. MNCs can, however, approximate the result of this game by locating product sales in low-tax countries when product prices reflect high value intangibles.⁵⁰

The current U.S. system is badly in need of replacement. If a real worldwide system is not politically possible as a replacement choice, then in our view, either form of territorial system is preferable to the present bollixed U.S. international income tax system, and the issue is which of the two types of territorial system should be chosen.

Regarding whether a multilateral decision is possible, a few commentators believe that it is plausible to expect that the United States and the world's major economic powers can agree on a universal allocation formula that will uniformly apportion international income among them in a way that avoids double taxation and that they all accept as a reasonable accommodation of their tax claims. We see no evidence that this kumbaya hope is

47 See Treas. Reg. § 1.861-7(c) (1960) (providing that the location of a sale of goods is generally where the seller's rights, title, and interest pass to the buyer).

48 See Avi-Yonah, Clausing & Durst, *supra* note 46, at 509, 513.

49 See Fleming, Peroni & Shay, *Putting Lipstick on a Pig*, *supra* note 25.

50 *Id.*

plausible. If the United States is to adopt formulary apportionment, it will have to do so unilaterally.

In that context, the problem must be seen as a choice between (1) traditional territoriality that perpetuates the costly arm's-length transfer pricing method that has been very feeble in restraining the shifting of income from intangibles but does exercise a modicum of restraint on the shifting of income from sales of tangible property and (2) formulary apportionment that eliminates the arm's-length system but that creates virtually unrestrained income shifting opportunities. What a choice!

B. Properly Designed Exemption or Territorial System (A Second-Best Solution)

Thus, we strongly prefer avoiding the above-described dilemma by reforming the U.S. international tax system into a real worldwide system. However, if Congress instead decides to reform the system by adopting an exemption or territorial system, we believe that such a system, whether of the traditional or formulary variety, should be structured in such a way as to have measures that protect against tax base erosion and minimize the distortive economic effects of an exemption system. In addition, if a territorial system is properly designed, its adoption will actually raise revenue (rather than lose revenue) as compared with the current U.S. international tax regime. As we have more fully explained in a prior article,⁵¹ such a properly designed territorial system should not be based on unsupported competitiveness assertions and should have the following design characteristics:

1. Only active foreign business income that meets a subject-to-tax requirement should be eligible for exemption treatment. In other words, exemption treatment should not apply to dividends from a foreign corporation unless either a meaningful foreign tax has been paid with respect to the active business earnings from which the dividends are distributed or the dividend payor is a resident of a country that has a bilateral tax treaty with the United States that reciprocally waives this subject-to-tax requirement;⁵²

2. Passive income should not be eligible for exemption even in the rare cases where it has been subject to a meaningful

⁵¹ See Fleming, Peroni & Shay, *Designing a U.S. Exemption System*, *supra* note 5. For our earlier analysis of exemption proposals, see J. Clifton Fleming Jr. & Robert J. Peroni, *Exploring the Contours of a Proposed U.S. Exemption (Territorial) Tax System*, 109 TAX NOTES 1557 (2005).

⁵² Fleming, Peroni & Shay, *Designing a U.S. Exemption System*, *supra* note 5, at 413–26.

foreign tax. Such income is highly mobile and subject to locational choice largely based on tax considerations;⁵³

3. Royalties, interest, services payments, and other foreign-source items paid by a foreign corporation to a U.S. person that do not bear a significant foreign tax should not qualify for exemption treatment, even if they relate to an active foreign business;⁵⁴

4. The current tax exemption for 50% of the income from U.S. export sales, which is accomplished through cross-crediting and the inappropriate source rules in sections 861(a)(6), 862(a)(6), 863(b), and 865(b), and the regulations issued under those provisions, should be eliminated;⁵⁵

5. Qualifying income earned by a U.S. corporation through an unincorporated branch should be eligible for exemption, notwithstanding the various significant problems that need to be worked out in order to extend exemption treatment to branch income;⁵⁶

6. The allocation of domestic expenses to foreign-source exempt income must be accomplished in a more realistic and appropriate way than the inadequate 5-percent "haircut" that is part of some congressional territorial proposals⁵⁷ (i.e., under those proposals, 5% of the dividends received from a foreign corporation would not be eligible for exemption treatment as a substitute for applying actual allocation-and-apportionment rules to the U.S. corporate shareholder's expenses). We believe that either factually based allocation-and-apportionment rules (i.e., a reformed and modified version of the allocation-and-apportionment rules under current law) should apply to expenses incurred by a U.S. corporation or, alternatively, a more significant "haircut" (i.e., greater than 5%) should be used, and serious consideration should be given to having the percentage vary based on the industry in which the U.S. corporation's business income is earned (these varying percentages could be established by the Treasury Department through administrative guidance pursuant to specific statutory authorization);⁵⁸ and

⁵³ *Id.* at 426–28.

⁵⁴ *Id.* at 431–35.

⁵⁵ *Id.* at 435–38, 446–48.

⁵⁶ *Id.* at 441–45.

⁵⁷ See, e.g., Tax Reform Act of 2014, H.R., 113th Cong. § 245A(a) (2014) (the 95-percent participation exemption deduction in the second Camp proposal).

⁵⁸ Fleming, Peroni & Shay, *Designing a U.S. Exemption System*, *supra* note 5, at 448–52.

7. The exemption system should prohibit the deduction against U.S. taxable income of foreign losses arising from foreign business activities producing income eligible for exemption treatment. Allowing the deduction of such losses is inconsistent with fundamental income tax theory (i.e., a taxpayer should not be allowed the double tax benefit of exempting foreign-source business income from tax and deducting for U.S. tax purposes expenses that relate to such income) and would in some cases result in a negative effective tax rate on exempt foreign-source income.⁵⁹

As our earlier article explained, a territorial system lacking these features would go beyond the United States's international law obligation to alleviate international double taxation, and to that extent, the United States would simply be engaging in a relinquishment of badly needed tax revenue in favor of the U.S. multinational corporate community.⁶⁰ As we noted in that article, advocates of a U.S. territorial system for taxing foreign income would likely find the above-described design features that would raise revenue as *ipso facto* objectionable because, in their view, they would undermine the competitiveness effects of a U.S. exemption system.⁶¹ This response is often augmented by an argument that the United States must enact an exemption system lacking the design features described above, notwithstanding that it goes beyond the requirements of international law, represents bad tax policy, and loses badly needed revenue, because our trading partners have done so.⁶² Thus, in the view of these territoriality advocates, the United States must follow those other countries and vigorously join this race to the bottom, so that U.S. multinationals can compete on a level playing field with their foreign rivals.⁶³ This use of these

⁵⁹ *Id.* at 452–56; Fleming, Peroni & Shay, *Worse than Exemption*, *supra* note 5, at 116–17.

⁶⁰ Fleming, Peroni & Shay, *Designing a U.S. Exemption System*, *supra* note 5, at 458–59.

⁶¹ *Id.* at 459 (citing Barbara Angus, Tom Neubig, Eric Solomon & Mark Weinberger, *The U.S. International Tax System at a Crossroads*, 127 TAX NOTES 45, 59 (2010) (generally objecting to a subject-to-tax requirement)); Olson, Merrill, Mundaca, Reilly & Spellings, *supra* note 3, at 65 (same and also generally objecting to a territorial regime that raises revenue); Martin A. Sullivan, *Let's Promote the Competitiveness of All American Businesses*, 133 TAX NOTES 1175, 1179 (2011) [hereinafter Sullivan, *Promote Competitiveness of All*] (“U.S. multinationals are not interested in territorial systems . . . [that effect] an overall tax increase. Nor do U.S. multinationals want a territorial system that is revenue neutral relative to current law. They want a territorial system that reduces their taxes.”).

⁶² Fleming, Peroni & Shay, *Designing a U.S. Exemption System*, *supra* note 5, at 459.

⁶³ *Id.* But see GRAVELLE, OPTIONS AND CHALLENGES, *supra* note 10, at 17 (“[M]oving to a territorial system because other countries have generally done so does not mean such a system is desirable either for them or for the United States.”).

competitiveness arguments suffers from the same flaws as its application to the general question of whether the United States should adopt a territorial system as a replacement for the current U.S. international tax system.⁶⁴

In 2011 and early 2014, Representative David Camp released two draft proposals of a participation dividend exemption system for taxing foreign income.⁶⁵ Both drafts contain only some of the recommended features above and seem to be based on the unsubstantiated competitiveness claims by territorial proponents. Thus, we do not recommend that Congress adopt either version of the Camp proposal in their current forms. In order to mold Representative Camp's proposed territorial system into a principled regime that does not undermine the U.S. tax base, more work needs to be done with respect to anti-base erosion features and to excluding from territorial treatment income that has not been subject to meaningful income taxation in any country.

III. INTERNATIONAL TAX REFORM IN THE INDIVIDUAL TAXPAYER AREA

A. Repeal the Foreign Earned Income Exclusion in Section 911

Under section 911 of current law, a U.S. citizen or resident alien who meets either a bona fide residence test or physical presence test can exclude up to \$99,200 (as indexed for inflation for the 2014 year)⁶⁶ of foreign earned income⁶⁷ and a housing cost amount. Proponents of section 911 argue that it is necessary to make U.S. businesses that employ U.S. workers abroad competitive in the global marketplace by not requiring them to absorb the higher costs of their U.S. expatriate employees living and working abroad through higher pay to those workers that would have to be passed on to their customers in the form of

⁶⁴ Fleming, Peroni & Shay, *Designing a U.S. Exemption System*, *supra* note 5, at 459.

⁶⁵ See HOUSE COMM. ON WAYS & MEANS, TECHNICAL EXPLANATION OF THE WAYS AND MEANS DISCUSSION DRAFT PROVISIONS TO ESTABLISH A PARTICIPATION EXEMPTION SYSTEM FOR THE TAXATION OF FOREIGN INCOME (2011); STAFF OF THE JOINT COMM. ON TAXATION, TECHNICAL EXPLANATION OF THE TAX REFORM ACT OF 2014, DISCUSSION DRAFT OF THE CHAIRMAN OF THE HOUSE COMMITTEE ON WAYS & MEANS TO REFORM THE INTERNAL REVENUE CODE: TITLE IV—PARTICIPATION EXEMPTION SYSTEM FOR THE TAXATION OF FOREIGN INCOME (2014). For our critique of Representative Camp's first discussion draft of this proposed exemption system, see Stephen E. Shay, J. Clifton Fleming, Jr. & Robert J. Peroni, *Territoriality in Search of Principles and Revenue: Camp and Enzi*, 141 TAX NOTES 173 (2013).

⁶⁶ See Rev. Proc. 2013-35, 2013-47 I.R.B. 537, 543 (containing the inflation adjustments for 2014).

⁶⁷ See I.R.C. § 911(a), (b)(2)(D)(i) (2012).

higher prices.⁶⁸ However, it seems questionable for the U.S. tax system to provide a “subsidy to U.S. businesses that results in an understatement of the true costs of operating abroad, thereby providing a [tax] incentive” for those businesses to shift operations to foreign countries.⁶⁹ Moreover, this exclusion distorts individuals’ behavior by providing a tax incentive for U.S. workers to accept employment abroad rather than in the United States in situations where they would not have done so without the tax incentive.⁷⁰ In addition, the section 911 exclusion is not limited to U.S. individuals who work for U.S. employers abroad but also applies to U.S. individuals working for foreign employers, thus strangely providing a tax subsidy for such foreign employers to invest in business operations abroad with U.S. workers rather than in operations in the United States.⁷¹ This exclusion also violates the traditional tax policy criteria of horizontal and vertical equity and, thus, is inconsistent with the ability-to-pay concept that underlies an income tax base.⁷² Section 911 also adds complexity to the tax system with a provision that has many requirements that are the subject of detailed regulations⁷³ and many judicial and administrative interpretations.⁷⁴ Finally, according to the most recent tax expenditure estimates by the Staff of the Joint Committee on Taxation, section 911 results in the loss of about \$30.3 billion of revenue for fiscal years 2013–2017 from the foreign earned income exclusion and about \$6.1 billion of revenue for fiscal years 2013–2017 from the housing exclusion.⁷⁵ This foregone revenue (while not huge in relation to total U.S. budget expenditures) is badly needed for other purposes and section 911, if subjected to a rigorous cost-benefit, tax expenditure analysis, would surely fail

⁶⁸ See GUSTAFSON, PERONI & PUGH, *supra* note 18, at 455.

⁶⁹ *Id.*; see also Peroni, *Back to the Future*, *supra* note 24, at 1008.

⁷⁰ See GUSTAFSON, PERONI & PUGH, *supra* note 18, at 455; Peroni, *Back to the Future*, *supra* note 24, at 1008. In other cases, a U.S. taxpayer who would have worked abroad anyway is nonetheless receiving a windfall in the form of the U.S. tax avoided on the exclusion amount. See Renée Judith Sobel, *United States Taxation of Its Citizens Abroad: Incentive or Equity*, 38 VAND. L. REV. 101, 157–58 (1985).

⁷¹ See GUSTAFSON, PERONI & PUGH, *supra* note 18, at 455; see also Peroni, *Back to the Future*, *supra* note 24, at 1008.

⁷² See Peroni, *Back to the Future*, *supra* note 24, at 1008–09; see also Sobel, *supra* note 70, at 156–57 (criticizing the regressive nature of the section 911 exclusion). U.S. persons who work in the United States have to pay full U.S. tax on their earned income while those who choose to work abroad and earn the same amount of earned income can exclude it up to the limits in section 911. *Id.*

⁷³ See Treas. Reg. §§ 1.911-1–1.911-8 (2014).

⁷⁴ See, e.g., GUSTAFSON, PERONI & PUGH, *supra* note 18, at 453–75 (detailed casebook discussion of section 911 judicial and administrative authorities); 1 KUNTZ & PERONI, *supra* note 19, ¶ B1.04 (detailed treatise discussion of the section 911 judicial and administrative authorities).

⁷⁵ See STAFF OF JOINT COMM. ON TAXATION, ESTIMATES OF TAX EXPENDITURES, *supra* note 23, at 30.

such scrutiny. Thus, fundamental reform of the U.S. international tax rules should include repeal of this poorly designed and inequitable tax subsidy provision.⁷⁶

B. Expand the De Minimis Rule in Section 904(j) and Make It Mandatory

Section 904(j) of current law contains a de minimis rule that exempts certain individual taxpayers from the foreign tax credit limitations in section 904. The de minimis rule applies if an individual taxpayer's only foreign-source income for the taxable year is "qualified passive income" (i.e., passive income reported on the requisite payee tax information statement),⁷⁷ the creditable foreign taxes paid during the year do not exceed \$300 (\$600, for married taxpayers filing a joint return), and the taxpayer elects to apply the rule. This de minimis rule does help to simplify the tax law and seems to have worked well so far as it goes. It makes little sense to require individuals with limited amounts of foreign taxes and foreign income to navigate the complexities of the section 904 limitations. However, we believe that the de minimis rule is too narrow in scope and should cover a larger amount of foreign taxes (e.g., \$10,000 for single taxpayers and \$20,000 for married taxpayers filing a joint return).⁷⁸ We also would not require that the taxpayer's foreign-source gross income be limited to passive income and, instead, would apply the de minimis rule to taxpayers with foreign-source business income, provided that the amount of the creditable taxes does not exceed the dollar limitations (as expanded under this proposal) and the taxpayer's total foreign-source gross income on which the foreign taxes were imposed is not less than the amount of the foreign taxes to be credited.⁷⁹ The taxpayer, of course, would be required to identify and report as taxable income such income on his or her tax return for the taxable year for which the foreign tax credits were sought to be taken. Finally, there is no reason that this de minimis rule should be subject to election and, thus, we would have it apply whenever its requirements are met. However, we would continue to limit the availability of this de minimis rule to

⁷⁶ See Joseph M. Dodge, *Some income Tax Simplification Proposals*, 41 FLA. ST. U. L. REV. 71, 134–35 (2013) (advocated repeal of section 911). Note that the section 911 exclusion is not necessary to mitigate international double taxation because a U.S. citizen or resident alien who pays foreign income tax on his or her foreign earned income receives a U.S. credit for those foreign taxes (subject to the limitations in Section 904).

⁷⁷ See I.R.C. § 904(j)(3)(A) (2012).

⁷⁸ See Peroni, *Back to the Future*, *supra* note 24, at 1001; Peroni, *A Hitchhiker's Guide*, *supra* note 15, at 393–94; see also Dodge, *supra* note 76, at 135–36; David R. Tillinghast, *International Tax Simplification*, 8 AM. J. TAX POL'Y 187, 233–34 (1990).

⁷⁹ See Dodge, *supra* note 76, at 136.

individual taxpayers; the de minimis rule should not apply to corporate taxpayers.⁸⁰

CONCLUSION

International tax reform will not be easy and there is a great danger that Congress could make things worse by adopting a defective exemption system in place of our current less-than-ideal worldwide system. We have suggested a number of operating considerations that we hope are kept in mind in designing the international tax reform provisions. We have also suggested a number of specific international tax reforms that we hope will be adopted.

⁸⁰ Allowing corporate taxpayers to use this de minimis rule would undermine its simplification benefits and would create opportunities for individuals to abuse the rule by conducting integrated business operations in multiple corporate entities. See Peroni, *A Hitchhiker's Guide*, *supra* note 15, at 393 n.8.

The Function of Corporate Tax-Residence in Territorial Systems

Omri Marian*

INTRODUCTION

Under the U.S. “worldwide” (or “residence-based”) tax system, corporations that are considered “domestic” for tax purposes are generally taxed on their worldwide income from whatever source derived.¹ Foreign corporations are taxed in the United States only to the extent they earn income that is sourced within the United States. The U.S. residence-based system is frequently contrasted with “territorial” (or “source-based”) systems, variants of which are adopted by most member countries of the Organization of Economic Cooperation and Development (OECD).² In a territorial system, income is only taxed if it is derived from sources within the geographical boundaries of a jurisdiction. This is generally true whether the income is earned by foreign or domestic taxpayers. Foreign-source income (meaning, income sourced outside the jurisdiction’s geographical boundaries) is generally exempt from tax.

In a previous article, I outlined a functional approach to corporate tax-residence determination in residence-based systems.³ This Essay complements that article by explaining the

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¹ This rule is of course subject to multiple exceptions that enable U.S. domestic corporations to avoid current taxation on most foreign-sourced income. See, e.g., Edward D. Kleinbard, *Stateless Income*, 11 FLA. TAX REV. 699, 700 (2011) (describing the United States residence-based system as an “ersatz variant on territorial systems”); J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Worse than Exemption*, 59 EMORY L.J. 79 (2009) (surveying the U.S. exception to residence-based taxation, concluding it does not function as a residence-based system). The starting point of the analysis, however, is that U.S. corporations’ worldwide income is subject to corporate tax in the United States.

² See Omri Marian, *Meaningless Comparisons: Corporate Tax Reform Discourse in the United States*, 32 VA. TAX REV. 133, 163–65 (2012) [hereinafter Marian, *Meaningless Comparisons*].

³ Omri Marian, *Jurisdiction to Tax Corporations*, 54 B.C. L. REV. 1613 (2013) [hereinafter Marian, *Jurisdiction to Tax Corporations*].

functional importance of corporate tax-residence determination in territorial systems. I differentiate between “positive” and “negative” functionalities of corporate tax-residence in territorial systems. Under a positive approach, corporate tax-residence positively points to the source of income earned by the corporation. Thus, corporate taxes serve as a proxy to source taxation. While the positive function had historical merit, it is currently obsolete.⁴

Under a negative approach, corporate tax-residence is only relevant to the extent it prevents income from being sourced to a jurisdiction in which income could not have possibly been generated. As such, residence determination serves as an instrument to prevent income shifting and base erosion. I suggest that this is the correct role of residence determination in the current environment.⁵

More specifically, multinational corporations use multiple “income shifting” techniques to erode the tax base in jurisdictions in which income has economically been generated. Such techniques are aimed at manipulating the *source* of income for tax purposes by having income that has been generated in a high-tax jurisdiction reported as earned in a low-tax jurisdiction. Income shifting techniques necessitate the use of affiliate corporations resident in different jurisdictions. At least one of these corporations must be a tax resident in a low-tax jurisdiction, so income can be booked (i.e., shifted) to that foreign affiliate. Such foreign affiliates usually perform little or no real economic activity. Therefore, I suggest that residence determination in territorial systems should be constructed so as to make sure that such foreign affiliates are *not* respected as tax residents of jurisdictions where no real activity takes place.

The issue of residence determination in territorial systems is a timely one in the United States. In recent years, the idea to replace the U.S. residence-based system with a territorial one gained substantial traction. One recent example is a comprehensive tax reform draft suggested by David Camp, the Chairman of the House Committee on Ways and Means. Camp’s proposal adopts the territorial variant known as a “participation exemption” system.⁶ Under a participation exemption system,

⁴ See discussion *infra* Part II.C.

⁵ See discussion *infra* Part III.

⁶ HOUSE COMM. ON WAYS & MEANS, 113TH CONG., TAX REFORM ACT OF 2014 DISCUSSION DRAFT SECTION-BY-SECTION SUMMARY tit. IV, available at http://waysandmeans.house.gov/uploadedfiles/ways_and_means_section_by_section_summary_final_022614.pdf.

dividends paid by foreign subsidiaries of U.S. corporations, as well as capital gains from the disposition of foreign subsidiaries, and other foreign operations will be largely exempt from U.S. tax. A similar recent proposal has been brought forward by Michael Enzi, a member of the Senate Finance Committee.⁷

One common theme of these recent territorial-reform proposals is their complete ignorance of the issue of corporate tax-residence. While the reason for such ignorance is not explicit, it is possibly based on the assumption that in territorial systems—in which the question of jurisdiction is a question of source rather than residence—residence determination is meaningless.⁸ This is wrong. The reason is that in many instances the source of income is keyed off the residence of a corporation. Income from dividends and interest payments is sourced to the residence of the paying corporation.⁹ Capital gains from the sale of a corporate subsidiary's stock are sourced to the residence of the corporate seller.¹⁰ There are other examples where source of income is directly linked to the residence of the taxpayer.¹¹ These source rules play an important role in intercompany payments that stand in the basis of income shifting techniques. Questions of source and residence are not really separate jurisdictional questions. Residence is used to manipulate source, and as such can be designed to prevent such manipulation.

Currently, the United States uses a formal test for corporate residence determination—the place of incorporation (POI). This test is notoriously easy to manipulate. All that one has to do in order to create a “foreign” affiliate in a tax haven is to incorporate one. Leaving this test intact under a territorial system may exacerbate the problem of income shifting.

⁷ United States Job Creation and International Tax Reform Act of 2012, S. 2091, 112th Cong. tit. I (2012).

⁸ See Marian, *Jurisdiction to Tax Corporations*, *supra* note 3, at 1630.

⁹ See Yariv Brauner, *An International Tax Regime in Crystallization*, 56 TAX L. REV. 259, 281 (2003) (“The basic rule sources the interest income to the country of the payor Most countries consider the residence of the payor as the country of source.” And “[a] powerful consensus also exists with respect to the source rules for dividends. They are sourced at the country of the dividends’ payor, which allows the source country to get the ‘first bite’ of taxation.”).

¹⁰ HUGH J. AULT & BRIAN J. ARNOLD, *COMPARATIVE INCOME TAXATION: A STRUCTURAL ANALYSIS* 539 (3d ed. 2010) (“[M]ost countries generally accept the international treaty norm that capital gains on shares are taxable only in the residence country of the shareholder.”).

¹¹ For some additional examples in the U.S. context, see I.R.C. §§ 861–863 (2012) (source depends on residence in the context of guarantee fees, communications income, certain sales through fixed place of business, and more).

This Essay continues as follows: In Part I, I explain the functional approach to corporate tax-residence determination. In short, the functional approach requires that tax-residence models will be constructed so as to support the policy purpose for which corporations are taxed in the first place. In territorial systems, any corporate-tax construct (including residence) can only make sense if it operates to assure that income produced in a specific jurisdiction is taxed in that jurisdiction. In Part II, I explore the possible functionalities of residence determination in supporting territorial taxation, using the United States as a case study. Historically, tax-residence positively functioned as a proxy to the source of income. Today, however, such function can no longer stand. In Part III, I discuss an alternative instrumentality of residence determination in territorial systems. Residence can have a negative functionality, namely it can point to jurisdictions that are clearly *not* the source of income. As such, residence determination functions as an anti-income-shifting mechanism. One way to achieve such a function is to adopt tax-residence determination that is based on formulary apportionment that takes into account a corporation's contribution to the control group earnings (though there are other tests that may achieve similar results). I conclude with a call to consider corporate-residence determination in U.S. territorial reform proposals.

I. THE FUNCTIONAL APPROACH TO CORPORATE TAX-RESIDENCE

A. The Functional Approach in Residence-Based Systems

Corporate tax-residence, namely, the determination whether a corporation is "domestic" or "foreign" for tax purposes, is a foundational legal construct. The tax-residence heavily affects the tax liability of the corporation and its affiliates. Unfortunately, corporate tax-residence is meaningless as a normative construct. The reason is that corporations are not real beings; they are imaginary entities. Corporations are not, in and of themselves, the target of policy making.¹² Rather, corporations are instruments. Corporations are used by their individual interest holders (such as shareholders, creditors, managers, and employees) to achieve certain goals. In turn, corporations are

¹² Daniel Shaviro, *The David R. Tillinghast Lecture: The Rising Tax Electivity of U.S. Corporate Residence*, 64 TAX L. REV. 377, 395 (2011) ("After all, corporations are not sentient beings, and cannot feel benefits or burdens. Thus, they are not directly of normative interest.").

targeted by policy makers to affect individuals who are involved with corporations.

Taxation of corporate entities is not different. Corporate taxes are one of the most common forms of taxation around the world. But it is not the corporations that are burdened by such tax. Individuals are.¹³ For example, shareholders may see a diminished net return on their investment as a result of the tax imposed at the corporate level. Alternatively, employees may bear the burden through decreased wages. Or, it may be the case that consumers are affected if corporate taxes are capitalized into the pricing of the corporate products and services.¹⁴

Given that corporations are nothing more than an instrumentality, I have suggested in a previous article that corporate tax-residence determination must also be instrumental to the policy of corporate taxation.¹⁵ Namely, in formulating a model for corporate tax-residence determination, we must work through two steps. First, define the policy purposes for which we tax corporations. Specifically, we must identify the group (or groups) of individuals whom we wish to burden by taxing corporations. The second step is to adopt the tax-residence test that best supports the policy purpose we identified. A corporate tax-residence test (as well as any corporate-tax construct, in fact) is only successful if it assures that corporate taxes eventually burden the intended individuals.

In residence-based systems, such as the United States, the underlying assumption is that there is a group or groups of individuals, the income of whom we wish to tax on a worldwide basis. Corporate tax is just an instrument to reach at the pockets of these individuals. Depending on who these individuals are, we may adopt different tax-residence tests.¹⁶ For example, if those individuals are shareholders, we may choose to determine the residence of corporations based on where the majority of shareholders reside. If we aim to burden the managers of corporations (in their capacity as managers), we might choose to

¹³ The question of who those individuals are is unresolved and subject to a lively academic debate. See Marian, *Meaningless Comparisons*, *supra* note 2, at 161–62.

¹⁴ See WILLIAM M. GENTRY, OFFICE OF TAX ANALYSIS, U.S. DEPT OF THE TREASURY, OTA PAPER 101, A REVIEW OF THE EVIDENCE ON THE INCIDENCE OF THE CORPORATE INCOME TAX 1 (2007) (“[C]orporate tax could be borne by some combination of the shareholders of corporations, investors in all capital through a decrease in the overall return to capital, workers through a decrease in wages, and customers through increased output prices.”).

¹⁵ Marian, *Jurisdiction to Tax Corporations*, *supra* note 3.

¹⁶ For a discussion of possible groups of individuals who may be the normative targets of corporate tax policy, see *id.* at 1638–49.

subject corporations to tax in the jurisdiction in which the corporate headquarters is located.

B. The Functional Approach in Territorial Systems

The assumption that corporate taxation is an instrument to tax the worldwide income of certain individuals cannot stand in territorial systems of taxation. The reason is that in territorial systems, a policy choice has already been made to only tax income sourced within the jurisdiction, regardless of the residency of the taxpayers earning such income. In our quest to determine the “correct” corporate-residence in territorial systems, we therefore must start with a positive assumption that territorial taxation is superior, as a policy matter, to worldwide taxation.¹⁷

Under a functional approach to territorial taxation, we could justify the taxation of corporate entities only to the extent it supports source-based taxation. Namely, that taxing a corporate entity somehow assures that income is subject to tax in the jurisdiction in which it has been created. This should be true regardless of the identity of the individuals involved with the corporation. This concludes the first step of the functional analysis of corporate tax-residence determination in territorial systems. In the next two parts, I address the second part of the analysis. Meaning, how different models of corporate tax-residence may functionally support source-based taxation.

II. THE “POSITIVE FUNCTION” OF CORPORATE TAX-RESIDENCE

A. Corporate-Residence as a Proxy for Source

The first obvious possible territorial instrumentality of corporate tax-residence is that residence of a corporation positively identifies the source of income. Under this approach, income earned by a corporation that is a tax-resident in jurisdiction X is assumed to be sourced in jurisdiction X. Similarly, payments made by a corporation resident in jurisdiction X (for example, dividend or interest payments) are assumed to be sourced in jurisdiction X. I refer to this function as the “positive function” of corporate tax-residence.

¹⁷ This is probably one of the most contested issues in international tax literature, and beyond the scope of this Essay; I assume that for whatever reason, policy makers have reached a conclusion that a territorial system of taxation is preferable. For a summary of arguments in the debate on territorial versus worldwide systems (as well as other tax methods), see JANE G. GRAVELLE, CONG. RESEARCH SERV., RL34115, REFORM OF U.S. INTERNATIONAL TAXATION: ALTERNATIVES 1 (2012).

The positive approach is very much apparent in the current system of international taxation. For example, practically all countries in the world source interest and dividend payments to the country of residence of the paying corporation.¹⁸ The philosophical underpinning for this rule is that the payments should be sourced to the place where the economic activity supporting the payment is taking place.¹⁹ Since it is the economic activity of the corporation that supports that payment, income should be sourced to the residence of the corporation. For this justification to make sense, however, we must add one additional logical link: we must assume that the economic activity of a corporation indeed takes place where the corporation resides for tax purposes.

Historically, this assumption seems to have had some traction. In 1923, the League of Nations commissioned a group of economists to study the taxation of cross-border transactions.²⁰ The resulting report proved to be an influential tax policy document.²¹ The report explicitly linked residence of business entities and the source of income earned by such entities. For example, the report referred to the “seat and residence” of a business as one of the four elements of “economic allegiance,” which in turn is one of the possible bases upon which the imposition of tax may be justified.²² The report acknowledged, however, the complexity associated with such an assumption. When discussing the source of dividends, for example, the report considered the “fact that the company may produce its goods in one State and sell them in another, or have its chief office in one State and yet secure most of its earnings from sales in other States.”²³ This may result in “multiplicity of the claims of origin” of the dividends.

Today, the positive view is sometimes used to explain the allocation of taxing jurisdictions on international income in the context of bilateral income tax treaties. Such treaties are

18 See generally Brauner, *supra* note 9; AULT & ARNOLD, *supra* note 10 and accompanying text.

19 See, e.g., Richard Vann, *International Aspects of Income Tax*, in TAX LAW DESIGN AND DRAFTING II 718, 722 (Victor Thuronyi ed., 1996).

20 Fin. Comm. Econ. & Fin. Comm'n, *Report on Double Taxation*, League of Nations Doc. E.F.S. 73 F. 19 (1923), available at <http://setis.library.usyd.edu.au/pubotbin/toccer-new?id=brulegi.sgml&images=acdp/gifs&data=/usr/ot&tag=law&part=1&division=div1> [hereinafter *Report on Double Taxation*].

21 It is argued that a coherent international tax regime exists and that its principals have been developed by the 1923 document. See Reuven S. Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 TEX. L. REV. 1301, 1303 (1996).

22 See *Report on Double Taxation*, *supra* note 20.

23 *Id.*

instruments that determine how income from cross-border transactions is allocated between the two signatory countries. Most treaties are based on a model published by the OECD. Professor Richard Vann concludes that under the OECD model, corporate tax functions as a “source tax” for business activities.²⁴ As Vann explains, tax treaties regularly provide that business income earned in a contracting state through a “permanent establishment” of a foreign taxpayer is taxed at source (i.e., the jurisdiction where the foreign taxpayer’s permanent establishment is located).²⁵ Permanent establishment is usually a fixed place of business, which is not legally separate (for example, by way of incorporation) from the controlling foreign taxpayer.²⁶ Business income earned not through a permanent establishment is generally exempt from source taxation.

However, foreign taxpayers may operate in the country of source not through permanent establishments, but rather through controlled subsidiaries that are respected as separate from their owners. Generally, holding the stock of a corporation does not give rise to a permanent establishment of a shareholder in the subsidiary’s jurisdiction. However, under the tax treaty network, such domestic subsidiaries are generally subject to tax jurisdiction in their country of residence. Thus, the taxation of domestic subsidiaries controlled by a foreign taxpayer “is in policy terms a source tax” on income of the controlling foreign taxpayer.²⁷ This equates the treatment of income earned by a foreign taxpayer operating through a permanent establishment with income earned through a subsidiary.

B. The Historical Success of the Positive Function in the United States

I now turn to the question of whether the positive approach has any merit in the context of international tax reform in the United States. The approach made historical sense. Namely, when the corporate tax-residence test was first formulated, it was reasonable to assume that the residence of a U.S. corporation positively pointed to the source of income earned by the corporation.

²⁴ Richard Vann, “*Liable to Tax*” and *Company Residence Under Tax Treaties*, in *RESIDENCE OF COMPANIES UNDER TAX TREATIES AND EC LAW* 197, 199 (Guglielmo Maisto ed., 2009) [hereinafter *RESIDENCE OF COMPANIES*].

²⁵ OECD, COMM. ON FISCAL AFFAIRS, MODEL TAX CONVENTION ON INCOME AND ON CAPITAL Art. 7 (2010), available at http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/model-tax-convention-on-income-and-oncapital-2010_9789264175181-en.

²⁶ *Id.* Art. 5.

²⁷ Vann, *supra* note 24, at 199–200.

Early U.S. corporate tax laws were justified as an instrument targeting either managers or shareholders. Such policy considerations were largely devoid, however, of international considerations. It was not until the third decade of the twentieth century that the U.S. worldwide, residence-based approach to international tax began to take shape.²⁸ However, as I explain below, late nineteenth to early twentieth century U.S. corporate taxes functionally operated as a source-based mechanism, and the residence test adopted back then made functional sense. That was the case whether the policy aim was shareholders or managers.

1. Why Did the United States Start to Tax Corporations?

The reasons for which Congress originally enacted corporate income tax laws are disputed. According to one reasoning, the first attempt by Congress to adopt a general tax on corporate profits—in the Tariff Act of 1894²⁹—was influenced by real entity theory of the corporation prevalent at that time.³⁰ Real entity view of the corporation would theoretically support the taxation of corporations separately from their shareholders. As a historical explanation, however, entity theory is largely rejected by modern scholars,³¹ with one commentator going as far as to note that “advances in the theory of corporate personality appear to have had only a modest influence, if any, on the taxation of the corporation.”³²

Currently, accounts explaining the emergence of corporate taxation in the United States generally follow one of two main

²⁸ Michael J. Graetz & Michael M. O'Hear, *The “Original Intent” of U.S. International Taxation*, 46 DUKE L.J. 1021, 1026 n.23 (1997) (referring to 1918–1928 as the “formative period” of U.S. international taxation); Reuven S. Avi-Yonah, *All of a Piece Throughout: The Four Ages of U.S. International Taxation*, 25 VA. TAX REV. 313, 317 (“The formative period of the U.S. international tax regime . . . was . . . the period between the two World Wars.”).

²⁹ The 1894 Act imposed a 2% tax on the net income of all “corporations, companies, or associations doing business for profits in the United States.” Tariff Act of 1894, ch. 349, § 32, 28 Stat. 509, 556. The Act was struck down as unconstitutional by the Supreme Court in *Pollock v. Farmers’ Loan & Trust Co.*, 157 U.S. 429, *aff’d on reh’g*, 158 U.S. 601 (1895).

³⁰ See GEORGE K. YIN & DAVID J. SHAKOW, AM. LAW INST., FEDERAL INCOME TAX PROJECT, TAXATION OF PRIVATE BUSINESS ENTERPRISES: REPORTERS’ STUDY 36–40 (1999) (arguing for a connection between the development of real entity theories of corporations and taxation of corporations as separate entities).

³¹ Reuven Avi-Yonah, *Corporations, Society, and the State: A Defense of the Corporate Tax*, 90 VA. L. REV. 1193, 1209 (2004) (explaining the reasons for which real-entity view of corporate tax is “unpersuasive”); Steven A. Bank, *Entity Theory as Myth in the Origins of the Corporate Income Tax*, 43 WM. & MARY L. REV. 447, 466 (2001) [hereinafter Bank, *Entity Theory as Myth*].

³² Bank, *Entity Theory as Myth*, *supra* note 31.

paths. According to one theory, corporate taxes as a real entity measure were first enacted in 1909, primarily as a regulatory device.³³ The tax reflected negative sentiment in Congress towards large-scale business entities³⁴ that accumulated substantial power towards the end of the nineteenth century. Influential corporate managers were identified as a source of abuse of power.³⁵ It has therefore been suggested that “the imposition of the corporate tax will enable the government, the shareholders and the public to obtain information that will serve as the basis for restricting such managerial abuses of power.”³⁶ Under this approach, the 1909 Act was an attempt to restrict managerial power.³⁷

Under a second theory, “corporate income tax was originally adopted as a substitute or ‘proxy’ for taxing corporate shareholders directly,”³⁸ and the 1909 Act was simply part of a continuous attempt to tax shareholders’ wealth accumulated by doing business in corporate form.³⁹ Congress imposed taxes on companies in the transportation, banking, and insurance industries—all industries dominated by the corporate form of doing business—as early as 1864.⁴⁰ With the proliferation of general incorporation laws during the second half of the nineteenth century, corporations came to dominate most businesses, making the industry-specific approach inadequate.⁴¹ The 1894 Act is seen as the first explicit federal attempt to systemically get at shareholders’ wealth through the taxation of corporations.⁴² After the 1894 Act was struck down by the

33 Reuven Avi-Yonah, *Why Was the US Corporate Tax Enacted in 1909?*, in 2 STUDIES IN THE HISTORY OF TAX LAW 377 (John Tiley ed., 2007) [hereinafter Avi-Yonah, *Why Was the US Corporate Tax Enacted?*]; Avi-Yonah, *supra* note 31, at 1217–20; Marjorie E. Kornhauser, *Corporate Regulation and the Origins of the Corporate Income Tax*, 66 IND. L.J. 53 (1990).

34 Ajay K. Mehrotra, *The Public Control of Corporate Power: Revisiting the 1909 U.S. Corporate Tax from a Comparative Perspective*, 11 THEORETICAL INQUIRIES L. 497, 510 (2010); see also Bank, *Entity Theory as Myth*, *supra* note 31, at 508–11.

35 Avi-Yonah, *supra* note 31, at 1220 (citing President Taft’s Message to Congress, 44 CONG. REC. 3344 (1909)).

36 Avi-Yonah, *Why Was the US Corporate Tax Enacted*, *supra* note 33, at 383.

37 *Id.* at 382–87.

38 Bank, *Entity Theory as Myth*, *supra* note 31, at 452; see also Steven A. Bank, *Entity Theory as a Myth in the US Corporate Excise Tax of 1909*, in 2 STUDIES IN THE HISTORY OF TAX LAW, *supra* note 33, at 393, 393 [hereinafter Bank, *US Corporate Excise Tax of 1909*].

39 Bank, *US Corporate Excise Tax of 1909*, *supra* note 38, at 395.

40 Bank, *Entity Theory as a Myth*, *supra* note 31, at 504–05.

41 *Id.* at 505–08 (describing the dramatic increase in doing business through a corporate form toward the end of the nineteenth century).

42 *Id.* at 462 (“The simultaneous income taxation of individuals and corporations was unprecedented at the federal level . . .”).

Supreme Court,⁴³ Congress reverted back to its industry-specific course of action in the War Revenue Act of 1898,⁴⁴ which imposed certain taxes on corporations engaged in the sugar and oil businesses. In its original version, the 1898 legislative proposals were broad enough to encompass all incorporated entities.⁴⁵ Congress ultimately rejected the idea in favor of taxation of two specific industries, sugar and oil.⁴⁶ However, “it was commonly understood that the object of the tax was two concerns—the Standard Oil Company and the American Sugar Refining Company.”⁴⁷ General taxation of all corporate entities was reintroduced in the 1909 Act, which was evidently tailored so as to withstand constitutional challenges, again as a mechanism to get at shareholders’ wealth.⁴⁸

2. Place of Incorporation Test Functioned to Support Source-Based Taxation

Assuming any of the historical justifications for U.S. corporate taxation are plausible, did corporate tax-residence constructs support such purposes? Tax-residence of corporations was first explicitly defined in the War Revenue Act of 1917.⁴⁹ Section 200 of the 1917 Act defined a “domestic” corporation to be any corporation “created under the law of the United States, or of any State, Territory, or District thereof.”⁵⁰ This definition—using the place of incorporation (POI) as the sole determinant of corporate tax residency—survives almost unchanged to this day.⁵¹ Curiously, the definition did not appear in the early version of the bill. Congressional records provide no explanation for the definition’s sudden appearance in the bill’s conference version.⁵²

⁴³ *Pollock v. Farmers’ Loan & Trust Co.*, 157 U.S. 429, *aff’d on reh’g*, 158 U.S. 601 (1895).

⁴⁴ War Revenue Act of 1898, ch. 448, 30 Stat. 448.

⁴⁵ See Bank, *US Corporate Excise Tax of 1909*, *supra* note 38, at 396–98 (discussing the original bill of the 1898 Act).

⁴⁶ The 1898 Act did not clearly define the corporations that were the subject of the tax. Rather, it defined the taxpayers subject to the tax by describing the business sectors in which they were engaged. Section 27 of the 1898 Act imposed the tax on “every person, firm, corporation, or company carrying on or doing the business of refining petroleum, or refining sugar.” 30 Stat. at 464.

⁴⁷ Bank, *US Corporate Excise Tax of 1909*, *supra* note 38, at 399.

⁴⁸ *Id.* at 400–01.

⁴⁹ War Revenue Act of 1917, ch. 63, § 200, 40 Stat. 300, 302.

⁵⁰ *Id.*

⁵¹ Under current I.R.C. § 7701(a)(4), a domestic corporation is any corporation “created or organized in the United States or under the law of the United States or of any State.” I.R.C. § 7701(a)(4) (2012).

⁵² The definition of “domestic” did not appear in early versions of the bill. See, e.g., H.R. REP. NO. 65-45 (1917). The first time the definition appeared in any formal version

However, the 1917 Act was merely a semantic change to an already functioning jurisdictional concept. Specifically, the same jurisdictional concepts had already been clearly established by the 1909 Act. Even though the 1909 Act did not explicitly define the terms "domestic" or "foreign" corporations, taxing jurisdiction applied, much like the 1917 Act, to

every corporation, joint stock company or association, organized for profit and having a capital stock represented by shares . . . *organized under the laws of the United States or of any State or Territory of the United States* . . . [or] organized under the laws of any foreign country and engaged in business in any State or Territory of the United States.⁵³

However, in the case of corporations organized under the laws of foreign countries, the tax applied to net income "from business transacted and capital invested within the United States."⁵⁴

Once again, the 1909 legislators left very little guidance, and certainly no explicit explanation, as to their adoption of the POI test.⁵⁵ One commentator, Rudolf Weber-Fas, expressed skepticism that any rationale for adopting the POI test in the United States existed at all,⁵⁶ and speculated that—given the minor role of international trade in U.S. economy at that time—international tax considerations have not been a source of "principal legislative concern."⁵⁷ Weber-Fas concluded that it is likely Congress simply adopted the POI test because it was used by many states at the time.⁵⁸

Indeed, during the nineteenth century, most states imposed various levies and property taxes on corporations "domiciled" or "resident" within the state's territory.⁵⁹ Thus, Weber-Fas implicitly suggests at least one possible explanation for the adoption of POI at the federal level: path-dependence. But this

was in the draft submitted to the Senate Committee on Finance on May 25, 1917. See STAFF OF S. COMM. ON FIN., 65TH CONG., ACT TO PROVIDE WAR REVENUE (1917). Congressional records do not reveal the background for this sudden appearance.

⁵³ Tariff Act of 1909, ch. 6, § 38, 36 Stat. 11, 112 (emphasis added); see also William P. McClure & Herman B. Bouma, *The Taxation of Foreign Income from 1909 to 1989: How a Tilted Playing Field Developed*, 43 TAX NOTES 1379, 1381 (1989).

⁵⁴ § 38, 36 Stat. at 113.

⁵⁵ Rudolf Weber-Fas, *Corporate Residence Rules for International Tax Jurisdiction: A Study of American and German Law*, 5 HARV. J. ON LEGIS. 175, 215 (1968).

⁵⁶ *Id.* ("The existence of a clear rationale or of a conscious policy behind the adoption of [the POI] principle is doubtful . . .").

⁵⁷ *Id.* at 216–17.

⁵⁸ *Id.* at 216.

⁵⁹ Mehrotra, *supra* note 34, at 511–17 (describing the adoption of corporate level taxes by multiple states during the nineteenth century).

path-dependence argument is significant, because at the state level, corporate tax-residence determination served as a source proxy.

Specifically, during much of the nineteenth century, states enjoyed territorial monopolies on corporate law.⁶⁰ Incorporation was not freely available. Rather, corporate charters were granted by special legislative acts of the states.⁶¹ Consistent with such notion, “it was generally understood that a corporation’s legal standing reached only to the borders of the incorporating state” and that “a corporation existed only within the borders of the sovereign that created it.”⁶² Consequently, it was accepted that a corporation, as a separate entity, “[could not] be taxed except by the State which created it,”⁶³ and that states could tax “foreign” corporations only on “[t]he privilege of acting” within the taxing state’s territory.⁶⁴

This view of the corporation worked well with state-level corporate taxation during most of the nineteenth century. At the time, corporations had limited geographical reach. “Businesses transacted primarily in local product, labor, and capital markets, and rarely had operations out-of-state.”⁶⁵ State-level corporate taxation had even been justified, among other reasons, on administrative grounds, noting the advantage of the state over the federal government in taxing locally-operated businesses.⁶⁶

It is not only the case the state-chartered businesses were locally operated by nature of their business;⁶⁷ many state laws also required it. “Corporations and legislatures expected—and legislatures sometimes mandated—that corporations would have significant operations in the incorporating state, that officers and directors would be residents of that state, and that shareholders’ and directors’ meetings would be held in the state.”⁶⁸ The

60 Frederick Tung, *Before Competition: Origins of the Internal Affairs Doctrine*, 32 J. CORP. L. 33, 46 (2006).

61 *Id.* at 46–47; Mehrotra, *supra* note 34, at 515.

62 Tung, *supra* note 60, at 54.

63 JOSEPH HENRY BEALE, JR., *THE LAW OF FOREIGN CORPORATIONS AND TAXATION OF CORPORATIONS BOTH FOREIGN AND DOMESTIC* § 462, at 619 (1904).

64 *Id.* § 462, at 620.

65 Tung, *supra* note 60, at 46; *see also* Thomas R. Navin & Marian V. Sears, *The Rise of a Market for Industrial Securities, 1887-1902*, 29 BUS. HIST. REV. 105, 107 (1955) (noting that until 1880, the U.S. economy was “typified by small single-plant companies serving limited markets”).

66 Mehrotra, *supra* note 34, at 516.

67 Tung, *supra* note 60, at 56 (“[F]irms ordinarily incorporated in the state where their organizers resided and where their major operations were located.”) (emphasis added).

68 *Id.* at 56–57.

functional result was a convergence of the place of residency of capital-owners, residency of managers, the place of incorporation, and the place where the corporation did business.

Under such a set of circumstances, it was perfectly sensible to view the place of residence of a company as the source of income earned by the company.⁶⁹ Consequently, payouts from a company of a state could have been assumed to be supported by income earned in that state.

This logic also extended to federal-level corporate taxes. Under the historical circumstances surrounding the crystallization of federal corporate taxation in the United States, the corporations that were the intended targets of corporate tax laws were incorporated in the United States and at the same time derived most of their income from U.S. sources.

Specifically, during the late nineteenth century, U.S. businesses were overwhelmingly focused on U.S. local markets, which provided a "continental size" consumer base for their products.⁷⁰ The economic opportunities of scale could all be exploited with no need to look to foreign markets. American companies thus tended to invest in their own backyard,⁷¹ and the

69 Interestingly, state-level corporate taxes had territorial effects similar to the ones experienced by civil law countries in mainland Europe. In Continental Europe of the nineteenth century, foreign companies were generally not recognized, nor allowed, to operate within a jurisdiction unless a treaty so provided. By the late nineteenth century, most mainland European jurisdictions had laws under which domestic companies were legally recognized only if they had their main economic activity within the jurisdiction of residence. The purpose of these sets of laws was to prevent shareholders from operating in their own jurisdiction through a foreign company, and by doing so, to avoid the reach of local corporate law. Similarly, these rules prevented shareholders from operating in a foreign jurisdiction through a domestic company, thus avoiding the foreign jurisdiction's corporate law. The result of these incorporation rules was that companies were only recognized and allowed to operate in the countries where their real activity took place, which later became known as the "real seat" or "central administration" principle. Considering the cost and speed of travel and communications at that time, it followed that management were placed in the same jurisdiction where operations were conducted. This "real seat" test has been carried into tax law, as most continental jurisdictions originally determined the tax-residence of corporations based on the "real seat" test. Many still do. See John F. Avery Jones, *Corporate Residence in Common Law: The Origins and Current Issues*, in RESIDENCE OF COMPANIES, *supra* note 24, at 121, 132-33.

70 MANSEL G. BLACKFORD, *THE RISE OF MODERN BUSINESS: GREAT BRITAIN, THE UNITED STATES, GERMANY, JAPAN & CHINA* 87 (3d ed., 2008).

71 JOHN MICKLETHWAIT & ADRIAN WOOLDRIDGE, *THE COMPANY: A SHORT HISTORY OF A REVOLUTIONARY IDEA* 164 (2003); LANCE E. DAVIS & ROBERT J. CULL, *INTERNATIONAL CAPITAL MARKETS AND AMERICAN ECONOMIC GROWTH, 1820-1914*, at 79-91 (1994) (discussing the insignificance of foreign investment by U.S. investors between 1797 and 1896).

United States only played a minor role in global trade.⁷² While U.S. exports steadily increased during the nineteenth century, the United States remained a net-capital importer until the end of the century.⁷³ Even amid positive inflow of investment, up until the early nineteenth century (when the 1909 Act became functional), foreign investment in the United States did not play a significant role in U.S. economic growth.⁷⁴ Thus, it would seem plausible to argue that jurisdiction to tax corporations could have acted as a functional equivalent of territorial taxation.

The corporations at issue were for the most part state-chartered corporations, which meant that their owners and managers were most probably U.S. residents (by virtue of being residents in the charter state), and that they operated primarily within the United States. Control patterns at the time also supported the localized view of the corporations. "As the 19th century was drawing to a close, family control of industrial enterprises was the norm in the United States and there were only very rare examples of companies with widely dispersed shareholdings and well-developed managerial hierarchies."⁷⁵ Thus, the assumption of identity between POI, residency of managers, residency of shareholders, and the place of activity obviously worked for the federal level just as it worked at the state level.

However, during the second half of the nineteenth century, an increasing number of states neglected the model of state-chartered corporations in favor of general incorporation laws.⁷⁶ Local business entrepreneurs were quick to take advantage of the liberalization of corporate laws, and "by 1904 corporations accounted for three-quarters of the United States' industrial outputs."⁷⁷ Between the 1890s and the early 1900s, the U.S. economy underwent an unprecedented wave of consolidations, resulting in the separation of management from

⁷² Robert E. Lipsey, *U.S. Foreign Trade and the Balance of Payments, 1800-1913*, at 5 (Nat'l Bureau of Econ. Research, Working Paper No. 4710, 1994), available at <http://www.nber.org/papers/w4710.pdf>.

⁷³ *Id.* at 10.

⁷⁴ DAVIS & CULL, *supra* note 71, at 111.

⁷⁵ Brian R. Cheffins, *Investor Sentiment and Antitrust Law as Determinants of Corporate Ownership Structure: The Great Merger Wave of 1897 to 1903*, at 4 (Dec. 15, 2002) (unpublished manuscript) (on file with *Chapman Law Review*), available at <http://escholarship.org/uc/item/2x90s8bc#page-1>.

⁷⁶ See ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 135-37 (1932) (describing the erosion of centralized ownership structure parallel to adoption of general corporate laws in multiple states).

⁷⁷ BLACKFORD, *supra* note 70.

control.⁷⁸ This period saw the institutionalization of managerial capitalism, namely the rise of professional, hierarchical salaried management at the expense of personal management by owners.⁷⁹ Thus, at the turn of the twentieth century, the assumption of identity between the place of incorporation, source of income, and the residency of shareholders or managers seemed not at all obvious.

Nonetheless, a functional argument for POI had merit even under the newly developed socio-economic environment of the early twentieth century. The wave of consolidations engulfing the United States starting in the 1890s indeed changed the ownership structures of U.S. corporations. However, it apparently did not change the national identity of the corporations' owners and managers, nor did it change the geographical source of the corporations' income. The consolidation movement was horizontal in nature. It was characterized by the amalgamation of multiple small and medium businesses in the same industry into trusts, and later into holding companies.⁸⁰ Owners of the "old" family businesses ceded management rights to some form of central management, but did not relinquish their ownership.⁸¹ The result was the diffusion of ownership, but the centralization of management.⁸² Thus, the transformation was from a situation in which many U.S. individuals owned and managed many U.S. incorporated corporations, to a situation in which many U.S. individuals owned or managed few U.S. incorporated corporations that earned income in the United States. To the extent that the true targets of corporate taxes were those individuals' income, POI still made sense.

Interestingly, the classes of owners and managers targeted by early corporate taxes never remained in the abstract. Individuals were, at times, identified by name. For example, in 1889, Thomas G. Shearman published an article titled *The Owners of the United States*.⁸³ The article was one of the earliest

78 PAUL FRENTROP, A HISTORY OF CORPORATE GOVERNANCE: 1602–2002, at 192–94 (2002); Navin & Sears, *supra* note 65; Cheffins, *supra* note 75, at 6–10.

79 Mehrotra, *supra* note 34, at 524.

80 For a description of the U.S. horizontal consolidation movement at the end of the nineteenth century see, e.g., FRENTROP, *supra* note 78, at 192–94; Navin & Sears, *supra* note 65; Cheffins, *supra* note 75, at 12 ("One key constituency which remained when a turn-of-the-century merger had been concluded was composed of the owners of the formerly autonomous firms encompassed within the consolidation. This was because of the merger package typically offered to incumbents with an industry.").

81 FRENTROP, *supra* note 78, at 193.

82 Cheffins, *supra* note 75, at 10–11.

83 Thomas G. Shearman, *The Owners of the United States*, 8 FORUM 262 (1898).

attempts to measure income distribution within the United States. Shearman found that “40,000 persons own[ed] over one half of the wealth of the United States, while one seventieth part of the people own[ed] over two thirds of the wealth.”⁸⁴ Even more significant was Shearman’s conclusion that while the top echelon of wealthy Americans greatly benefited from the indirect effects of taxation, they carried little of the tax burden.⁸⁵ Shearman’s article turned out to be highly influential.⁸⁶

Shearman supported his conclusions not by numbers alone, but also, for lack of a better description, by “name calling.” Shearman identified by name many of the wealthiest Americans avoiding the tax burden, putting faces on the abstract notion of “rich Americans.” He spelled out names such as Astor, Vanderbilt, Rockefeller, and many more as specific examples.⁸⁷ “Name calling” was common in floor debates, both in the context of the 1894 Act and of the 1909 Act. Wealth distribution played a major role in these debates, and elected officials frequently named the intended targets of corporate taxes.⁸⁸ These wealthy individuals were understood to be the intended target of the Acts.

Significantly, these identified individuals held most of their wealth in corporations incorporated in the United States. These corporations, in turn, earned much (if not all) of their income from U.S. operations.⁸⁹ Standard Oil and the American Sugar

⁸⁴ *Id.* at 271.

⁸⁵ *Id.* at 272.

⁸⁶ Shearman was invited to testify at the Ways and Means tax subcommittee when potential changes to tax law had begun to be discussed in 1893. STEVEN S. WEISMAN, *THE GREAT TAX WARS: LINCOLN TO WILSON—THE FIERCE BATTLES OVER MONEY AND POWER THAT TRANSFORMED THE NATION* 124 (2002).

⁸⁷ Shearman, *supra* note 83, at 265.

⁸⁸ In the context of the 1894 Act, see, e.g., WEISMAN, *supra* note 86, at 137 (referring to Benton McMillin, the chairman of the Ways and Means Subcommittee on Taxation and one of the original drafters of the 1894 bill, who argued that empires fell due to wealth concentration, noting that “the Emperor of Russia, the Sultan of Turkey, the Emperor of Austria, the Emperor of Germany, the King of Italy, Queen Victoria and others who . . . were worth less than the Rothschilds, Rockefellers, Vanderbilts and others in the United States”); see *id.* at 144 (noting that Senator William Allen of Nebraska, who “[i]n defending the tax . . . asserted that 9 percent of the families in America owned 71 percent of the wealth. In New York alone, he declared . . . there were 119 millionaires! He rattled off their names: Vanderbilt, Whitney, Rockefeller and so on . . .”). In the context of the 1909 Act, see *id.* at 219 (quoting Representative Cordell Hull as complaining about the “infamous system of class legislation” that burdened the average person while “virtually exempting the Carnegies, the Vanderbilts, the Morgans, and the Rockefellers, with their aggregated billions of hoarded wealth”).

⁸⁹ The source of wealth of these corporations has also been part of the political debate. Corporations were regarded as a “class of our citizens who own and control a very large and increasing part of the property of the country; who enjoy certain public franchises of very substantial character.” STEVEN A. BANK, *FROM SWORD TO SHIELD: THE*

Refinery Company, the intended targets of the 1898 Act,⁹⁰ were both perfect examples. Standard Oil was incorporated by John Davison Rockefeller in 1870 in Ohio.⁹¹ The American Sugar Refining Company, substantially owned and managed by Henry Osborne Havemeyer, was incorporated in 1891 in New Jersey.⁹² Other examples of companies owned or managed by individuals who were identified in tax reform debate included the Vanderbilts' railroad empire, which was composed of several state-chartered corporations incorporated during the nineteenth century,⁹³ as was the Goulds' railroad conglomerate.⁹⁴ The Astors' fur trading empire was operated, among others, via the American Fur Company, incorporated in New York in 1808.⁹⁵

To summarize, from a jurisdictional point of view, it does not matter if one prefers the regulatory argument or wealth distribution argument to explain the corporate tax acts of the late nineteenth and the early twentieth centuries in the United States. The intended targets of the corporate tax acts were named. These individuals held their fortune by virtue of their ownership or control of corporations that were incorporated and operated in the United States. Under such circumstances, the POI model effectively operated to tax income earned by such individuals from their U.S.-based operations.

C. The Modern Failure of the Positive Function in the United States

Thus far I have shown that in the historical context surrounding the adoption of corporate taxation in the United

TRANSFORMATION OF THE CORPORATE INCOME TAX, 1861 TO PRESENT 46–47 (2010) (citing William L. Wilson, *The Income Tax on Corporations*, 158 N. AM. L. REV. 1).

⁹⁰ See *supra* text accompanying notes 44–47.

⁹¹ 7 DICTIONARY OF AMERICAN HISTORY, 520–21 (Stanley I. Kutler ed., 3d ed. 2003).

⁹² See WM. SULZER, AMERICAN SUGAR REFINING COMPANY 9 (1904), available at <http://ia700409.us.archive.org/27/items/cu31924103062851/cu31924103062851.pdf>.

⁹³ For example, Vanderbilt is well known for his involvement within the New York & Erie Railroad. See EDWARD J. RENEHAN JR., COMMODORE: THE LIFE OF CORNELIUS VANDERBILT 243 (2007). The New York & Erie Railroad was incorporated under a state act of New York. See *Erie Ry. Co. v. Pennsylvania*, 88 U.S. 492, 493 (“The Erie Railroad Company was chartered by an act of the legislature of the State of New York, April 24th, 1832, with power to construct a railroad from the city of New York to Lake Erie, through the southern tier of counties of the State of New York.”).

⁹⁴ For example, in 1860 Jay Gould purchased the controlling interest in the Rutland & Washington Railroad Company and became its president. See 7 THE NATIONAL CYCLOPEDIA OF AMERICAN BIOGRAPHY, JAMES T. WHITE COMPANY 218 (1899). The Rutland & Washington Railroad Company was chartered under an act of the state of Vermont in 1847. See 1 THE RAILROAD LAWS AND CHARTERS OF THE UNITED STATES 844 (W.P. Gregg & Benjamin Pond eds., 1851).

⁹⁵ STATE OF N.Y., AN ACT TO INCORPORATE THE AMERICAN FUR COMPANY, ch. CXL (1835) (passed April 6, 1808).

States, the POI test for tax-residence determination operated as a source-based tax instrument. This is a functional rather than a historical argument. Namely, I do not suggest that the original drafters of U.S. corporate tax law have purposely so designed the tax-residence test. This would necessitate full-blown historical research, well beyond the scope of a symposium piece. However, the functional argument demonstrates that the adopted residence test (POI) supported source taxation, and that in turn, source-based taxation supported the historical purposes for which the United States adopted corporate taxes.

The consideration of current territorial reform proposals thus begs two questions: First, will a POI test support source taxation under current economic conditions? Namely, if a corporation is incorporated in the United States, does POI positively point to the United States as the source of income (and if a corporation is incorporated elsewhere, does this suggest that the source of income is not the United States)? Second, if the answer is in the negative, is there any other corporate tax-residence test that might positively point to the source of income earned and distributed by a corporation?

It is clear that the answer to the first question is in the negative. Today, unlike the early twentieth century, the United States takes a leading role in the global economy.⁹⁶ U.S.-incorporated corporations can freely operate around the world and earn foreign-source income. The assumption that such corporations accumulate all of their wealth from domestic operations is no longer viable. Conversely, there is ample evidence that U.S.-incorporated corporations accumulate most of their profits not directly, but in affiliates incorporated in low-to-no tax jurisdictions (where no economic activity takes place).⁹⁷ It is easy and practically costless to incorporate a subsidiary in a tax haven, thereby avoiding U.S. taxing jurisdiction altogether. Meaning, foreign incorporation does not mean that income is *not* sourced to the United States. POI is dysfunctional to the extent we expect it to point to the source of income.

⁹⁶ As of December 2013, “[t]he United States is the largest investor abroad and the largest recipient of direct investment in the world.” JAMES K. JACKSON, CONG. RESEARCH SERV., RS21118, U.S. DIRECT INVESTMENT ABROAD: TRENDS AND CURRENT ISSUES (2013).

⁹⁷ See DONALD J. MARPLES & JANE G. GRAVELLE, CONG. RESEARCH SERV., R40178, TAX CUTS ON REPATRIATION EARNINGS AS ECONOMIC STIMULUS: AN ECONOMIC ANALYSIS (2011); see also STAFF OF PERMANENT SUBCOMM. ON INVESTIGATIONS OF THE COMM. ON HOMELAND SEC. & GOVERNMENTAL AFFAIRS, 112TH CONG., REP. ON REPATRIATING OFFSHORE FUNDS: 2004 TAX WINDFALL FOR SELECT MULTINATIONALS (Comm. Print 2011).

Answering the second question—whether any tax-residence test other than POI can positively point to the source of income of a corporation—is more complex. The United States’s formal POI test is frequently contrasted with more substantive corporate tax-residence tests used by other jurisdictions. Substantive tests inquire into various “connecting factors” that define “the link between a company and the national territory of the State who wants to exercise its jurisdiction to tax that company”⁹⁸ Such tests may include, among others, the central management and control (CMC) test;⁹⁹ the place of effective management (POEM);¹⁰⁰ the place where main economic activity is carried on;¹⁰¹ or the place of residence of shareholders.¹⁰² An argument can be made that a substantive residence test can theoretically point to the source of income. The logic is that substantive tests point to the jurisdiction of the corporation’s real economic attributes, where income is presumably generated.

98 See Peter Behrens, *General Principles of Residence of Companies*, in RESIDENCE OF COMPANIES, *supra* note 24, at 3, 26–27; see also Pasquale Pistone, *EC Law and Tax Residence of Companies*, in RESIDENCE OF COMPANIES, *supra* note 24, at 183, 184–85.

99 The CMC test is used by all commonwealth jurisdictions, and widely adopted throughout the world. Under this test, “a company resides for purposes of income tax where its real business is carried on[,] . . . and the real business is carried on where the central management and control actually abides.” *De Beers Consolidated Mines, Ltd. v. Howe*, [1906] 5 A.C. 455 (H.L.) 458. For an excellent discussion on the adoption of the managed and controlled tests by Commonwealth jurisdictions, see ROBERT COUZIN, *CORPORATE RESIDENCE AND INTERNATIONAL TAXATION* 22 (2002); see also AULT & ARNOLD, *supra* note 10, at 435 (noting that Commonwealth jurisdictions traditionally adhered to the CMC test).

100 This test is adopted by most civil law jurisdictions, and is the test prescribed by the OECD model, which it defines as “the place where key management and commercial decisions that are necessary for the conduct of the entity’s business as a whole are in substance made.” OECD COMMITTEE ON FISCAL AFFAIRS, *MODEL TAX CONVENTION ON INCOME AND ON CAPITAL: CONDENSED VERSION* 77 (2008). In most cases POEM is one and the same as CMC. See HM REVENUE & CUSTOMS, *INTM120210—COMPANY RESIDENCE: GUIDANCE ORIGINALLY PUBLISHED IN THE INTERNATIONAL TAX HANDBOOK*, at ITH348 (2010), available at <http://www.hmrc.gov.uk/manuals/intmanual/intm120210.htm#IDA1ORZF> (explaining the apparent differences between CMC and POEM and concluding that “it is not that easy to divorce effective management from central management and control and in the vast majority of cases they will be located in the same place”). For a description of different factual tests adopted by civil law jurisdictions, see Luc De Broe, *Corporate Tax Residence in Civil Law Jurisdictions*, in RESIDENCE OF COMPANIES, *supra* note 24, at 95.

101 In Italy, a corporation will be considered “domestic” for tax purposes if, among satisfaction of other criteria, its main business purpose is in Italy for the greater part of the financial year. See, e.g., CARLO GALLI, *INT’L BUREAU OF FISCAL DOCUMENTATION, CORPORATE TAXATION—ITALY* 26 (2013).

102 Countries using some variation of the residence-of-shareholders test include, for example, Australia and Italy. See Michael Dirks, *Australia*, in RESIDENCE OF COMPANIES, *supra* note 24, at 311, 324–29 (discussing the ownership-presumption model adopted in Australia); see also Mario Tenore, *Italy*, in RESIDENCE OF COMPANIES, *supra* note 24, at 519, 540–44 (discussing the ownership-presumption model adopted by Italy).

Unfortunately, due to the nature of income and operations of multinational corporations, this argument is unconvincing. A single corporation can operate in multiple jurisdictions. Multiple different activities (such as research, manufacturing, advisement, sales, and so on) can each take place in a different jurisdiction (or each in multiple jurisdictions), notwithstanding all are aimed at generating the same stream of income. Under such circumstances, few streams of income can be said to have identifiable sources, and therefore no residence test can be said to point to the source of the income of a corporation. The production of income is no longer bound by physical proximities that converge around a single factor (or even around multiple factors with clear locational attributes). In short, “[t]here is no unifying normative concept that justifies treating income as derived in one jurisdiction rather than another.”¹⁰³

This does not mean that corporate tax-residence has no function in supporting source-based taxation. To the contrary, tax-residence still plays a major part in sourcing income, but we must rethink the instrumentality of residence determination in such context. I address this issue in the next Part.

III. THE “NEGATIVE” FUNCTION OF CORPORATE TAX-RESIDENCE

A. Corporate Tax-Residence and Income Shifting

In order to understand what might be the territorial instrumentality of corporate tax-residence determination, we must make a preliminary assumption, that income indeed has a source, or sources (notwithstanding we may have difficulty identifying such sources). Once this threshold is cleared, we must question what role (if any) corporate tax-residence could play in supporting source taxation in an environment where the positive identification of sources is almost impossible.

The positive difficulty with source-based taxation materializes in the problem of income shifting. Income shifting is a generic name for any technique by which a multinational group is able to have income that is economically generated in one jurisdiction, reported for tax purposes in another jurisdiction. For example, a patent could be completely developed in the labs of a corporation residing in a tax jurisdiction. It is very easy,

¹⁰³ Marian, *Jurisdiction to Tax Corporations*, *supra* note 3, at 1631; Edward D. Kleinbard, *The Lessons of Stateless Income*, 65 TAX L. REV. 99, 143 (2011) (“[T]he global tax norms that define the geographic source of income or expense are largely artificial constructs, difficult to administer and often devoid of any conceptual foundation.”) [hereinafter Kleinbard, *The Lessons of Stateless Income*].

however, to have the patent legally owned by an affiliate that resides in a tax haven. Thus, all royalties are paid to the tax haven corporation where income is booked, notwithstanding that all research activity took place in the parent's jurisdiction, and that the affiliate did not meaningfully participate in the activity. Professor Edward Kleinbard famously coined the phrase "stateless income" to describe the resulting tax consequences. He defines stateless income as "the movement of taxable income within a multinational group from high-tax to low-tax source countries *without* shifting the location of externally-supplied capital or activities involving third parties."¹⁰⁴

Income shifting techniques have received much attention in recent tax reform discourse in the United States¹⁰⁵ and are the focus of a major project undertaken by the OECD.¹⁰⁶ To date, most mechanisms that have been put in place to address income shifting have, in one way or another, focused on making sure that income that is being "shifted" is "resourced" to its "true" origin.¹⁰⁷ For example, intercompany pricing measures focus on making sure that intercompany dealings are priced at arm's-length, so profits are not booked with foreign affiliates in tax havens. "Anti-stripping" mechanisms are intended to assure that income is not "stripped" from the source jurisdiction through deductible payments to a foreign affiliate. Controlled Foreign Corporation (CFC) regimes make income that is nominally earned by foreign affiliates taxed to the parent unless the foreign affiliate is substantively engaged in an active trade or business in the foreign jurisdiction.

Importantly for our purposes, any income shifting technique depends on the existence of both "domestic" and "foreign" affiliate corporations. Corporate tax-residence is thus an integral part to any income shifting technique, and as such can be a significant instrument in preventing it.

¹⁰⁴ Kleinbard, *supra* note 1, at 702.

¹⁰⁵ See Omri Marian, *Meaningful Corporate Tax Residence*, 140 TAX NOTES 470, 470–71 (2013).

¹⁰⁶ For a discussion on the BEPS OECD project, see Yariv Brauner, *What the BEPS?*, FLA. TAX REV. (forthcoming 2014), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2408034.

¹⁰⁷ Kleinbard, *The Lessons of Stateless Income*, *supra* note 103, at 140–51 (discussing common anti-income-shifting mechanisms).

B. The Negative Function Explained: Formalism as a Proxy for Non-Source

While corporate tax-residence cannot positively point to the source of income, it can identify the jurisdictions in which income is definitely *not* generated. Since income shifting heavily depends on corporate tax-residence determination, the idea would be to design the residence test in a manner that would not allow income to be reported in a jurisdiction where a corporation has no real economic attributes. I refer to this approach as the “negative function” of corporate tax-residence.

A stylized example will help to demonstrate this “negative function.” Assume a world of three jurisdictions: Fredonia, Sylvania, and Florin. Both Fredonia and Sylvania are developed, high-tax jurisdictions. Florin is a tax haven. The GCH Group is a global leader in the designing and manufacturing of widgets. GCH’s headquarters as well as its research facilities are found in Fredonia, and are operating through a publically traded corporation, FredoniaCo. Each widget designed by FredoniaCo is IP protected, but the IP is owned by a GCH subsidiary resident in Florin, FlorinCo. FlorinCo has no employees. Two other GCH subsidiaries, FreCo and SylCo are residents in Fredonia and Sylvania, respectively. They both pay FlorinCo royalties for the right to manufacture the IP-protected widgets in their respective jurisdictions. FreCo and SylCo then sell the widgets in Fredonia and Sylvania, respectively, at a substantial markup over the cost of production. The deductible royalty to FlorinCo is set to match the gain from selling the widgets. In such a manner, all income is booked to FlorinCo (i.e., the royalties income), in spite of the fact that there is no economic activity in Florin. No income is booked to either Sylvania or Fredonia—due to the deductible royalties—in spite of the fact that both Sylvania and Fredonia are jurisdictions where real economic activity takes place.

Assume that at some point FlorinCo makes payments (for example, in the form of dividends) to Sylvania or Fredonia. If Fredonia and Sylvania are both territorial jurisdictions, such payments will not result in income recognition in those jurisdictions, since the payments will be foreign-sourced. That is the case because payments of dividends and interest are generally sourced to the residence of the payor, which in this case is Florin.

Traditional anti-shifting mechanism will focus the efforts on resourcing the income from Florin to Sylvania or Fredonia (for example, by adjusting the dollar value of the royalties, thereby reducing deductions to FreCo and SylCo). My suggestion would

be to support these mechanisms by a residency construct that assures that FlorinCo is not considered a resident in Florin, where it has no economic attributes. Under such circumstances, no income will be sourced to Florin (since FlorinCo will be resident in a place other than Florin), and income shifting is prevented.

Importantly, the function of such residence determination is strictly negative. It does not positively point to the source of income as being in Fredonia or Sylvania, even though these are the only two available alternatives if Florin is ruled out. But where the "real residence" is, is irrelevant in this context. Negative residency construction simply prevents "false-residency." Income will thus be sourced to a jurisdiction where some economic attributes exist (regardless if income was indeed produced in that jurisdiction), and *not* where income could not have possibly been produced.

Obviously, the negative function of corporate tax-residence demands that tax-residence be determined based on substantive connecting factors of the corporation to a jurisdiction. A formal residency determination such as POI would make it very easy (as is the case today under U.S. law) to incorporate pocketbook entities in tax havens, and book income to such entities. In a sense, "formal" residency attributes serve as a proxy to "non-source."

C. The Negative Function in Practice: Formulary Apportionment as a Tax-Residence Test

The last part of the functional puzzle is to determine how to construct a substantive corporate tax-residence test that can properly function to prevent income shifting.

It has previously been argued that corporate tax-residence is largely elective, in the sense that the taxpayer can arrange their affairs in a way that corporations reside for tax purposes in a jurisdiction of their choosing.¹⁰⁸ As a factual matter such argument is probably correct, and presents challenges to the functional project. However, arranging residence in one jurisdiction rather than another is not costless. Residence electivity is a matter of degree.¹⁰⁹ This largely solves the problem for our purposes. The sole requirement of a "negative" tax-residence construction in a territorial system is that it

¹⁰⁸ Shaviro, *supra* note 12, at 381–85.

¹⁰⁹ *Id.* at 384.

decreases the electivity of tax-residence of a corporation to an extent that a corporation could not be resident where it has no (or very little) economic attributes. There is no need to identify “real” residency. In other words, the idea would be to increase the costs of residence election.

Increasing the cost of residence electivity means that tax-residence of corporations should not be determined by a single “substantive” factor (for example, the place of management). A single factor test will be rather easy to manipulate. For example, many jurisdictions use the place of central management and control (CMC) as the tax-residence test for corporations. It used to be the case that the place of CMC was presumed to be the place where board meetings are held.¹¹⁰ This test is easy to manipulate by having the board meetings conducted in a tax haven. Effectively, it makes the CMC test a formal one. In other words, single factor tests may be too elective.

Obviously, an alternative would be to use multiplicity of factors, such as CMC, the place where the economic activity takes place, and so on. The problem with such an approach is that it is difficult to administer. In today’s world, a corporation may have its management, assets, and operations spread across the globe. Deciding a single location for residence under such circumstances is administratively challenging (which factors should take precedent?) and largely meaningless.

Nonetheless, our aim is not to “discover” the “true” residency of a corporation. It would therefore be satisfactory to combine the “multiplicity of factors” approach with an administratively feasible approach that is less than accurate. Luckily, such an approach has already been suggested and heavily discussed in other contexts: the formulary apportionment approach.

¹¹⁰ In the past, where the board met was seen as the decisive factor for purposes of making a determination as to the place of management, as expressed in the previous version of the OECD tax-treaty model. See OECD COMM. ON FISCAL AFFAIRS, MODEL TAX CONVENTION ON INCOME AND ON CAPITAL 81 (2005) (“The place of effective management will ordinarily be the place where the most senior person or group of persons (for example a board of directors) makes its decisions, the place where the actions to be taken by the entity as a whole are determined.”). However, in July of 2008, the OECD neglected the “place of board meeting” presumption, and adopted a much more nuanced (and less clear) test to determine the place of management: the decision is based on “facts and circumstances.” See OECD COMM. ON FISCAL AFFAIRS, MODEL TAX CONVENTION ON INCOME AND ON CAPITAL 77 (2008) (“All relevant facts and circumstances must be examined to determine the place of effective management.”).

Formulary apportionment has been proposed as an alternative to the territorial versus global taxation debate.¹¹¹ Specifically, formulary apportionment is a method used to allocate taxing jurisdiction from multijurisdictional activity by taking into account the relative weights (therefore “formulary”) of various economic attributes such as payroll, assets, and sales in various jurisdictions. “Under a formulary profit split, tax liabilities would reflect the economic reality of globally integrated businesses, and they would not vary among businesses based on their relative abilities to shift the ownership of intangible property.”¹¹²

The formulary apportionment approach is by no means uncontested.¹¹³ Many doubt that such an approach can be applied as a unilateral measure, question which economic “attributes” should be taken into account in the formula, and doubt the extent to which such attributes are immune to taxpayers’ manipulation. But for our purpose, it does not really matter. We do not seek a “correct” result. All we need it to determine is that a corporation is *not* resident somewhere.

If a formula that takes into account number of employees, tangible assets, and sales figures is used to determine the residency of a corporation, a corporation will have very little chance to end up a resident in a jurisdiction where it has no economic activity. Of course, in order to make sense, the formula must not be calculated on a per-corporation basis. In such a case, a single employee in a small office may constitute all of the economic attributes of a corporation incorporated in a tax haven, which would defeat the purposes of the test. Rather, the measurement must be proportional to the entire control group. For example, a corporation would not be able to claim residency in a jurisdiction unless it meets certain formulary thresholds in that jurisdiction, compared to the group’s aggregate attributes.

It is likely that a corporation will end up a resident in a jurisdiction where it has some real infrastructure, which in turn implies that the jurisdiction is not a tax haven. As such, there is

111 Reuven S. Avi-Yonah, Kimberly A. Clausing & Michael C. Durst, *Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split*, 9 FLA. TAX REV. 498 (2009).

112 *Id.* at 507.

113 For more skeptical views of formulary apportionment see, e.g., Julie Roin, *Can the Income Tax be Saved? The Promise and Pitfalls of Adopting Worldwide Formulary Apportionment*, 61 TAX L. REV. 169 (2008), and see also J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Formulary Apportionment in the U.S. International Income Tax System: Putting Lipstick on a Pig?*, 36 MICH. J. INT’L L. (forthcoming 2014).

no “foreign corporation” resident in a tax haven, to which income can be shifted.

CONCLUSION

Corporate tax-residence plays an important role in territorial tax systems. Poorly constructed corporate tax-residence tests may be detrimental to source taxation. Conversely, properly constructed corporate tax-residence models can support source taxation by preventing income shifting. In turn, this purpose can be achieved by increasing the cost of electing tax-residence that is detached from real economic considerations. I have suggested one way to do so—formulary apportionment—but other cost-increasing mechanisms may achieve similar results. Of course, the nuts and bolts of each residence reform will have to be worked out, a task well beyond the scope of a symposium piece.

Increasing the cost of residence electivity may draw critique, as it may make the U.S. tax system less competitive. To the extent one truly believes in territorial taxation, such critique cannot stand. If an instrument is designed to support taxation of income in its true source, it makes little sense to argue against it. It makes little sense to support source taxation as an ideological matter and at the same time advocate competitiveness by allowing taxpayers to strip income away from the jurisdiction of source. Competitiveness must be addressed by other means, such as reducing corporate tax rates.

Recent international tax reform proposals in the United States seem to embrace the idea of territorial taxation. Unfortunately, such proposals, in their focus on source taxation, largely lose sight of the relevance of tax-residence determination to territorial taxation. Residence determination plays an important role in sourcing income, and is the linchpin for income-shifting mechanisms that operate against source-based taxation. This conclusion is particularly important to the United States, where the cost of tax-residence electivity is practically zero. It is therefore prudent, if not necessary, that any territorial reform proposal in the United States considers the tax-residence of corporations.

The Offshore Shell Game: U.S. Corporate Tax Avoidance Through Profit Shifting

Tracy A. Kaye*

I. CURRENT STATE OF AFFAIRS

On March 12, 2014, the Bloomberg News headline read *Cash Abroad Rises \$206 Billion as Apple to IBM Avoid Tax*.¹ The article goes on to note that U.S. multinational corporations “have accumulated \$1.95 trillion outside the U.S., up 11.8 percent from” last year, with the offshore profits of Apple Inc., Microsoft Corp., and International Business Machines Corp. comprising 18.2% (\$37.5 billion) of the total increase.² A tax and budget advocate at the U.S. Public Interest Research Group stated that “[t]he loopholes in our tax code right now give such a big reward to companies that use gimmicks to make it look like they earn their profits offshore.”³

This press coverage is important because public perception matters to legislators on Capitol Hill and the public is becoming increasingly aware of the corporate tax avoidance issue. In fact, there is global concern that U.S. multinationals are using transfer pricing rules and other techniques to shift reported income to low-tax countries without actually changing where they invest their resources.⁴ Profit shifting allows U.S. multinationals to maintain their actual investments in high-tax countries that have the appropriate infrastructure and labor forces necessary for actual business operations but report profits

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¹ Richard Rubin, *Cash Abroad Rises \$206 Billion as Apple to IBM Avoid Tax*, BLOOMBERG, Mar. 12, 2014, <http://www.bloomberg.com/news/2014-03-12/cash-abroad-rises-206-billion-as-apple-to-ibm-avoid-tax.html> (“The largest U.S.-based companies added \$206 billion to their stockpiles of offshore profits last year, parking earnings in low-tax countries until Congress gives them a reason not to.”).

² *Id.*

³ *Id.*

⁴ See CONG. BUDGET OFFICE, PUB. NO. 4150, OPTIONS FOR TAXING U.S. MULTINATIONAL CORPORATIONS 2 (2013), available at http://www.cbo.gov/sites/default/files/cbofiles/attachments/43764_MultinationalTaxes_rev02-28-2013.pdf.

in tax havens or low-tax jurisdictions. This tax avoidance is accomplished by transfers of intellectual property or intangibles to low-tax jurisdictions, the allocation of debt to high-tax countries, and transfer pricing strategies with respect to goods.⁵

The United States's transfer pricing rules (section 482 and the accompanying Treasury regulations)⁶ require that the pricing of sales and services transactions between members of the multinational group use an arm's length standard in order to protect the U.S. tax base. These rules are necessary to ensure that taxpayers do not shift income properly attributable to the United States to a related foreign company.⁷ However, a 2013 Congressional Research Service (CRS) study states that U.S. multinationals "reported earning 43% of their overseas profits in the country group comprised of Bermuda, Ireland, Luxembourg, the Netherlands, and Switzerland" in 2008, while only 4% of their foreign employees and 7% of their foreign investment was located in those jurisdictions.⁸ On the other hand, Australia, Canada, Germany, Mexico, and the United Kingdom only accounted for 14% of their overseas profits with 40% of foreign employees and 34% of foreign investment located in these jurisdictions.⁹ All this evidence strongly indicates profit shifting. Furthermore, a 2008 Government Accountability Office study noted that 83% of the 100 largest publicly traded U.S. corporations have subsidiaries in tax havens or banking secrecy jurisdictions.¹⁰

It is clear that the transfer pricing rules are not functioning as intended. The Internal Revenue Service estimates that it is involved in income shifting controversies with respect to approximately 250 taxpayers involving \$68 billion in potential

⁵ JANE G. GRAVELLE, CONG. RESEARCH SERV., R40623, TAX HAVENS: INTERNATIONAL TAX AVOIDANCE AND EVASION 8-11 (2013), *available at* <http://www.fas.org/sfp/crs/misc/R40623.pdf>.

⁶ All section references are to the Internal Revenue Code of 1986, as amended.

⁷ STAFF OF THE JOINT COMM. ON TAXATION, 111TH CONG., PRESENT LAW AND BACKGROUND RELATED TO POSSIBLE INCOME SHIFTING AND TRANSFER PRICING 5 (Comm. Print 2010), *available at* <https://www.jct.gov/publications.html?func=startdown&id=3692>. "Absent transfer pricing rules, the lack of external market forces would permit multinational groups to shift income in any manner they choose among group members." *Id.* at 18.

⁸ MARK P. KEIGHTLEY, CONG. RESEARCH SERV., R42927, AN ANALYSIS OF WHERE AMERICAN COMPANIES REPORT PROFITS: INDICATIONS OF PROFIT SHIFTING 4-5 (2013), *available at* <https://www.fas.org/sfp/crs/misc/R42927.pdf>.

⁹ *Id.*

¹⁰ U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-09-157, INTERNATIONAL TAXATION: LARGE U.S. CORPORATIONS AND FEDERAL CONTRACTORS WITH SUBSIDIARIES IN JURISDICTIONS LISTED AS TAX HAVENS OR FINANCIAL PRIVACY JURISDICTIONS 4 (2008), *available at* <http://www.gao.gov/new.items/d09157.pdf>.

income adjustments.¹¹ Furthermore, these transfer pricing problems are particularly acute where intellectual property and other intangibles are involved.¹² At a hearing held in May 2013, the Permanent Subcommittee on Investigations (PSI) of the U.S. Senate Homeland Security and Governmental Affairs Committee heard testimony on the shifting of profits offshore by U.S. multinationals. The PSI's report explained how Apple Inc. shifted billions of profits to Ireland where it had "negotiated a special corporate tax rate of less than two percent" by "transferr[ing] the economic rights to its intellectual property through a cost sharing arrangement" with its offshore subsidiaries.¹³ A cost sharing agreement allows "related entities to share the cost of developing an intangible asset and a proportional share of the rights to the intellectual property that results."¹⁴ The Treasury Department estimated the potential loss of revenues to the government from this profit shifting as ranging between \$10 billion to \$80 billion annually,¹⁵ while a CRS study that summarized the economic research reported approximate revenue losses between \$30 billion to \$90 billion a year.¹⁶

British, French, and Italian revenue agencies have also been scrutinizing the various American companies known as GAFA (Google, Amazon, Facebook, and Apple).¹⁷ The French government has even published an expert report on the taxation issues of the digital economy, calling for "urgent action."¹⁸ In June 2012, the G-20 declared that base erosion and profit

¹¹ *The Shifting of Profits Offshore by U.S. Multinational Corporations: Hearing Before the Permanent Subcomm. on Investigations of the S. Comm. on Homeland Sec. & Governmental Affairs*, 113th Cong. 6 (2013) (written testimony of Samuel M. Maruca, Director, Transfer Pricing Operations, Internal Revenue Serv.), available at <http://www.hsgac.senate.gov/download/?id=35c9f013-0b45-43d7-809a-1737db468345>.

¹² See generally U.S. DEPT OF THE TREASURY, REPORT TO THE CONGRESS ON EARNINGS STRIPPING, TRANSFER PRICING AND U.S. INCOME TAX TREATIES 1 (2007), available at <http://www.treasury.gov/resource-center/tax-policy/Documents/ajca2007.pdf>.

¹³ *The Shifting of Profits Offshore by U.S. Multinational Corporations: Hearing Before the Permanent Subcomm. on Investigations of the S. Comm. on Homeland Sec. & Governmental Affairs*, 113th Cong. 2 (2013) [hereinafter *PSI Report*] (memorandum from Sen. Carl Levin, Chairman, and Sen. John McCain, Ranking Minority Member, Permanent Subcomm. on Investigations), available at http://www.levin.senate.gov/download/exhibit1a_profitshiftingmemo_apple.

¹⁴ *Id.* at 7–8.

¹⁵ *The Shifting of Profits Offshore by U.S. Multinational Corporations: Hearing Before the Permanent Subcomm. on Investigations of the S. Comm. on Homeland Sec. and Governmental Affairs*, 113th Cong. 3 (2013) (written testimony of Mark Mazur, Assistant Secretary for Tax Policy, U.S. Dep't of the Treasury), available at <http://www.hsgac.senate.gov/download/?id=28f352a5-87d2-4c16-9262-ca629ab17fe8s>.

¹⁶ KEIGHTLEY, *supra* note 8, at 1–2 (citations omitted).

¹⁷ See *id.* at 2–3; see also Rubin, *supra* note 1.

¹⁸ PIERRE COLLIN & NICOLAS COLIN, TASK FORCE ON TAXATION OF THE DIGITAL ECONOMY 3 (2013). For a summary of the report, see Alberto Pluviano, *The French Government Report on the Taxation of the Digital Economy*, 10 DIRITTO E PRATICA TRIBUTARIA INTERNAZIONALE 97 (2013).

shifting must be prevented and called upon the Organization for Economic Cooperation and Development (OECD) to get involved in this issue.¹⁹

II. OECD BASE EROSION AND PROFIT SHIFTING PROJECT

The OECD issued a report on base erosion and profit shifting (BEPS) in February 2013. This BEPS report reviews various data and studies, finding an increased separation between the locations of the actual business activities and the reporting of profits for tax purposes.²⁰ The OECD followed up this report in July 2013 with an Action Plan of fifteen steps to address profit shifting by multinational corporations and move toward international coherence in corporate income taxation.²¹ The OECD BEPS Action Plan targets harmful tax practices by establishing a working party on aggressive tax planning and by requiring disclosure of aggressive tax planning arrangements as well as the global allocation among countries of the income, economic activity, and taxes paid to the relevant tax administrations.²² Actions 8–10 focus on various transfer pricing issues, including those with respect to intangibles, so as to “[a]ssure that transfer pricing outcomes are in line with value creation.”²³

The OECD BEPS Action Plan seeks to realign taxation with the relevant economic substance and ensure that taxable profits cannot be artificially shifted.²⁴ By the end of 2015, expect recommendations for revisions to domestic tax laws, the OECD Model Tax Convention, the Commentary to the OECD Model Tax Convention, and the OECD Transfer Pricing Guidelines, as well as the development of a multilateral instrument to facilitate implementation of these recommendations.²⁵ The OECD’s Committee on Fiscal Affairs has already released for public comment, discussion drafts of the tax issues surrounding the digital economy, hybrid entities and instruments, and transfer pricing guidelines for intangibles, along with a discussion draft on preventing treaty abuse.

¹⁹ The OECD is a fifty-year-old influential forum where over thirty governments, including the United States, come together to discuss tax and economic policy, among other topics, and set international standards.

²⁰ OECD, ADDRESSING BASE EROSION AND PROFIT SHIFTING 15 (2013).

²¹ OECD, ACTION PLAN ON BASE EROSION AND PROFIT SHIFTING (2013) [hereinafter OECD BEPS ACTION PLAN].

²² See *id.* Action 5, at 18, Actions 11–12, at 21–22.

²³ *Id.* Actions 8–10, at 20.

²⁴ *Id.* at 13–14.

²⁵ *Id.* Action 15, at 24–25.

In 2013, G-20 finance ministers unanimously endorsed the OECD BEPS Action Plan at their July 20 meeting in Moscow,²⁶ as did the G-20 Leaders on September 6.²⁷ Note that the G-20 includes countries such as China, India, Saudi Arabia, Russia, Brazil, Indonesia, South Africa, and Argentina that are not members of the OECD but may participate in this project as Associates “on an equal footing with OECD members.”²⁸

III. UNITED STATES PARTICIPATION AND PROPOSALS

The United States issued a joint statement with the Nordic countries at the G-20 Summit in Russia supporting the OECD efforts on base erosion and profit shifting issues and is actively participating in the BEPS project.²⁹ In 2012, President Obama issued *The President's Framework for Business Tax Reform*, declaring that “empirical evidence suggests that income-shifting behavior by multinational corporations is a significant concern that should be addressed through tax reform.”³⁰ The Permanent Subcommittee on Investigations of the U.S. Senate Homeland Security and Governmental Affairs Committee has recommended strengthening the transfer pricing rules with respect to intellectual property as well as various Subpart F reforms.³¹ Senator Carl Levin, Chairman of the PSI, reintroduced his legislation, the Stop Tax Haven Abuse Act, in September 2013 to “[l]imit incentives to move intellectual property and related marketing rights offshore”³² A CRS report on tax havens

26 Kevin A. Bell, *G-20 Finance Ministers Meeting in Moscow Unanimously Back Anti-Evasion Action Plan*, INT'L TAX MONITOR, July 24, 2013, at 8.

27 *G20 Leaders' Declaration*, G20 (Sept. 6, 2013), <http://www.g20.org/news/2013/0906/782776427.html> (“We fully endorse the ambitious and comprehensive Action Plan—originated in the OECD—aimed at addressing base erosion and profit shifting We welcome the establishment of the G20/OECD BEPS project and we encourage all interested countries to participate. Profits should be taxed where economic activities deriving the profits are performed and where value is created.”).

28 See OECD BEPS ACTION PLAN, *supra* note 21, at 25.

29 *Joint Statement by Kingdom of Denmark, Republic of Finland, Republic of Iceland, Kingdom of Norway, Kingdom of Sweden, and the United States of America*, WHITE HOUSE OFF. PRESS SECRETARY (Sept. 4, 2013), <http://www.whitehouse.gov/the-press-office/2013/09/04/joint-statement-kingdom-denmark-republic-finland-republic-iceland-kingdom>.

30 THE WHITE HOUSE & DEPT OF THE TREASURY, THE PRESIDENT'S FRAMEWORK FOR BUSINESS TAX REFORM 7 (2012), available at <http://www.treasury.gov/resource-center/tax-policy/Documents/The-Presidents-Framework-for-Business-Tax-Reform-02-22-2012.pdf>.

31 *PSI Report*, *supra* note 13, at 6. The Subpart F regime requires current U.S. taxation on the domestic parent corporation for certain types of income earned by certain foreign corporations known as controlled foreign corporations. See I.R.C. §§ 951–964. Subpart F defines which income is not eligible for the deferral regime: for example, income from the sales of foreign property to related parties. I.R.C. § 951.

32 *Summary of the Levin-Whitehouse-Begich-Shaheen Stop Tax Haven Abuse Act S. 1533*, CARL LEVIN U.S. SENATOR MICH. (Sept. 19, 2013), <http://www.levin.senate.gov/newsroom/press/release/summary-of-the-levin-whitehouse-begich-shaheen-stop-tax-haven-abuse-act>.

summarizes the numerous policy options available to address corporate profit shifting.³³

International tax reform proposals in the Administration's Fiscal Year 2015 budget released March 2014 include the current taxation of excess returns associated with transfers of intangibles offshore, the creation of a new category of Subpart F income for transactions involving digital goods or services, as well as deferral of the interest expense deduction related to the deferred income of the foreign subsidiaries of U.S. multinational corporations.³⁴ Other changes to discourage the shifting of profits offshore include restricting the use of hybrid arrangements that create stateless income and limiting the shifting of income through intangible property transfers.³⁵ The proposals to reform the U.S. international tax system would raise approximately \$276 billion from U.S. multinationals over the next ten years.³⁶ No one expects these provisions to be enacted immediately, but they are an important message to the international community as to the U.S. Administration's preferred solutions to the BEPS problem!

CONCLUSION

The United States is facing serious issues with respect to the base erosion and income shifting problems outlined in the BEPS Report and testimony given at the *Hearings on Offshore Profits Shifting Before the Senate PSI*. These issues need to be substantively addressed before any effort should be made on proposals to exempt foreign income or to change the U.S. international tax regime to a territorial system. The United States should participate fully in the OECD's effort to address the base erosion problem and begin making the necessary adjustments to the U.S. international tax regime that currently enables U.S. multinational corporations to legally avoid corporate taxes. The regulatory and statutory fixes needed for the U.S. international tax regime have been identified and should be adopted.

³³ GRAVELLE, *supra* note 5, at 24–29.

³⁴ U.S. DEPT OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2015 REVENUE PROPOSALS 45–46, 49–50, 58–59 (2014), *available at* <http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2015.pdf>.

³⁵ *Id.* at 47, 61.

³⁶ *Id.* at 280.

State-Level Carbon Taxes and the Dormant Commerce Clause: Can Formulary Apportionment Save the World?

Darien Shanske*

INTRODUCTION

A carbon price is coming, or so it would seem. Even though in the United States there have only been a handful of successful state-level efforts,¹ large firms are assuming that a price will be placed on their greenhouse gas emissions.² Yet until recently, it was unclear as a practical matter how a national price for carbon was going to get established.³ Indeed, it is still unclear, but one possible avenue has opened up. This is because in June 2014, the Environment Protection Agency (“EPA”) released draft rules mandating significant reduction in the release of carbon, a greenhouse gas. Specifically, by 2030 these rules aim to “achieve CO₂ emission reductions from the power sector of approximately 30 percent from CO₂ emission levels in 2005.”⁴ These rules give states great flexibility in achieving the required reductions.⁵

* I would like to thank all the participants in the 2014 *Chapman Law Review* Symposium on Business Tax Reform. I would also like to thank Ash Bhagwat, Dan Farber, David Gamage, Carlton Larson, John Swain, and Michael Wara. I was largely inspired to write this piece after reading the analysis of related issues by Mark Gergen and discussing them with him and the NorCal Tax Roundtable. Mark P. Gergen, *The Case in Economic Theory for Wrapping a Carbon Tax Around Cap and Trade* 6 (Aug. 27, 2013) (unpublished paper), available at http://www.law.berkeley.edu/files/Gergen_09092013.pdf. I am grateful to thank Mike Parnes for excellent research support. All mistakes are my own.

¹ For instance, there is California’s AB 32. CAL. HEALTH & SAFETY CODE § 38500 (West 2014).

² Coral Davenport, *Large Companies Prepared to Pay Price on Carbon*, N.Y. TIMES, Dec. 5, 2013, at A1, available at http://www.nytimes.com/2013/12/05/business/energy-environment/large-companies-prepared-to-pay-price-on-carbon.html?_r=0&pagewanted=print; *Carbon Copy*, ECONOMIST, Dec. 14, 2013, <http://www.economist.com/news/business/21591601-some-firms-are-preparing-carbon-price-would-make-big-difference-carbon-copy>.

³ Much less an international price, especially since so much attention has been focused on what the United States has done—or not done. See, e.g., Coral Davenport, *Governments Await Obama’s Move on Carbon to Gauge U.S. Climate Efforts*, N.Y. TIMES, May 27, 2014, at A11.

⁴ Carbon Pollution Emission Guidelines for Existing Stationary Sources: Electric Utility Generating Units, 79 Fed. Reg. 34,830, 34,832 (proposed June 18, 2014) (to be codified at 40 C.F.R. 60.5700), available at <http://www.gpo.gov/fdsys/pkg/FR-2014-06-18/pdf/2014-13726.pdf>.

⁵ *Id.* at 34,834–35.

Though imposition of a carbon tax is not explicitly mentioned one way or another in the draft rules as an acceptable approach, market-based approaches, such as California's cap and trade regime, are explicitly held up as possible models.⁶ Accordingly, *The New York Times* reported that "E.P.A. officials said states could even choose to comply by enacting a state-level tax on carbon pollution."⁷ In any event, and even before the EPA announcement, there has been some interest in the states in establishing a state-level carbon tax.⁸

This Article is about one specific aspect of the design of a state-level carbon tax.⁹ I will not be arguing whether or not, on balance, a state-level carbon tax is a good idea, though in fact I do believe that it is.¹⁰ There are many thorny design issues relating to a carbon tax at any level of government—for instance, should it be structured as a payment made by consumers, sort of like a retail sales tax,¹¹ or should it be structured as a levy imposed at certain carbon-intensive choke points? I will not be addressing such issues either in any detail; though, for the sake of the argument, I will stipulate some simple carbon tax structures.

⁶ See *id.* at 34,882 ("[A] state could change the relative costs of generation for more carbon-intensive and less carbon-intensive generating units by imposing a cost on carbon emissions. A state could do so through any of several market-based mechanisms.").

⁷ Coral Davenport & Peter Baker, *Taking Page from Health Care Act, Obama Climate Plan Relies on States*, N.Y. TIMES, June 3, 2014, at A16. For the argument that the EPA has the authority to approve state plans that rely on the carbon tax, see SAMUEL D. EISENBERG, MICHAEL WARA, ADELE MORRIS, MARTA R. DARBY & JOEL MINOR, *A STATE TAX APPROACH TO REGULATING GREENHOUSE GASES UNDER THE CLEAN AIR ACT* (2014), available at <http://www.brookings.edu/research/papers/2014/05/22-state-tax-regulating-greenhouse-gas-clean-air-act-morris>.

⁸ See, e.g., Henry J. Reske, *State Studying Possibility of Carbon Tax*, 70 ST. TAX NOTES 735, 735 (2013). Of course, the primary state-level experiments to date have been with cap and trade, and these systems too could become a national model.

⁹ Strictly speaking, carbon dioxide is only one form of greenhouse gas—that is, the type of gas implicated in causing global warming. As will be noted below, I will not be assuming that the carbon tax imposed by a state would only be on carbon. However, I will be following Metcalf and Weisbach by labeling this tax a "carbon tax" even if it applies to other gases as well. See Gilbert E. Metcalf & David Weisbach, *The Design of a Carbon Tax*, 33 HARV. ENVTL. L. REV. 499, 500 (2009). The tax in British Columbia, for example, does only tax carbon. See David G. Duff, *Carbon Taxation in British Columbia*, 10 VT. J. ENVTL. L. 87, 93 (2008).

¹⁰ For useful summaries of the arguments, see Donald B. Marron & Eric J. Toder, *Tax Policy Issues in Designing a Carbon Tax*, AM. ECON. REV., May 2014, at 563; Adele Morris, *An EPA-Sanctioned State-Based Carbon Tax Could Reduce Emissions and Improve State Finances*, BROOKINGS (Apr. 1, 2014, 5:10 PM), <http://www.brookings.edu/blogs/up-front/posts/2014/04/01-epa-carbon-tax-can-help-environment-state-finances-morris>; Roberta F. Mann, *The Case for the Carbon Tax: How to Overcome Politics and Find Our Green Destiny*, 39 ENVTL. L. REP. 10,118 (2009).

¹¹ See Dan Farber, *The Possible Merits of a Hybrid Sales+Carbon Tax*, LEGALPLANET (Oct. 8, 2012), <http://legal-planet.org/2012/10/08/the-possible-merits-of-a-hybrid-salescarb-on-tax/>.

So what *will* I be discussing? I will be addressing whether the federal Constitution, and in particular the judicially crafted dormant Commerce Clause (“DCC”), prevents a state from imposing border tax adjustments (“BTAs”) as part of its carbon tax. There are strong arguments that the DCC would pose an obstacle. In particular, any border adjustments would have to be somewhat imprecise, but the Supreme Court has been very miserly about permitting an approximately compensating tax to fall on imports to a state.¹² But perhaps this is going too quickly. There are several routes by which a properly designed carbon tax with border tax adjustments might pass muster.¹³

I. OUTLINE OF A CARBON TAX

I will not be writing about the details of carbon tax design, but we should outline at least a reasonable design of a carbon tax so that we can understand the problem that might come before a court. My outline will roughly follow the carbon tax design proposed by Gilbert Metcalf and David Weisbach.

Most, eighty percent, of the greenhouse gas produced in our economy is produced by fossil fuels.¹⁴ Fossil fuel production occurs via a number of chokepoints, such as refineries, of which there are under 200 in the United States.¹⁵ So let us suppose that

¹² Steven Ferrey, *Goblets of Fire: Potential Constitutional Impediments to the Regulation of Global Warming*, 35 *ECOLOGY L.Q.* 835, 880–81 (2008) (doubting complementary tax doctrine can save border adjustments). *But see* William Funk, *Constitutional Implications of Regional CO₂ Cap-and-Trade Programs: The Northeast Regional Greenhouse Gas Initiative as a Case in Point*, 27 *UCLA J. ENVTL. L. & POL’Y* 353, 366–67 (2009) (providing a slightly more optimistic analysis).

¹³ Note that border adjustments imposed by a state would also likely raise issues related to international trade. These issues are beyond the scope of this Article, though note that at least some commentators plausibly see the issues as largely analogous, and thus perhaps a solution within the U.S. federal system might suggest an answer internationally. Mark P. Gergen, *The Case in Economic Theory for Wrapping a Carbon Tax Around Cap and Trade* 6 (Aug. 27, 2013) (unpublished paper), available at http://www.law.berkeley.edu/files/Gergen_09_092013.pdf; *see also* Joost Pauwelyn, *Carbon Leakage Measures and Border Tax Adjustments Under WTO Law*, in *RESEARCH HANDBOOK ON ENVIRONMENT, HEALTH AND THE WTO* 448 (Geert Van Calster & Denise Prévost eds., 2013) (explaining why border tax adjustments might be permissible under international trade law); Carol McAusland & Nouri Najjar, *Carbon Footprint Taxes* § 5 (Oct. 24, 2013) (unpublished manuscript), available at <http://people.landfood.ubc.ca/carol.mcausland/McAusland%20Najjar%20Carbon%20Footprint%20Taxes.pdf> (detailed discussion of WTO issues). Or perhaps not. Indeed, if state border tax adjustments did cause sufficient problems for the United States, then they might be struck down domestically as running afoul of the Foreign dormant Commerce Clause. *See Japan Lines, Ltd. v. Cnty. of L.A.*, 441 U.S. 434, 453–54 (1979).

¹⁴ Metcalf & Weisbach, *supra* note 9, at 522.

¹⁵ *Id.* at 523.

a state imposes a \$15/metric ton tax on carbon, collected at refineries.¹⁶

This new tax will make exports from the taxing state more expensive and imports to the state cheaper. To illustrate this, let us focus on a different concrete example: concrete. The process of concrete production produces carbon over and above the energy that the production of concrete requires.¹⁷ There are only a small number of cement plants in the United States, and thus this is another good time and place to impose a carbon tax. So, suppose Oregon imposes a carbon tax; it will thereby significantly disadvantage its domestic concrete producers not only in the export market, but also within the state.¹⁸ Note that this disadvantage is not a result of anything the Oregon producer has or has not done; the disparity is a result of the fact that this producer is based in a state trying to mitigate a worldwide externality, but, by hypothesis, many other states are not.¹⁹

This economic problem is also an environmental problem and a political problem. Obviously, if more expensive Oregon concrete is replaced by cheaper out-of-state concrete made cheaper because of a lack of a carbon tax, then the carbon tax will not only hurt Oregon business, but it will not reduce total carbon emissions. This problem is called "leakage." Naturally, the prospect of economic harm suffered for no environmental gain is likely to hurt the political prospects of any such reform right from the start.

The direct fix is to credit the Oregon producer for all of the concrete that she is exporting and impose an equivalent tax on imports of concrete. In this case, it is perhaps easy enough for Oregon to estimate the carbon tax it has imposed on the concrete and to strip it out, and also to add this cost to imports. The Oregon concrete producer would pay a per unit tax on its concrete and then get a refund for the concrete it exported. A concrete importer would then need to pay the same per unit cost

¹⁶ Note that this price is higher than the current price on the European or California exchanges, where the numbers are approximately \$6.70 and \$11.50, respectively. *Carbon Copy*, *supra* note 2. This price is much lower than that used by at least some large firms. Exxon Mobil is reportedly using \$60/ton. *Id.*

¹⁷ Metcalf & Weisbach, *supra* note 9, at 530.

¹⁸ Cf. JENNY H. LIU & JEFF RENFRO, NW. ECON. RESEARCH CTR., CARBON TAX AND SHIFT: HOW TO MAKE IT WORK FOR OREGON'S ECONOMY 15 (2013), *available at* <http://www.pdx.edu/nerc/carbontax2013.pdf> (identifying the problem).

¹⁹ Metcalf & Weisbach, *supra* note 9, at 540. Note also that a whole other issue is raised if the other state (or nation) is trying to control carbon emissions, but in a manner not directly comparable—e.g., California's cap and trade system. We will leave those questions to the side for the moment, though note that the same basic analysis should apply should one state try to unilaterally adjust its regime to cope with the different carbon prices set by other jurisdictions (say through using an adjustable credit).

when it imports concrete.²⁰ However, because this tax would be specifically on imports, would this tax not be constitutionally prohibited as a facial discrimination? This is our first doctrinal question.

Even more perplexing, if Oregon is to truly achieve its goals, it will need also to use approximations based on the *origin* of goods and services. That is, it is likely cheaper to produce concrete in a state that has cheaper—but let us suppose more carbon intensive—power sources. Assuming that Oregon could impose some type of border adjustment, could it impose one that ultimately takes into account the origin of a good or service? Let's return to our Oregon concrete producer and suppose it is paying 1 x per unit in carbon taxes. Under these adjustments, an out-of-state importer may need to pay 1.2 x per unit—or perhaps 0.9 x—depending on the origin of the concrete. As for out-of-state producers paying *more*, this seems to be an even more blatant facial discrimination. This is our second question. Our third question has to do with how carbon intensity is being measured, as surely it is just an approximation. How much imprecision, if any, is permissible?

And so these are the three doctrinal questions posed by border tax adjustments: (1) Can there be any special tax at all on imports, even if it is the same as a tax on domestic production? (2) Could a state differentiate its border adjustments between products based on approximations of their carbon intensity if such approximations take geography into account? (3) Even if questions one and two are answered in the affirmative, how much approximation is permissible?

II. THE PRIMA FACIE ANSWERS: BORDER ADJUSTMENTS ARE DOOMED

The Supreme Court imposes an almost per se rule of invalidity as to taxes that discriminate between in-state and out-of-state taxpayers. Thus, the answer to the second question, about applying different rates to products based on the different carbon footprints of different states or regions, is very likely to be “no” and that would seem to be the end of the story whatever the answers to the other questions.²¹ Indeed, out-of-state producers

²⁰ This is an easy example; how would one strip out the carbon tax from in-state services? This is why it is important to apply the tax at just a few points where this kind of calculation is at least roughly possible.

²¹ See *Rocky Mountain Farmers Union v. Corey*, 740 F.3d 507, 513 (9th Cir. 2014) (Smith, J., dissenting); see also Joseph Allan MacDougald, *Why Climate Law Must Be Federal: The Clash Between Commerce Clause Jurisprudence and State Greenhouse Gas Trading Systems*, 40 CONN. L. REV. 1431, 1435 (2008) (similar analysis).

seem necessarily to be at a disadvantage to the extent that the border adjustment takes into account the additional carbon burned in transporting a product.

As to the first and third questions—can there be a special import charge at all and how much imprecision is permissible—the Court has tolerated special taxes on imports (the use tax) only when they precisely matched up with a tax on domestic consumption (the sales tax).²² Because assessing the carbon intensity of both domestic and imported products is going to be the product of informed guesswork, it looks like such a practice will not pass muster either. Thus, the answer to the first and third questions is also “no.”

A. First Counterargument: There Is Not a Facial Discrimination

California is in the midst of implementing a cap and trade system (“AB 32”) for controlling greenhouse gasses. A cap and trade system and a carbon tax can function in exactly the same way; both are trying to place a price on carbon in order to encourage conservation. The tax is a tax and so is clearly a cost. In cap and trade, polluters need to pay for the privilege to pollute, which is also a cost. One downside to cap and trade is that it imposes a significant burden on the regulator to try to estimate how much different industries pollute, and thus how many credits they will need to purchase. If the regulator gets this wrong, all manner of problems can result. For instance, on a system-wide level, if the regulator sells too many permits at too low a price (or gives them away), then the desired reductions will not occur.²³ Within an industry, if the regulator incorrectly requires Firm A to purchase more permits than Firm B, then Firm B is given a comparative advantage wholly because of the regulation. This should sound familiar because it is the same problem that spurred us to consider border tax adjustments.

As part of its implementation of AB 32, California’s cap and trade system, California’s Air Resources Board (“CARB”) adopted a Low Carbon Fuel Standard. This standard sets an annual limit on the carbon intensity of fuels; blenders of fuels over the limit must purchase credits from blenders below the limit. In order to assess how a particular fuel did relative to the standard, CARB had to develop a complicated metric that differentiated among

²² See, e.g., *Henneford v. Silas Mason Co.*, 300 U.S. 577, 583–84 (1937).

²³ This is essentially what happened to the European Trading System. See *ETS, RIP?*, *ECONOMIST*, Apr. 20, 2013, <http://www.economist.com/news/finance-and-economics/21576388-failure-reform-europes-carbon-market-will-reverberate-round-world-ets>.

fuels by region (among other things). The rationale for differentiating between regions was that there were differences in the carbon intensity of fuels produced in different places. If California wanted its system to actually reduce carbon, it needed to rely on such metrics.

A federal district court struck down the California Fuel Standard. Among other reasons, and the key reason for our purposes, the court found that taking into account the source of fuels was a facial discrimination that failed strict scrutiny.²⁴ A panel of the Ninth Circuit overturned the district court by a vote of 2 to 1.²⁵ Crucially, the panel only overturned the case as to the facial constitutional challenge to the fuel standard, and thus the standard may still be found wanting after a fact-intensive analysis.²⁶ The full Ninth Circuit refused to hear the case en banc.²⁷ The Supreme Court refused to grant certiorari.²⁸

As to the facial discrimination argument, the majority reasoned that there was no facial discrimination because the California regulations were not targeting out-of-state producers because they produced out-of-state; rather, the regulations were motivated by and based on an entirely different concern, namely measuring carbon intensity.²⁹ Sometimes in-state producers did better by this metric and sometimes not.³⁰ California was not basing its regulations on state borders.

Interestingly, though this was not formally a tax case, the decision revolved around several key DCC tax cases.³¹ Conceptually, this makes sense because, as noted above, regulations and taxes are often policy substitutes. Accordingly, though Supreme Court cases seem to apply a different test to taxes versus regulations, I know of no case where the Court says

²⁴ *Rocky Mountain Farmers Union v. Goldstone*, Nos. CV-F-09-2234 LJO DLB, CV-F-10-163 LJO DLB, 2011 WL 6936368 (E.D. Cal. Dec. 29, 2011).

²⁵ *Rocky Mountain Farmers Union v. Corey*, 730 F.3d 1070 (9th Cir. 2013).

²⁶ This point was emphasized by the author of the Ninth Circuit decision in his concurrence to the denial of the hearing en banc. *Rocky Mountain Farmers Union v. Corey*, 740 F.3d 507, 510 (9th Cir. 2014) (Gould, J., concurring).

²⁷ *Id.* at 513.

²⁸ *Rocky Mountain Farmers Union v. Corey*, No. 13-1148, 2014 WL 1118399, at *1 (U.S. June 30, 2014).

²⁹ *Corey*, 730 F.3d at 1089 (“[T]he Fuel Standard does not base its treatment on a fuel’s origin but on its carbon intensity. The Fuel Standard performs lifecycle analysis to measure the carbon intensity of all fuel pathways.”). The dissent disagreed with this characterization of the fuel standard. *Id.* at 1108 (Murguia, J., dissenting). Note that this factual dispute might be decisive in this case, but the doctrinal argument would still stand that if a regulation truly did not base itself on geography, then it would not count as a facial discrimination.

³⁰ *Id.* at 1083–84 (majority opinion) (noting California ethanol producers pay more because they import midwestern corn).

³¹ See, e.g., *id.* at 1089 (distinguishing *Oregon Waste*).

that there are different rules, or justifies different rules.³² In any event, the Ninth Circuit, in interpreting lead tax cases, seems to outline a promising strategy for defending a carbon tax with border adjustments, should it be properly designed from the start. Specifically, the carbon intensity framework needs to apply to *all* products and services. So long as the regulatory structure is sufficiently rigorous and based on factors other than jurisdictional lines, then it should pass muster even if some inputs take geography into account.

An additional important feature of the California regulation is worth noting. The Fuel Standard works in general by setting defaults and then allowing firms to argue for individualized determinations.³³ Thus, the majority opinion noted that any mischief caused by the general formulas—including to out-of-state producers—could be corrected.³⁴ The dissent did not believe that these individualized determinations went far enough.³⁵ It is not clear how important this issue ultimately was to the majority's reasoning, but permitting individual firms to challenge a default seems to be a prudent feature should one wish to design a system that would be upheld under the Ninth Circuit's reasoning.³⁶

B. Second Counterargument: Even If There Is Facial Discrimination, Perhaps It Is Not Fatal Because of the Complementary Tax Doctrine

As was appropriate, the majority opinion in *Rocky Mountain* hewed closely to Supreme Court precedent in arriving at its conclusion upholding California's Low Carbon Fuel Standard. Yet the majority in *Rocky Mountain* might not have hewed to existing precedent closely enough. Are there other routes to upholding border adjustments? I believe that there are.

The first route is to argue that, under current doctrine, a border adjustment represents a complementary tax and, as such, the *prima facie* discrimination is not invalid because it "achiev[es] a legitimate local purpose that cannot be achieved through nondiscriminatory means."³⁷ The key modern application

³² See generally David Gamage & Darien Shanske, *The Saga of State 'Amazon' Laws: Reflections on the Colorado Decision*, 65 ST. TAX NOTES 197, 199 (2012).

³³ *Corey*, 730 F.3d at 1082.

³⁴ *Id.* at 1094; *Corey*, 740 F.3d at 510 (Gould, J., concurring).

³⁵ *Corey*, 730 F.3d at 1109 (Murguia, J., dissenting).

³⁶ By analogy, Gamage and Heckman have argued that a similar scheme—of a reasonable default that can be overcome—ought to allow states to require remote vendors to collect use taxes. David Gamage & Devin J. Heckman, *A Better Way Forward for State Taxation of E-Commerce*, 92 B.U. L. REV. 483 (2012).

³⁷ *Or. Waste Sys. Inc. v. Dep't of Env'tl. Quality of Or.*, 511 U.S. 93 (1994).

of the doctrine is *Henneford v. Silas Mason Co.*,³⁸ where the Supreme Court upheld Washington's imposition of a use tax on out-of-state purchases to compensate for the sales tax it imposed on sales made within the state. Thus, if the Court, or a court, does not accept the *Rocky Mountain* argument that there is no discrimination at all, then it might accept an argument based on the complementary tax doctrine that the discrimination is justified. Certainly, if the carbon tax were identically imposed on imports—that is, taking no account of carbon intensity—the case looks pretty strong. But what if, as seems important, a state did try to take the relative carbon intensity of imports into account?

A leading recent case on the doctrine, and one seemingly similar to our scenario, is *Oregon Waste Systems*.³⁹ In *Oregon Waste Systems*, Oregon imposed a surcharge on waste imported from out-of-state of \$2.25/ton, while the in-state charge was \$0.85/ton.⁴⁰ Oregon's statute required that the surcharge "be based on the costs to the State of Oregon and its political subdivisions of disposing of solid waste generated out-of-state which are not otherwise paid for."⁴¹ Thus, Oregon had a colorable argument that its surcharge was compensating, but it failed the demanding three-part test for a discriminatory tax to be upheld as complementary.

The test for complementary taxes is as follows: First, a special out-of-state burden must be identified. Second, the out-of-state surcharge has to approximate, but not exceed, the identified burden. Third, the event that triggers the in-state and out-of-state tax must be "substantially equivalent."⁴² The Oregon scheme failed the first and third prongs—indeed it was a kind of Catch-22. The only identifiable charge was the charge paid by in-state producers, but this was only a third as much as charged to out-of-state producers. Thus, there was no identifiable burden. The State countered that the identified charge should take into account the general taxes that in-state producers paid but that out-of-state producers did not. Yet this argument ran smack into prong three; the occasion for paying a general property tax, for example, was not substantially equivalent to that of paying a special surcharge on imported waste.

³⁸ *Henneford v. Silas Mason Co.*, 300 U.S. 577 (1937).

³⁹ *Or. Waste Sys.*, 511 U.S. 93; cf. 1 JEROME R. HELLERSTEIN, WALTER HELLERSTEIN & JOHN A. SWAIN, *STATE TAXATION* ¶ 4.14.[3][c] (3d ed. 2012) (arguing that making the exception limited makes pragmatic and principled sense).

⁴⁰ *Or. Waste Sys.*, 511 U.S. at 96.

⁴¹ *Id.*

⁴² *Id.* at 103.

Taking a step back, accepting that compensating for *general* taxes would suffice does seem likely to lead to abuse and retaliation, and so the Court was on firm ground in *Oregon Waste Systems*.⁴³ It is, however, quite another thing for a state to adopt a tax on a broad new tax base, namely carbon, and then try to mitigate its impact with border adjustments. This situation is much more analogous to *Henneford*—the case that upheld the use tax as a complement to the sales tax. Or, put another way, a border adjustment would be based on an identified event—the production of carbon—and that event is substantially identical wherever it happens. With prongs one and three covered, this brings us to prong two—whether the border adjustment calculation is close enough for purposes of the DCC, and herein lies the trouble, perhaps. The problem arises out of a different sales tax case.

State sales taxes may be compensated by use taxes, but what about *local* sales taxes, say imposed at the county level? Presumably, an individual county can impose a use tax to complement its sales tax, but what if a state wanted to simplify matters by imposing a state-level use tax supplement that is the average of all local sales taxes? This is what Missouri did, imposing a 1.5% average use tax at the state level to compensate for the sales tax imposed by some 1000 localities.⁴⁴ The Court in *Lohman* found that this added use tax violated prong two—a statewide average created a burden that was greater on imported goods in many instances, and it did not matter if this average helped importers the rest of the time.

Lohman suggests that the approximations that would be the necessary basis for border adjustments under a state-level carbon tax may fail. After all, the methodology that a state would need to use would need to be an average or other kind of approximation,⁴⁵ even if more individualized determination were also theoretically possible. However, these border adjustments could be distinguished from the average state-level sales tax at issue in *Lohman*. This is not a case where a statewide average is essentially whitewashing local discrimination, which was the Court's concern.⁴⁶ Here, the averages are being used to calculate what can only be calculated approximately even if a more

⁴³ See also *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996).

⁴⁴ *Associated Indus. of Mo. v. Lohman*, 511 U.S. 641, 644 (1994).

⁴⁵ Cf. *Rocky Mountain Farmers Union v. Corey*, 730 F.3d 1070, 1093 (9th Cir. 2013) (noting California fuel standard uses averages).

⁴⁶ *Id.* at 649–50.

individualized methodology were used; there is no underlying fact of the matter.⁴⁷

C. Third Counterargument: Formulary Apportionment as a Model for Approximation

The Court could still interpret *Lohman* differently. In particular, it might decide that it stands for a very broad principle: no averaging, only a precisely known amount can be compensated for. Or, relatedly, perhaps the Court would reason that there is an underlying fact about carbon intensity that can be discovered without a formula. The Court should be coaxed not to so interpret *Lohman* by reference to its formulary apportionment cases.

The test of whether a tax scheme violates the DCC is called the *Complete Auto* Test (“CAT”).⁴⁸ The second prong of the CAT bars discrimination; this test is very similar, perhaps identical, to the test for regulations. This is the prong we have essentially been discussing, but there is a third prong under the CAT: a tax must be fairly apportioned. Of course, if a tax is not fairly apportioned, then it is likely discriminatory, but this prong is not wholly duplicative. A typical apportionment formula, on its face, applies to all firms in the same way, whatever their location, but fair apportionment requires that that chosen method of apportionment be reasonable. The Court has long accepted rough formulas for apportioning the value or income of multi-state enterprises, such as using the relative amount of railroad track within a state.⁴⁹ This is an area in which the Court accepted a reality on the ground, namely that railroads were multistate enterprises,⁵⁰ the value of which could not be precisely located in a given state. The analogy with carbon production is strong. Let’s return to California’s fuel standard. It turns out that all fuels are

⁴⁷ Furthermore, as discussed above, the border adjustment regime could allow for individual challenges to the results yielded by the more general methodology. See *supra* notes 34–37 and accompanying text.

⁴⁸ *Complete Auto Transit v. Brady*, 430 U.S. 274 (1977).

⁴⁹ See, e.g., *Nashville, Chattanooga & St. Louis Ry. v. Browning*, 310 U.S. 362 (1940); *Norfolk & W. Ry. Co. v. Mo. State Tax Comm’n*, 390 U.S. 317, 324 (1968) (“A number of such formulas have been sustained by the Court, even though it could not be demonstrated that the results they yielded were precise evaluations of assets located within the taxing State.”). Interestingly, this last case, *Norfolk*, is the rare case where the Court did find a formula irrational because there was a pre-existing value against which the Court could compare the value arrived at by formula. That is not the case as to carbon intensity.

⁵⁰ A buried assumption is that the railroads are a “unitary business,” which is by no means always a simple matter to determine, but there is no question that the Court has accepted very large and disparate entities as sufficiently unitary to permit apportionment. See generally *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159 (1983).

not the same in terms of carbon intensity. For instance, some fuel has ethanol and some of that ethanol comes from the American Midwest and some from Brazil. In general, entire processes are producing carbon, but exactly how much requires an estimation based on many factors, including geography.

Two relatively recent apportionment precedents are particularly notable in supporting this analogy. First, there is *Moorman*.⁵¹ In *Moorman*, a manufacturer based in Illinois challenged Iowa's use of a single-sales factor method of apportionment for the purpose of ascertaining where the income of a multistate corporation was earned (and therefore taxable).⁵² The Illinois manufacturer noted that Illinois, like most states at the time, used a three-factor method of apportionment.⁵³ This method looked to the relative proportion of sales, property, and payroll that a multistate corporation earned in a particular state. Iowa used only the sales factor.⁵⁴ This choice of formula served to increase the income apportionable to Iowa of an Illinois business with Iowa sales, but to decrease the apportionable income of an Iowa business exporting to Illinois. Thus, Iowa's then solitary use of the single sales factor seems to advantage its domestic businesses. Nevertheless, the Court upheld Iowa's use of the single sales factor. At the heart of the Court's reasoning was the observation that it was not Iowa's formula that discriminated or was unreasonable; rather, it was the interaction of Iowa's system with the different systems of other states. The Court refused to dictate and enforce a uniform formula.⁵⁵ *Moorman* therefore stands for the principle that the Court will not pick and choose between formulas even if a chosen formula gives the state that adopts it an edge (or at least an apparent edge).

The second important precedent is *Trinova*.⁵⁶ In *Trinova*, the challenge was to Michigan's use of formulary apportionment in connection with its value added tax.⁵⁷ The plaintiffs asserted that value added could be more easily geographically located than total firm value or income, and thus use of a formula was unreasonable.⁵⁸ The Court held otherwise.⁵⁹ Presumably, Michigan could have attempted to locate value added more

⁵¹ *Moorman Mfg. Co. v. Blair*, 437 U.S. 267 (1978).

⁵² *Id.* at 269–72.

⁵³ *Id.* at 276.

⁵⁴ *Id.*

⁵⁵ *Id.* at 278–79.

⁵⁶ See generally *Trinova Corp. v. Mich. Dep't of Treasury*, 498 U.S. 358 (1991).

⁵⁷ There was also a challenge to the formula as discriminatory, a challenge the Court summarily dismissed. *Id.* at 384–86.

⁵⁸ *Id.* at 373–74.

⁵⁹ *Id.* at 374.

precisely, but the State was permitted to use an approximate formula given the still significant complexity and guesswork involved in locating value added.⁶⁰

The formulary apportionment line of cases thus provides an argument, by analogy, that ought to buttress the use of approximate formulas for making border adjustments. If Michigan could use a formula rather than try to track down value added, then why can't Oregon do something similar as to carbon intensity? Or, put another way, the plaintiffs in the formulary apportionment cases regularly insisted that they knew, via separate accounting, where the value or income of their firms was located. The Court has repeatedly rejected this contention; since locating multi-state firm value or income is like "slicing a shadow,"⁶¹ the states were not required to accept the shadow slices proffered by the plaintiffs. If this is true for firm value or income, why should this not be true for carbon intensity?

III. SIDEBAR: APPLICATION OF THE SPIRIT OF THE PUBLIC UTILITY EXCEPTION?

It must be granted that the Court could reject the fair apportionment analogy, instead holding that what is acceptable approximating under the fair apportionment prong of CAT is not necessarily acceptable under the anti-discrimination prong. As for anti-discrimination, no approximating is permitted. Yet there are hints in the Court's recent DCC jurisprudence that it will not reach out to invalidate sensible state innovations.

We should remember that the DCC is federal constitutional common law. The current DCC test for whether a tax passes constitutional muster, the four prong *Complete Auto* Test, was a result of a backwards look at what the Court had done in actual cases—while all the while overturning large parts of the doctrine to that point, and all in the name of forging a more pragmatic test.⁶² Since the advent of the *Complete Auto* Test in 1977, one

⁶⁰ *Id.* at 379 ("The same factors that prevent determination of the geographic location where income is generated, factors such as functional integration, centralization of management, and economies of scale, make it impossible to determine the location of value added with exact precision.").

⁶¹ *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 192 (1983).

⁶² *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 277–78 (1977); cf. Jesse H. Choper & Tung Yin, *State Taxation and the Dormant Commerce Clause: The Object-Measure Approach*, 1998 SUP. CT. REV. 193, 199 ("The central problem with *Complete Auto* is that its four prongs are functionally overlapping and redundant in attempting to fulfill the bedrock constitutional value served by judicial review of state taxation of interstate commerce: nondiscrimination against interstate commerce.").

prong has become largely irrelevant,⁶³ another prong has taken on a surprising life of its own,⁶⁴ and (at least) two additional prongs are tucked into one of the remaining two prongs.⁶⁵ Thus, quite reasonably, Justice Scalia has written (with Justice Thomas concurring) that he “look[s] forward to the day when *Complete Auto* will take its rightful place . . . among the other useless and discarded tools of our negative Commerce Clause jurisprudence.”⁶⁶ Indeed, a current majority of the Court, writing through Chief Justice Roberts, has recently written that “[t]he dormant Commerce Clause is not a roving license for federal courts to decide what activities are appropriate for state and local government to undertake.”⁶⁷

This strong language comes from the Court’s 2007 decision in *United Haulers*.⁶⁸ In that case, the Court essentially overturned a recent precedent⁶⁹ in order to allow localities essentially to monopolize the local waste processing business. I have argued elsewhere that the best way to understand this decision is as accepting of a new economic reality.⁷⁰ The waste management industry used to be one in which competition was possible. Yet, as the environmental impact of waste disposal has grown, so too has the expense of treating waste properly. Thus, as was the case apparently in the two-county region at issue in *United Haulers*, waste management had become a natural monopoly. That is, any one—very expensive—treatment plant could handle all the waste in the region. Adding a second plant would only be wasteful. In such a circumstance, the Court narrowed earlier precedent in order to allow governments to pursue an economically sensible solution to a regional problem;

⁶³ The fourth prong, so-called “fair relation.” See *Commonwealth Edison Co. v. Montana*, 453 U.S. 609, 610 (1981).

⁶⁴ This is the first prong, “substantial nexus,” which was held in *Quill* to require a more substantial nexus than that required by the Due Process Clause. See *Quill Corp. v. Heitkamp*, 504 U.S. 298, 311–12 (1992).

⁶⁵ The Court looks for the internal and external consistency of a tax; these requirements are sometimes placed under the anti-discrimination prong, and sometimes the fair apportionment prong. See, e.g., *Armco Inc. v. Hardesty*, 467 U.S. 638, 644 (1984) (internal consistency required under fair apportionment and anti-discrimination prongs); *Okla. Tax Comm’n v. Jefferson Lines, Inc.*, 514 U.S. 175, 185 (1995) (internal and external consistency under fair apportionment prong).

⁶⁶ *Jefferson Lines, Inc.*, 514 U.S. at 201 (Scalia, J., concurring).

⁶⁷ *United Haulers Ass’n v. Oneida-Herkimer Solid Waste Mgmt. Auth.*, 550 U.S. 330, 343 (2007).

⁶⁸ See *id.*

⁶⁹ See generally *C & A Carbone, Inc. v. Town of Clarkstown*, 511 U.S. 383 (1994).

⁷⁰ Darien Shanske, *The Supreme Court and the New Old Public Finance: A New Old Defense of the Court’s Recent Dormant Commerce Clause Jurisprudence*, 43 URB. LAW. 659, 669 (2011).

namely, the governments were permitted to build one expensive plant and then force local waste haulers to use it.⁷¹

By analogy, the problem of reducing carbon emissions is a new one and one that transcends state borders. The science and economics of carbon leakage are hard to gainsay—or at least inappropriate for a court to gainsay. Why should the Court reject all the doctrinal arguments made thus far only to hamstring state efforts to address what the Court has already accepted is a major problem?⁷² This is an apt place to review the arguments thus far to see just how many “off-ramps” are available to the Court, at least if confronted by a well-designed system of BTAs. First, following the argument of *Rocky Mountain*, the Court can find that there is simply no discrimination. Second, the Court could accept that BTAs satisfy the complementary tax doctrine as it currently stands. Third, the Court could accept that BTAs satisfy a slightly revised complementary tax doctrine through not holding it constitutionally problematic that the BTAs rely on approximations (as they must). This argument would rely on an analogy with formulary apportionment. The Court should be propelled to one of these routes by the same sense of its institutional limitations that led to the decision in *United Haulers*.

But perhaps the Court will refuse to do so. Or, at any rate, perhaps the uncertainty here will, as a pragmatic matter, prevent the implementation of a robust carbon tax with BTAs. Is there another way to structure a carbon tax so as to achieve the benefits of BTAs?

IV. ALTERNATIVE DESIGN: FORMULARY APPORTIONMENT AS A SUBSTITUTE FOR BORDER ADJUSTMENTS

Up to this point we have been considering formulary apportionment as an *analogy* for a border adjustment. Yet the mere fact that these adjustments would occur on imports (and exports) arguably might be too great a hurdle to clear with the Supreme Court. Fortunately, there is still one additional possible approach: *replace* border adjustments with formulary apportionment.

Here is roughly how this might work. Instead of taxing a refinery as it refines oil, the carbon tax would tax the refining firm once a year in much the same way states currently

⁷¹ The Court has made similar adjustments to its doctrine in other, related, areas of law and, in particular, rate regulation where the Court ultimately decided to leave the setting of utility rates to expert regulators (for the most part). *Id.* at 714–16.

⁷² See, e.g., *Massachusetts v. EPA*, 549 U.S. 497 (2007).

administer their corporate income tax. Take an oil refiner—the firm would report how much oil it refined for use in the state, but before that number became the basis of the carbon tax, the state would apply an apportionment formula based on the carbon intensity of the oil it imported.⁷³ Thus, a firm that imports oil would need to pay its carbon tax after the amount of oil it imported was adjusted for the carbon intensity of its source, among other factors. As with current apportionment formulas, and as with California's fuel standard, a taxpayer should be able to challenge the formula. Regardless of the statute, formulas can be challenged as unconstitutional because unreasonable. The standard state act for apportionment, the Uniform Division of Income for Tax Purposes Act ("UDITPA"), offers taxpayers the possibility of additional relief, even if a formula does not fall below the constitutional floor, and this should be the case with carbon formulary apportionment as well.⁷⁴

Here is a more detailed example of how this structure might work and how it differs from just using BTAs. Let's go back to our basic carbon tax that charges a per unit charge on carbon and suppose, for a moment, that BTAs are acceptable. Now consider our Oregon hypothetical oil refiner. It has refined 1,000,000 units for use in Oregon and it is also taxed \$10 per unit for an initial liability of \$10,000,000. Half the refined oil came from Oregon, half from Texas. The Texas oil is judged by Oregon's methodology as more carbon intensive than that from Oregon. On those imports, the refiner is taxed at \$12 per unit and so the refiner owes total carbon tax of \$6,000,000 on this half of its production, for a total liability of \$11,000,000. It is this additional surcharge in particular that, as we discussed, might doom the BTAs.

What would apportionment look like? The refining company would file one annual return. In the current case of the corporate income tax, it is not known how much income is generated by a given state, and so one takes the total income a corporation has earned nationally and multiplies that number by some fraction—say the portion of sales in a given state/total sales. This ratio of

⁷³ See McAusland & Najjar, *supra* note 13 for a more detailed discussion of how such a system might work in terms of estimating the cost of carbon embodied in products. See also Charles E. McLure Jr., *The Carbon-Added Tax: A CAT that Won't Hunt*, POL'Y OPTIONS, Oct. 2010, at 62, 66 ("The most efficient way to implement a carbon tax is to impose it upstream. It is true that an upstream carbon tax would not provide the information required to calculate BTAs; it should be necessary to calculate BTAs in some other ad hoc way Fortunately, BAs [border adjustments] would be needed for trade only in a limited number of carbon-intensive basic products that are traded heavily with countries that do not limit CO₂ emissions.").

⁷⁴ UNIF. DIV. OF INCOME FOR TAX PURPOSES ACT § 18 (1957).

in-state sales to all sales may not be very easy to compute, but it is the relatively known data point we are using to estimate the known unknown, namely the income that can be fairly apportioned to a given state. So, suppose our Oregon oil refiner earned \$10,000,000 nationally. Then let's assume that Oregon used only the sales factor to apportion income and the oil refiner made 10% of its sales in Oregon, then \$1,000,000 of the refiner's income would be taxable in Oregon. The calculation looks like this:

Corporate Income Tax		
		Notes
Total Income	\$10,000,000	Known.
Apportionment Formula	10% X	Formulas take political geography into account, often strategically.
Taxable Base	<u>\$1,000,000</u>	Estimate resulting from formula.

Note that Oregon has a choice of apportionment formulas and, like most states, has probably chosen its formula strategically. Market states tend to prefer using only the sales factor, especially if that is what neighboring states are using; natural resource rich states tend to hang on to use of the property factor.⁷⁵

In the case of this theoretical new carbon tax, we also have a problem figuring out the base—namely total carbon emissions. As with the current corporate income tax system, we do know some things that will be useful for estimating state carbon emissions. We know, for instance, the brute number of the amount of oil a refinery has refined for use in state.⁷⁶ We also know, at least for the firm as a whole, where the oil came from.⁷⁷ We also know, thanks to the models of the type used by

⁷⁵ Darien Shanske, *A New Theory of the State Corporate Income Tax: The State Corporate Income Tax as Retail Sales Tax Complement*, 66 TAX L. REV. 305, 312–20 (2013).

⁷⁶ If we did not know the amount of oil refined for use in one state, then a reasonable formula could be applied here as well. Of course, the more formulas that are applied, the greater the deviation from the simple “God’s eye” example offered above, but that is alright because the underlying assumption here is precisely that this information is not known, and so reasonable approximations are permissible.

⁷⁷ As observed in the note above—more precise information is to be preferred, but firm-wide formulas should be acceptable unless they reach results that would implicate the concerns of section 18 of UDITPA.

California, how intensive these various sources are. And so we get the following:

Carbon Tax, Simple

		<u>Notes</u>
Total Raw Units in State	1,000,000	For instance, gallons of gasoline refined. This is assumed known.
Weighting Formula	110% X	Only takes environmental inputs into account, though these are geographically sensitive.
Taxable Base	<u>1,100,000</u>	

Note that, at least at this point, there is a stronger constitutional argument for carbon apportionment versus single sales factor apportionment insofar as the formula is not based on strategic calculations, but on a best guess as to carbon intensity.

But how does this system mimic border adjustments exactly? Returning to our example above, the key step would be to disaggregate the raw units by source and then to weigh them by carbon intensity, and so the calculation might look like this:

Carbon Tax, Breaking Out Weighting

		<u>Notes</u>
Total Raw Units in State	1,000,000	
Units from Region A	500,000	The weighing is only tangentially by "region." It is instead based on relevant characteristics of the region, such as its primary energy inputs or methods of oil extraction, etc.
Region A Weight	100% X	
Weighted Region A	<u>500,000</u>	
Units from Region B	500,000	
Region B Weight	120% *	
Weighted Region B	<u>600,000</u>	
Total Weighing	110%	
Taxable Base	<u>1,100,000</u>	

Note that, at least in this simple example, formulary apportionment has reached the same result as the border adjustment example above.

Using formulary apportionment to avoid the need for border adjustments is not a novel idea. This was part of the reform proposal of the California Commission on the Twenty-First Century Economy ("COTCE").⁷⁸ The heart of the COTCE

⁷⁸ STATE OF CAL. COMM. ON THE 21ST CENTURY ECON., REPORT OF THE COMMISSION ON THE 21ST CENTURY ECONOMY (2009), available at http://www.cotce.ca.gov/documents/reports/documents/Commission_on_the_21st_Century_Economy-Final_Report.pdf.

proposal was a state-level value added tax, called a Business Net Receipts Tax (“BNRT”). Yet imposing a broad new tax, it was feared, would disadvantage California businesses. The Commission did not believe it could impose border adjustments to strip out—or impose—its new tax. The COTCE proposal used formulary apportionment (only the sales factor) to try to make up for the lack of border adjustments. Unfortunately, and as critics noted, formulary apportionment cannot replace border adjustments in this context.⁷⁹ For instance, actual exporters would have their BNRT reduced by use of the single sales factor because only in-state sales would be used in the formula, but those domestic producers who sell to the exporters would not see any reductions because all of their sales are in state. This is because the design of the BNRT did not allow the tax to be added or subtracted on a transaction-by-transaction basis.

This criticism does not hold for a carbon tax, at least in the modified form we are discussing. The carbon tax would only be remitted by a handful of large producers; thus, there would not be the problem of many businesses having the carbon tax built into their prices without chance of rebate. Furthermore, the deep issue with relying on apportionment in the context of a value-added tax is that sales are different from value added. In the case of a carbon tax, the formula would be measuring carbon intensity, which is the same as the base of the tax.⁸⁰

CONCLUSION

This short Article is not an argument for a carbon tax in any form, though clearly it assumes that one would be worth pursuing. Rather, in this Article I have taken on the common assumption that a particular, and oft-proposed, design feature of a carbon tax—border tax adjustments—is not possible for a state-level carbon tax in the United States. I think this assumption is incorrect, or at least it may be incorrect. If carefully designed, taking into account the precedents and arguments discussed here, I believe a carbon tax with border tax adjustments could survive dormant Commerce Clause challenges. Alternatively, I believe an upstream carbon tax that used formulary apportionment to approximate border

⁷⁹ Charles E. McLure, Jr., *The Business Net Receipts Tax: A Dog That Will Not Hunt*, 37 HASTINGS CONST. L.Q. 745, 749–63 (2010); see also Kirk J. Stark, *Houdini Tax Reform: Can California Escape Its Fiscal Straightjacket?*, CAL. POLY OPTIONS, 2011, at 171, 173.

⁸⁰ I delve into some of the complexities of using sales as a proxy for income in another article. See Shanske, *supra* note 75, at 344–47.

State Income Taxation of Out-of-State Corporate Partners

*John A. Swain**

INTRODUCTION

A recurring issue in state taxation is whether an out-of-state partner is subject to tax in a state where the partnership is doing business when the partner's sole connection with the state is membership in the partnership.¹ State taxing authorities will almost invariably seek to assert jurisdiction. It is one thing to treat partnerships as pass-through entities; it is quite another to allow them to serve as "pass-out" entities that permit income earned in the state to avoid tax altogether. From a tax policy perspective, allowing such income to escape taxation would skew the economic playing field in favor of partnerships comprised of (untaxed) out-of-state partners and against partnerships comprised of (fully taxed) in-state partners.

This tax policy concern might be mitigated in the case of out-of-state partners taxed as individuals, since state individual income taxes are generally imposed on the income of residents wherever earned. Thus, it might plausibly be expected that the out-of-state partner's state of residence will ensure full income tax accountability. For corporate taxpayers, however, the state of residence (or corporate domicile) cannot be relied upon to ensure full accountability. This is because all states that impose a corporate income tax have eschewed residence-based taxation, either as a matter of policy choice or federal constitutional constraints. Instead, these states have embraced a source-based, formula apportionment approach to the taxation of corporate business income.² Thus, unless corporate income is taxed at its

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¹ Partners whose sole connection with a state is membership in a partnership doing business in the state will hereinafter simply be referred to as "out-of-state partners" or "out-of-state limited partners."

² See 1 JEROME R. HELLERSTEIN, WALTER HELLERSTEIN & JOHN A. SWAIN, *STATE TAXATION* ¶¶ 8.01–.02, 8.07 (3d ed. 2012) (discussing the history and operation of the "unit rule" in the context of property taxation and the "unitary business" rule and the "right to apportion" in the context of corporate income taxation).

source, it will usually not be taxed at all.³ For this reason, this Article focuses on the income taxation of out-of-state corporate partners, viewed from both a jurisprudential and tax policy perspective.

I. THE AUTHORITIES

A. Constitutional Principles

The assertion of jurisdiction to tax out-of-state corporate partners implicates both the Due Process and Commerce Clauses of the U.S. Constitution. In *Quill Corp. v. North Dakota*,⁴ the U.S. Supreme Court held that due process was not offended by the state's imposition of a use tax collection obligation on a non-physically present out-of-state seller. All that due process required was "some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax."⁵ The Court went on to say: "In this case, there is no question that . . . [the taxpayer] has purposefully directed its activities at North Dakota residents, [and] that the magnitude of those contacts is more than sufficient for due process purposes"⁶ The *Quill* Court, however, set a higher jurisdictional bar under the Commerce Clause, reasoning that while the "analytical touchstone" of due process analysis is "notice" or "fair warning," the "substantial nexus" requirement under the Commerce Clause is informed more by concerns about state taxes and regulations that may "unduly burden interstate commerce."⁷ Thus, at least in the context of sales and use taxes, the Court established a "physical-presence" nexus test, requiring that a seller must be physically present in a state in order for the state to impose a use tax collection obligation on that seller.⁸ The opinion also suggests, however, that the physical-presence test may be limited to sales and use taxes.⁹ Indeed, in the wake of

³ See *infra* note 48 and accompanying text (discussing the ineffectiveness of various mechanisms adopted by "non-source" states to absorb "nowhere income" in the context of corporate partners). The risk of non-taxation is greatest where the partnership's factors are included in the calculation of the corporate partner's apportionment ratio in states where the partnership is not doing business. See generally Bobby L. Burgner, *Income Taxes: Special Problems in Formulary Apportionment*, 1180 TAX MGMT. MULTISTATE TAX PORTFOLIOS (BNA) at 1180:0003d (2014). This is because some of the corporation's income will in effect be apportioned to the partnership state, and unless the partnership state asserts jurisdiction over the corporate partner and imposes a tax, some portion of the corporate partner's income will escape taxation. *Id.*

⁴ *Quill Corp. v. N.D.*, 504 U.S. 298 (1992).

⁵ *Id.* at 306 (quoting *Miller Bros. Co. v. Md.*, 347 U.S. 340, 344–45 (1954)).

⁶ *Id.* at 308.

⁷ *Id.* at 312.

⁸ *Id.* at 317–18.

⁹ *Id.* at 317.

Quill, the overwhelming majority of state courts have held that the *Quill* physical-presence test does not extend to state income taxes, although the Court has yet to squarely address the issue.¹⁰

B. Authorities Imposing Tax on Out-of-State Corporate Partners

In most states, a corporate partner in a partnership doing business in the state is subject to the state's corporate income or franchise tax on its distributive share of the partnership income, even if the corporate partner has no other ties to the state.¹¹ The tax is based on the aggregate—as distinguished from the entity—theory of partnerships, under which each general partner is deemed to be conducting the partnership business directly and as owning a share of its assets; or on the alternative theory that the partners who actually conduct the business act as agents for the out-of-state partners.¹² The states generally apply this rule to limited corporate partners as well as to general partners. Thus tribunals in Illinois,¹³ Kentucky,¹⁴ Massachusetts,¹⁵ New York

¹⁰ 1 HELLERSTEIN, HELLERSTEIN & SWAIN, *supra* note 2, ¶ 4.14.

¹¹ This discussion draws freely from 1 HELLERSTEIN, HELLERSTEIN & SWAIN, *supra* note 2, ¶ 6.12. Portions of the next three sections (B., C., and D.) are reprinted with permission with some updated material, from Jerome R. Hellerstein, Walter Hellerstein, and John Swain, STATE TAXATION ¶ 6.12 (3d ed. 2011). See also Michael W. McLoughlin & Walter Hellerstein, *State Tax Treatment of Foreign Corporate Partners and LLC Members After Check-The-Box*, ST. & LOC. TAX LAW., 2003, at 1; Prentiss Willson, Jr. & Mark Windfeld-Hansen, *State Taxation of Pass-Through Entities: General Principles*, 1500 TAX MGMT. MULTISTATE TAX PORTFOLIOS (BNA) at 1500:0002d (2014); People *ex rel.* Badische Fabrik v. Roberts, 42 N.Y.S. 502, 505 (N.Y. App. Div. 1896), *aff'd*, 46 N.E. 161 (N.Y. 1897); *In re Chapman v. Browne*, 48 N.Y.S.2d 598, 598 (N.Y. App. Div. 1944).

¹² See *supra* note 11. As a Tennessee trial court declared, “[A] general partner of a general partnership doing business in Tennessee is present in Tennessee, is doing business in Tennessee, and meets all requirements for taxable nexus with Tennessee through the partnership in Tennessee.” *Vodafone Ams. Holdings, Inc. v. Farr*, No. 07-1860-IV, Tenn. Chancery Ct., 20th Jud. Dist., Davidson Cnty. (Nov. 2, 2012) (Ex. 1 to *Vodafone Ams. Holdings, Inc. v. Roberts*, No. 07-1860-IV, Tenn. Chancery Ct., 20th Jud. Dist., Davidson Cnty. (Mar. 19, 2013)); *In re Shell Gas Gathering Corp. # 2 & Shell Gas Pipeline Corp. # 2*, 2009 WL 1745811 (N.Y. Div. Tax App. 2009), *aff'd* DTA Nos. 821569 & 821570 (Sept. 23, 2010) (where an administrative law judge (ALJ) sustained the state's power to tax foreign holding companies whose only connections with the state were their interests in a general partnership that, in turn, held a general partnership interest in a firm that did business in New York).

¹³ See *Borden Chems. & Plastics, L.P. v. Zehnder*, 726 N.E.2d 73, 84 (Ill. App. Ct. 2000) (holding that a nonresident limited partner was subject to tax on distributive share of partnership income based on partnership's in-state activities).

¹⁴ *Revenue Cabinet v. Asworth Corp.*, Nos. 2007-CA-002549-MR & 2008-CA-000023-MR, 2009 WL 3877518, (Ky. Ct. App. Nov. 20, 2009), available at http://scholar.google.com/scholar_case?case=14564833589495378568&hl=en&as_sdt=6&as_vis=1&oi=scholar (corporation whose only connection with Kentucky was ownership of limited partnership interest in partnership doing business in Kentucky was taxable as a partner doing business in Kentucky) (unpublished opinions may be cited in Kentucky only if there is no published opinion that would adequately address the issues before the court. Ky. St. RCP Rule 76.28(4)).

City,¹⁶ Alabama,¹⁷ North Carolina,¹⁸ and Oregon¹⁹ have so ruled. The Georgia Court of Appeals likewise ruled that a nonresident limited partner in a partnership engaged in securities investment in the state is subject to tax.²⁰

On the federal level, it can be noted that the United States has adopted a similar approach, treating foreign corporate limited partners of partnerships engaged in a U.S. trade or business as personally engaged in that trade or business.²¹

C. Authorities Holding, on Statutory Grounds, that Out-of-State Corporate Partners Are Not Subject to Tax

Tribunals in some jurisdictions, however, have reached a different conclusion, although typically on the ground that the limited partners were not “doing business” in the state under the state statute rather than on the ground that they were not constitutionally subject to tax, an issue these decisions do not

15 See *Utelcom, Inc. v. Comm’r*, No. C262339, 2005 WL 244820, at *2 (Mass. App. Tax. Bd. Jan. 31, 2005) (nonresident corporate limited partner was “doing business” in the state based on activities of partnership within the state and was taxable on its distributive share of partnership income earned in the state); see also *SAHI USA, Inc. v. Comm’r*, No. C262668, 2006 WL 3068116 (Mass. App. Tax Bd. Oct. 27, 2006), available at www.mass.gov/anf/docs/atb/2006/06p794.doc (same).

16 *In re Mazie Corp.*, TAT(H) No. 92-353 (GC), 2000 WL 1162056 (N.Y.C. Tax App. Tribunal July 21, 2000) (foreign corporation whose only contact with New York City was ownership of limited partnership that owned real property in the city had nexus with the city).

17 The Alabama Department of Revenue ruled that holding a limited partnership interest in an Alabama real estate business does not constitute “doing business” in the state for Alabama franchise tax purposes. Ala. Rev. Rul. 98-002 (Ala. Dep’t Rev. 1998).

18 N.C. Tax Review Bd., Admin. Dec. No. 351 (Jan. 28, 1999) (corporation with no connection to state other than interest in limited partnership that owned and operated restaurants in the state is doing business in North Carolina); N.C. Dep’t of Revenue, Secretary of Revenue, Dec. No. 97-548 (Apr. 24, 1998) (corporate limited partner in partnership doing business in North Carolina, but with no other connection to the state, is “doing business” in North Carolina and is subject to tax on an apportioned share of its distributive share of partnership income); cf. N.C. Dep’t of Revenue, Secretary of Revenue Dec. No. 2007-28 (Sept. 14, 2007) (corporation with no connection to state other than investment in limited liability company (LLC), which elected to be treated as a partnership for federal tax purposes, is taxable on pro rata share of LLC’s apportionable business income from its North Carolina activities).

19 *CRIV Inv., Inc. v. Dep’t of Revenue*, 14 Or. Tax 181, 184 (Or. T.C. 1997) (“When the income is distributable partnership income, it is immaterial that taxpayer is a limited rather than a general partner.”).

20 Dep’t of Revenue v. Sledge, 528 S.E.2d 260, 262 (Ga. Ct. App. 2000). Georgia law now provides, however, that a nonresident limited partner in a partnership engaged exclusively in selling, buying, and holding securities does not have Georgia taxable income. See GA. CODE ANN. § 48-7-24(c) (West 2006). This provision does not, however, change the jurisdictional principle announced in the case; it simply provides an exclusion for a particular category of income. *Id.*

21 See I.R.C. § 875(1) (2012); 2 JOEL D. KUNTZ & ROBERT J. PERONI, U.S. INTERNATIONAL TAXATION C1-90 (2013).

address. Decisions from Alabama, California,²² Louisiana,²³ and Tennessee²⁴ fall within this description. In a similar vein, New York generally does not treat a limited partner as doing business in New York, unless “it is engaged, directly or indirectly, in the participation or in the domination or control of all or any portion of the business activities or affairs of the partnership.”²⁵

D. Authorities Holding, on Constitutional Grounds, that Out-of-State Corporate Partners Are Not Subject to Tax

The decisions of two New Jersey courts, however, may be read as suggesting that a taxpayer, whose only connection to New Jersey was its investment in a limited partnership doing business there, could not *constitutionally* be taxed by the state.²⁶ There, the taxpayer was a limited partner owning a ninety-nine percent interest in a partnership that provided outsourcing

²² See, e.g., *In re Appeals of Amman & Schmid Finanz AG*, No. 96-SBE-008, 1996 WL 281551 (Cal. State Bd. of Equalization Apr. 11, 1996) (holding that foreign corporations with interests in limited partnerships that acquired, managed, rented, and sold California real property were not subject to California franchise tax, because the corporations were inactive participants in the partnerships). Unlike general partners, the corporations were not entitled to possess specific partnership property or to participate in partnership management. *Id.* Their only contact with the state was the receipt of their distributive share of the partnerships' California-source income. *Id.* Accordingly, the corporations were not doing business in California. *But see* Appeal of Int'l Health Inst., LLC, No. 305199, 2006 WL 680482 (Cal. St. Bd. of Equalization Mar. 7, 2006) (explaining that a single-member LLC that purchased interests in California LLCs and partnerships was “doing business” in California).

²³ See, e.g., *Utelcom, Inc. v. Bridges*, 77 So. 3d 39 (La. Ct. App. 2011) (franchise tax measured by capital stock).

²⁴ The Tennessee Department of Revenue ruled that a foreign corporation owning a limited partnership interest in a partnership engaged in the real estate construction business in Tennessee is not “doing business” in that state under Tennessee’s franchise and excise taxes as long as this activity constitutes the limited partner’s only business endeavor in Tennessee and the limited partner exercises no power, management, or control over the partnership. Tenn. Rev. Ltr. Rul. 97-49 (Dec. 2, 1997).

²⁵ N.Y. COMP. CODES R. & REGS. tit. 20, § 1-3.2(a)(6)(i) (2013). The regulations spell out in detail factual situations that will subject a foreign corporate limited partner to the New York tax. *Id.* This regulation may have taken its cue from the Uniform Limited Partnership Act, which provides that a limited partner is not liable for the debts (including the tax debts) of the partnership, as is a general partner, unless “he takes part in the control of the business.” UNIF. LTD. P'SHIP ACT § 303 cmt. (amended 2001), 6 U.L.A. (2008) (citing UNIF. LTD. P'SHIP ACT § 7 (1916)).

²⁶ *BIS LP, Inc. v. Dir., Div. of Taxation*, 25 N.J. Tax 88, 102–05 (N.J. Tax Ct. 2009), *aff'd and remanded*, 2011 WL 3667622 (N.J. Super. Ct. App. Div. 2011) (unpublished, not citable or precedential in New Jersey). In a separate portion of the New Jersey Tax Court’s decision, the court held that the taxpayer was a qualified investment company under New Jersey Law, subject to a reduced tax for the periods at issue, because the investment in the limited partnership should be treated as an investment in a security. N.J. STAT. ANN. § 54:10A-4(f) (West 2014); *BIS*, 25 N.J. Tax at 94–95. It refused to follow a regulation, issued after the tax year in question, purportedly “clarifying” the taxing authority’s position, which excluded direct investments in pass-through entities from the definition of a qualified investment asset if the entity would not have satisfied the definition of an investment company if it had been organized as a corporation. *Id.* at 99.

technology services for its clients. The taxpayer's sole connection to New Jersey was its limited partnership interest. The New Jersey statutes assert jurisdiction over every corporation "exercising its corporate franchise in this State,"²⁷ and further provide that: "[a] taxpayer's exercise of its franchise in this State is subject to taxation in this State if the taxpayer's business activity in this State is sufficient to give this State jurisdiction to impose the tax under the Constitution and statutes of the United States."²⁸

The New Jersey Tax Court approached the jurisdictional question as if it turned entirely on one of the bases set forth in the regulations for asserting jurisdiction over a foreign corporate limited partner—namely, whether "the business of the partnership is integrally related to the business of the foreign corporation."²⁹ Using this criterion, and relying heavily on the U.S. Supreme Court's unitary business decisions, the court concluded there was no jurisdiction because the taxpayer and the partnership "were not integrally related."³⁰ Specifically, the court noted that the taxpayer was a "passive investor," that it had "no control or potential for control in the limited partnership," and that it "was . . . not in the same line of business."³¹ It further observed that the corporate partner's interest was "more akin to an example in the regulations, which illustrates that a foreign corporation that simply holds a limited partnership interest in a foreign New Jersey partnership and is not part of the unitary business of the partnership is not subject to the [corporation business tax]."³²

In affirming the New Jersey Tax Court's decision "substantially for the reasons stated by Judge Bianco [the Tax Court Judge],"³³ the Appellate Division added little to Judge Bianco's analysis, but it strongly reinforced the impression that

27 N.J. STAT. ANN. § 54:10A-2 (West 2014).

28 *Id.* The implementing regulations reiterate the constitutional nexus standard for exercising a franchise. N.J. ADMIN. CODE §§ 18:7-1.6(b), -7.6(b) (2014).

29 *Id.* § 18:7-7.6(c).

30 *BIS*, 25 N.J. Tax at 105 (2009).

31 *Id.*

32 *Id.* The example in the regulation provides:

Corporation LMN holds a limited partnership interest in the same limited partnership. The corporation and the partnership are not part of a unitary business, and the limited partnership does not have liabilities to third parties. LMN is not subject to corporation business tax in New Jersey since it is a true limited partner . . .

N.J. ADMIN. CODE § 18:7-7.6, ex. IV (2014).

33 *BIS LP, Inc. v. Dir., Div. of Taxation*, No. 7847-2007, 2011 WL 3667622, at *2 (N.J. Super. Ct. App. Div. 23, 2011) (unpublished, not citable or precedential in New Jersey).

both courts' decisions rested on constitutional grounds. Thus, in response to the state's assertion that an amendment to the New Jersey statute reflected an intent to apply the tax broadly "to all circumstances permitted by the federal and state constitutions,"³⁴ the Appellate Division responded that "such an intent, like the statutory provisions themselves, cannot override *constitutional limitations* on a state's taxing power."³⁵ In characterizing Judge Bianco's opinion, the Appellate Division declared that "[h]e found that [the taxpayer] . . . did not have sufficient business activity to give New Jersey jurisdiction to impose tax *under the Constitution*."³⁶ Finally, in concluding, the Appellate Division observed that "the Director has not shown that Judge Bianco erred in finding no *constitutional basis* for imposing the [tax] at issue."³⁷

The New Jersey courts' decisions would have been unexceptional if the question had been simply whether a state can constitutionally assert jurisdiction over a holding company with no contact with a state other than its investment in a non-unitary corporation. Indeed, even the existence of a unitary relationship between an in-state and an out-of-state corporation may not, by itself, establish nexus over an out-of-state corporate affiliate.³⁸ The problem, however, is that we are dealing with partnerships, not corporations. In this context, the New Jersey decisions cannot be reconciled, at least as a matter of constitutional law, with the overwhelming weight of authority (described above) that even a limited partner is deemed to be doing business (and is subject to tax) wherever the partnership is doing business. Those decisions that have held limited partners nontaxable in the states in which the partnerships have carried on business have relied on state statutory, rather than federal constitutional, grounds.

One might try to reconcile the New Jersey decisions with these cases on the theory that they were construing the state statute rather than the federal Constitution. Moreover, the courts can hardly be taken to task for following the example in the state taxing authority's own regulations, which supports the view that the limited partner was not taxable under the facts presented in the example. However, because the state statute explicitly asserts jurisdiction as far the federal Constitution

³⁴ *Id.* at *5.

³⁵ *Id.* (emphasis added).

³⁶ *Id.* (emphasis added).

³⁷ *Id.* at *7 (emphasis added).

³⁸ See 1 HELLERSTEIN, HELLERSTEIN & SWAIN, *supra* note 2, ¶¶ 6.13[2], 8.07[1]; see also *Barclays Bank PLC v. Franchise Tax Bd.*, 512 U.S. 298, 311–12 & n.10 (1994).

would permit, the decisions seem inconsistent with the plain language of the statute.

Perhaps the distinction between a limited partner and a corporate shareholder is a meaningless one, and the strong policy for resolving tax cases on the basis of substance rather than form justifies the New Jersey courts' analyses.³⁹ Although such a position is plausible, it does not accurately reflect the contemporary understanding of constitutional restraints on state taxation, which generally treats limited partners the same as general partners for jurisdictional purposes.

II. TAX POLICY PERSPECTIVE

Persons engaged in cross-border activities should compete on a level tax playing field with similarly situated persons who engage in intrastate commerce.⁴⁰ To subject cross-border economic actors to multiple taxation, for example, would put them at an unfair competitive disadvantage compared to persons engaging in economic activities solely in state. Indeed, a prohibition against multiple taxation of multistate businesses is firmly embedded in Dormant Commerce Clause jurisprudence, which is designed to maintain our national common market.⁴¹

Though not a constitutional imperative, a closely related principle is that cross-border actors should not be given an unfair competitive *advantage* over local economic actors through "double non-taxation."⁴² As one of the early architects of the international income tax regime put it: "[T]he state which with a fine regard for the rights of the taxpayer takes pains to relieve double taxation, may fairly take measures to ensure that the person or property pays at least one tax."⁴³ Together, the tenets of avoiding multiple taxation of cross-border activities, on the one hand, and

39 See *Int'l Harvester Co. v. Wis. Dep't of Taxation*, 322 U.S. 435, 445 (1944) (upholding a withholding tax on dividends received by out-of-state shareholders measured by dividends attributable to the corporation's in-state earnings); 2 JEROME R. HELLERSTEIN, WALTER HELLERSTEIN & JOHN A. SWAIN, *STATE TAXATION* ¶ 20.05[1][a][i] (3d ed. 2012) (discussing jurisdiction to tax out-of-state shareholders).

40 This is a specific instance of the generally recognized tax policy value of horizontal equity. See generally JOHN L. MIKESELL, *FISCAL ADMINISTRATION: ANALYSIS AND APPLICATIONS FOR THE PUBLIC SECTOR* 282–84 (4th ed. 1995).

41 1 HELLERSTEIN, HELLERSTEIN & SWAIN, *supra* note 2, ¶ 4.14.

42 Reuven S. Avi-Yonah, *All of a Piece Throughout: The Four Ages of U.S. International Taxation*, 25 VA. TAX REV. 313, 316 (2005).

43 Michael J. Graetz & Michael M. O'Hear, *The "Original Intent" of U.S. International Taxation*, 46 DUKE L.J. 1021, 1039 n.72 (1997) (quoting Thomas S. Adams, *Interstate and International Double Taxation*, in *LECTURES ON TAXATION* 101, 112–13 (Roswell Magill ed., 1932)).

ensuring full accountability on the other, have been called the “single tax principle.”⁴⁴

In global (residence-based) tax systems, full accountability is easily achieved, at least in theory. The state of residence taxes all of its residents’ activity wherever that activity occurs, and so the issue of “double non-taxation” (under-taxation) does not arise, and double taxation (over taxation) is prevented by the allowance of a credit for foreign taxes paid.⁴⁵ The American states, however, either as a matter of policy choice or federal constitutional constraints, generally have eschewed residence-based taxation of business income. Instead, they have embraced a territorial (source-based) approach to the taxation of these items.⁴⁶

Traditional, geographically based sourcing rules, however, are not well suited to capturing the income of a resident corporate limited partner earned in a state that chooses not to tax out-of-state limited partners. While states are well aware of the problem of under-taxation generally⁴⁷ and have proposed (and sometimes adopted) a variety of mechanisms for achieving full accountability—such as “throwback,” “throwaround,” and “throwout”⁴⁸—these rules only apply to income over which the source state has no power to tax under federal law, either statutory or constitutional.⁴⁹ The application of throwback and

44 Reuven S. Avi-Yonah, *International Taxation of Electronic Commerce*, 52 TAX L. REV. 507, 517–20 (1997).

45 Determining the source of such activity may be, and often is, still important in connection with efforts to avoid double taxation. For example, if a jurisdiction that taxes income on a residence basis treats nowhere income as having its source in the state of residence, then it typically will deny a credit for taxes paid to another jurisdiction that claims to be the source of the nowhere income and taxes it on the basis of such claim. See REUVEN S. AVI-YONAH, DIANE M. RING & YARIV BRAUNER, *U.S. INTERNATIONAL TAXATION* chs. 2, 8 (3d ed. 2011).

46 See generally 1 HELLERSTEIN, HELLERSTEIN & SWAIN, *supra* note 2, ¶¶ 8.01, 8.02, 8.07 (discussing the history and operation of the “unit rule” in the context of property taxation and the “unitary business” rule and the “right to apportion” in the context of corporate income taxation). States do, however, tax on the basis of residence (with a credit for taxes imposed by the state of source) in other contexts, e.g., personal income taxation. See 2 HELLERSTEIN, HELLERSTEIN & SWAIN, *supra* note 39, ¶¶ 20.04, 20.10.

47 Of course, that “problem” may lie in the eye of the beholder, and non-taxation of activity that occurs in locations where it is not taxable would not amount to a “problem” in the eyes of many observers. In a real sense, this Article is an exploration of the conceptual and legal tension between these conflicting views of the non-taxation of economic activity.

48 See 1 HELLERSTEIN, HELLERSTEIN & SWAIN, *supra* note 2, ¶¶ 9.18[1][b], 9.18[1][c]; see also Walter Hellerstein, *Construing the Uniform Division of Income for Tax Purposes Act: Reflections on the Illinois Supreme Court’s Reading of the “Throwback” Rule*, 45 U. CHI. L. REV. 768, 775 (1978) (discussing throwback and throwout rules).

49 See *Whirlpool Props., Inc. v. Dir.*, Div. of Taxation, 26 A.3d 446, 452 (N.J. 2011) (finding that a “throwout” rule was constitutional only insofar as sales in states which did not have the constitutional (or federal statutory) power to tax were thrown out). See generally John A. Swain & Walter Hellerstein, *State Jurisdiction to Tax “Nowhere” Activity*, 33 VA. TAX REV. 209 (2013).

similar rules in situations where a state simply has chosen not to impose a tax on income⁵⁰ that is fully within the state's power to tax is undoubtedly unconstitutional. Thus, even where throwback and similar rules have been adopted, they would not effectively enforce full accountability in the case of out-of-state corporate partners.⁵¹

Accordingly, if full accountability of partnership income is to be achieved as a practical matter, source states will need to enforce a tax on corporate partners' distributive share of partnership income. As already noted, many states have straightforwardly done so by asserting jurisdiction over out-of-state corporate partners and their distributive share of partnership income. States that have failed to do so on statutory grounds could extend their jurisdictional reach with the stroke of a legislative pen. As for New Jersey, where two courts have held that the state cannot reach out-of-state limited partners as a matter of federal constitutional law, it can only be urged that the judiciary reconsider this view, which seems predicated on a false analogy between limited partners and corporate shareholders.

Even if a state were to remain uncomfortable with asserting jurisdiction over out-of-state corporate limited partners, the state could, as is often done, impose a withholding tax on the in-state partnership—an entity over which the state clearly has jurisdiction as a constitutional matter and against which the state can often more effectively collect the tax as a practical matter.⁵² Finally, a state might consider imposing an entity-level tax on partnership income as a way to effectively collect tax against income earned within the state. A full exploration of entity-level taxation of partnerships (and limited liability companies) is outside the scope of this paper. For purposes of achieving full accountability, however, an entity-level taxation regime would need to ensure that the aggregate taxation of the entity's in-state income—taking into account both the entity level tax and the tax on partners' (or members') distributive shares—would be equal regardless of whether the entities have in-state or out-of-state partners (or members).

50 Or on the taxpayer earning such income.

51 The states that fail to tax out-of-state partners have generally done so on state statutory grounds. See *supra* Part I.C.

52 See 2 HELLERSTEIN, HELLERSTEIN & SWAIN, *supra* note 39, ¶ 20.06[5] (withholding regimes limited to nonresident partners); KUNTZ & PERONI, *supra* note 21, ¶ C2.02[2][e] (2014) (discussing foreign partner distributive share withholding requirements under the Internal Revenue Code).

Reconsidering the Tax Treatment of Pensions and Annuities

*Jonathan Barry Forman**

INTRODUCTION

A number of recent proposals would curtail the current federal income tax benefits for annuities, pensions, and individual retirement accounts (IRAs). For example, in his 2014 Federal Budget, President Barack Obama proposed an overall cap on the total amount that individuals could accumulate in their tax-favored retirement plans.¹ More specifically, once an individual had accumulated enough to provide an annuity of \$205,000 a year starting at age sixty-two (about \$3.4 million in 2013), the proposal would prohibit further contributions.² Similarly, in 2010, the National Commission on Fiscal Responsibility and Reform (co-chaired by Erskine Bowles and former Senator Alan Simpson) proposed an annual cap on retirement contributions.³ The proposal would cap the total employer and employee retirement plan contributions at the lesser of 20% of the employee's compensation or \$20,000.⁴ This Article considers the merits of these and other proposals to limit the tax benefits for annuities, pensions, and IRAs.

Part I of this Article explains how the current tax system provides favorable tax treatment for annuities, pensions, and IRAs. Part II then discusses a number of proposals to curtail that

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¹ U.S. DEPT OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2014 REVENUE PROPOSALS 165–66 (2013), *available at* <http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2014.pdf>.

² *Id.*

³ NAT'L COMM'N ON FISCAL RESPONSIBILITY & REFORM, THE MOMENT OF TRUTH 31 fig. 7 (2010), *available at* http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/TheMomentofTruth12_1_2010.pdf.

⁴ *Id.*

favorable tax treatment. Finally, Part III considers the important issues raised by those proposals.

I. THE CURRENT FEDERAL TAX SYSTEM PROVIDES FAVORABLE TAX TREATMENT FOR ANNUITIES, PENSIONS, AND INDIVIDUAL RETIREMENT ACCOUNTS

Under the current federal income tax system, investment income is generally subject to federal personal income tax rates of up to 39.6% in 2014;⁵ however, dividend income and capital gains are generally taxed at no more than a 20% rate.⁶ This Part explains how the current tax system also provides favorable tax treatment for annuities, pensions, and IRAs.⁷

A. Annuities

An annuity is a financial instrument (e.g., an insurance contract) that converts a lump sum of money into a stream of income payable over a period of years, typically for life.⁸ Pertinent here, annuities are often used to provide lifetime retirement income.⁹ For example, for a sixty-five-year-old man who purchased a \$100,000 immediate, level-payment lifetime annuity, without inflation protection, as of January 1, 2014, the annual payout would be around \$6864 or 6.86% of the annuity's purchase price.¹⁰ Because women tend to live longer than men, the annual payout for a sixty-five-year-old woman who elected an immediate, level-payment lifetime annuity, as of January 1, 2014, would be just \$6408 or 6.41% of the annuity's purchase price.¹¹

⁵ I.R.C. § 1 (2012); Rev. Proc. 2013-35, 2013-47 I.R.B. 537.

⁶ I.R.C. § 1(h).

⁷ There are tax advantages associated with many other investments. For example, home mortgage interest is generally deductible, and gains from the sale of a personal residence are often excludable. I.R.C. §§ 163(a), 121. Interest on state and local bonds is exempt from tax. I.R.C. § 103. Insurance proceeds payable by reason of the death of the insured are exempt from tax. I.R.C. § 101(a). Also, gains are not typically taxed until they are realized. I.R.C. §§ 61(a)(3), 1001(a). Moreover, if property is held until death, the basis in the property often "steps up" to its fair market value, which means that the appreciation is never taxed. I.R.C. § 1014(a).

⁸ See JOSEPH BANKMAN, DANIEL N. SHAVIRO & KIRK J. STARK, *FEDERAL INCOME TAXATION* 117 (16th ed. 2012). The person holding an annuity is called an annuitant. *Id.*

⁹ See, e.g., Farrell Dolan, *Applying the 4-Box Strategy to Retirement Income Planning: Generating a Lifetime of Income*, LIMRA'S MARKETFACTS Q., Fall 2009, at 84, 88, available at <http://pjwalkercommunications.com/wp-content/uploads/2010/02/Market-Facts.pdf>; Darla Mercado, *Making the Case for Annuities*, INVESTMENTNEWS (Mar. 25, 2012, 12:01 AM), <http://www.investmentnews.com/article/20120325/REG/303259969&issupdate=20120323&sid=RI0326>.

¹⁰ *Immediate Annuities Update*, ANNUITY SHOPPER, Jan. 2014, at 9, 18 tbl.5, available at www.immediateannuities.com/pdfs/as/annuity-shopper-2014-01.pdf (\$6864 = \$572 × 12).

¹¹ *Id.* (\$6408 = \$534 × 12).

The income tax system provides very favorable tax treatment of investments in annuities.¹² Although the value of an annuity investment grows over time, no tax is imposed until annuity distributions commence. In short, there is no tax on the so-called “inside buildup” until the “annuity starting date.” Even then, the annuitant can exclude a fraction of each benefit payment from income. That fraction (the “exclusion ratio”) is based on the amount of premiums or other after-tax contributions made by the individual. The exclusion ratio enables the individual to recover her own after-tax contributions tax-free and to pay tax only on the remaining portion of benefits which represents income.

This deferral of taxation until benefits are actually received is a very valuable tax benefit (i.e., compared to say, a regular bank account where the interest income is taxed on an annual basis¹³). For example, according to the Joint Committee on Taxation, the exclusion of investment income on annuity (and life insurance) contracts will result in a tax expenditure of more than \$30 billion in Fiscal Year 2015 and more than \$150 billion over five years.¹⁴

B. Pension Plans and Individual Retirement Accounts (IRAs)

The United States has a voluntary pension system, and employers have considerable choice about whether and how to provide pension benefits to their employees.¹⁵ However, when employers do provide pensions, those pensions are typically subject to regulation under the Employee Retirement Income Security Act of 1974 (ERISA).¹⁶

¹² See I.R.C. § 72.

¹³ I.R.C. § 61(a)(4).

¹⁴ STAFF OF THE JOINT COMM. ON TAXATION, 113TH CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2012–2017, at 35 tbl.1 (Comm. Print 2013), available at <https://www.jct.gov/publications.html?func=startdown&id=4503>; see also *infra* Table 2.

¹⁵ See, e.g., Jonathan Barry Forman & George A. (Sandy) Mackenzie, *The Cost of “Choice” in a Voluntary Pension System*, N.Y.U. REV. EMP. BENEFITS & EXECUTIVE COMPENSATION, 2013, at 6-1, 6-3.

¹⁶ Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 864 (codified as amended at 29 U.S.C. §§ 1001–1461 (Supp. III 1997) and in scattered sections of the Internal Revenue Code, 26 U.S.C.); see also STAFF OF THE JOINT COMM. ON TAXATION, 112TH CONG., PRESENT LAW AND BACKGROUND RELATING TO THE TAX TREATMENT OF RETIREMENT SAVINGS 2 (Comm. Print 2012), available at <https://www.jct.gov/publications.html?func=startdown&id=4418> (“These plans afford employers flexibility in the design and structure of the retirement plans they adopt, subject to . . . [ERISA].”).

1. Retirement Savings are Tax-Favored

Most retirement savings qualify for even more generous tax treatment than annuities. For example, employer contributions to a pension are not taxable to the employee;¹⁷ the pension fund's earnings on those contributions are tax-exempt;¹⁸ and retirees pay tax only when they receive distributions of their pension benefits.¹⁹ Nevertheless, the employer is allowed a current deduction for its contributions (within limits).²⁰

More specifically, pension benefits may be fully taxable or partially taxable, depending on whether the employee made any after-tax contributions. For example, an employee's pension benefits will be fully taxable if the employee's employer contributed all of the cost for the pension without any of the cost being included in the employee's taxable wages.²¹

On the other hand, if an employee made after-tax contributions to a pension, she can exclude a fraction of each benefit payment from income.²² As with regular annuities, that fraction—the “exclusion ratio”—is based on the amount of premiums or other after-tax contributions made by the employee, and this approach enables the employee to recover her own after-tax contributions tax free and to pay tax only on the remaining portion of benefits which represents income.²³

Taxpayers who begin receiving annuity payments from a pension plan after November 18, 1996, generally use the Simplified Method to figure the tax-free part of the payments.²⁴ Under the Simplified Method, the Internal Revenue Code provides a table with a fixed number of anticipated payments that depends upon the annuitant's age as of the annuity starting date. The taxpayer then divides the total cost over the applicable number of anticipated payments and excludes the amount so determined each year. For example, if the annuity is payable over the life of a single individual, the number of anticipated payments is determined as follows:

¹⁷ I.R.C. § 402.

¹⁸ I.R.C. § 501(a).

¹⁹ I.R.C. §§ 72, 402. *See generally* I.R.S. Publication No. 575 (Jan. 2, 2014), available at <http://www.irs.gov/pub/irs-pdf/p575.pdf>.

²⁰ I.R.C. § 404.

²¹ I.R.S. Publication No. 575, *supra* note 19, at 11. Pension benefits would also be fully taxable if the participant has already received all of her previously taxed contributions tax free in previous years. *Id.*

²² I.R.C. §§ 72, 402.

²³ *See supra* Part I.A.

²⁴ I.R.S. Publication No. 575, *supra* note 19, at 11–15.

<i>Age at annuity starting date</i>	<i>Number of anticipated payments</i>
55 or under	360
56–60	310
61–65	260
66–70	210
71 or older	160

If the annuity is payable over two lives, the number of anticipated payments is determined as follows:

<i>Combined ages at annuity starting date</i>	<i>Number of anticipated payments</i>
110 or under	410
111–120	360
121–130	310
131–140	260
141 or older	210

Also, since 2006, employers have been permitted to set up so-called “Roth 401(k) plans.”²⁵ Contributions to these plans are not excludable, but neither the plan’s investment returns nor distributions are taxable.

Favorable tax rules are also available for IRAs.²⁶ Almost any worker can set up an IRA with a bank or other financial institution. In 2014, individuals without pension plans can contribute and deduct up to \$5500 to a regular IRA, although individuals over age 50 can contribute and deduct another \$1,000 (for a total of up to \$6500); and spouses can contribute and deduct similar amounts.²⁷

Since 1998, individuals have been permitted to set up Roth IRAs.²⁸ Unlike regular IRAs, contributions to Roth IRAs are not deductible. Instead, withdrawals are tax free. Like regular IRAs, however, Roth IRA earnings are tax exempt.

²⁵ I.R.C. § 402A; *see infra* note 41 and accompanying text.

²⁶ I.R.C. § 219; I.R.S. Publication No. 590 (Jan. 5, 2014), *available at* <http://www.irs.gov/pub/irs-pdf/p590.pdf>.

²⁷ *See* I.R.S. News Release IR-2013-86 (Oct. 31, 2013), *available at* [http://www.irs.gov/uac/IRS-Announces-2014-Pension-Plan-Limitations-Taxpayers-May-Contribute-up-to-\\$17,500-to-their-401\(k\)-plans-in-2014](http://www.irs.gov/uac/IRS-Announces-2014-Pension-Plan-Limitations-Taxpayers-May-Contribute-up-to-$17,500-to-their-401(k)-plans-in-2014).

²⁸ I.R.C. § 408A.

Finally, since 2002, certain low- and moderate-income individuals have been able to claim a non-refundable tax credit of up to \$1000 for certain qualified retirement savings contributions.²⁹ The credit equals a percentage (50%, 20%, or 10%) of up to \$2000 of contributions.³⁰ In effect, the credit acts like an employer match: the government matches a portion of the employee's contributions.

2. Types of Pension Plans

Pension plans generally fall into two broad categories based on the nature of the benefits provided: defined benefit plans and defined contribution plans.

a. Defined benefit plans

In a defined benefit plan, an employer promises employees a specific benefit at retirement.³¹ For example, a plan might provide that a worker's annual retirement benefit (*B*) is equal to 2% times the number of years of service (*yos*) times final average compensation (*fac*) ($B = 2\% \times yos \times fac$). Under this traditional, final-average-pay formula, a worker who retires after thirty years of service with final average compensation of \$50,000 would receive a pension of \$30,000 a year for life ($\$30,000 = 2\% \times 30 yos \times \$50,000 fac$).³² While many defined benefit plans allow for lump sum distributions, the default benefit for defined benefit plans is a retirement income stream in the form of a lifetime annuity.³³

b. Defined contribution plans

Under a typical defined contribution plan, the employer simply withholds a specified percentage of the worker's compensation, which it contributes to an individual investment

²⁹ I.R.C. § 25B.

³⁰ *Id.*

³¹ Jonathan Barry Forman & Amy Nixon, *Cash Balance Pension Plan Conversions*, 25 OKLA. CITY U. L. REV. 379, 385 (2000). To provide that benefit, the employer typically makes payments into a trust fund, contributed funds grow with investment returns, and eventually the employer withdraws funds from the trust fund to pay the promised benefits. *Id.* Employer contributions are based on actuarial valuations, and the employer bears all of the investment risks and responsibilities. *Id.* at 385–86.

³² *Id.* at 386. Final average compensation is often computed by averaging the worker's salary over the last three or five years prior to retirement. *Id.* Alternatively, some plans use career-average compensation instead of final-average compensation. Under a career earnings formula, benefits are based on a percentage of an average of career earnings for every year of service by the employee. *Id.*

³³ In the United States, defined benefit plans are generally designed to provide annuities, i.e., "definitely determinable benefits . . . over a period of years, usually for life, after retirement." Treas. Reg. § 1.401-1(b)(1)(i) (as amended in 2014).

account for the worker.³⁴ For example, contributions might be set at 10% of annual compensation.³⁵ Under such a plan, a worker who earned \$50,000 in a given year would have \$5000 contributed to an individual investment account for her ($\$5000 = 10\% \times \$50,000$).³⁶ Her benefit at retirement would be based on all such contributions plus investment earnings.³⁷ Unlike traditional defined benefit plans, defined contribution plans usually make distributions in the form of lump-sum or periodic distributions rather than lifetime annuities.

There are a variety of different types of defined contribution plans, including money purchase pension plans, profit-sharing plans, stock bonus plans, target benefit plans, and employee stock ownership plans (ESOPs).³⁸ Profit-sharing and stock bonus plans often include a feature that allows workers to choose between receiving cash currently or deferring taxation by placing the money in a retirement account, according to Internal Revenue Code section 401(k). Consequently, these plans are often called “401(k) plans,” and they are the most popular type of retirement plan in the United States.³⁹ The maximum annual amount of such elective deferrals that can be made by an individual in 2014 is \$17,500, although workers over the age of 50 can contribute another \$5500 (for a total of up to \$23,000).⁴⁰ Similar limits apply to Roth 401(k) plans.⁴¹

c. Hybrid retirement plans

So-called “hybrid” retirement plans mix the features of defined benefit and defined contribution plans.⁴² For example, a cash balance plan is a defined benefit plan that looks like a defined contribution plan.⁴³

³⁴ Forman & Nixon, *supra* note 31, at 386.

³⁵ *Id.*

³⁶ *Id.*

³⁷ *Id.* Defined contribution plans are also known as “individual account” plans because each worker has her own account, as opposed to defined benefit plans, where the plan’s assets are pooled for the benefit of all of the employees. *Id.*

³⁸ See, e.g., U.S. Bureau of Labor Statistics, *Six Ways to Save for Retirement*, PROGRAM PERSP., Mar. 2011, at 1, 1–2, available at http://www.bls.gov/opub/perspectives/program_perspectives_vol3_issue3.pdf.

³⁹ See, e.g., U.S. Bureau of Labor Statistics, *BLS Examines Popular 401(k) Retirement Plans*, PROGRAM PERSP., Nov. 2010, at 1, 1, available at http://www.bls.gov/opub/perspectives/program_perspectives_vol2_issue6.pdf.

⁴⁰ I.R.S. News Release IR-2013-86, *supra* note 27.

⁴¹ *Id.*; I.R.C. § 402A (2012).

⁴² Forman & Nixon, *supra* note 31, at 387.

⁴³ *Id.* Like other defined benefit plans, employer contributions are based on actuarial valuations, and the employer bears all of the investment risks and responsibilities. Like defined contribution plans, however, cash balance plans provide workers with individual accounts (albeit hypothetical). *Id.* A simple cash balance plan might allocate 10% of salary

C. The Economics of Tax Deferral

The basic tax advantage of annuities, pension plans, and IRAs is tax deferral. For example, Table 1 shows the value of the tax advantages associated with saving in a regular pension plan (or IRA), as compared with saving in a regular savings account.⁴⁴ A regular savings account is funded with deposits that come from after-tax income and accumulate only at an annual after-tax interest rate—that is, the interest or investment income earned in such an account is taxed annually. The table assumes that a person age forty-five has \$1000 in wages and wishes to save it for fifteen years for purposes of retirement at age sixty. The market interest rate during the full fifty years is assumed to be 8%.

TABLE 1. TAX ADVANTAGES OF A \$1000 CONTRIBUTION TO A REGULAR PENSION PLAN

	Example 1: Tax Rate of 15% in Working Years		Example 2: Tax Rate of 40% in Working Years	
	Regular Account	Qualified Plan	Regular Account	Qualified Plan
Contribution	\$1000	\$1000	\$1000	\$1000
Tax on contribution	150	—	400	—
Deposit	850	1000	600	600
Value at withdrawal	2280	3172	1212	3172
Retirement tax rate (%)	—	15	—	40
Tax on withdrawal	0	476	0	1269
Net withdrawal	2280	2696	1212	1903
Gain over regular account	—	416	—	691
Percent gain	—	18	—	57
Alternative retirement tax rate (%)	—	0	—	30
Tax on withdrawal	0	0	0	952
Net withdrawal	2280	3172	1212	2221
Gain over regular account	—	892	—	1008
Percent gain	—	39	—	83

Sources: CONG. BUDGET OFFICE, TAX POLICY FOR PENSIONS AND OTHER RETIREMENT SAVING 4 tbl.1 (1987), available at <http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/50xx/doc5011/doc05-entire.pdf>; JOHN H. LANGBEIN, SUSAN J. STABILE & BRUCE A. WOLK, PENSION AND EMPLOYEE BENEFIT LAW 336 (4th ed. 2006).

to each worker's account each year and credit the account with 5% interest on the balance in the account. Under such a plan, a worker who earned \$50,000 in a given year would get an annual cash balance credit of \$5000 ($\$5000 = 10\% \times \$50,000$), plus an interest credit equal to 5% of the balance in her hypothetical account as of the beginning of the year. *Id.* at 386.

⁴⁴ CONG. BUDGET OFFICE, TAX POLICY FOR PENSIONS AND OTHER RETIREMENT SAVING 4 tbl.1 (1987), available at <http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/50xx/doc5011/doc05-entire.pdf>; JOHN H. LANGBEIN, SUSAN J. STABILE & BRUCE A. WOLK, PENSION AND EMPLOYEE BENEFIT LAW 336 (4th ed. 2006).

Consider Example 2 in Table 1. The example assumes that the employee is a high-income individual in the 40% income tax bracket when working and when retired. If the \$1000 is paid directly to the employee, the employee would immediately pay \$400 in tax and deposit \$600 after tax into the savings account. That \$600 savings account would earn 8% interest, but the after-tax rate of return would be just 4.8%. The \$600 in the account compounded at 4.8% interest over fifteen years would yield \$1212, which could be withdrawn tax free.

If the employer had instead contributed that \$1000 to a regular pension plan, the full \$1000 would have compounded at the 8% pretax rate and yield \$3172 at the end of fifteen years. Upon withdrawal, that \$3172 would all be taxed at the employee's 40% income tax rate, leaving the employee with \$1903 after tax. That is a net gain of \$691 (57%) over the regular savings account.

The examples in Table 1 show the economic advantages of regular pension plans and IRAs over regular savings accounts. The tax advantages are greatest for those in the highest tax brackets in their working years. There are also even greater advantages to deferring income for longer periods.

Contributions to Roth IRAs and Roth 401(k) plans are made after-tax; however, withdrawals are tax free. Accordingly, these arrangements offer essentially the same tax economic benefits as qualified plans and traditional IRAs. For example, following Example 2 in Table 1, assume that an employee in the 40% tax bracket paid \$400 tax on \$1000 of earnings and contributed the remaining \$600 to a Roth IRA with an 8% tax-free interest rate. After fifteen years, that investment would be worth \$1903, exactly what the employee would have had with the regular pension plan.

D. Current Estimates of the Tax Expenditures Associated with Annuities, Pensions, and IRAs

As more fully discussed in Part III below, the special tax rules for annuities, pensions, and IRAs are routinely identified as "tax expenditures" in the tax expenditure budgets prepared annually by the Office of Management and Budget and by the Joint Committee on Taxation.⁴⁵ Policymakers often use these tax expenditure estimates as a rough guide to the cost of these

⁴⁵ OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, ANALYTICAL PERSPECTIVES, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2015, at 205 tbl.14-1 (2014); STAFF OF THE JOINT COMM. ON TAXATION, *supra* note 14.

special income tax provisions.⁴⁶ For example, Table 2 reproduces the Office of Management and Budget’s 2015 Federal Budget estimates of the revenue losses attributable to the special income tax benefits for annuities, pensions, and IRAs.⁴⁷ All in all, these tax expenditures are quite large. In fact, two of these items are among the top ten largest tax expenditures each year, and five are in the top twenty.⁴⁸

TABLE 2. ESTIMATES OF TOTAL INCOME TAX EXPENDITURES FOR FISCAL YEARS 2015–2019

	2015	2016	2017	2018	2019	2015–19
Exclusion of interest on insurance & annuities	23,040	24,690	26,370	28,180	30,090	132,370
Net exclusion of pension contributions & earnings:						
Defined benefit plans	42,340	44,750	47,270	49,160	51,440	234,960
Defined contribution plans	61,050	77,020	88,740	92,770	94,820	414,400
IRAs	17,480	18,540	19,630	20,650	21,720	98,020
Savers tax credit	1210	1260	1300	1280	1300	6350
Self-Employed plans	25,530	28,100	30,890	33,860	37,150	155,530

Source: OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, ANALYTICAL PERSPECTIVES, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2015, at 205 tbl.14-1 (2014).

II. MANY PROPOSALS WOULD CURTAIL THE FAVORABLE TAX TREATMENT FOR ANNUITIES, PENSIONS, AND INDIVIDUAL RETIREMENT ACCOUNTS

This Part summarizes a variety of recent proposals to limit the tax benefits associated with annuities and pensions.⁴⁹ Some of these proposals have been around for decades, and some are relatively recent.

46 “Admittedly, however, tax expenditure estimates do not necessarily equal the increase in Federal revenues that would result from repealing the special provisions.” Jonathan Barry Forman, *Comparing Apples and Oranges: Some Thoughts on the Pension and Social Security Tax Expenditures*, 5 EMP. RTS. & EMP. POL’Y J. 297, 308 n.50 (2001).

47 OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, *supra* note 45, at 205 tbl.14-1, 206, 208.

48 *Id.* at 216 tbl.14-3.

49 See also *Tax Reform Options: Promoting Retirement Security: Hearing Before the S. Comm. on Finance*, 112th Cong. (2011), available at <http://www.finance.senate.gov/hearings/hearing/?id=ba387157-5056-a032-5252-c7bf71fc6c90>; Jack VanDerhei, *Tax Reform Options: Promoting Retirement Security*, EMP. BENEFIT RES. INST., Nov. 2011, at 1, available at http://www.ebri.org/pdf/briefspdf/EBRI_IB_11-2011_No364_RetTaxRfm2.pdf.

A. Include Investment Income from Annuities (and Life Insurance) in Taxable Income

Perhaps the oldest tax reform proposal that still has currency is the suggestion that we should include the investment income from annuities (and life insurance) in taxable income.⁵⁰ Under a comprehensive income tax (i.e., a theoretically pure income tax), individuals would pay tax on the sum of the wages, interest, dividends, and other forms of economic income that they earn.⁵¹ As more fully explained below, this proposal would extend comprehensive income tax treatment to annuities (and life insurance) by taxing the inside buildup in those policies.⁵²

Portions of the premiums paid for annuities are invested and earn interest, dividends, and other types of investment income. That investment income—the inside buildup—is generally not taxable until the annuitant begins receiving annuity distributions. A similar deferral of tax occurs on investments in whole-life insurance policies.⁵³ Under a pure income tax, investors in these insurance products would be taxed on those investment earnings annually, just like investors in bank accounts, taxable bonds, and mutual funds. According to the Joint Committee on Taxation, including the investment income

⁵⁰ See, e.g., CONG. BUDGET OFFICE, PUB. NO. 4664, OPTIONS FOR REDUCING THE DEFICIT: 2014 TO 2023, at 126 tbl. (2013), available at www.cbo.gov/sites/default/files/cbofiles/attachments/44715-OptionsForReducingDeficit-3.pdf; DAVID F. BRADFORD & THE U.S. TREASURY TAX POLICY STAFF, BLUEPRINTS FOR BASIC TAX REFORM 178 (2d ed. 1984).

⁵¹ The classic economic definition of income (also known as the Haig-Simons definition of income) is as follows:

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. In other words, it is merely the result obtained by adding consumption during the period to “wealth” at the end of the period and then subtracting “wealth” at the beginning. The *sine qua non* of income is *gain*, as our courts have recognized in their more lucid moments—and gain to someone during a specified time interval. Moreover, this gain may be measured and defined most easily by positing a dual objective or purpose, consumption and accumulation, each of which may be estimated in a common unit by appeal to market prices.

HENRY C. SIMONS, PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY 50 (1938); Robert Murray Haig, *The Concept of Income—Economic and Legal Aspects*, in THE FEDERAL INCOME TAX 1, 7 (Robert Murray Haig ed., 1921). See generally BROOKINGS INST., COMPREHENSIVE INCOME TAXATION (Joseph A. Pechman ed., 1977); BROOKINGS INST., WHAT SHOULD BE TAXED: INCOME OR EXPENDITURE? 50–51 (Joseph A. Pechman ed., 1980); Henry Aaron, *What Is a Comprehensive Tax Base Anyway?* 22 NAT’L TAX J. 543 (1969); DAVID F. BRADFORD & THE U.S. TREASURY TAX POLICY STAFF, *supra* note 50.

⁵² See CONG. BUDGET OFFICE, *supra* note 50.

⁵³ *Id.* A whole-life insurance policy provides life insurance coverage throughout the insured’s whole life, as opposed to term-life insurance, which provides coverage for a specified period. *Id.*

from annuities and life insurance in taxable income would raise \$24 billion in Fiscal Year 2015 and \$210 billion over ten years.⁵⁴

B. Cap the Total Accumulation of Retirement Benefits

In his 2014 Federal Budget, President Barack Obama proposed an overall cap on the total amount that individuals could accumulate in their tax-favored retirement plans.⁵⁵ More specifically, once an individual had accumulated enough to provide a joint and survivor annuity of \$205,000 a year, starting at age sixty-two, the proposal would prohibit further contributions under such plans. The maximum annuity cap was designed to equal the maximum annuity that can be paid by a qualified defined benefit plan (\$205,000 in 2013 and \$210,000 in 2014),⁵⁶ and the Treasury estimated that the maximum permitted accumulation for an individual in 2013 was around \$3.4 million.⁵⁷

Pertinent here, during the 2012 Presidential race, Governor Mitt Romney was reported to have accumulated \$87 million in his IRA,⁵⁸ and proposals like this seem to be intended to curtail such large accumulations. The Joint Committee on Taxation estimates that this Obama Administration proposal would raise \$210 million in Fiscal Year 2015 and \$3.8 billion over ten years.⁵⁹

In fact, the Obama Administration's proposal calls for a combined limit on defined benefit plans and individual account plans (i.e., defined contribution plans and IRAs). That is, further contributions would be limited for participants whose total individual account balances *plus* their defined benefit plans would be sufficient to provide the maximum allowable annuity (e.g., \$210,000 a year for a sixty-two-year-old in 2014). To avoid

⁵⁴ *Id.*; see also *supra* Table 2 (showing slightly different tax expenditure estimates, \$23 billion in Fiscal Year 2015 and \$132 billion over five years).

⁵⁵ U.S. DEPT OF THE TREASURY, *supra* note 1, at 166; STAFF OF THE JOINT COMM. ON TAXATION, 113TH CONG., DESCRIPTION OF CERTAIN REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2014 BUDGET PROPOSAL 144 (Comm. Print 2013), available at <https://www.jct.gov/publications.html?func=startdown&id=4538>. "[T]ax-favored retirement plans include traditional IRAs (including SEPs and SIMPLE IRAs), Roth IRAs, qualified retirement plans [(e.g., I.R.C. § 401(k) plans)], [I.R.C. §] 403(b) plans, and governmental [I.R.C. §] 457(b) plans." *Id.*

⁵⁶ I.R.C. § 415(b)(1)(A) (2012); I.R.S. News Release IR-2013-86, *supra* note 27.

⁵⁷ U.S. DEPT OF THE TREASURY, *supra* note 1, at 166.

⁵⁸ Tom Hamburger, *Mitt Romney Exited Bain Capital with Rare Tax Benefits in Retirement*, WASH. POST (Sept. 2, 2012), http://www.washingtonpost.com/politics/mitt-romney-exited-bain-capital-with-rare-tax-benefits-in-retirement/2012/09/02/1bddc8de-ec85-11e1-a80b-9f898562d010_story.html.

⁵⁹ STAFF OF THE JOINT COMM. ON TAXATION, 113TH CONG., ESTIMATED BUDGET EFFECTS OF THE REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2014 BUDGET PROPOSAL [1], at 8 (Comm. Print 2013), available at <https://www.jct.gov/publications.html?func=startdown&id=4520>.

the complexity that can result from administering such a combined limit on individuals who participate in both defined benefit and individual account plans,⁶⁰ John Turner and his colleagues have suggested that it would be simpler to have a separate \$5 million cap just for individual account plans.⁶¹ Turner and his colleagues further recommend that individuals with balances in excess of that \$5 million cap should be required to take taxable distributions from their plans equal to the excess over that \$5 million cap.⁶²

C. Cap Contributions at the Lesser of 20% of Compensation or \$20,000

In 2010, the National Commission on Fiscal Responsibility and Reform (co-chaired by Erskine Bowles and Senator Alan Simpson) suggested an annual cap on retirement contributions.⁶³ The proposal would cap the total employer and employee retirement plan contributions at the lesser of 20% of the employee's compensation or \$20,000.⁶⁴ This so-called "20/20" proposal, which would limit the ability of high-income individuals to use retirement tax expenditures, was offered as a part of the Commission's larger plan to raise revenue in order to cut deficits and reduce marginal tax rates.

Needless to say, the 20/20 proposal has had plenty of critics.⁶⁵ Critics are particularly concerned that capping contributions would limit the incentives that business owners

⁶⁰ See, e.g., I.R.S. Notice 99-44 (1999), available at www.irs.gov/pub/irs-drop/n-99-44.pdf; ANN TRICHILO & MARTY PIPPINS, INTERNAL REVENUE SERV., CHAPTER 8B—ISSUES RELATED TO THE REPEAL OF IRC SECTION 415(e) (2002), available at <http://www.irs.gov/pub/irs-tege/epch8b02.pdf> (discussing the repeal of former I.R.C. section 415(e), which had provided complicated limits on individuals who participated in both defined benefit and defined contribution plans); Louis T. Mazawey, *Practical Ways to Deal with the Repeal of Section 415(e)*, 16 PRAC. TAX LAW. 41 (2001), available at http://files.ali-cle.org/thumbs/datastorage/lacidoirep/articles/PTL_MAZAWAY-01-924_thumb.pdf.

⁶¹ See, e.g., John A. Turner, David D. McCarthy & Norman P. Stein, *Defined Contribution Plans with Very Large Individual Account Balances*, 1 J. RETIREMENT 113, 120 (2014).

⁶² *Id.*; see also Brendan McFarland & Sylvester J. Schieber, *Proposed Lifetime Pension Limits: Less than Meets the Eye*, TOWERS WATSON (Mar. 18, 2014), <http://www.towerswatson.com/en/Insights/Newsletters/Americas/Insider/2014/proposed-lifetime-pension-limits-less-than-meets-the-eye>.

⁶³ NAT'L COMM'N ON FISCAL RESPONSIBILITY & REFORM, *supra* note 3.

⁶⁴ *Id.*; see also Jack VanDerhei, *Capping Tax-Preferred Retirement Contributions: Preliminary Evidence of the Impact of the National Commission on Fiscal Responsibility and Reform Recommendations*, EMP. BENEFIT RES. INST., July 2011, at 2, available at http://www.ebri.org/pdf/notespdf/EBRI_Notes_07_July-11.TaxCap_UnionHI.pdf.

⁶⁵ See, e.g., AM. BENEFITS COUNCIL, "20/20" CAP ON RETIREMENT SAVINGS WOULD UNDERMINE RETIREMENT SECURITY (2012), available at http://www.americanbenefitscouncil.org/documents2012/401k-limits_2020-talkingpoints110612.pdf.

and managers would have to offer retirement plans that today cover so many rank-and-file workers.

Along the same lines, the Congressional Budget Office recently outlined a proposal to reduce the current limits on annual contributions to retirement plans.⁶⁶ Under the proposal, the maximum individual contribution would be limited to \$15,500 per year for 401(k)-type plans and \$5000 per year for IRAs; and the proposal would also limit the total of employee and employer contributions to defined contribution plans to \$46,000.⁶⁷ This proposal would raise \$6.7 billion in Fiscal Year 2015 and around \$89 billion over ten years.⁶⁸

D. Move Towards (or Away from) the Roth Model

A number of reform proposals have called for the pension system to move either towards or away from the Roth model. Recall that with a traditional IRA, individuals can deduct their contributions, but distributions are taxable; on the other hand, with a Roth IRA, contributions are not deductible, but distributions are tax-free.⁶⁹ If the tax rate is the same at both times, these two tax benefits are equivalent. In the real world, however, tax rates are not the same at both times, and critics of the Roth approach generally note that giving taxpayers a choice almost certainly means that the Treasury will lose revenue as taxpayers choose which approach is best for them. On the other hand, supporters of the Roth approach often see Roths as a way of encouraging low-income workers to save for retirement. Allowing individuals to convert their traditional IRAs into Roth IRAs by recognizing income now has also been a way to raise revenue during the near-term five- and ten-year budget windows that Congress uses to reach its revenue targets.⁷⁰

House Ways and Means Committee Chairman Dave Camp's recent tax reform proposals come down in favor of Roths, apparently as a way of raising revenue in order to lower

⁶⁶ CONG. BUDGET OFFICE, *supra* note 50, at 133–34.

⁶⁷ *Id.* Under current law, the total of employer and employee contributions to a defined contribution plan cannot exceed \$52,000 in 2014. I.R.C. § 415(c)(1)(A) (2012); I.R.S. News Release IR-2013-86, *supra* note 27.

⁶⁸ CONG. BUDGET OFFICE, *supra* note 50, at 133–34.

⁶⁹ See *supra* notes 26–28 and accompanying text.

⁷⁰ See, e.g., Richard Rubin & Margaret Collins, *Tax Break for Roth IRA Conversion Attracted 10% of High Earners*, BLOOMBERG BUSINESSWEEK (Jan. 4, 2014), <http://www.businessweek.com/news/2014-01-04/tax-break-for-roth-ira-conversion-attracted-10-percent-of-high-earners>; Deborah L. Jacobs, *Why-and How-Congress Should Curb Roth IRAs*, FORBES (Mar. 26, 2012), <http://www.forbes.com/sites/deborahljacobs/2012/03/26/why-and-how-congress-should-curb-roth-iras>; Leonard E. Burman, *Roth Conversions as Revenue Raisers: Smoke and Mirrors*, 111 TAX NOTES 953 (2006).

marginal tax rates. Under one of his tax reform proposals, “the income eligibility limits for contributing to Roth IRAs would be eliminated”; at the same time, however, “new contributions to traditional IRAs” would be prohibited.⁷¹ The proposal would increase revenues by \$14.8 billion over the next ten years.⁷² Similarly, under another provision, employees would generally be able to contribute no more than half of the maximum elective deferral amount (\$8750 = 1/2 of \$17,500 in 2014) into a traditional 401(k) plan; anything more would have to go into a Roth 401(k); and this proposal would raise \$143.7 billion over the next ten years.⁷³

President Barack Obama recently proposed that the government offer no-fee starter retirement savings accounts known as “myRAs” (short for “My Retirement Accounts”) that would be taxed like Roth IRAs: earnings generally could be withdrawn tax free after age fifty-nine-and-a-half.⁷⁴ Participants in these new accounts would earn interest at the same variable interest rate as the federal employees’ Thrift Savings Plan (TSP) Government Securities Investment Fund.⁷⁵

President George W. Bush also favored Roth-style retirement accounts. From 2004 through 2009, his Federal Budgets recommended consolidating traditional and Roth IRAs into so-called Retirement Savings Accounts (RSAs) that would be taxed like Roth IRAs.⁷⁶

On the other hand, President Obama’s 2015 Budget would limit the tax deferral benefits of Roth plans by requiring them to follow the same required minimum distribution (RMD) rules that apply to other retirement accounts.⁷⁷ That is, like qualified plans and regular IRAs, individuals would generally have to begin taking RMDs from when they reach age seventy-and-a-half.⁷⁸

⁷¹ HOUSE COMM. ON WAYS & MEANS, 113TH CONG., TAX REFORM ACT OF 2014 DISCUSSION DRAFT SECTION-BY-SECTION SUMMARY 36 (2014), *available at* http://waysandmeans.house.gov/uploadedfiles/ways_and_means_section_by_section_summary_final_022614.pdf.

⁷² *Id.* at 37.

⁷³ *Id.* at 39–40.

⁷⁴ See U.S. DEP’T OF THE TREASURY, MYRA: A SIMPLE, SAFE, AFFORDABLE RETIREMENT SAVINGS ACCOUNT (2014), *available at* http://www.treasurydirect.gov/ready/savegrow/start_saving/retirementaccountfactsheetenglish.pdf.

⁷⁵ *Id.*

⁷⁶ STAFF OF THE JOINT COMM. ON TAXATION, *supra* note 16 at 59.

⁷⁷ OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2015, at 26–27 (2014), *available at* <http://www.whitehouse.gov/sites/default/files/omb/budget/fy2015/assets/budget.pdf>.

⁷⁸ U.S. DEP’T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION’S FISCAL YEAR 2015 REVENUE PROPOSALS 251–52 (2014), *available at* <http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2015.pdf>.

The proposal would raise \$484 million over ten years.⁷⁹ This change could make Roth accounts and Roth conversions much less attractive.⁸⁰

E. Replace the Current Exclusion with a Refundable Tax Credit

Over the years, there have been a number of proposals to replace the current exclusions (and deductions) for retirement savings with tax credits. For example, in 2011, William Gale of the Brookings Institution suggested that we replace the current system of exclusions and deductions with a flat-rate refundable tax credit, given to the employee, with that credit being directly deposited in the employee's retirement account.⁸¹ For example, instead of allowing an employee to exclude or deduct her retirement contributions, a 30% credit would be deposited into her individual account. The Urban-Brookings Tax Policy Center estimates that this proposal would be revenue-neutral over ten years: it would take tax benefits from high-income households and increase benefits for low- and moderate-income households.⁸²

Along these lines, over the years, there have been a variety of proposals to limit the value of certain tax expenditures. For example, the tax system could limit the value of itemized deductions and exclusions to, say, 28% of their total value.⁸³ Then, taxpayers in income tax brackets with statutory rates above 28% would receive less benefit from itemized deductions and exclusions than under current law, while taxpayers in lower tax brackets would be unaffected by the change. This type of 28% limit could be applied to the exclusion for 401(k)-type contributions and to the deduction for IRA contributions.

⁷⁹ *Id.* at 284.

⁸⁰ See Jeffrey Levine, *Required Minimum Distributions for Roth IRAs?*, FIN. PLAN. (Mar. 5, 2014), <http://www.financial-planning.com/blogs/required-minimum-distributions-for-roth-2688468-1.html>.

⁸¹ WILLIAM G. GALE, TAX REFORM OPTIONS: PROMOTING RETIREMENT SECURITY 5 (2011), available at <http://finance.senate.gov/imo/media/doc/Testimony%20of%20William%20Gale.pdf> (testimony submitted to the United States Senate Committee on Finance).

⁸² *Id.* at 6.

⁸³ See U.S. DEPT OF THE TREASURY, *supra* note 78, at 154–55; CONG. BUDGET OFFICE, *supra* note 50, at 121. Similarly, President George Bush's recent Advisory Panel on Federal Tax Reform recommended replacing most itemized deductions with a 15% tax credit. THE PRESIDENT'S ADVISORY PANEL ON FED. TAX REFORM, SIMPLE, FAIR, AND PRO-GROWTH: PROPOSALS TO FIX AMERICA'S TAX SYSTEM 102 (2005), available at <http://www.taxpolicycenter.org/taxtopics/upload/Tax-Panel-2.pdf>.

III. PROPOSALS TO IMPOSE TOUGH LIMITS ON THE TAX BENEFITS FOR ANNUITIES, PENSIONS, AND IRAS WOULD RAISE REVENUE THAT COULD BE USED TO SUBSIDIZE LOW- AND MODERATE-INCOME HOUSEHOLDS

Advocates of imposing tougher limits on the tax benefits for annuities, pensions, and IRAs tend to be interested in raising revenue for deficit reduction, for cuts in marginal tax rates, or for subsidies for low- and moderate-income households. This Part discusses some of the underlying issues.

A. The Favorable Tax Rules for Annuities, Pensions, and IRAs Are Costly

As already mentioned, under a theoretically pure income tax, individuals would pay tax annually on all of their investment income.⁸⁴ Of course, the federal income tax deviates from that comprehensive income tax ideal in a number of ways. In fact, the current federal tax system is really a hybrid income-consumption tax system in which some investments are taxed on the income tax model and others are taxed under the consumption tax model (i.e., as taxpayers spend their money).⁸⁵ Pertinent here, for example, the current taxation of pensions deviates from the income tax ideal in that employer contributions are typically excluded from gross income, and pension fund earnings are exempt from tax.

In that regard, the Congressional Budget and Impoundment Act of 1974 requires the federal government to keep track of the revenue “lost” as a result of deviations from an ideal income tax through so-called tax expenditure budgets.⁸⁶ More specifically, the Congressional Budget and Impoundment Act of 1974 defines “tax expenditures” as: “those revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability”⁸⁷

⁸⁴ See *supra* note 51 and accompanying text.

⁸⁵ UNEASY COMPROMISE: PROBLEMS OF A HYBRID INCOME-CONSUMPTION TAX 1 (Henry J. Aaron, Harvey Galper, & Joseph A. Pechman eds., 1988); Edward J. McCaffery, *Tax Policy Under a Hybrid Income-Consumption Tax*, 70 TEX. L. REV. 1145, 1152 (1992). In general, wages, interest, dividends, and other forms of income are taxed when received, regardless of whether or not saved. On the other hand, pension benefits are taxed under the consumption tax model.

⁸⁶ Congressional Budget and Impoundment Act of 1974, Pub. L. No. 93-344, § 101(c), § 102(a), 88 Stat. 297, 300.

⁸⁷ *Id.* § 3(a)(3), 88 Stat. at 299 (codified at 2 U.S.C. § 622(3) (2012)). For a historical analysis, see Jonathan B. Forman, *Origins of the Tax Expenditure Budget*, 30 TAX NOTES 537, 537-45 (1986).

Thus, the definition of a tax expenditure draws a distinction between the ideal provisions of an income tax and the special or preferential provisions that are exceptions to that ideal structure. For example, according to the Joint Committee on Taxation:

[T]he normal structure of the individual income tax includes the following major components: one personal exemption for each taxpayer and one for each dependent, the standard deduction, the existing tax rate schedule, and deductions for investment and employee business expenses. Most other tax benefits to individual taxpayers are classified as exceptions to normal income tax law.⁸⁸

As we have seen, these exceptions from an ideal income tax are routinely identified as tax expenditures by the Office of Management and Budget and the Joint Committee on Taxation.⁸⁹ The Congressional Budget Act of 1974 does not, however, actually specify the ideal structure of a tax law, so deciding which provisions are special or preferential is necessarily a matter of judgment, over which there is often much debate.⁹⁰

Pertinent here, many tax experts would prefer if tax expenditure estimates were based on a consumption tax ideal rather than an income tax ideal.⁹¹ Under a consumption tax, savings are not supposed to be taxed until they are spent (i.e., consumed). Consequently, using a consumption tax ideal would lead to a quite different set of tax expenditure estimates. Indeed, the tax expenditure associated with pensions would be zero (or, to the extent of any “over-taxation” of pensions, negative).⁹²

⁸⁸ STAFF OF THE JOINT COMM. ON TAXATION, *supra* note 14, at 3.

⁸⁹ See, e.g., OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, *supra* note 45, at 203, 205 tbl.14-1; STAFF OF THE JOINT COMM. ON TAXATION, *supra* note 14, at 2.

⁹⁰ See, e.g., Boris I. Bittker, *Accounting for Federal “Tax Subsidies” in the National Budget*, 22 NAT’L TAX J. 244, 245 (1969); Stanley S. Surrey & William F. Hellmuth, *The Tax Expenditure Budget—Response to Professor Bittker*, 22 NAT’L TAX J. 528, 530 (1969); Boris I. Bittker, *The Tax Expenditure Budget—A Reply to Professors Surrey and Hellmuth*, 22 NAT’L TAX J. 538, 538 (1969).

⁹¹ See Jonathan B. Forman *The Impact of Shifting to a Personal Consumption Tax on Pension Plans and Their Beneficiaries*, in TAX REFORM: IMPLICATIONS FOR ECONOMIC SECURITY AND EMPLOYEE BENEFITS 51, 56–57 (Dallas L. Salisbury ed., Employee Benefit Research Institute 1997); see also PETER BRADY, INV. CO. INST., *THE TAX BENEFITS AND REVENUE COSTS OF TAX DEFERRAL* 6 (2012), available at http://www.ici.org/pdf/ppr_12_tax_benefits.pdf (suggesting that current tax expenditure budgets vastly overstate the tax costs of retirement savings).

⁹² See, e.g., OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, ANALYTICAL PERSPECTIVES: BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2004 app. at 140 tbl.2 (2003), available at <http://www.gpo.gov/fdsys/pkg/BUDGET-2004-PER/pdf/BUDGET-2004-PER.pdf>. Pertinent here, see Edward A. Zelinsky, *The Tax Treatment of Qualified Plans: A Classic Defense of the Status Quo*, 66 N.C. L. REV. 315, 315 (1988); Norman P. Stein, *Qualified Plans and Tax Expenditures: A Reply to Professor Zelinsky*, 9 AM. J. TAX POLY 225, 239 (1991); Edward A. Zelinsky, *Qualified Plans and*

Certainly, the government has the power to eliminate or curtail the tax benefits for annuities, pensions, and IRAs; but should it? As we have seen, there are already a number of limits on contributions and benefits (e.g., the \$17,500 annual cap on 401(k)-type contributions). The question is really whether it makes sense to toughen the current limits and/or impose new limits on deferred savings. Proponents of comprehensive income taxation tend to favor such tougher caps, while proponents of consumption taxation tend to oppose tougher caps.

To be sure, a good deal of revenue could be raised from curtailing the current tax benefits for annuities, pensions, and IRAs. And certainly that revenue could be used for deficit reduction, for cuts in marginal tax rates, or for additional retirement savings subsidies for low- and moderate-income households. Those are all worthwhile uses for additional revenue, but if raising revenue is the goal, it is not clear that curtailing the tax benefits for savings is the best way to raise revenue. While the retirement savings tax benefits are among the largest tax expenditures in the tax expenditure budget,⁹³ curtailing them might undermine our already fragile retirement system.

Historically, Congress has often let revenue needs drive pension policy.⁹⁴ Instead, it should be driven by genuine concerns about how to ensure that our pension system will provide adequate retirement incomes for all American workers.⁹⁵

B. The Favorable Tax Rules for Annuities, Pensions, and IRAs Could Be Better Targeted to Help Low- and Moderate-Income Households

Many proponents of curtailing the tax benefits for annuities, pensions, and IRAs believe that those benefits could be better targeted to help low- and moderate-income households.⁹⁶ In that regard, there is no question that these tax expenditures are

Identifying Tax Expenditures: A Rejoinder to Professor Stein, 9 AM. J. TAX POL'Y 257, 257 (1991).

⁹³ See *supra* note 48 and accompanying text.

⁹⁴ See, e.g., David A. Pratt, *Pension Simplification*, 35 J. MARSHALL L. REV. 565, 566 (2002).

⁹⁵ See, e.g., G.A. (Sandy) Mackenzie & Jonathan Barry Forman, *Reforming the Second Tier of the U.S. Pension System: Tabula Rasa or Step by Step?*, 46 J. MARSHALL L. REV. 631, 633 (2013).

⁹⁶ See, e.g., Turner, McCarthy & Stein, *supra* note 61; GALE, *supra* note 81; Chuck Marr, Nathaniel Frentz & Chye-Ching Huang, *Retirement Tax Incentives Are Ripe for Reform: Current Incentives Are Expensive, Inefficient, and Inequitable*, CENTER ON BUDGET & POLY PRIORITIES (Dec. 13, 2013), <http://www.cbpp.org/cms/index.cfm?fa=view&id=4063>; TERESA GHILARDUCCI, WHEN I'M SIXTY-FOUR: THE PLOT AGAINST PENSIONS AND THE PLAN TO SAVE THEM 54–57 (2008).

skewed in favor of high-income households. For example, Table 3 shows that the top quintile of households receive roughly two-thirds of the tax benefits from the exclusion of pension contributions and earnings.⁹⁷ Meanwhile, the bottom quintiles get hardly any tax benefits.

TABLE 3. DISTRIBUTION OF THE EXCLUSION OF NET CONTRIBUTIONS AND EARNINGS, BY INCOME GROUP, 2013

	Lowest quintile	Second quintile	Middle quintile	Fourth quintile	Highest quintile	All quintiles
Share	2	5	9	18	66	100
Share of after-tax income	0.4	0.7	0.8	1.2	2.0	1.4

Source: CONG. BUDGET OFFICE, PUB. NO. 4308, THE DISTRIBUTION OF MAJOR TAX EXPENDITURES IN THE INDIVIDUAL INCOME TAX SYSTEM 15 tbl. 2 (2013), available at http://www.cbo.gov/sites/default/files/cbofiles/attachments/43768_DistributionTaxExpenditures.pdf.

Accordingly, curtailing the tax benefits for retirement contributions and/or benefits likely would reduce the proportion of tax expenditures that goes to high-income households and increase the relative proportion that goes to low- and moderate-income households. Alternatively, replacing the current system of exclusions and deductions with refundable tax credits could also improve the distribution of benefits. However, to the extent that these changes would limit the incentives that business owners and managers have to offer retirement plans, overall coverage might decline. All in all there are tradeoffs, and the focus should be on designing a low-cost pension system that will provide adequate retirement incomes for all American workers.⁹⁸

C. The Current System Is Already Too Complicated and Needs to Be Simplified

One of the major problems with the current retirement savings system is its incredible complexity. In addition to the wide variety of annuity options, there are a plethora of

⁹⁷ CONG. BUDGET OFFICE, PUB. NO. 4308, THE DISTRIBUTION OF MAJOR TAX EXPENDITURES IN THE INDIVIDUAL INCOME TAX SYSTEM 15 tbl.2 (2013), available at http://www.cbo.gov/sites/default/files/cbofiles/attachments/43768_DistributionTaxExpenditures.pdf; see also *Distribution of Tax Expenditures for Housing, Health and Retirement Savings*, TAX POLY CENTER, http://www.taxpolicycenter.org/taxtopics/Tax_Expenditures_tables.cfm (last visited Feb. 20, 2014); *T13-0295 Tax Benefit of Certain Retirement Savings Incentives (Cash-flow Approach)*, TAX POLY CENTER (Dec. 18, 2013), <http://www.taxpolicycenter.org/numbers/displayatab.cfm?DocID=4041>.

⁹⁸ See, e.g., Forman & Mackenzie, *supra* note 15, at 6-43.

retirement plans including traditional defined benefit plans, cash balance plans, money purchase pension plans, target benefit plans, profit-sharing plans, stock bonus plans, employee stock ownership plans (ESOPs), SIMPLE plans, SEPs, IRAs, and Roth IRAs. Every one of these plans has a different set of rules and regulations, limits on contributions, vesting rules, and tax advantages. The net result is bewildering complexity for everyone. As a result, many analysts have called for simplification.⁹⁹

Pertinent here, we already have numerous limits on retirement contributions and benefits, and extensive regulations that govern annuities, pensions, and IRAs. As Congress thinks about adding new limits and toughening existing ones, one hopes that it also takes the opportunity to reform and simplify the current system.

CONCLUSION

In recent years, there have been a number of proposals to curtail the favorable tax treatment that is currently available for annuities, pensions, and IRAs. Advocates of imposing tougher limits on the tax benefits for annuities, pensions, and IRAs tend to be interested in raising revenue for deficit reduction, for cuts in marginal tax rates, or for subsidies for low- and moderate-income households. These are worthy goals; however, as Congress thinks about limiting the tax incentives for annuities, pensions, and IRAs, it needs to be careful not to undermine our already fragile retirement system.

⁹⁹ See, e.g., Pratt, *supra* note 94; Forman & Mackenzie, *supra* note 15; David A. Pratt, *Focus on . . . Pension Simplification*, 9 J. PENSION BENEFITS 8 (2002); Pamela Perun & C. Eugene Steuerle, *Reality Testing for Pension Reform 2* (May 6, 2003) (unpublished manuscript), available at http://www.urban.org/UploadedPDF/410797_reality_testing_pension_reform.pdf.

One-Size-Fits-Small: A Look at the History of the FBAR Requirement, the Offshore Voluntary Disclosure Programs, and Suggestions for Increased Participation and Future Compliance

Stephan Michael Brown*

INTRODUCTION

According to the most recent estimate in 2006, the tax gap, defined as “the amount of tax liability faced by taxpayers that is not paid on time,”¹ was \$450 billion,² with an estimated \$100 billion resulting from unreported international income annually.³ Perhaps not coincidentally, in 2002, the foreign bank account reporting (hereinafter “FBAR”) compliance rate was estimated to be potentially less than 20%.⁴ In response, the government has drastically increased the penalties for noncompliance,⁵ and the Internal Revenue Service (hereinafter “IRS”) has introduced a series of pseudo-amnesty programs.⁶ The recent Offshore

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1 Internal Revenue Serv., *The Tax Gap*, IRS.GOV, <http://www.irs.gov/uac/The-Tax-Gap> (last updated Dec. 3, 2013).

2 See Internal Revenue Serv., *Tax Gap “Map”*, IRS.GOV., (Dec. 2011), http://www.irs.gov/pub/newsroom/tax_gap_map_2006.pdf.

3 STAFF OF S. PERMANENT SUBCOMM. ON INVESTIGATIONS, 110TH CONG., REP. ON TAX HAVEN BANKS AND U.S. TAX COMPLIANCE 1 (Comm. Print 2008); see also Susan C. Morse, *Tax Compliance and Norm Formation Under High-Penalty Regimes*, 44 CONN. L. REV. 675, 701 n.92 (2012) (providing several estimates ranging from \$50 billion to \$255 billion annually).

4 See SEC’Y OF THE TREASURY, A REPORT TO CONGRESS IN ACCORDANCE WITH §361(b) OF THE UNITING AND STRENGTHENING AMERICA BY PROVIDING APPROPRIATE TOOLS REQUIRED TO INTERCEPT AND OBSTRUCT TERRORISM ACT OF 2001, at 6 (2002), available at http://www.fincen.gov/news_room/rp/files/ReportToCongress361.PDF. A perfectly accurate compliance rate would have been difficult to determine due to the limited amount of available information. However, this approximation is based on the Service’s estimate from the limited information it did have. *Id.*

5 31 U.S.C. § 5321(a)(5)(C) (2012).

6 See I.R.S. News Release IR-2003-5 (Jan. 14, 2003), available at www.irs.gov/pub/irs-news/ir-03-05.pdf (announcing the 2003 Offshore Voluntary Compliance Initiative);

Voluntary Disclosure (hereinafter "OVD") programs have been instrumental in increased compliance for FBAR and reporting of worldwide income.⁷ Although the programs have been considered successful,⁸ there are still a large number of taxpayers who remain noncompliant with respect to reporting their foreign income and assets.⁹

This Article will offer suggestions to improve the current OVD program which will further the purposes of increased compliance and revenue collection.¹⁰ Part I will provide a history of FBAR, including the events leading to increased penalties for noncompliance and the introduction of the first OVD program in 2003. Part II will establish the reemergence of the pseudo-amnesty OVD programs in 2009 and 2011, as well as the quiet disclosure and opt-out alternatives to voluntary disclosure. Part III will evaluate the meaning of "willfulness" in the context of FBAR penalties by detailing recent developments in case law, and will discuss the resulting uncertainties in the context of the OVD program. Part IV will explore the continuation of the OVD program in its current state, including an analysis of problems with the program.

Internal Revenue Serv., *Statement from IRS Commissioner Doug Shulman on Offshore Income*, IRS.GOV (Mar. 26, 2009), <http://www.irs.gov/uac/Statement-from-IRS-Commissioner-Doug-Shulman-on-Offshore-Income> (announcing the 2009 Offshore Voluntary Disclosure Initiative); I.R.S. News Release IR-2011-84 (Aug. 8, 2011), *available at* <http://www.irs.gov/uac/IRS-Reminds-Taxpayers-that-the-Aug.-31-Deadline-Is-Fast-Approaching-for-the-Second-Special-Voluntary-Disclosure-Initiative-of-Offshore-Accounts> (announcing the 2011 Offshore Voluntary Disclosure Program); I.R.S. News Release IR-2012-5 (Jan. 9, 2012), *available at* [http://www.irs.gov/uac/IRS-Offshore-Programs-Produce-\\$4.4-Billion-To-Date-for-Nation's-Taxpayers;-Offshore-Voluntary-Disclosure-Program-Reopens](http://www.irs.gov/uac/IRS-Offshore-Programs-Produce-$4.4-Billion-To-Date-for-Nation's-Taxpayers;-Offshore-Voluntary-Disclosure-Program-Reopens) (announcing the 2012 Offshore Voluntary Disclosure Program).

⁷ See Leandra Lederman, *The Use of Voluntary Disclosure Initiatives in the Battle Against Offshore Tax Evasion*, 57 VILL. L. REV. 499, 526 (2012).

⁸ See I.R.S. News Release IR-2012-64 (June 26, 2012), *available at* [http://www.irs.gov/uac/IRS-Says-Offshore-Effort-Tops-\\$5-Billion,-Announces-New-Details-on-the-Voluntary-Disclosure-Program-and-Closing-of-Offshore-Loop-hole](http://www.irs.gov/uac/IRS-Says-Offshore-Effort-Tops-$5-Billion,-Announces-New-Details-on-the-Voluntary-Disclosure-Program-and-Closing-of-Offshore-Loop-hole) (quoting IRS Commissioner Doug Shulman, who stated that the IRS "continue[d] to make strong progress in our international compliance efforts that help ensure honest taxpayers are not footing the bill for those hiding assets offshore").

⁹ See NAT'L TAXPAYER ADVOCATE, 2012 ANNUAL REPORT TO CONGRESS 134 (2012) ("While an estimated five to seven million U.S. citizens reside abroad, and many more U.S. residents have FBAR filing requirements, the IRS received only 741,249 FBAR filings in 2011, and as of September 29, 2012, it had received fewer than 28,000 OVD submissions from FBAR violators. Thus, significant FBAR filing compliance problems likely remain unaddressed.").

¹⁰ See Internal Revenue Serv., *Offshore Voluntary Disclosure Program Frequently Asked Questions and Answers*, IRS.GOV, <http://www.irs.gov/Individuals/International-Taxpayers/Offshore-Voluntary-Disclosure-Program-Frequently-Asked-Questions-and-Answers> (last updated Aug. 26, 2013) (stating that the objective of the program is "to bring taxpayers that have used undisclosed foreign accounts and undisclosed foreign entities to avoid or evade tax into compliance with United States tax laws").

This Article will conclude that in order to further increase compliance, the OVD program should eliminate the one-size-fits-all approach by expanding the current penalty structure with the goal of drastically increasing participation. The program should be given an end date, and it should coincide with public prosecutions of the most egregious offenders. Doing so will give taxpayers who have not yet come forward to disclose their foreign accounts a great incentive to do so by reducing the penalty for past actions. The result will be a huge boost to current and future tax revenues. Alternatively, if the program is not expanded, the majority of taxpayers who have not yet come forward will likely continue to hide their assets offshore and the international tax gap will continue to be astoundingly large, putting a strain on compliant taxpayers.

I. HISTORY OF FOREIGN BANK ACCOUNT REPORTING AND PENALTIES FOR NONCOMPLIANCE

The FBAR requirement was initially established by the Currency and Foreign Transactions Reporting Act of 1970, commonly referred to as the Bank Secrecy Act, part of which is codified in Title 31 of the United States Code.¹¹ The purpose of the requirement was to obtain data with “a high degree of usefulness in criminal, tax, or regulatory investigations or proceedings.”¹² In 2001, the Patriot Act¹³ expanded the purpose to include protecting against international terrorism.¹⁴ The Patriot Act amendment made the reporting requirements of Title 31 more of a priority, with one commentator noting, “Nowadays, once something has been labeled as crucial to the ubiquitous ‘war on terror,’ there seem to be few (if any) limits on governmental efforts.”¹⁵

Section 5314(a) of the Patriot Act provides that

the Secretary of the Treasury shall require a resident or citizen of the United States or a person in, and doing business in, the United States, to keep records, file reports, or keep records and file reports, when the resident, citizen, or person makes a transaction or

¹¹ See 31 U.S.C. §§ 5311–5314 (2012); see also U.S. Dep’t of the Treasury, *Bank Secrecy Act*, FINCEN.GOV, http://www.fincen.gov/statutes_regs/bsa/ (last visited Apr. 6, 2014).

¹² 31 U.S.C. § 5311 (2000) (prior to 2004 amendment).

¹³ Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA PATRIOT ACT) Act of 2001, Pub. L. No. 107-56, 115 Stat. 272 (codified at 31 U.S.C. § 5314 (2012)).

¹⁴ 31 U.S.C. § 5311 (2012) (adding “or in the conduct of intelligence or counterintelligence activities, including analysis, to protect against international terrorism”).

¹⁵ Hale E. Sheppard, *Evolution of the FBAR: Where We Were, Where We Are, and Why It Matters*, 7 HOUS. BUS. & TAX L.J. 1, 3 (2006).

maintains a relation for any person with a foreign financial agency.¹⁶

The Code then states that the “records and reports shall contain . . . information in the way and to the extent the Secretary prescribes.”¹⁷ Under this authority, the Secretary of the Treasury developed Form TD F 90-22.1 “Report of Foreign Bank and Financial Accounts,”¹⁸ commonly referred to as Foreign Bank Account Reporting, or FBAR, which has recently been replaced by FinCEN Form 114.¹⁹ The Form requires reporting of the maximum value of all foreign accounts exceeding \$10,000 at any time during the calendar year.²⁰

Prior to 2004, the Secretary of the Treasury could have imposed a civil monetary penalty on any person “willfully violat[ing]” the FBAR requirement.²¹ According to the Supreme Court in *Cheek v. United States*, “[w]illfulness . . . require[d] the Government to prove that the law imposed a duty on the defendant, that the defendant knew of this duty, and that he voluntarily and intentionally violated that duty.”²² Furthermore, “carrying this burden require[d] negating a defendant’s claim of ignorance of the law or a claim that because of a misunderstanding of the law, he had a good-faith belief that he was not violating any of the provisions of the tax laws.”²³ Although willfulness required such a high evidentiary standard, if proven, the Secretary could have imposed monetary civil penalties, ranging from \$25,000 up to the balance in the account at the time of the violation, whichever was greater, with a maximum penalty of \$100,000 for each violation.²⁴ In addition to the civil penalty provision, any person found willfully violating

¹⁶ 31 U.S.C. § 5314(a).

¹⁷ *Id.*

¹⁸ U.S. DEPT OF THE TREASURY, FORM TD F 90-22.1, REPORT OF FOREIGN BANK AND FINANCIAL ACCOUNTS (2012) [hereinafter FORM TD F 90-22.1], available at www.fincen.gov/forms/files/f9022-1_fbar.pdf.

¹⁹ Internal Revenue Serv., 2012 Offshore Voluntary Disclosure Program, IRS.GOV, <http://www.irs.gov/uac/2012-Offshore-Voluntary-Disclosure-Program> (last updated Jan. 24, 2014).

²⁰ See FORM TD F 90-22.1, *supra* note 18, at 6; see also FIN. CRIMES ENFORCEMENT NETWORK, BSA ELECTRONIC FILING REQUIREMENTS FOR REPORT OF FOREIGN BANK AND FINANCIAL ACCOUNTS (FINCEN FORM 114) 4 (2014), available at <http://www.fincen.gov/forms/files/FBAR%20Line%20Item%20Filing%20Instructions.pdf>.

²¹ 31 U.S.C. § 5321(a)(5)(A) (2000) (prior to 2004 amendment).

²² *Cheek v. United States*, 498 U.S. 192, 201 (1991).

²³ *Id.* at 202. Although this case was regarding the FBAR civil penalty under Title 31, the Court opted to use the term “tax laws.” Several courts and commentators use terms such as “tax laws” and “taxpayers” when referring to the FBAR penalty. See, e.g., *United States v. Williams*, 489 F. App’x 655 (4th Cir. 2012); *United States v. McBride*, 908 F. Supp. 2d 1186 (D. Utah 2012); Internal Revenue Serv., *supra* note 10. Due to the nature of the OVD programs, this Article will do the same.

²⁴ 31 U.S.C. § 5321(a)(5)(B)(ii) (2000) (prior to 2004 amendment).

the FBAR requirement could have been subject to a criminal penalty of up to \$250,000, or up to five years in prison, or both.²⁵

Section 361(b) of the Patriot Act requires annual reports to Congress as follows:

The Secretary of the Treasury shall study methods for improving compliance with the reporting requirements established in section 5314 of title 31, United States Code, and shall submit a report on such study to the Congress by the end of the 6-month period beginning on the date of enactment of this Act [Oct. 26, 2001] and each 1-year period thereafter. The initial report shall include historical data on compliance with such reporting requirements.²⁶

The initial report, given in April 2002,²⁷ estimated that FBAR compliance was potentially below 20%.²⁸ The report also indicated that enforcement was virtually nonexistent.²⁹ Some of the reasons cited for the lack of enforcement included difficulty in obtaining evidence of undisclosed foreign financial accounts,³⁰ the U.S. Department of Justice's preference to charge taxpayers with other violations (typically illegal conduct such as tax evasion, fraud, or money laundering),³¹ and the difficulty prosecutors had in demonstrating willfulness for civil penalties.³²

The report gave recommendations for improving compliance with FBAR reporting requirements, and provided the IRS and the Financial Crimes Enforcement Network (hereinafter "FinCEN")³³ with five objectives for the following year: update and improve the FBAR form and instructions, review filing and processing procedures, enhance outreach and education to tax practitioners, establish a joint task force on prosecutions and enforcement, and consider delegating penalty authority from FinCEN to the IRS.³⁴ Additionally, although the report

²⁵ 31 U.S.C. § 5322(a) (2012).

²⁶ Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA PATRIOT ACT) Act of 2001, Pub. L. No. 107-56, § 361(b), 115 Stat. 272, 332.

²⁷ SECY OF THE TREASURY, *supra* note 4.

²⁸ *Id.* at 6.

²⁹ *Id.* at 8 ("Between 1996 and 1998, Justice Department statistics reveal that only nine indictments were filed charging 31 U.S.C. 5314; in 1999 and 2000, no one appears to have been charged. The Customs Service reports only three convictions since 1995."); *see also id.* at 9 (reporting only twelve referrals for civil enforcement since 1993, only two of which were assessed monetary penalties).

³⁰ *Id.* at 8.

³¹ *Id.* at 9.

³² *Id.* at 10.

³³ The Financial Crimes Enforcement Network was established in 1990 as a bureau of the Department of the Treasury and was tasked with enforcing the FBAR provisions under Chapter 53 of Title 31, among other things. *See* 31 U.S.C. § 310 (2012).

³⁴ SECY OF THE TREASURY, *supra* note 4, at 12–13.

recognized that uninformed taxpayers³⁵ would benefit from education and outreach,³⁶ it found that this would not increase compliance for “taxpayers who fail to file because they are concealing income or are engaged in some kind of criminal activity.”³⁷ For this group, the report suggested deterrence through “a series of highly publicized criminal actions against intentional violators in order to raise the cost of being an FBAR scofflaw.”³⁸

In April 2003, the second report was presented, the bulk of which detailed the progress made on the objectives from the initial report.³⁹ In an agreement reached weeks before the second report was issued, FinCEN delegated its authority to enforce FBAR provisions to the IRS.⁴⁰ The IRS also took over the responsibility of updating and improving the FBAR form and instructions; however, no such updates or improvements were made and no new target date was given for this goal.⁴¹ The IRS also assumed the responsibility of reviewing filing and processing procedures of the FBAR forms,⁴² and began taking steps to improve outreach and education such as utilizing media outlets and working with tax practitioner organizations.⁴³ Lastly, a joint task force was formed between the IRS, FinCEN, and the Department of Justice to enhance prosecutions and enforcement, which included the IRS’s 2003 Offshore Voluntary Compliance Initiative (hereinafter “OVCI”).⁴⁴ The second report concluded with goals for the following year: emphasize examination of offshore activities, identify potential non-filers, continue outreach and education, and use input from filers to improve the FBAR form.⁴⁵

The 2003 OVCI was the first program administered by the IRS designed to allow taxpayers with “offshore financial arrangements” to voluntarily come forward and “clear up their

35 Common scenarios in which taxpayers may be unwittingly subject to the FBAR rules include students studying abroad, taxpayers with temporary offshore work assignments, individuals with inherited foreign accounts, and immigrants. See Sheppard, *supra* note 15, at 26–27.

36 SEC’Y OF THE TREASURY, *supra* note 4, at 10–11.

37 *Id.* at 11.

38 *Id.*

39 See SEC’Y OF THE TREASURY, A REPORT TO CONGRESS IN ACCORDANCE WITH §361(b) OF THE UNITING AND STRENGTHENING AMERICA BY PROVIDING APPROPRIATE TOOLS REQUIRED TO INTERCEPT AND OBSTRUCT TERRORISM ACT OF 2001, at 3 (2003), available at http://www.fincen.gov/news_room/rp/files/fbar3613.pdf.

40 *Id.* at 4–5.

41 *Id.* at 5.

42 *Id.*

43 *Id.* at 5–6.

44 *Id.* at 6–7.

45 *Id.* at 7–8.

tax liabilities.”⁴⁶ The program came on the heels of an Offshore Credit Card Program that included credit card summonses in 2000 and 2002 meant to find offshore tax evaders.⁴⁷ The purpose was to quickly bring taxpayers back into compliance and to simultaneously gather information about promoters of offshore schemes.⁴⁸ Essentially, the initiative was a pseudo-amnesty program allowing taxpayers to voluntarily amend their tax returns to include offshore income in exchange for a waiver of certain penalties and a guarantee of no criminal prosecution.⁴⁹ According to a July 2003 IRS News Release, the program brought in \$75 million in taxes, at a cost of approximately \$2 million.⁵⁰ These results were not without controversy however, with one report suggesting that only \$3.3 million had been assessed at a cost of an estimated \$56 million.⁵¹ Although the success may have been limited, the IRS did identify over 400 offshore promoters, about half of which were previously unknown to the IRS.⁵²

In April 2005, a third report was presented,⁵³ ingeniously referred to as the third annual report.⁵⁴ This report detailed the progress made on the objectives from the prior two periods, including reiterating and at times expanding on the second report.⁵⁵ One noteworthy point included in the third annual report was a list of several problems identified with the current FBAR form, leading to the uninspired conclusion that the IRS would concentrate on the instructions, “leaving material revision of the form itself to another day.”⁵⁶ Also of note, the report

⁴⁶ See I.R.S. News Release IR-2003-5, *supra* note 6, at 1.

⁴⁷ *Id.* at 2.

⁴⁸ *Id.* at 1.

⁴⁹ *Id.*; see also Rev. Proc. 2003-11, 2003-4 I.R.B. 311.

⁵⁰ I.R.S. News Release IR-2003-95 (July 30, 2003), available at <http://www.irs.gov/pub/irs-news/ir-03-95.pdf>.

⁵¹ See Lederman, *supra* note 7, at 507. Such results lead one to question government accounting methods. If a taxpayer's calculations resulted in such a discrepancy, it would be deemed fraudulent.

⁵² See I.R.S. News Release IR-2003-95, *supra* note 50.

⁵³ SECY OF THE TREASURY, A REPORT TO CONGRESS IN ACCORDANCE WITH §361(b) OF THE UNITING AND STRENGTHENING AMERICA BY PROVIDING APPROPRIATE TOOLS REQUIRED TO INTERCEPT AND OBSTRUCT TERRORISM ACT OF 2001 (USA PATRIOT ACT) (2005) (listing the year 2004 in the web address even though the report was presented in 2005). One point of interest is the date is that not included on the cover page as in the prior two reports, perhaps because the report came a year later than that mandated by law under the Patriot Act. Furthermore, this is the last report to Congress despite the continuing requirement for annual reports.

⁵⁴ *Id.* at 3.

⁵⁵ *Id.* at 5–11.

⁵⁶ *Id.* at 6–8. The Form and Instructions were eventually updated in 2008. See Philip T. Pasmanik & Neil A. J. Sullivan, *Report of Foreign Bank and Financial Accounts: Significant Revisions and Severe Penalties*, J. ACCT. (July 2009), <http://www.journalofaccountancy.com/Web/TTAFBARReport.htm>.

showed a 17% increase in FBAR filings from 2000 to 2003, believed to be in significant part from the 2003 OVCI.⁵⁷

Overall, these reports convinced Congress that FBAR compliance was unsatisfactory, and several bills were introduced to address the problem.⁵⁸ Eventually, on October 22, 2004, the American Jobs Creation Act of 2004⁵⁹ was passed, part of which gave section 5321 a major overhaul.

Following this overhaul, a revised section 5321(a)(5)(C) increased the penalty for a person who willfully violates the FBAR requirement to the greater of \$100,000 or 50% of the account balance, with no ceiling.⁶⁰ As one commentator noted, "Given the astronomical balance in some unreported accounts, and the fact that the IRS often applies the penalty on a per-account-per-year basis, the penalties can be enormous."⁶¹ Under section 5321(a)(5)(A), the Secretary of the Treasury was given discretion to impose a penalty of up to \$10,000 for non-willful violations,⁶² though an exception for "reasonable cause" is provided if "the amount of the transaction or the balance in the account at the time of the transaction was properly reported."⁶³ The criminal penalties remain unchanged following this overhaul.⁶⁴

II. 2009 AND 2011 OVD PROGRAMS AND ALTERNATIVES

Six years passed before the successor to OVCI, the 2009 Offshore Voluntary Disclosure Program (hereinafter "OVDP"), was put in place.⁶⁵ This program ran in conjunction with a

⁵⁷ See SEC'Y OF THE TREASURY, *supra* note 53, at 11.

⁵⁸ See Sheppard, *supra* note 15, at 17 n.101.

⁵⁹ American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418.

⁶⁰ 31 U.S.C. § 5321(a)(5)(C) (2012).

⁶¹ See Hale E. Sheppard, *Third Time's the Charm: Government Finally Collects 'Willful' FBAR Penalty in Williams*, 117 J. TAX'N 319, 320 (2012); see also NAT'L TAXPAYER ADVOCATE, *supra* note 9, at 147 ("Because the statute of limitations period is six years, the maximum penalty for large accounts is essentially 300 percent of the maximum account balances (assuming a relatively constant balance).").

⁶² 31 U.S.C. § 5321(a)(5)(A)-(B)(i). The IRS has taken the aggressive position that the non-willful penalty can be applied on a per-account, per-year basis; however, this issue has not yet been litigated. Internal Revenue Serv., *Internal Revenue Manual 4.26.16.4, Report of Foreign Bank and Financial Accounts*, IRS.GOV (July 1, 2008), http://www.irs.gov/irm/part4/irm_04-026-016.html.

⁶³ 31 U.S.C. § 5321(a)(5)(B)(ii)(II).

⁶⁴ 31 U.S.C. § 5322(a).

⁶⁵ See Memorandum from Linda E. Stiff, Deputy IRS Comm'r for Servs. and Enforcement, to Comm'r, Large and Mid-Size Bus. Div. and Comm'r, Small Bus./Self-Employed Div. (Mar. 23, 2009) [hereinafter Memorandum from Linda E. Stiff], available at <http://hodgen.com/irs-amnesty-offshore-account/>; see also Internal Revenue Serv., *supra* note 6.

crackdown on offshore tax evasion⁶⁶—which focused on the international banking giant UBS—that began when a disgruntled employee revealed that “he was part of a UBS team that made frequent trips across the Atlantic to aggressively market investment strategies to rich Americans to elude the scrutiny of the Internal Revenue Service.”⁶⁷ In the summer of 2008, the U.S. Department of Justice issued a John Doe Summons asking UBS to disclose the names of all of its U.S. clients, representing “the first time that the United States ha[d] attempted to pierce Swiss bank secrecy by compelling a Swiss bank to name its U.S. clients.”⁶⁸ This led to an agreement by UBS to pay a \$780 million penalty and release the names of 250 Americans.⁶⁹

The Department of Justice was not satisfied, however, and in February 2009 “filed another civil lawsuit against UBS seeking the identities of 52,000 more Americans suspected of stashing a total of \$15 billion at the bank.”⁷⁰ Following an agreement between the United States and Swiss governments, a settlement was reached in the case, with UBS agreeing to supply the names of close to 4450 American account holders the IRS suspected of evading taxes.⁷¹ Specific details of the agreement were not released until after the completion of the 2009 OVDP, which brought in more than 15,000 taxpayers, many more than the 1000 taxpayers the IRS expected would participate.⁷²

The 2009 OVDP required taxpayers to amend or file six years of tax returns and FBARs, and pay any resulting increase in tax with interest.⁷³ Taxpayers were assessed either an accuracy or delinquency penalty for all six years, with no possibility for a reasonable cause exception.⁷⁴ Additionally, in lieu of all other penalties, including the statutory FBAR

⁶⁶ The timing of the 2009 program was intended to capitalize on the publicity of the scandal. See Lederman, *supra* note 7, at 510 (“The 2009 initiative was timed to profit from the publicity about Birkenfield and UBS . . .”).

⁶⁷ Graham Bowley, *A Privileged World Begins to Give Up Its Secrets*, N.Y. TIMES, Aug. 23, 2009, at WK3.

⁶⁸ Jared Seff, *Cracking Down on Tax Evaders—Swiss Banking: Secrets, Lies, and Deception*, 38 S.U. L. REV. 159, 162 (2010).

⁶⁹ *Id.* at 162–63.

⁷⁰ *Id.* at 164.

⁷¹ *Id.* At 164–65. Although the results of the agreement have led to increased disclosure by many Americans, some members of Congress were not appeased. As Michigan Senator Carl Levin stated, “[T]he tortured wording and the many limitations in this Annex shows the Swiss Government trying to preserve as much bank secrecy as it can for the future, while pushing to conceal the names of tens of thousands of suspected U.S. tax cheats. It is disappointing that the U.S. government went along.” *Id.* at 172.

⁷² See Lederman, *supra* note 7, at 510.

⁷³ See Internal Revenue Serv., *supra* note 6.

⁷⁴ See Memorandum from Linda E. Stiff, *supra* note 65, at 2.

penalties, participants in the program had to pay a penalty equal to 20% of the amount in foreign accounts in the year with the highest aggregate balance during the six-year period.⁷⁵ The IRS warned that taxpayers who do not come forward through the program could be subject to additional penalties, with agents instructed to pursue “both civil and criminal avenues, and consider all available penalties including the maximum penalty for the willful failure to file the FBAR report and the fraud penalty.”⁷⁶ The IRS considered the program a resounding success, boasting an estimated \$3.4 billion of tax revenue.⁷⁷

Although the IRS considered the 2009 OVDP as highly effective, some taxpayers chose to go outside of the program and make a “quiet disclosure”⁷⁸ by simply amending their returns to include any foreign income and paying the resulting tax. A quiet disclosure was seen by taxpayers as a safe substitute to get around the severe penalties imposed through the OVDP.⁷⁹ The IRS, on the other hand, saw it as undermining the credibility of a program that was otherwise proving a success.⁸⁰ The government discouraged the practice, therefore, by reminding those opting to make a quiet disclosure that they were risking criminal prosecution, relief from which was only possible by open participation in the program.⁸¹ Despite this, there has not been a widely publicized case of significant penalties being assessed after a quiet disclosure. Therefore, the public’s perception may be that circumventing the program to avoid penalties is a viable option.⁸²

⁷⁵ *Id.* There was a narrow exception to reduce the penalty to 5% if the taxpayer did not open the foreign accounts, there was no activity in the accounts, and all U.S. taxes had been paid on the funds in the accounts, with only account earnings escaping taxation. *Id.*

⁷⁶ See Internal Revenue Serv., *supra* note 6.

⁷⁷ See I.R.S. News Release IR-2012-5, *supra* note 6. Following the program, the IRS combed through the data received and continued to prosecute UBS clients. See Lederman, *supra* note 7, at 511. As another strategy to curb offshore tax evasion, in 2010 Congress enacted the Foreign Account Tax Compliance Act (FATCA) as part of the Hiring Incentives to Restore Employment (HIRE) Act, requiring additional foreign asset reporting on U.S. tax returns while creating some overlap with existing FBAR requirements. *Id.* at 512. FATCA also imposes information-sharing obligations on foreign banks, incentivized by a 30% withholding on United States-sourced payments against institutions that do not comply. *Id.*

⁷⁸ See Internal Revenue Serv., *Voluntary Disclosure: Questions and Answers*, IRS.GOV, Q&A 10 (May 6, 2009), <http://www.irs.gov/uac/Voluntary-Disclosure:-Questions-and-Answers>.

⁷⁹ See Morse, *supra* note 3, at 720–21.

⁸⁰ *Id.* at 721.

⁸¹ *Id.* at 722.

⁸² *Id.* The closest the government has come to such a prosecution occurred in August of 2011, after a taxpayer made a quiet disclosure by amending his returns and submitting FBARs. Although he was in compliance in those regards, he left off significant income from a partnership on both the original returns and the amended ones. See Jeremy

Following the success of the 2009 OVDP, on February 8, 2011, the 2011 Offshore Voluntary Disclosure Initiative (2011 OVDI) was introduced.⁸³ The program was similar to the 2009 OVDP, with three key differences: the look-back period was extended to eight years,⁸⁴ the penalty imposed on the highest aggregate offshore account balances was increased from 20% to 25%—although some taxpayers may qualify for a reduced penalty of 5% or 12.5% in certain narrow circumstances⁸⁵—and, to help combat quiet disclosures, the program provided participants with an option to opt out of the penalty.⁸⁶

Opting out of the civil settlement structure alternative allows taxpayers who do not agree with the flat penalty under the program to opt out of the penalty.⁸⁷ However, taxpayers choosing to opt out are subjected to a complete examination.⁸⁸ The examiner will determine whether willfulness exists, and no penalty will be assessed if the IRS deems that the failure to file was due to reasonable cause.⁸⁹ While participation in the program comes with a recommendation not to prosecute for violations up to the date of the disclosure,⁹⁰ participants who opt out “could be referred to Criminal Investigation for investigation and possible prosecution and assertion of the civil fraud penalty.”⁹¹ Without any type of assurances, it is not a surprise

Pelofsky, *Bank Executive to Plead Guilty to Hiding Account*, REUTERS, May 19, 2011, available at <https://1.next.westlaw.com/Document/I2ed6a540956511e19fefb85885c303b5/View/FullText.html>. The question remains whether the government will prosecute a taxpayer making a quiet disclosure that is complete and accurate. See Remy Farag, *HSBC Client Prosecuted After Quiet Disclosure*, J. INT'L TAX'N, Aug. 2011, at 8, 9. The IRS says they will be on the lookout for taxpayers making quiet disclosures and look to penalize and perhaps prosecute. See Internal Revenue Serv., *supra* note 10, at FAQ 15–16. The reality of that threat remains questionable. See Randall P. Andreozzi & Arlene M. Hirschweiler, *FBAR: Handle With Care*, 43 TAX ADVISER 330, 335 (2012) (“Since *Schiavo* involves an *incomplete* quiet disclosure, whether the IRS will treat *complete and accurate* quiet disclosures similarly remains unclear.”).

⁸³ See I.R.S. News Release IR-2011-84, *supra* note 6.

⁸⁴ See Lederman, *supra* note 7, at 515. The look-back period was extended so OVD participants “did not get a ‘pass’ with respect to the 2003 and 2004 tax years.” *Id.*

⁸⁵ *Id.* at 516. The circumstances necessary for the 5% penalty were similar to the requirements under the 2009 OVDP, see *supra* note 75, except that instead of no account activity being allowed, there must have been less than \$1000 withdrawn per year. See Internal Revenue Serv., *2011 Offshore Voluntary Disclosure Program Frequently Asked Questions*, IRS.GOV, FAQ 52, <http://www.irs.gov/Businesses/International-Businesses/2011-Offshore-Voluntary-Disclosure-Initiative-Frequently-Asked-Questions-and-Answers> (last updated Jan. 24, 2014). In order to qualify for the 12.5% penalty, the highest aggregate balance during the look-back period must have been less than \$75,000. *Id.* at FAQ 53.

⁸⁶ See Lederman, *supra* note 7, at 516.

⁸⁷ See Internal Revenue Serv., *supra* note 85, at FAQ 51.

⁸⁸ *Id.*

⁸⁹ *Id.* at FAQ 51.1.

⁹⁰ *Id.* at FAQ 51.3.

⁹¹ *Id.*

that less than 1% of program participants have opted out since it has become an option.⁹² As a recent report by the National Taxpayer Advocate noted,

even where taxpayers feel strongly that their FBAR noncompliance was due to reasonable cause or was not willful, faced with the choice of accepting the IRS's proposed penalty . . . or opting for a full examination — with the hope of avoiding the penalty . . . of far more than their net worth . . . — many will not want to risk opting out.⁹³

The IRS reported that it had received a total of 33,000 voluntary disclosures under the 2009 and 2011 programs combined, and collected \$4.4 billion.⁹⁴ However, at the time of these two OVD programs, taxpayers and tax practitioners alike were just becoming aware of the FBAR requirements, so many of the OVD participants would not have been subject to the civil penalty for willfulness for the tax years at issue.⁹⁵ Even so, the IRS opted to impose a penalty that is an excellent deal for willful violators, but a terrible option for non-willful violators.⁹⁶ Unfortunately, many taxpayers entering the program succumbed to the fear tactics of the IRS and agreed to pay a penalty through the OVD program that is greater than the penalty that would have otherwise been assessed, if any.⁹⁷

III. WILLFULNESS: THE *WILLIAMS* TRILOGY AND THE CURRENT STATE OF UNCERTAINTY

As discussed in Part II above, under the old law, imposing the FBAR penalty required a high evidentiary standard due to the willfulness requirement.⁹⁸ This resulted in a serious lack of prosecutions under the old regime.⁹⁹ More recently, however, a trilogy of cases culminating in the Fourth Circuit as *United States v. Williams*¹⁰⁰ has left tax practitioners with considerable

⁹² See NAT'L TAXPAYER ADVOCATE, *supra* note 9, at 138 (depicting 30 out of 11,941 participants electing to opt out of the 2011 program, with only 8 of those cases closed as of September 29, 2012, one year after the close of the 2011 program).

⁹³ *Id.* at 149.

⁹⁴ See I.R.S. News Release IR-2012-5, *supra* note 6.

⁹⁵ See Morse, *supra* note 3, at 715 ("It is conceivable, given the historic lack of publicity about, and enforcement of, the FBAR filing requirements, that a defendant might be able to show a lack of willfulness.").

⁹⁶ See *id.* at 714 ("[The government] used twenty percent . . . and twenty-five percent . . . as the price for entering the voluntary disclosure program. This represents a discount from the statutory civil willfulness penalty of fifty percent of the account balance for each annual failure to file.").

⁹⁷ See *id.* at 715–16.

⁹⁸ See Cheek v. United States, 498 U.S. 192, 201 (1991).

⁹⁹ See SEC'Y OF THE TREASURY, *supra* note 4.

¹⁰⁰ See Sheppard, *supra* note 61, at 319 ("The *Williams* trilogy has been a long road, with stops in the U.S. Tax Court (131 TC 54 (2008); *Williams I*), the U.S. district court

uncertainty as to what is required to establish willfulness with respect to FBAR violations.¹⁰¹ In these cases, the taxpayer was an attorney who, after graduating from NYU, worked in the corporate finance department of a major international law firm.¹⁰² He then obtained employment at Mobil Oil Corporation, where he worked in various legal and business positions, including, in 1991, exploring business opportunities for Mobil in the newly opened Russian markets.¹⁰³ Two years later, he created a British Virgin Islands corporation, ALQI Holdings, Ltd., and opened up two bank accounts in the corporation's name for holding the funds he received from foreign sources.¹⁰⁴ From 1993 to 2000, Williams deposited more than \$7 million into these accounts, which generated more than \$800,000 of interest and investment income.¹⁰⁵ With respect to these foreign accounts, Williams had three duties: report the foreign income on his tax returns, check "yes" on Schedule B of his tax return to indicate that he has one or more foreign accounts,¹⁰⁶ and file an FBAR.¹⁰⁷ He violated all three of these duties.¹⁰⁸

Beginning in 2000, Williams came under scrutiny by the IRS, which eventually led to guilty pleas in 2003 on one count of criminal tax evasion and one count of criminal conspiracy to defraud the government.¹⁰⁹ At his sentencing in September 2003, the court imposed a punishment of forty-six months in jail, a \$25,000 fine, restitution of over \$3.5 million, and three years of supervised release.¹¹⁰

Williams's troubles were not over yet, as the IRS initiated a civil examination of his finances following the criminal

(106 AFTR2d 2010-6150 (2010); *Williams II*), and, most recently, the Fourth Circuit in *Williams III*.”).

¹⁰¹ See *id.* (“[*Williams III*], already the subject of much criticism by the tax community, raises more questions than answers.”).

¹⁰² See *id.* at 320.

¹⁰³ *Id.*

¹⁰⁴ *Id.*

¹⁰⁵ *Id.*

¹⁰⁶ U.S. DEPT OF THE TREASURY, FORM 1040, SCHEDULE B—INTEREST AND ORDINARY DIVIDENDS (2000), available at <http://www.irs.gov/pub/irs-prior/f1040sab--2000.pdf>. Line 7a asks: “At any time during 2000, did you have an interest in or a signature or other authority over a financial account in a foreign country, such as a bank account, securities account, or other financial account?” *Id.* It then instructs the taxpayer to “[s]ee page B-2 for exceptions and filing requirements for Form TD F 90-22.1.” *Id.* The government argues that this instruction is enough to establish knowledge of the FBAR requirement. See *United States v. Williams*, No. 1:09-cv-437, 2010 WL 3473311, at *4 (E.D. Va. Sept. 1, 2010).

¹⁰⁷ See Sheppard, *supra* note 61, at 320.

¹⁰⁸ *Id.*

¹⁰⁹ *Id.* at 321.

¹¹⁰ *Id.* at 322.

sentencing.¹¹¹ In January 2007, the revenue agent asked him to file an FBAR for 2000, which Williams later claimed was the first time he had heard of the requirement.¹¹² Thereafter, the IRS issued a notice of deficiency, assessing significant increases to Williams's income tax liabilities for the tax years 1993 through 2000, as well as penalties for negligence and civil fraud.¹¹³ Additionally, the revenue agent assessed a civil FBAR penalty for 2000,¹¹⁴ charging Williams the then-maximum penalty of \$100,000 for each account.¹¹⁵

Following these assessments, Williams petitioned the Tax Court, contesting all of the proposed deficiencies as well as the FBAR penalties.¹¹⁶ The Tax Court determined that it only has authority to review determinations of taxes imposed by Title 26, concluding that "the [FBAR] penalty . . . falls outside our jurisdiction to review deficiency determinations."¹¹⁷

Williams never paid the FBAR penalty, so in April 2009 the government filed a complaint in district court in order to collect.¹¹⁸ Due to Williams's checking "No" on Schedule B in response to having any foreign bank accounts, the government argued that his "signature on his Form 1040 is *prima facie*

¹¹¹ *Id.*

¹¹² *Id.*

¹¹³ *Id.* Generally, the statute of limitations for income tax and related penalties is three years from the later of the date of filing or the due date of the return. I.R.C. § 6501(a) (2012). However, there is no statute of limitations for fraudulent or unfiled returns. I.R.C. § 6501(c)(1)–(3).

¹¹⁴ Sheppard, *supra* note 61, at 322. The FBAR penalties have a six-year statute of limitations. 31 U.S.C. § 5321(b)(1) (2012). Therefore, the only year subject to this penalty was 2000. Sheppard, *supra* note 61, at 322.

¹¹⁵ See Sheppard, *supra* note 61, at 322.

¹¹⁶ *Id.*

¹¹⁷ Williams v. Comm'r, 131 T.C. 54, 58 (2008). The Tax Court also concluded that it lacks jurisdiction to address any FBAR penalty collection issue. *Id.* at 59. The Bankruptcy Court also lacks jurisdiction over FBAR penalty assessments. United States v. Simonelli, 614 F. Supp. 2d 241, 246–47 (D. Conn. 2008) (finding that the FBAR penalty is not a tax penalty and is consequently barred from discharge). 28 U.S.C. § 1346(a)(1) (2012) provides an avenue in district court for

[a]ny civil action against the United States for the recovery of any internal-revenue tax alleged to have been erroneously or illegally assessed or collected, or any penalty claimed to have been collected without authority or any sum alleged to have been excessive or in any manner wrongfully collected under the internal-revenue laws.

Based on this statute, if the penalty is assessed, it cannot be litigated unless it is paid. Thus, it appears that no avenue exists to litigate assessment of a civil FBAR penalty without paying it, except to wait for the government to bring a collection suit as in *Williams II*.

¹¹⁸ United States v. Williams, No. 1:09-cv-437, 2010 WL 3473311, at *1–2 (E.D. Va. Sept. 1, 2010). The suit was brought pursuant to 31 U.S.C. § 5321(b)(2), allowing the government to commence a civil action to recover an FBAR penalty within two years of assessment. *Id.* at *1.

evidence that Williams knew the contents of his tax return.”¹¹⁹ The court was not persuaded, emphasizing that “these actions occurred after Williams found out that the U.S. and Swiss authorities knew about the ALQI accounts.”¹²⁰ Considering these facts, the Court determined that “it clearly follows logically that Williams was aware that the authorities knew about the ALQI accounts by the fall of 2000, significantly before June 30, 2001 [This] strongly indicate[s] . . . that Williams lacked any motivation to willfully conceal the accounts from authorities after that point.”¹²¹ The court concluded that “Williams’ failure to disclose already-frozen assets in a foreign account was not an act undertaken intentionally or in deliberate disregard for the law, but instead constituted an understandable omission given the context in which it occurred.”¹²² The holding strongly suggested that “the IRS would have a hard time proving willfulness when a taxpayer didn’t know about FBARs. [It also] may have caused some with foreign accounts not to step forward.”¹²³

Unsurprisingly, the government was dissatisfied with this holding, and filed an appeal in November 2010.¹²⁴ Beginning with precedent in criminal matters before transitioning to a broader definition for civil violations, the court in *Williams III* gave the following overview in an attempt to define willfulness in the FBAR context:

“Willfulness may be proven through inference from conduct meant to conceal or mislead sources of income or other financial information,” and it “can be inferred from a conscious effort to avoid learning about reporting requirements.” *United States v. Sturman*, 951 F.2d 1466, 1476 (6th Cir.1991) (internal citations omitted) (noting willfulness standard in criminal conviction for failure to file an FBAR). Similarly, “willful blindness” may be inferred where “a defendant was subjectively aware of a high probability of the existence of a tax liability, and purposefully avoided learning the facts point to such liability.” *United States v. Poole*, 640 F.3d 114, 122 (4th Cir.2011) (affirming criminal conviction for willful tax fraud where tax preparer ‘closed his eyes to’ large accounting discrepancies). Importantly, in cases “where willfulness is a statutory condition of civil liability, [courts] have generally taken it to cover not only knowing violations of a standard, but *reckless* ones as well.” *Safeco Ins. Co. of America v. Burr*, 551 U.S. 47, 57, 127 S.Ct. 2201, 167 L.Ed.2d 1045 (2007)

¹¹⁹ *Id.* at *4.

¹²⁰ *Id.*

¹²¹ *Id.*

¹²² *Id.* at *5.

¹²³ Robert W. Wood, *FBAR Penalties Just Got Even Worse*, FORBES (July 22, 2012, 11:49 PM), <http://www.forbes.com/sites/robertwood/2012/07/22/fbar-penalties-just-got-even-worse/>.

¹²⁴ *United States v. Williams*, 489 F. App’x 655 (4th Cir. 2012).

(emphasis added). Whether a person has willfully failed to comply with a tax reporting requirement is a question of fact. *Rykoff v. United States*, 40 F.3d 305, 307 (9th Cir.1994) ¹²⁵

Shortly thereafter, the court stated that “the evidence as a whole leaves us with a definite and firm conviction that the district court clearly erred in finding that Williams did not willfully violate § 5314.”¹²⁶ The court found that Williams’s signature is *prima facie* evidence that he knew what he was signing, and “at a minimum line 7a’s directions to ‘[s]ee instructions for exceptions and filing requirements for Form TD F 90-22.1’ put Williams on inquiry notice of the FBAR requirement.”¹²⁷ The court determined that Williams’s lack of attention to the contents of his tax return “constitute[d] willful blindness to the FBAR requirement.”¹²⁸ The court was further convinced that Williams’s acknowledgement “that he willfully failed to report the existence of the ALQI accounts to the IRS or Department of the Treasury as part of his larger scheme of tax evasion. [This] . . . [wa]s an admission of violating § 5314”¹²⁹ The court concluded that “at a minimum, Williams’s undisputed actions establish reckless conduct, which satisfies the proof requirement under § 5314 . . . [and] that the district court clearly erred in finding that willfulness had not been established.”¹³⁰

The dissent argued that “a reasonable factfinder [may] conclude that the violation was willful, as the majority believes. But there is also evidence supporting the opposite view.”¹³¹

In December 2012, a Utah district court affirmed the precedent set in *Williams III*, finding that “[f]or an individual to act ‘willfully,’ an individual need not have been subjectively aware of the FBAR reporting requirement or else an individual would be able to defeat liability by deliberately avoiding learning of his or her legal duties.”¹³²

Interestingly, the Court in *Williams III* applied a significantly lower legal standard than the IRS published in its

¹²⁵ *Id.* at 658.

¹²⁶ *Id.* at 659.

¹²⁷ *Id.*

¹²⁸ *Id.*

¹²⁹ *Id.* at 660.

¹³⁰ *Id.*

¹³¹ *Id.* at 661 (Agee, J., dissenting).

¹³² *United States v. McBride*, 908 F. Supp. 2d 1186, 1210 (D. Utah 2012). Additionally, the District Court cited the overturned decision from *Williams II* (noting that the decision was overturned on other grounds), stating that “in a civil FBAR penalty case, . . . the United States’ burden of proof was ‘the preponderance of the evidence’ on all questions before the court, including the question of whether the taxpayer’s failure to report in that case was ‘willful.’” *Id.* at 1201.

Internal Revenue Manual (hereinafter “IRM”), which requires “the person’s knowledge of the [FBAR] reporting requirements and the person’s conscious choice not to comply.”¹³³ Although the IRM suggests that willful blindness might rise to the level of willfulness, the IRS states that “[t]he mere fact that a person checked the wrong box, or no box, on a Schedule B is not sufficient, by itself, to establish that the FBAR violation was attributable to willful blindness.”¹³⁴

In addition to this conflicting standard, it has been noted that “[g]auging the impact of *Williams III* on opt out decisions will be interesting, yet difficult to quantify The taxpayer’s success in *Williams II*, followed by the taxpayer’s defeat in *Williams III*, will trigger additional uncertainty for taxpayers”¹³⁵ Logic dictates that the same uncertainty will apply in the context of quiet disclosures.

The initial success in *Williams II* was a victory for taxpayers, likely encouraging many to avoid the high penalties in the OVD programs altogether, and instead take their chances with an opt-out or a quiet disclosure. Even though the decision was overturned in *Williams III*, the taxpayer clearly intended to hide his assets offshore, and many taxpayers realize that they are unlikely to face an FBAR penalty of any kind if their failure to report is less egregious. Unsurprisingly, the vast majority of taxpayers with foreign accounts still have not come forward through the OVD programs.¹³⁶

IV. 2012 OVDP LEAVES ROOM FOR IMPROVEMENT

Due to the success of the prior programs, the IRS announced the 2012 Offshore Voluntary Disclosure Program (hereinafter “2012 OVDP”).¹³⁷ Like the 2011 OVDI, the look-back period is eight years, however the penalty on the maximum aggregate of foreign account balances has been increased to 27.5%, and the program is indefinite.¹³⁸ The IRS makes clear that the program is

¹³³ Internal Revenue Serv., *supra* note 62.

¹³⁴ *Id.*

¹³⁵ See Sheppard, *supra* note 61, at 332.

¹³⁶ See NAT’L TAXPAYER ADVOCATE, *supra* note 9, at 142 (suggesting less than 1% have entered the OVD programs).

¹³⁷ See I.R.S. News Release IR-2012-5, *supra* note 6.

¹³⁸ See I.R.S. News Release IR-2012-64, *supra* note 8; Lederman, *supra* note 7, at 517 (suggesting a risky proposition that the open-ended nature of the 2012 OVDP allows taxpayers to strategize with regard to the timing of the voluntary disclosure if the earliest year in the look-back period would create a larger amount of tax and penalty than the current year).

subject to change at any time, including a potential increase in penalties or an end to the program altogether.¹³⁹

Although the OVD Programs have been widely regarded as effective, there is a perception of unfairness as a result of the severe across-the-board penalty for failing to report foreign bank accounts, regardless of the circumstances.¹⁴⁰ Alternatives such as opting out or making a quiet disclosure may be the best choice for some taxpayers, but the uncertainty surrounding both options, in addition to threats imposed by the IRS for utilizing these alternatives,¹⁴¹ has forced many to accept the draconian penalties imposed by the OVD programs.¹⁴²

Although “[t]axpayers may normally correct their own inadvertent violations without significant penalties or burdens,” the IRS’s threats against quiet disclosures and the opt-out alternatives discourage self-correction.¹⁴³ Rather than face the extreme penalties offered through the program, or risk being caught making a quiet disclosure, “some taxpayers are likely to ignore their problems until the IRS offers them a reasonable way to correct inadvertent errors.”¹⁴⁴ Collectively, these problems have contributed to many taxpayers paying too much under the

139 See Internal Revenue Serv., *supra* note 82, at FAQ 1.

140 See Kevin E. Packman, *Noncompliance After the IRS Offshore Income Reporting Initiative—What Options Remain?*, 111 J. TAX’N 281, 283 (2009) (“The Initiative effectively eliminated the reasonable cause exception for failure to file the FBAR and assumed that all such failures were attributable to the taxpayer’s willfulness.”).

141 See NAT’L TAXPAYER ADVOCATE, *supra* note 9, at 137 (“Because of these threats, many taxpayers were concerned that the IRS would always seek the maximum FBAR penalties, regardless of the situation.”); see also Gregory J. Bertsch & Benjamin C. Hughes, *Final FBAR Regulations: Navigating the Complex Requirements of Reporting Foreign Bank Accounts*, 25 J. TAX’N & REG. FIN. INSTITUTIONS 23, 31 (2011) (“IRS examiners are given discretion to mitigate penalties and assess less than the maximum amount; however, the recent trend has been for the IRS to pursue willful penalties and assess the maximum amount permitted.”).

142 See NAT’L TAXPAYER ADVOCATE, *supra* note 9, at 137 (finding “some benign actors were so fearful . . . that they accepted the IRS settlement and paid more than they owed”).

143 *Id.* at 135–36 (“[T]hose who failed to report income could normally avoid accuracy-related penalties by filing ‘qualified amended returns’ before being contacted by the IRS. Thus, in the absence of any special IRS program, a taxpayer could correct a failure to report a foreign account and income from the account while avoiding most penalties by simply filing three (or six) years worth of returns (or amended returns) and FBARs. This approach encourages voluntary compliance and self-correction, which is the IRS’s stated goal.”).

144 *Id.* at 137. An important aspect in assessing the FBAR penalty outside of the OVD programs is the fact that taxpayers and practitioners alike were unaware of the reporting requirements. However, due to the recent crackdown, the resulting increased awareness will raise the likelihood of the existence of willfulness. See Michael Sardar, *What Constitutes ‘Willfulness’ for Purposes of the FBAR Failure-to-File Penalty?*, 113 J. TAX’N 183, 187 (2010).

current one-size-fits-all structure, and the majority of taxpayers choosing to remain noncompliant.¹⁴⁵

V. SUGGESTIONS FOR INCREASED OVD PARTICIPATION AND FUTURE COMPLIANCE

Overall, the recent OVD programs have been effective, but there is a lot of room for improvement, as most taxpayers remain non-compliant.¹⁴⁶ The purpose of any amnesty program should be to increase compliance over the long term.¹⁴⁷ The few billions that have been collected is paltry compared to the purported \$100 billion annual tax gap resulting from offshore income.¹⁴⁸ Rather than leaving taxpayers with a choice between paying too much or remaining noncompliant, the OVD program should be greatly expanded to make participation an easy decision, which will substantially increase voluntary compliance in the future, thereby reducing the annual tax gap significantly.¹⁴⁹

The OVD program should utilize a tiered-penalty structure based on the amount of tax owed and the existence of mitigating factors, instead of the one-size-fits-all approach currently being used.¹⁵⁰ Currently, the 2012 OVDP offers options for reduced penalties of 5% and 12.5%.¹⁵¹ In addition to an opt-out option,¹⁵² however, the reduced penalties are too narrow for most taxpayers entering the program to utilize, and opting out is generally an unappealing option as previously discussed in Part II above.¹⁵³

¹⁴⁵ See NAT'L TAXPAYER ADVOCATE, *supra* note 9, at 147 n.61 ("[T]he IRS's current approach may be more likely to reduce voluntary compliance and increase tax evasion.").

¹⁴⁶ See *id.* at 142 ("While the OVD programs attracted over 27,000 applications (perhaps less than one percent of those who did not file FBARs) and collected almost \$5.5 billion, a more effective initiative could prompt significantly more taxpayers to come into compliance voluntarily.").

¹⁴⁷ See Lederman, *supra* note 7, at 520 ("[R]evenue-raising should not be the primary purpose of an amnesty Instead, bringing taxpayers into compliance should be.").

¹⁴⁸ See STAFF OF S. PERMANENT SUBCOMM. ON INVESTIGATIONS, 110TH CONG., REP. ON TAX HAVEN BANKS AND U.S. TAX COMPLIANCE 1 (Comm. Print 2008). Based on the 2006 estimate, the international tax gap since 2003 is approximately \$1 trillion.

¹⁴⁹ See NAT'L TAXPAYER ADVOCATE, *supra* note 9, at 153. The program should be timed so that simultaneously, the forced compliance elements of FATCA will begin, increasing the incentive for taxpayers to comply while it is still voluntary, and reducing the risk of wasting IRS resources.

¹⁵⁰ The National Taxpayer Advocate has suggested a similar approach with three tiers. The first tier would provide an avenue to avoid all penalties, including civil penalties on the additional income, if the amount due on the amended returns is less than the greater of \$5000 or 10% of the total tax. The second tier would eliminate the penalty on the highest account balance for taxpayers who can show reasonable cause or who acted non-willfully. The third tier would allow for anyone else who voluntarily comes forward to participate in the program under the current penalty structure. See *id.* at 150–51.

¹⁵¹ See Internal Revenue Serv., *supra* note 10, at FAQ 52–53.

¹⁵² *Id.* at FAQ 51.

¹⁵³ See NAT'L TAXPAYER ADVOCATE, 2013 ANNUAL REPORT TO CONGRESS 232 (2013). The opt-out option is unappealing for many due to the risks associated with an audit as

Historically speaking, only a small percentage of taxpayers who failed to report offshore accounts will ever be assessed with the willful penalty, which is generally the only penalty that is higher than the penalty assessed through the program. Therefore, the IRS should expand all three of these already existing options to fit the circumstances of the majority of program participants.¹⁵⁴

The IRS may be experimenting with the idea of providing avenues for a reduced penalty with the addition of the Streamlined Compliance Program, which occurs outside of the OVD program, providing penalty relief for taxpayers who were residing outside of the United States, did not file a tax return, and had a tax liability below \$1500 per year.¹⁵⁵ This is an excellent approach by the IRS as it signifies their realization that one size does not fit all; however, much like the other alternatives available, it is far too narrow.¹⁵⁶ The alternative penalty structures should be capable of being utilized just as much as, if not more than, the highest penalty applicable under the OVD program.

In the spirit of fairness, taxpayers who have previously participated in an OVD program should be given an opportunity to establish cause for a lower penalty based on the new parameters and obtain any resulting refund without the possibility of higher penalties being imposed.¹⁵⁷ In order to maximize credibility and increase awareness, the program should be given an end date,¹⁵⁸ and the IRS should carry out on

well as significantly slower processing times. *Id.* Unfortunately, to date, the “inflexible opt-in-opt-out approach offered bad actors a relatively better deal and also provided them with better customer service than benign actors.” *Id.* at 233.

¹⁵⁴ See NAT'L TAXPAYER ADVOCATE, *supra* note 9, at 153. When compared to the penalty assessed under the program, “[t]he existing FBAR statute offers . . . taxpayers a better deal, capping the maximum penalty at \$10,000 per violation if the IRS cannot prove the violation was willful and eliminating the penalty altogether if the taxpayer can show ‘reasonable cause’ for his or her failure to report the account(s).” *Id.* at 148.

¹⁵⁵ See Internal Revenue Serv., *Frequently Asked Questions Regarding the Streamlined Filing Compliance Procedures for Non-Resident, Non-Filer Taxpayers*, IRS.GOV, <http://www.irs.gov/Individuals/International-Taxpayers/FAQReStreamlinedFilingComplianceProceduresNRNFTPs> (last updated Dec. 10, 2013). The \$1500 threshold is not a requirement, but rather a guideline, as the IRS generally will not consider taxpayers with tax below this amount a risk factor. *Id.*

¹⁵⁶ See NAT'L TAXPAYER ADVOCATE, *supra* note 153, at 231 (“A new ‘streamlined’ program is less burdensome, but is overly narrow and does not provide certainty.”).

¹⁵⁷ The IRS may balk at returning money it previously received under the OVD penalty structure; however, if the tiered approach is successful at increasing future compliance, any refunds given will be insignificant in relation to the reduction in the annual tax gap.

¹⁵⁸ See Lederman, *supra* note 7, at 518, 524 (suggesting that the ongoing nature of the 2012 OVDP undermines its credibility and effectiveness).

their threats against quiet disclosures¹⁵⁹ and publicly prosecute the most egregious examples of willful behavior.

Currently, IRS resources are tied up processing voluntary disclosures of taxpayers who willingly came forward, leaving few resources to pursue willful evaders.¹⁶⁰ Expanding the program as suggested will significantly increase voluntary compliance and will free up valuable IRS resources to pursue taxpayers who are purposefully evading taxes through the use of offshore accounts.¹⁶¹ This group of tax evaders makes up a significantly large portion of lost revenues annually, and should be the intended target of IRS enforcement.¹⁶²

¹⁵⁹ See Morse, *supra* note 3, at 721 (determining that the lack of public prosecutions of serious tax offenders who have made quiet disclosures undermines the IRS's warnings against them). It is clear when comparing the 2003 OVCI to the 2009 OVDP, that the concurrent highly-publicized UBS scandal was extremely effective in increased participation in the program. However, it appears unlikely that the IRS has the resources to carry out their threat. See NAT'L TAXPAYER ADVOCATE, *supra* note 9, at 135 (noting concern that the IRS has "[i]ncreased the cost and burden of correcting past violations, as well as the IRS resources required to process these corrections . . .").

¹⁶⁰ See NAT'L TAXPAYER ADVOCATE, *supra* note 153, at 233.

¹⁶¹ See Gerard Ryle et al., *Secret Files Expose Offshore's Global Impact*, in *SECRECY FOR SALE: INSIDE THE GLOBAL OFFSHORE MONEY MAZE* 4, 5 (2013), available at <http://cloudfront-files-1.publicintegrity.org/documents/pdfs/ICIJ%20Secrecy%20for%20Sale.pdf> ("[O]ffshore financial secrecy has spread aggressively around the globe, allowing the wealthy and the well-connected to dodge taxes . . .").

¹⁶² See Lederman, *supra* note 7, at 527 (citing Marie Sapirie, *New Offshore Voluntary Disclosure Initiative Features 25 Percent Penalty, Greater Clarity*, TAX NOTES TODAY, Feb. 9, 2011, at 27-1) (quoting Gregory S. Lynam: "While it is great that the IRS is stepping up use of all of its enforcement tools, there is a danger that the IRS may focus on the little fish that voluntarily swim into the net.").

Addendum

September 10, 2014

On June 18, 2014, the IRS announced a modification of terms to the 2012 Offshore Voluntary Disclosure Program.¹⁶³ The modification includes an expansion to the Streamlined Compliance Program to include taxpayers living in the United States, taking effect July 1, 2014. Under this modification, taxpayers that did not act willfully may qualify for a reduced OVD penalty of 5%, and only have to amend three years of tax returns.¹⁶⁴ In order to qualify, the taxpayer must certify that the failure to report all income, pay all tax, and/or submit all required information returns, including FBARs, was not willful.¹⁶⁵

This is a significant change to the government's previous hardline approach, and it is completely in line with the suggestions proposed in this Article. It appears that this new and improved approach may be around for quite some time, which is apparently necessary as compliance slowly begins to improve.

One major flaw with this new approach is the unwillingness of the government to allow taxpayers who previously entered the program to seek reimbursement under the new parameters.¹⁶⁶ Although the government has an efficiency interest in abstaining from reviewing previously resolved cases, this will likely result in an understandable perception of unfairness towards those who came forward immediately to be compliant. This is an unfortunate result, as the taxpayers who previously entered the OVD programs were the first to come forward, and were the most anxious to be in full compliance with the government. Arguably, a majority of this group is most deserving of paying smaller penalties.

In spite of this unfortunate flaw, this new modification is an excellent approach to tackling the problems addressed in this

¹⁶³ See Internal Revenue Serv., *2012 Offshore Voluntary Disclosure Program*, IRS.GOV, <http://www.irs.gov/uac/2012-Offshore-Voluntary-Disclosure-Program> (last updated June 18, 2014).

¹⁶⁴ See Internal Revenue Serv., *Streamlined Filing Compliance Procedures*, IRS.GOV, <http://www.irs.gov/Individuals/International-Taxpayers/Streamlined-Filing-Compliance-Procedures> (last updated Aug. 19, 2014).

¹⁶⁵ *Id.*

¹⁶⁶ See Internal Revenue Serv., *Transition Rules: Frequently Asked Questions (FAQs)*, IRS.GOV, FAQ 2, <http://www.irs.gov/Individuals/International-Taxpayers/Transition-Rules-Frequently-Asked-Questions-FAQs> (last updated June 18, 2014) (stating that a taxpayer who has already completed an OVD program "will not be eligible").

Article, and should go a long way towards closing the significant tax gap resulting from noncompliance in this area.

The Home-Sale Exclusion: A Proposal Targeted at Eliminating Speculation

Andrew Gahan*

“Tonight I propose a new tax cut for homeownership that says to every middle income working family in this country, if you sell your home, you will not have to pay a capital gains tax on it ever, not ever.”

– President Bill Clinton at the 1996 Democratic National Convention.¹

INTRODUCTION

Homeownership has long been considered an integral part of the American Dream, and the Internal Revenue Code certainly treats homeowners with preference.² The government has generally encouraged homeownership over the past eighty years.³ From 1999 to 2005, the rate of homeownership increased from 66.8% to over 69%, an all-time high.⁴ After the dramatic rise in home prices and subsequent burst of the housing bubble, which resulted in roughly four million foreclosures across the nation and precipitated the worst recession since the Great Depression, it is clear that the efficacy of homeownership promotion has its limits.⁵

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1 U.S. NAT'L ARCHIVES & RECORDS ADMIN., PUBLIC PAPERS OF THE PRESIDENTS OF THE UNITED STATES, WILLIAM J. CLINTON 1412 (1996).

2 ROBERT CARROLL ET AL., COSTS AND BENEFITS OF HOUSING TAX SUBSIDIES 1 (2011), available at http://www.pewtrusts.org/uploadedFiles/wwwpewtrustsorg/Reports/Economic_Mobility/Pew_Housing_Report.pdf.

3 THE DEPT OF THE TREASURY & U.S. DEPT OF HOUS. AND URBAN DEV., REFORMING AMERICA'S HOUSING FINANCE MARKET: A REPORT TO CONGRESS 4 (2011), available at <http://www.treasury.gov/initiatives/documents/reforming%20america's%20housing%20finance%20market.pdf>.

4 Allen C. Goodman & Thomas G. Thibodeau, *Where are the Speculative Bubbles in US Housing Markets?*, 17 J. HOUSING ECON. 117, 118 (2008).

5 See Barbara Kiviat, *The Case Against Homeownership*, TIME MAG. (Sept. 11, 2010), <http://www.time.com/time/magazine/article/0,9171,2013850,00.html>; Tara Steele, *Nearly Four Million Foreclosures Completed Since Housing Crash*, AGBEAT (Dec. 3, 2012), <http://agbeat.com/housing-news/nearly-four-million-foreclosures-completed-since-housing-crash-began/> (“According to information provider, CoreLogic's National Foreclosure Report for October [2012], there have been approximately 3.9 million completed foreclosures in the U.S. since the economic crash . . . in September 2008.”).

The housing bubble of the early 2000s was surely inflated by a number of different sources. Government policies promoting homeownership (mainly the loosening of lending standards), historically low interest rates, securitization of mortgage debt, and an active market of various financial instruments fueled by an irrationally exuberant marketplace expecting housing prices would ever rise, all contributed to its creation.⁶ Individual homeowners began taking advantage of the rapidly rising home prices, earning tax-free gains by buying and selling homes.⁷ The story of Ryan Wampler in a *New York Times* article exemplifies the opportunity afforded by the tax code in buying and selling personal residences, excluding the gain from income.⁸ The Taxpayer Relief Act of 1997 greatly increased the amount of gain a taxpayer could exclude from gross income on the sale of a personal residence.⁹ A tax provision originally intended to simplify the tax consequences of selling a home became an incredibly valuable tool in home speculation.¹⁰ What was previously available to those taxpayers aged fifty-five and older became available to taxpayers of all ages.¹¹ Tax preferences can have a powerful effect on investment decisions.¹² By giving such a large tax preference to gains realized from the sale of a principal residence, the Internal Revenue Code encourages people to view homes as short-term investments.¹³ If homeownership is still an important aspect of the American Dream, then the tax code should not accelerate the creation of housing bubbles by rewarding those taxpayers who happen to time correctly a series of purchases and sales, resulting in tax-free gains. The ability to use the tax code for short-term (and tax-free) housing investments should be eliminated. This can be accomplished by making the home-sale exclusion available on a

⁶ See *infra* Part II.A.

⁷ See, e.g., Vikas Bajaj & David Leonhardt, *Tax Break May Have Helped Cause Housing Bubble*, N.Y. TIMES (Dec. 18, 2008), http://www.nytimes.com/2008/12/19/business/19tax.html?_r=0.

⁸ *Id.* ("Three times in eight years, Mr. Wampler—himself a home builder and developer—sold his home in the Phoenix area, always for a nice profit. With prices in Phoenix soaring, he made almost \$700,000 on the three sales. And thanks to a tax break proposed by President Bill Clinton and approved by Congress in 1997, he did not have to pay tax on most of that profit.").

⁹ See *infra* Part I.B.3.

¹⁰ See *infra* Part I.B.3.

¹¹ See *infra* Part I.B.

¹² U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-05-1009SP, UNDERSTANDING THE TAX REFORM DEBATE: BACKGROUND, CRITERIA, & QUESTIONS 38 (2005), available at <http://www.gao.gov/new.items/d051009sp.pdf>.

¹³ Bajaj & Leonhardt, *supra* note 7.

much more infrequent basis than the current once-every-two-years availability.¹⁴

As part of the discussion on the efficacy of government policies encouraging homeownership, this Comment addresses the popular home-sale exclusion found in section 121 of the Internal Revenue Code. Part I articulates how the section operates and gives an account of the Code's historical treatment of gains on the sale of a principal residence. Part II gives a cursory review of the housing bubble and major accepted causes, including arguments as to how section 121 may have contributed. Finally, Part III proposes amendments to the exclusion that may help eliminate its catalytic effects during home price increases and formation of housing bubbles.

I. EXCLUDING GAIN FROM THE SALE OF A PRINCIPAL RESIDENCE

A. The Current Treatment of Gains

Section 121 enables taxpayers to escape gain recognition on the sale of a principal residence.¹⁵ This exclusion from gross income is available so long as, during the five years preceding the sale, the taxpayer owned and used the property as his or her principal residence for periods aggregating two or more years.¹⁶ While there are limitations on the amount of gain that can be excluded, Congress set them high in an effort to ensure that most home sales would be tax free.¹⁷ The exclusion limitation for single filers is \$250,000¹⁸ and \$500,000 for taxpayers filing a joint return.¹⁹ This simply means that single-filing taxpayers selling a home will be able to exclude up to \$250,000 of gain from that sale, and married couples filing jointly will be able to exclude up to \$500,000 of gain. In addition, taxpayers may only apply section 121 to a sale or exchange once every two years.²⁰

For a husband and wife filing a joint return to qualify for the \$500,000 exclusion, one of the spouses must meet the ownership

¹⁴ See *infra* Part III.

¹⁵ I.R.C. § 121(a) (2012).

¹⁶ *Id.*

¹⁷ H.R. REP. NO. 105-148, at 347 (1997) ("By excluding from taxation capital gains on principal residences below a relatively high threshold, few taxpayers would have to refer to records in determining income tax consequences of transactions related to their house.").

¹⁸ I.R.C. § 121(b)(1).

¹⁹ I.R.C. § 121(b)(2)(A).

²⁰ I.R.C. § 121(b)(3)(A); *cf.* Treas. Reg. § 1.121-4(g) (2014) (providing that section 121 shall not apply to any sale or exchange in which the taxpayer elects not to have the section apply). *But see infra* note 29 (explaining that there are circumstances where a limited exclusion is available).

requirement,²¹ both spouses must meet the two-year use requirement,²² and neither spouse can have taken advantage of the exclusion within two years prior to the sale.²³ If these requirements are not satisfied, then the limitation will be the sum of the limitations “each spouse would be entitled if such spouses had not been married.”²⁴ In such a case, each spouse is “treated as owning the property during the period that either spouse owned the property.”²⁵

Properties treated as residences under section 121 are not limited to typical fixed homes.²⁶ And for those taxpayers using more than one property as a residence, the property that the taxpayer uses a majority of the time during the year ordinarily will be considered the taxpayer’s principal residence, but a number of factors will also be used in coming to this determination.²⁷

The section also affords a reduced exclusion—in certain circumstances²⁸—for taxpayers failing to satisfy the ownership and/or use requirements as well as taxpayers that had previously applied section 121 to another sale less than two years before the sale at issue.²⁹ This reduced maximum exclusion is calculated as follows:

by multiplying the maximum dollar limitation of \$250,000 (\$500,000 for certain joint filers) by a fraction. The numerator of the fraction is the shortest of the period of time that the taxpayer owned the property during the 5-year period ending on the date of the sale or exchange; the period of time that the taxpayer used the property as the taxpayer’s principal residence during the 5-year period ending on

21 I.R.C. § 121(b)(2)(A)(i); Treas. Reg. § 1.121-2(a)(3)(A) (2014).

22 I.R.C. § 121(b)(2)(A)(ii); Treas. Reg. § 1.121-2(a)(3)(B).

23 I.R.C. § 121(b)(2)(A)(iii); Treas. Reg. § 1.121-2(a)(3)(C).

24 I.R.C. § 121(b)(2)(B).

25 *Id.*

26 Treas. Reg. § 1.121-1(b)(1) (2014) (“A property used by the taxpayer as the taxpayer’s residence may include a houseboat, a house trailer, or the house or apartment that the taxpayer is entitled to occupy as a tenant-stockholder in a cooperative housing corporation.”).

27 Treas. Reg. § 1.121-1(b)(2) (“[R]elevant factors in determining a taxpayer’s principal residence, include, but are not limited to: (i) The taxpayer’s place of employment; (ii) The principal place of abode of the taxpayer’s family members; (iii) The address listed on the taxpayer’s federal and state tax returns, driver’s license, automobile registration, and voter registration card; (iv) The taxpayer’s mailing address for bills and correspondence; (v) The location of the taxpayer’s banks; and (vi) The location of religious organizations and recreational clubs with which the taxpayer is affiliated.”).

28 See *infra* note 31 and accompanying text.

29 I.R.C. § 121(c)(1); Treas. Reg. § 1.121-3(a) (2014) (“In lieu of the limitation under section 121(b) and § 1.121-2, a reduced maximum exclusion limitation may be available for a taxpayer who sells or exchanges property used as the taxpayer’s principal residence but fails to satisfy the ownership and use requirements described in § 1.121-1(a) and (c) or the 2-year limitation described in § 1.121-2(b).”).

the date of the sale or exchange; or the period of time between the date of a prior sale or exchange of property for which the taxpayer excluded gain under section 121 and the date of the current sale or exchange. The numerator of the fraction may be expressed in days or months. The denominator of the fraction is 730 days or 24 months (depending on the measure of time used in the numerator).³⁰

The special circumstances when the reduced maximum exclusion becomes available include sales or exchanges by reason of a change in place of employment, health, or, to the extent provided in the regulations, unforeseen circumstances.³¹ The preceding paragraphs describe the general application of section 121 as would apply to most taxpayers; however, the entire gamut of the section provides many nuanced and intricate rules expressed in both the Code and Regulations.³² For purposes of this Comment, the outline of section 121 as set out above shall serve as a sufficient platform to address the issues presented. The current rules governing gain recognition from the sale of principal residences found in section 121 have largely been in effect since the passage of the Taxpayer Relief Act of 1997 (TRA-97).³³ In prior years, there were two Code sections that governed gain recognition from the sale of a principal residence: sections 1034³⁴ and (prior) 121.³⁵

B. Historical Treatment of Gains

TRA-97 dramatically altered the treatment of gains on the sale of a principal residence.³⁶ Previously, taxpayers were able to defer gain through a rollover provision found in section 1034.³⁷ This section enabled nonrecognition of gain realized on the sale of a principal residence, so long as another principal home of equal or greater value was purchased within two years of such sale.³⁸ In addition to the rollover treatment provided in section 1034, prior section 121 allowed for a one-time exclusion of up to \$125,000 for taxpayers aged fifty-five and older.³⁹ Although the current treatment of home-sale gains has only been in force since 1997, section 121's predecessors were used for many decades to defer or exclude gain on the sale of a principal residence.

³⁰ Treas. Reg. § 1.121-3(g)(1). For examples illustrating this calculation, see *id.* § 1.121-3(g)(2).

³¹ I.R.C. § 121(c)(2)(B); *see also* Treas. Reg. § 1.121-3(c)-(e).

³² *See generally* I.R.C. § 121(a)-(g); *see also* Treas. Reg. §§ 1.121-1 to -5 (2014).

³³ Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788.

³⁴ I.R.C. § 1034 (repealed 1997).

³⁵ I.R.C. § 121 (repealed 1997).

³⁶ *See infra* Part I.B.3.

³⁷ I.R.C. § 1034(a) (repealed 1997).

³⁸ *Id.*

³⁹ I.R.C. § 121(a)-(b) (repealed 1997).

1. Deferring, Not Excluding, Gain

Section 1034 first appeared in the Code in 1951, when Congress amended then-section 112—a prior version of current section 1031.⁴⁰ When The Revenue Code of 1954 was enacted, the rollover provision was divorced from section 112 and given its own place in the Code—section 1034.⁴¹ Over time the language of the section largely remained the same, allowing taxpayers the chance to defer recognition of gain by purchasing a new home of equal or greater value within a relatively short period of time.⁴² By itself, section 1034 enabled most taxpayers to escape gain recognition, but in 1964, Congress provided further relief for older homeowners.⁴³

2. The Once-In-A-Lifetime-Exclusion

That relief came in the form of (former) section 121's once-in-a-lifetime exclusion, initially limited to \$20,000, for taxpayers aged sixty-five years or older.⁴⁴ Originally, determining the amount a taxpayer could exclude required a few steps. First, the taxpayer must have turned sixty-five before the date of sale or exchange.⁴⁵ Second, the taxpayer would have had to own and use the property as his principal residence for an aggregate of five years over the eight years preceding the sale.⁴⁶ If the taxpayer established those two requirements, she proceeded to the thornier determination of the amount excludable. Under subsection (b), "[i]f the adjusted sale prices exceed[ed] \$20,000, the taxpayer [could] exclude part of the gain proportionate . . . between \$20,000 and the adjusted sale price."⁴⁷ For example, if T, age sixty-five, sold his residence that had a

⁴⁰ Revenue Act of 1951, Pub. L. No. 183-521, 65 Stat. 452.

⁴¹ I.R.C. § 1034 (1954).

⁴² Compare I.R.C. § 1034(a) (1954) (providing a period of one year before and after the sale), with I.R.C. § 1034(a) (1996) (providing a period of two years before and after such sale).

⁴³ See Charles L. B. Lowndes, *The Revenue Act of 1964: A Critical Analysis*, 1964 DUKE L.J. 667, 687 ("As part of a continuing concern over senior citizens, the 1964 Act provides that a person sixty-five years of age or older who sells property which he has occupied as his principal residence for at least five of the preceding eight years, may elect to exclude the gain from the sale from his gross income, provided the adjusted sale price does not exceed \$20,000.").

⁴⁴ Revenue Act of 1964, Pub. L. No. 88-272, § 206, 78 Stat. 19, 38; see also Dennis J. Ventry, Jr., *The Accidental Deduction: A History and Critique of the Tax Subsidy for Mortgage Interest*, 73 L. & CONTEMP. PROBS. 233, 259 n.220 (2010) (noting that at the time that Congress set the exclusion limitation at \$20,000, the median home price was roughly \$12,000).

⁴⁵ I.R.C. § 121(a)(1) (1964).

⁴⁶ I.R.C. § 121(a)(2) (1964). Compare this requirement with the two-out-of-the-last-five-years requirement under current section 121. See *supra* note 15 and accompanying text.

⁴⁷ Lowndes, *supra* note 43.

basis of \$21,000 for \$30,000, he could have excluded \$6,000 (\$20,000/\$30,000 of the \$9,000 gain) from his income.⁴⁸

In 1976, this section was amended to increase the amount excludable to \$35,000.⁴⁹ At another point, the exclusion was increased to \$125,000⁵⁰ and the age requirement decreased to fifty-five.⁵¹ Along the way there were proposals that the age requirement be eliminated, offering a once-in-a-lifetime exclusion of \$100,000 for any taxpayer who otherwise qualified under section 121.⁵² For whatever reason, the proposed amendment did not become the law in 1978, but a much bigger change occurred in 1997.

3. The Taxpayer Relief Act of 1997

TRA-97 repealed sections 1034 and 121 in their entirety and replaced them with current section 121.⁵³ The deferment option under section 1034 was completely discarded and replaced by the much larger exclusion from gross income found in current section 121.⁵⁴ The major changes from the prior sections included discarding the age limitation, discarding the once-in-a-lifetime availability, and substantially increasing the amount of gain excludable from gross income.

The legislative history reveals multiple reasons for the change. Congress's first concern was one of simplification. The House Report reasons that many taxpayers will buy and sell multiple homes over a lifetime, and calculating the basis⁵⁵—which is used as the benchmark for calculating gain on the sale of a home—“is among the most complex tasks faced by a typical taxpayer.”⁵⁶ The report explains that “even though most homeowners never pay any income tax on the capital gain on their principal residences, as a result of the rollover provisions and the \$125,000 one-time exclusion, *detailed records of transactions and expenditures on home improvements must be kept, in most cases, for many decades.*”⁵⁷ To claim the exclusion, a taxpayer was required to calculate the basis in each home owned, adjusting for any untaxed gains from previous transactions

48 *Id.*

49 Revenue Act of 1976, Pub. L. No. 94-455, § 1404, 90 Stat. 1520, 1733.

50 H.R. REP. NO. 97-215, at 28 (1981) (Conf. Rep.).

51 H.R. REP. NO. 95-1800, at 109 (1978) (Conf. Rep.).

52 H.R. REP. NO. 95-1445, at 7 (1978).

53 Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 312, 111 Stat. 788, 836.

54 *Id.*

55 Ordinarily, a taxpayer's basis in property is the cost of such property. I.R.C. § 1012(a) (2012).

56 H.R. REP. NO. 105-148, at 347 (1997).

57 *Id.* (emphasis added).

deferred under section 1034.⁵⁸ The basis calculation, Congress acknowledged, “may involve augmenting the original cost basis of each home by expenditures on improvements. In addition to the record-keeping burden this creates, taxpayers face the difficult task of drawing a distinction between improvements that add to basis, and repairs that do not.”⁵⁹ Any mistakes in this calculation of basis would lead to miscalculations of capital gains and either under or overpayment of tax liabilities resulting from the sale of principal residences.⁶⁰ The \$500,000 exclusion available every two years, Congress believed, would alleviate any difficulty in determining basis because few taxpayers “would have to refer to records in determining income tax consequences of transactions related to their house.”⁶¹

Other reasons for the change offered in the House Report included eliminating the encouragement of taxpayers to purchase larger and more expensive houses than they otherwise would,⁶² the constraint on the mobility of aging taxpayers,⁶³ and removing a potential marriage penalty.⁶⁴

Section 121 is but one of the housing subsidies afforded to homeowners in the Code. Other tax subsidies for homeowners include the mortgage interest deduction⁶⁵ and the property tax deduction.⁶⁶ Both of these Code provisions, along with an unwritten exclusion of imputed rent,⁶⁷ have been the subjects of

⁵⁸ *Id.*

⁵⁹ *Id.*

⁶⁰ *Id.*

⁶¹ *Id.*

⁶² *Id.* (“To postpone the entire capital gain from the sale of a principal residence, the purchase price of a new home must be greater than the sales price of the old home. This provision of present law encourages some taxpayers to purchase larger and more expensive houses than they otherwise would in order to avoid a tax liability, particularly those who move from areas where housing costs are high to lower-cost areas. This promotes an inefficient use of taxpayer’s financial resources.”).

⁶³ *Id.* (“Present law also may discourage some older taxpayers from selling their homes. Taxpayers who would realize a capital gain in excess of \$125,000 if they sold their home and taxpayers who have already used the exclusion may choose to stay in their homes even though the home no longer suits their needs. By raising the \$125,000 limit and by allowing multiple exclusions, this constraint to the mobility of the elderly would be removed.”).

⁶⁴ *Id.* at 348 (“[A]n individual is not eligible for the one-time capital gains exclusion if the exclusion was previously utilized by the individual’s spouse. This restriction has the unintended effect of penalizing individuals who marry someone who has already taken the exclusion.”).

⁶⁵ I.R.C. § 163(h) (2012).

⁶⁶ I.R.C. § 164(a)(1).

⁶⁷ Imputed rent is generally referred to as the rental value of the home. Larry Ozzanne, *Taxation of Owner-Occupied and Rental Housing* 2 (Cong. Budget Office, Working Paper No. 2012-14, 2012), available at http://www.cbo.gov/sites/default/files/cbofiles/attachments/11-2-2012Taxation_of_Housing.pdf.

critique over the years.⁶⁸ In addition to the tax incentives of homeownership, the government has promoted homeownership in a number of other ways.⁶⁹ Not long after the passage of TRA-97, we experienced a bubble and burst in the computer technology industry commonly referred to as the “dot-com bubble.”⁷⁰ In the background of that bubble, another one was forming, one that would have much more damaging and lasting effects.

II. INFLATED HOME PRICES: CAUSES OF THE HOUSING BUBBLE

A majority of the 1990s, when adjusted for inflation, experienced relatively little increase in housing prices.⁷¹ Beginning in 1998, home prices began to increase sharply, topping off in 2006.⁷² While there are multiple theories of causes—or perhaps *the* cause—of the housing bubble and subsequent burst, this Comment, while first acknowledging some of the most widely accepted causes of the bubble, focuses on the preferential tax treatment of homeownership,⁷³ specifically the ability for a taxpayer to exclude up to \$500,000 of gain realized on the sale of a principal residence under IRC section 121,⁷⁴ as a catalyst to the creation of the housing bubble.

A. Non-Tax Explanations

It may be prudent to point out at the outset that any one cause would likely be insufficient to shoulder all of the blame for the development of the housing bubble.⁷⁵ In its simplest form, a

⁶⁸ See generally Rebecca N. Morrow, *Billions of Tax Dollars Spent Inflating the Housing Bubble: How and Why the Mortgage Interest Deduction Failed*, 17 *FORDHAM J. CORP. & FIN. L.* 751 (2012); William T. Mathias, *Curtailing the Economic Distortions of the Mortgage Interest Deduction*, 30 *U. MICH. J.L. REFORM* 43 (1996); Ventry, *supra* note 44, at 234.

⁶⁹ See *infra* Part II.A.1.

⁷⁰ For an overview of the “dot-com” bubble, see generally ROBERT J. SHILLER, *IRRATIONAL EXUBERANCE* xi–xiv (2d ed. 2005).

⁷¹ Jeff Holt, *A Summary of the Primary Causes of the Housing Bubble and the Resulting Credit Crisis: A Non-Technical Paper*, 8 *J. BUS. INQUIRY* 120, 121 (2009), available at <http://www.uvu.edu/woodbury/docs/summaryoftheprimarycauseofthehousingbubble.pdf> (“Home prices were relatively flat throughout most of the 1990s. According to the S&P/Case-Shiller Index, home prices increased by about 8.3 percent from the 1st quarter of 1990 to the 1st quarter of 1997.”).

⁷² *Id.* (“Then home prices began a rapid increase—peaking in the 2nd quarter of 2006 over 132 percent higher than they had been in the 1st quarter of 1997.”).

⁷³ In addition to the exclusion allowed under section 121, other preferential tax provisions for homeowners include the mortgage interest deduction under I.R.C. § 163(h) and the property tax deduction under I.R.C. § 164(a)(1).

⁷⁴ See *infra* Part II.B.1.

⁷⁵ Holt, *supra* note 71, at 128 (“Each of the four primary causes played an important role in creating the housing bubble and the credit crisis. The combination of all four causes created a type of ‘perfect storm’ causing the housing bubble to be extreme and the

bubble can be described as a phenomenon in which assets are temporarily overpriced due to excessive public expectations of future price increases.⁷⁶

1. Government Promotion of Homeownership

It has been argued that the bubble began to inflate in 1997 as a result of various government policies intended to promote homeownership among the American people.⁷⁷ Some of these policies include the relaxing of mortgage-lending standards designed to allow individuals who previously would not have qualified for loans to do so.⁷⁸ The Community Reinvestment Act⁷⁹ (CRA) is a prime example. The CRA was implemented to offset redlining⁸⁰ and encourage commercial banks and saving associations to help meet the needs of borrowers in all segments of their communities, including low- and moderate-income neighborhoods.⁸¹ In the mid-1990s, regulations were promulgated to give bite to the CRA “by setting quotas for mortgage lending to distressed communities and threatening sanctions for banks who [sic] did not meet them.”⁸² It has also been argued that the CRA’s reach encompassed banks not formally covered by the Act.⁸³ For

resulting credit crisis to be severe. Three of the causes, though they contributed to the housing bubble, were not essential to the development of the bubble.”).

⁷⁶ Karl E. Case & Robert J. Shiller, *Is There a Bubble in the Housing Market?*, BROOKINGS PAPERS ON ECON. ACTIVITY, 2003, at 299 (“The term ‘bubble’ is widely used but rarely clearly defined. We believe that in its widespread use the term refers to a situation in which excessive public expectations of future price increases cause prices to be temporarily elevated.”).

⁷⁷ See Edward Pinto, *Acorn and the Housing Bubble*, WALL ST. J., Nov. 13, 2009, at A23, available at http://online.wsj.com/article/SB20001424052748703298004574459763052141456.html#mod=todays_us_opinion.

⁷⁸ *Id.* (“Less well understood is that this bubble was the result of government policies that lowered mortgage-lending standards to increase home ownership.”).

⁷⁹ 12 U.S.C. § 2901 (1977).

⁸⁰ “Credit discrimination (usu. unlawful discrimination) by an institution that refuses to provide loans or insurance on properties in areas that are considered to be poor financial risks or to people who live in those areas.” BLACK’S LAW DICTIONARY 1391 (9th ed. 2009).

⁸¹ Pinto, *supra* note 77.

⁸² Robert Hardaway, *The Great American Housing Bubble: Re-Examining Cause and Effect*, 35 U. DAYTON L. REV. 33, 36 (2009); see also Peter Wallison & Edward Pinto, *A Government-Mandated Housing Bubble*, FORBES (Feb. 16, 2009, 12:01 AM), http://www.forbes.com/2009/02/13/housing-bubble-subprime-opinions-contributors_0216_peter_wallison_edward_pinto.html (“New CRA regulations in 1995 required banks to demonstrate that they were making mortgage loans to underserved communities, which inevitably included borrowers whose credit standing did not qualify them for a conventional mortgage loan.”); Holt, *supra* note 71, at 124 (“In 1995 the Community Reinvestment Act was modified to compel banks to increase their mortgage lending to lower-income households. To meet the new requirements of the Community Reinvestment Act, many banks relaxed their mortgage lending standards.”).

⁸³ Hardaway, *supra* note 82, at 42 (“Those in the second camp respond that the CRA nevertheless put pressure even on banks not formally covered, and that the threat of sanctions increased that pressure.”).

example, some of the changes of the CRA worked to coerce banks into lending in low-income neighborhoods.⁸⁴

In sum, the CRA and its progeny enabled people to qualify for loans they never would have under traditional lending standards.⁸⁵ Lower lending standards increased the number of loans made with smaller down payments.⁸⁶ The increased purchasing power of borrowers “fueled a house price bubble of unprecedented magnitude over the period 1997–2006.”⁸⁷ While banks were typically averse to this type of higher risk lending, securitization and mortgage-backed securities offered the perfect opportunity to avoid it.⁸⁸

2. Securitization of Mortgage Debt

The securitization⁸⁹ of mortgage debt was inextricably intertwined with the housing bubble.⁹⁰ Mortgage-backed

⁸⁴ *Id.* at 43 (quoting Dennis Sewell, *Clinton Democrats Are to Blame for the Credit Crunch*, SPECTATOR, Oct. 4, 2008, at 14, 15) (“Changes were made to the Community Reinvestment Act to establish a system by which banks were rated according to how much lending they did in low-income neighborhoods. A good CRA rating was necessary if a bank wanted to get regulators to sign off on mergers, expansions, even new branch openings. A poor rating could be disastrous for a bank’s business plan.”).

⁸⁵ Holt, *supra* note 71, at 124 (“Standards for mortgage loans were fairly consistent in the decades prior to the development of the housing bubble. Most mortgages were 30-year fixed rate loans of at least 20 percent or mortgage insurance if the 20 percent down payment requirement were not met. [However, in the mid-1990s,] [d]own payment requirements and income requirements were reduced.”).

⁸⁶ Pinto, *supra* note 77 (“As a result of congressional and regulatory actions, the percentage of conventional first mortgages (not guaranteed by the Federal Housing Administration or the Veteran’s Administration) used to purchase a home with the borrower putting 5% or less down tripled from 9% in 1991 to 27% in 1995, eventually reaching 29% in 2007.”).

⁸⁷ *Id.*

⁸⁸ See, e.g., Kofi Bofah, *Does Securitization Reduce Bank Risk?*, SAN FRANCISCO GATE, <http://homeguides.sfgate.com/credit-securitization-reduce-bank-risk-2975.html> (last visited Mar. 19, 2014) (“Banks orchestrate these transactions to reduce their exposure to individual financial risks . . . [This] effectively pass[es] default risks onto investors who choose to buy securitized products.”).

⁸⁹ For a simple explanation of securitization, see Andreas Jobst, *What is Securitization*, FIN. & DEV., Sept. 2008, at 48, available at <http://www.imf.org/external/pubs/ft/fandd/2008/09/pdf/basics.pdf> (“Securitization is the process in which certain types of assets are pooled so that they can be repackaged into interest-bearing securities. The interest and principal payments from the assets are passed through to the purchasers of the securities.”). See also JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 570 (7th ed. 2013) (“Securitization is the transfer of illiquid debt into tradable securities.”); ANDREW DAVIDSON ET AL., SECURITIZATION: STRUCTURING AND INVESTMENT ANALYSIS 3 (2003) (“The process of packaging financial promises and transforming them into a form whereby they can be freely transferred among a multitude of investors is securitization.”).

⁹⁰ See *Securitization of Assets: Problems and Solutions: Hearing Before the Subcomm. on Sec., Ins., & Inv. of the U.S. S. Comm. on Banking, Hous., & Urban Affairs*, 111th Cong. 1 (2009) (statement of Patricia A. McCoy, George J. and Helen M. England Professor of Law and Director, Insurance Law Center, University of Connecticut School of Law), available at <http://www.banking.senate.gov/public/index.cfm?FuseAction=>

securities⁹¹ (MBSs) provided investors with a chance to take advantage of a booming real estate market without actually owning property.⁹² Collateralized debt obligations⁹³ (CDOs) allowed investment banks to split up—otherwise known as “tranch”—the revenue streams of any special purpose entity⁹⁴ (SPE) and pay out to investors on a priority schedule that was structured by risk and return preferences, suiting the needs of particular investors.⁹⁵ Furthermore, credit default swaps⁹⁶ (CDSs) guarded against the risk of bad debt for investors seeking a steady lower-risk investment.⁹⁷ The viability of these financial tools essentially relied on home prices continuing to rise.⁹⁸ Banks became originators instead of lenders and had “little incentive to worry about the quality of any single mortgage since the mortgage [would] soon be sold.”⁹⁹ Because banks were less worried about creditworthiness and were willing to lend with less money down¹⁰⁰—in some instances no money down—buyers were able to pay higher prices for housing. While banks were willing to

Files.View&FileStore_id=02242b1f-27e9-4aa0-ae0f-3a1c0eacc7e6 (“During the housing bubble, private-label securitization financed the majority of subprime and nontraditional mortgages. This system proceeded on the assumption that housing prices would keep going up. When housing prices fell and people could not refinance out of unaffordable loans, investors lost confidence in private-label mortgage securitization and the system collapsed in August 2007.”).

91 “Mortgage-backed securities (MBS) are debt obligations that represent claims to the cash flows from pools of mortgage loans, most commonly on residential property.” *Mortgage-Backed Securities*, SEC.GOV, <http://www.sec.gov/answers/mortgagesecurities.htm> (last visited Mar. 19, 2014).

92 Manav Tanneeru, *How a ‘Perfect Storm’ Led to the Economic Crisis*, CNN (Jan. 29, 2009), <http://www.cnn.com/2009/US/01/29/economic.crisis.explainer/>.

93 A CDO is an investment-grade security backed by a pool of bonds, loans, and other assets. *Collateralized Debt Obligation – CDO*, INVESTOPEDIA, <http://www.investopedia.com/terms/c/cdo.asp> (last visited Mar. 30, 2013).

94 Also known as a Special Purpose Vehicle (SPV), an SPE is “an entity set up, usually by a financial institution, specifically to purchase assets and realize their off-balance-sheet treatment for legal and accounting purposes.” Jobst, *supra* note 89, at 48.

95 Anna Katherine Barnett-Hart, *The Story of the CDO Market Meltdown: An Empirical Analysis* 7 (Mossavar-Rahmani Ctr. for Bus. & Gov’t, Working Paper No. 4, 2009), available at <http://www.hks.harvard.edu/m-rcbg/students/dunlop/2009-CDOMeltDown.pdf> (“[T]ranching of the cash flows made it possible to create securities with different risk profiles appropriate to specific investors.”).

96 “A credit default swap is . . . where the purchaser of the swap makes payments up until the maturity date of a contract. Payments are made to the seller of the swap. In return, the seller agrees to pay off a third party debt if this party defaults on the loan. A CDS is considered insurance against non-payment. A buyer of a CDS might be speculating on the possibility that the third party will indeed default.” *Credit Default Swap – CDS*, INVESTOPEDIA, <http://www.investopedia.com/terms/c/creditdefaultswap.asp> (last visited Mar. 21, 2013).

97 *Id.*

98 Hardaway, *supra* note 82, at 39.

99 Holt, *supra* note 71, at 125.

100 Adam J. Levitin & Susan M. Wachter, *Explaining the Housing Bubble*, 100 GEO. L.J. 1177, 1194–95 (2012).

lend at unprecedented high loan-to-value ratios, borrowers were encouraged to do so because historically low interest rates made it incredibly cheap to do so.

3. Low Interest Rates

Mortgage interest rates in the United States hit an all-time high in October of 1981 at 18.45%¹⁰¹ as the Federal Reserve increased interest rates in a successful effort to combat inflation.¹⁰² For the most part, mortgage interest rates fell over the next two decades, with the 30-year fixed rate mortgage falling below 6% in early 2003.¹⁰³ The low rate continued through most of 2005.¹⁰⁴

In addition to low mortgage rates, from 2002 to 2004 the Federal Reserve pushed the federal funds rate¹⁰⁵ down to historically low levels in an attempt to strengthen the recovery from the 2001 recession.¹⁰⁶ Low short-term rates “not only fueled growth in the dollar volume of mortgage lending, but had unintended consequences for the type of mortgages written.”¹⁰⁷ The short-term rates became lower relative to 30-year rates, and “[a]djustable-rate mortgages (ARMs), typically based on a one-year interest rate, became increasingly cheap relative to 30-year fixed-rate mortgages.”¹⁰⁸ With an ARM, a home purchaser who could not afford the payment of a mortgage with a regular fixed-rate mortgage would be able to afford the payment of an ARM loan because the rate started out much lower.¹⁰⁹ With

¹⁰¹ *30-Year Fixed-Rate Mortgages Since 1971*, FREDDIE MAC, <http://www.freddiemac.com/pmms/pmms30.htm> (last visited Apr. 4, 2013) [hereinafter FREDDIE MAC].

¹⁰² Holt, *supra* note 71, at 121; see also Paul Volcker, *What Led to the High Interest Rates of the 1980s?*, PBS (May 29, 2009, 12:02 PM), <http://www.pbs.org/newshour/businessdesk/2009/05/what-led-to-the-high-interest.html>.

¹⁰³ FREDDIE MAC, *supra* note 101.

¹⁰⁴ Holt, *supra* note 71, at 121.

¹⁰⁵ The “federal funds rate” is the interest rate at which a depository institution lends immediately available funds—balances at the Federal Reserve—to another depository institution overnight. *Federal Funds Rate*, INVESTOPEDIA, <http://www.investopedia.com/terms/f/federalfundsrates.asp> (last visited Mar. 10, 2013).

¹⁰⁶ Holt, *supra* note 71, at 122–23 (“The U.S. economy entered into a recession in March of 2001. Over the course of 2001, the Federal Reserve lowered the federal funds rate eleven times, from 6.50 percent to 1.75 percent. When the economic recovery proved sluggish and no sign of significant inflation appeared, the Fed continued its low interest rate policy, lowering the federal funds rate to 1.25 percent in November of 2002 and to 1.00 percent in June of 2003. The Fed began gradually increasing the rate in June of 2004, but the rate remained at 2.00 percent or lower for more than three years.”).

¹⁰⁷ Lawrence H. White, *Federal Reserve Policy and the Housing Bubble*, 29 CATO J. 115, 118 (2009).

¹⁰⁸ *Id.*

¹⁰⁹ Holt, *supra* note 71, at 123 (“For example, the monthly principal and interest payment on a \$200,000 30-year fixed rate mortgage with an interest rate of 6 percent would be about \$1,200. The monthly principal and interest payment on a \$200,000 30-year ARM with an initial interest rate of 4 percent would be only about \$950.”).

a booming housing market, lenders developed variations of ARMs. Borrowers looking for even lower payments could choose to pay only interest, thus never paying down the loan. Or a borrower could choose to pay only a portion of the interest, which would then increase the principal by adding the unpaid interest on top of the principal.¹¹⁰ These ARMs made monthly mortgage payments much more affordable for people, and thus enabled home prices to rise.¹¹¹ Real estate prices began to look like bargains as interest rates fell.¹¹² Low rates and expanding mortgage credit increased demand for, and prices of, existing houses, and encouraged the construction of new housing on undeveloped land.¹¹³ In essence, “the Fed’s easy-credit policy (combined with encouragements for riskier mortgage lending) inflated the housing bubble,”¹¹⁴ and researchers at the International Monetary Fund found that “the unusually low level of interest rates in the United States between 2001 and 2003 contributed somewhat to the elevated rate of expansion in the housing market, in terms of both housing investment *and the run-up in house prices up to mid-2005.*”¹¹⁵

4. Irrational Exuberance

“Irrational exuberance”¹¹⁶ is a term “now often used to describe a heightened state of speculative fervor.”¹¹⁷ One assumption led to widespread confidence in the housing market: home prices would never fall.¹¹⁸ Even after the bubble burst, it has been argued that this belief was not irrational.¹¹⁹

¹¹⁰ *Id.*

¹¹¹ *Id.*

¹¹² White, *supra* note 107, at 119.

¹¹³ *Id.*

¹¹⁴ *Id.*

¹¹⁵ *Id.* (emphasis added) (quoting R. CARDARELLI ET AL., THE CHANGING HOUSING CYCLE AND THE IMPLICATIONS FOR MONETARY POLICY 19 (2008), available at <http://www.imf.org/external/pubs/ft/weo/2008/01/pdf/c3.pdf>).

¹¹⁶ Alan Greenspan made this term famous in a black-tie dinner speech entitled “The Challenge of Central Banking in a Democratic Society” before the American Enterprise Institute at the Washington Hilton Hotel in December of 1996. See Robert J. Shiller, *Definition of Irrational Exuberance*, IRRATIONALEXUBERANCE.COM, <http://irrational.exuberance.com/definition.htm> (last visited Feb. 1, 2014). Greenspan said: “But how do we know when irrational exuberance has unduly escalated asset values, which then become subject to unexpected and prolonged contractions as they have in Japan over the past decade?” *Id.*

¹¹⁷ *Id.*

¹¹⁸ See, e.g., Jonathan McCarthy & Richard W. Peach, *Are Home Prices the Next “Bubble”?*, FRBNY ECON. POL’Y REV., Dec. 2004, at 1, 2, available at <http://www.newyorkfed.org/research/epr/04v10n3/0412mcca.pdf> (opining that market fundamentals sufficiently explained the increase in home prices and that a bubble did not exist).

¹¹⁹ Hardaway, *supra* note 82, at 45 (suggesting that a sixty-seven year trend of increasing home prices justified the assumption of homebuyers, banks, investment banks, hedge funds, or money market funds that prices would in fact continue to rise).

But Robert Shiller points out that although home prices had gone up on average over the past century, the increase occurred in two short periods: right after World War II and since 1998.¹²⁰ As prices began to soar, people started believing that if they didn't purchase a house, they would be priced out of the market.¹²¹ This now-or-never attitude, coupled with incredibly lax lending standards, led people to purchase homes priced well above typical multiples of earnings.¹²² Despite rising prices and the risk involved with extremely leveraged positions,

[h]ome buyers continued to purchase homes (often for speculative purposes) even though the monthly payments would eventually prove unmanageable. They assumed that they would be able to "flip" the home for a profit or refinance the loan when the adjustable rate increased. This too would work if home prices kept rising.¹²³

The dream of owning a home, the chance at striking it rich, and the assurance that home investments were not risky led the market to continue to bid up prices until they were no longer sustainable.

B. Section 121: A Catalyst to Bubble

Akin to many of the other proffered causes of the housing bubble, section 121 could never shoulder all of the blame for the rapid increase in home prices. Very few have articulated an argument accusing the home sale exclusion as a major cause of the housing bubble, but even those mentioning its contribution have been met with skepticism and rebuff.¹²⁴ The housing bubble was undoubtedly the result of an amalgam of causes. While factors such as the government's zealous promotion of homeownership, securitization of mortgage debt, low interest rates, and widespread belief of a continued increase of prices may serve as some of the more popular explanations for the bubble, the argument that section 121 played a part is by no means undermined simply because of the existence of other

¹²⁰ SHILLER, *supra* note 70, at 12–14.

¹²¹ *Id.* at 17–18.

¹²² *Id.* at 13 ("The ascent in home prices after 1997 was much faster than the increase in incomes, and this raises concerns about the long-run stability of home prices, especially in the most volatile states. In the eight most volatile U.S. states from 1985 to 2002, the median price of a home rose from 4.9 years' per capita income to 7.7 years' per capita income; thus in these states there are significant new stresses on family budgets in making mortgage payments.").

¹²³ Holt, *supra* 71, at 126.

¹²⁴ See, e.g., Len Burman, *Did the Capital Gains Tax Break on Home Sales Help Inflate the Housing Bubble?*, TAX POL'Y CENTER (Dec. 22, 2008, 1:17 PM), <http://taxvox.taxpolicycenter.org/2008/12/22/did-the-capital-gains-tax-break-on-home-sales-help-inflate-the-housing-bubble/> (arguing that the tax break did not help inflate the housing bubble).

explanations. In fact, multiple theories of the cause of the housing bubble reinforce the importance of understanding all contributing factors in order to ensure that such a devastating bubble and subsequent burst does not repeat itself. Another bubble of that magnitude is unlikely to occur anytime soon.¹²⁵ That prediction, however, does nothing to lessen the need to eradicate lingering bubble impetus.

There are (at least) three ways section 121 may have acted as a stimulant to the inflation of the housing bubble. First, by providing such a large exclusion (as opposed to a limited exclusion and rollover provision under prior law), the tax code favored gains realized from an investment in housing over gains from an investment in other capital assets. Thus, section 121 increased the value of an investment in housing because the after-tax takeaway had potential to be much greater. Second, TRA-1997 provided a significant exclusion to the entire home-owning populace, a larger and different demographic than under prior law. Lastly, the once-in-a-lifetime limitation for the exclusion under prior law was repealed and replaced with the ability to take advantage of a bigger exclusion every two years.

1. Increase in After-Tax Value of Housing Investment

Upon enacting section 121, Congress greatly increased the appeal of a personal residence as an investment. The new section, when compared to other investment options, increased the after-tax return one could receive on a personal residence.¹²⁶ As the after-tax return of an investment in a personal residence increases, the price a purchaser is willing to pay for a home necessarily increases.¹²⁷ Investing in housing was now more appealing to people because it was “an investment they could understand” and the possibility of taking up to \$500,000 of tax-free profit was more than enough incentive for “citizens in

¹²⁵ Robert J. Shiller, *Housing Bubbles are Few and Far Between*, N.Y. TIMES (Feb. 5, 2011), available at <http://www.nytimes.com/2011/02/06/business/06view.html>.

¹²⁶ See Gary L. Maydew & Robert D. Swanson, *Personal Residences Now Offer More Tax Shelter*, 62 PRAC. TAX STRATEGIES 235, 235 (1999) (“When taxpayers and practitioners think of post-1986 tax shelters, they likely envision real estate, oil and gas working interests, or other exotic investments. The personal residence, however, while not exotic or exciting, has traditionally been a good way to shelter income from taxation, and TRA '97 has greatly improved the after-tax return on personal residences.”) (emphasis added).

¹²⁷ Seth Hanlon, *Tax Expenditure of the Week: Tax-Free Capital Gains for Primary Residences*, CENTER FOR AM. PROGRESS (Apr. 6, 2011), <http://www.americanprogress.org/issues/open-government/news/2011/04/06/9386/tax-expenditure-of-the-week-tax-free-capital-gains-for-primary-residences/> (“This rule . . . also inflates home values because it means that investments in homes get a better after-tax return than other investments—raising the price that future buyers are willing to pay.”).

search of half-millionaire status.”¹²⁸ But if the new provision actually increased the value of a home—by increasing the after-tax return—then it does not necessarily contribute to a bubble, which is “a situation in which excessive public expectations of future price increases causes prices to be temporarily elevated.”¹²⁹ On the other hand,

[b]y favoring real estate, the tax code pushed many Americans to begin thinking of their houses more as an investment than as a place to live. It helped change the national conversation about housing. Not only did real estate look like a can't-miss investment for much of the last decade, it was also a tax-free one.¹³⁰

The more people with an eye toward an investment in housing, the more momentum a national belief in a continual increase of housing prices would have.

2. Qualifying for the Exclusion: A Change in Demographic

Under prior law, only those taxpayers aged fifty-five and older qualified for any exclusion and it was capped at \$125,000.¹³¹ By eliminating the age requirement, the exclusion was available to the entire home-owning populace. The new provision offered tax-free gains—up to \$500,000—to anyone who purchased a house and used it as a principal residence for two years.¹³² A necessary element of a housing bubble is a population willing to purchase homes at inflated prices. By enlarging the group of people who benefit from the exclusion, the group of buyers willing to purchase homes increases because the higher prices go, the more valuable the exclusion becomes.

In addition to enlarging the *number* of homeowners able to qualify for the exclusion, the *type* of homeowners changed. Before, those able to exclude any gain were fifty-five and older, but after the new provision was enacted, all taxpayers that owned a home became eligible.¹³³ Older investors tend to be more risk averse and thus, less likely to engage in speculative practices.¹³⁴ On the other hand, younger taxpayers “have a

¹²⁸ Vernon L. Smith, *The Clinton Housing Bubble*, WALL ST. J., Dec. 18, 2007, at A20, available at <http://online.wsj.com/article/SB119794091743935595.html>.

¹²⁹ Case & Shiller, *supra* note 76.

¹³⁰ Bajaj & Leonhardt, *supra* note 7.

¹³¹ See *supra* Part I.B.

¹³² See *supra* Part I.A.

¹³³ See *supra* Part I.

¹³⁴ Steven M. Albert & John Duffy, *Differences in Risk Aversion Between Young and Older Adults*, 1 NEUROSCIENCE AND NEUROECONOMICS 3, 7 (2012), available at www.dovepress.com/getfile.php?fileID=12034; see also Tapen Sinha, *Are Older People More Risk Averse?*, BOND U. BUS. DISCUSSION PAPERS, June 1992, at 1, 8, available at http://epublications.bond.edu.au/cgi/viewcontent.cgi?article=1034&context=discussion_pa

lifetime to make up for a high-risk investment that goes bad.”¹³⁵ By extending an opportunity to exclude gain to a demographic that is less averse to risk on average, the chance of section 121 being used for speculative purposes goes up. Part of the appeal of using section 121 for speculative purposes is that it is available every two years.

3. Short Exclusion Cycle

Unlike the prior exclusion available before TRA-97, which provided a once-in-a-lifetime exclusion to older taxpayers, the new provision can be utilized an unlimited number of times so long as two years have passed since the last application of section 121.¹³⁶ This once-every-two-years availability is the crux of how section 121 may have been used for speculative purposes—thus contributing to the run-up of housing prices.¹³⁷ Evidence suggests that after the law changed, the number of home sales increased as the new code section alleviated a “lock-in” effect.¹³⁸ Homeowners were able to turnover homes frequently without having to recognize gain. The ability to take advantage of the exclusion every two years is frequent enough for some homeowners to buy and sell *solely* in order to realize tax-free gains.¹³⁹ While some would argue that the reason for making the exclusion available every two years is because the new section absorbed the old rollover provision and taxpayers weren’t paying any taxes on gains under the prior law,¹⁴⁰ there’s a difference between deferring gain that is reinvested and excluding gain that can be used for any purpose.¹⁴¹

Buying and selling homes every two years as a way to earn tax-free income was not the purpose of section 121.¹⁴² Nevertheless, during times of rapid increase in prices, the large

pers (“[O]n the average for gain situations older people are more risk (loss) averse than younger people.”).

¹³⁵ RICHARD T. WILLIAMSON, *SELLING REAL ESTATE WITHOUT PAYING TAXES: A GUIDE TO CAPITAL GAINS TAX ALTERNATIVES* 10 (2003).

¹³⁶ See *supra* Part I.A.

¹³⁷ Hanlon, *supra* note 127.

¹³⁸ Hui Shan, *The Effect of Capital Gains Taxation on Home Sales: Evidence from the Taxpayer Relief Act of 1997* 4 (Divs. of Research & Statistics and Monetary Affairs Fed. Reserve Bd., Working Paper No. 2008-53, 2008), available at <http://www.federalreserve.gov/pubs/feds/2008/200853/200853pap.pdf>.

¹³⁹ See Bajaj & Leonhardt, *supra* note 7.

¹⁴⁰ See, e.g., Burman, *supra* note 124.

¹⁴¹ See, e.g., Kay Bell, *Capital Gains Tax Break is a Boon for Most Owners*, BANKRATE (May 16, 2005), <http://www.bankrate.com/brm/news/real-estate/REguide/tax-breaks1.asp> (“Another bonus of the new rules: You don’t have to buy another home with the sale proceeds. You can use the money to travel to Europe in style, buy an RV and drive across the country or get all those designer shoes you never could afford before.”).

¹⁴² See *supra* Part I.B.3.

exclusion enables just that. Even those suggesting section 121 contributed very little to the housing bubble acknowledge that “there are flaws in the implementation of the 1997 law” and that “[i]t shouldn’t apply to people who flip homes every two years.”¹⁴³ In the end, even if section 121 had a less-than-significant part in creating the housing bubble, the provision provides ample opportunity for speculation. If there is a simple solution—which this Comment suggests there is—then section 121 should be amended to eradicate speculative application of the exclusion.

III. A SIMPLE FIX

Section 121 was enacted primarily to simplify the tax consequences of selling a home, eliminate the encouragement of purchasing more expensive homes than a taxpayer otherwise would, remove a restraint on the mobility of the elderly, and lift a potential marriage penalty.¹⁴⁴ The legislative history reveals no intention of enabling taxpayers to turn personal residences into short-term investments; however, that’s exactly the opportunity that has been afforded to those willing to ride increasing home prices in search of tax-free income.

While the exclusion cannot by itself create a housing bubble,¹⁴⁵ it can act as a catalyst as soon as prices do start to increase, because the faster prices increase, the more valuable the exclusion becomes. Eliminating the ability to use section 121 for speculative purposes would require nothing more than eliminating the ability to apply the section once every two years by simply extending the period in which a person must live in the residence. This is not a novel suggestion.¹⁴⁶ In a 2005 report, an advisory panel for President Bush made a similar suggestion: “The Panel recommends that the length of time an individual must own and use a home as a principal residence to qualify for the tax exemption be increased from two out of five years to three out of five years.”¹⁴⁷ Others have also suggested requiring a longer period of use, up to ten years, in order to reduce excess volatility in housing prices.¹⁴⁸ Another way the section could be limited in order to dampen speculation is to

¹⁴³ Burman, *supra* note 124.

¹⁴⁴ See *supra* Part I.B.3.

¹⁴⁵ The exclusion is still available and there is no current “bubble.”

¹⁴⁶ See, e.g., PRESIDENT’S ADVISORY PANEL, SIMPLE, FAIR, AND PRO-GROWTH: PROPOSALS TO FIX AMERICA’S TAX SYSTEM 74–75 (2005), available at <http://www.treasury.gov/resource-center/tax-policy/Documents/Simple-Fair-and-Pro-Growth-Proposals-to-Fix-Americas-Tax-System-11-2005.pdf>.

¹⁴⁷ *Id.*

¹⁴⁸ WILLIAM LIM, THE U.S. TAXPAYER RELIEF ACT OF 1997 AND THE SUBSEQUENT HOUSING BUBBLE 9 (2011), available at <http://wbiconpro.com/314-Lim.pdf>.

allow its application once every five years instead of the once every two years under current law. By limiting the ability to take advantage of the section to once every five years, the possibility of earning tax-free income from flipping houses drastically decreases.

A personal residence remains a popular tax shelter¹⁴⁹ and the appeal of section 121 flourishes during times of home price increases. After a housing boom and bust, resulting in roughly four million foreclosures,¹⁵⁰ many people are left in worse positions than they were before buying into the American Dream. Homeowners will benefit from gradual rises in home values, but not from rapid increases that inevitably come crashing down. If limiting the applicability of section 121 to home sales decreases the chance of another housing bubble, then the relatively simple fix is something Congress should consider.

CONCLUSION

Because the housing bubble was the result of a number of factors, it is not surprising that the elimination of one or more of those factors has chilled the housing market. The most significant reaction to the financial crisis was the tightening of lending standards.¹⁵¹ Even creditworthy borrowers are now finding it difficult to obtain funds.¹⁵² Restricting the availability of credit to guard against loan default may seem a natural response to the credit crisis, but some argue that in order for the economy to make a full recovery, the housing market must make a full recovery.¹⁵³

149 See, e.g., William Baldwin, *Eighteen Ways to Get Tax-Free Income*, FORBES (Feb. 7, 2011, 5:53 PM), <http://www.forbes.com/sites/baldwin/2011/02/07/eighteen-ways-to-get-tax-free-income/> (suggesting taking advantage of the home sale exclusion by buying a fixer-upper, working on it yourself, and selling it after the two-year requirement is satisfied).

150 Steele, *supra* note 5.

151 See generally Nick Timiraos, *Fannie Mae Tightens Underwriting for Interest-Only Mortgages*, WALL ST. J. (Apr. 30, 2010, 6:24 PM), <http://online.wsj.com/article/SB10001424052748703871904575216683364999118.html>; Jeannine Aversa, *More Banks Stiffen Rules, Fed Finds*, WASH. POST (Feb. 5, 2008), http://articles.washingtonpost.com/2008-02-05/business/36796286_1_domestic-respondents-federal-reserve-survey-foreign-banks.

152 Suzy Khimm, *Are Creditworthy Americans Having Trouble Getting Mortgages?* WASH. POST (Mar. 1, 2012, 9:00 AM), http://www.washingtonpost.com/blogs/wonkblog/post/are-creditworthy-americans-having-trouble-getting-mortgages/2012/02/29/gIQAcdoziR_blog.html.

153 Sam Hughes, *A Strong Housing Market Is Critical to Our Economic Recovery*, CENTER FOR AM. PROGRESS (Nov. 15, 2012), <http://www.americanprogress.org/issues/housing/news/2012/11/15/45042/a-strong-housing-market-is-critical-to-our-economic-recovery/>.

If this is true, one can expect government policies to be geared toward keeping home prices high and even facilitating their return to prior highs.¹⁵⁴ While less people now “think of housing as an investment” and may even see it “as risky,” that alone does not preclude another bubble from forming.¹⁵⁵ Indeed, despite the slow housing market, “many people continue to think of housing as an investment.”¹⁵⁶ So long as section 121 encourages taxpayers to “buy and sell to [their] heart’s content,”¹⁵⁷ it will remain an appealing tool for speculation because it may “take a while for the housing market to recover fully,”¹⁵⁸ but “it does seem that we are in danger of encountering another whopper bubble *someday*.”¹⁵⁹ As bubbles are hard to predict, as well as hard to identify in the midst of one, Congress should act sooner rather than later in constricting the ability of taxpayers to turn homes into short-term investments in hopes of earning tax-free capital gains, because such speculation only hastens the formation of a bubble.

¹⁵⁴ See Hardaway, *supra* note 82, at 40–41 (“For example, federal government policy has been largely geared toward keeping home prices high . . .”).

¹⁵⁵ Shiller, *supra* note 125.

¹⁵⁶ *Id.*

¹⁵⁷ John Adams, *Tax Benefits of Home Ownership Are Almost Too Good to Be True*, REALTOR.COM, <http://www.realtor.com/basics/buy/closepossess/taxbenefits.asp?source=web> (last visited Apr. 10, 2013).

¹⁵⁸ Shiller, *supra* note 125.

¹⁵⁹ *Id.* (emphasis added).

Breaking the Bank: The Tax Benefits of Legalizing Online Gambling

Dallis Nicole Warshaw*

INTRODUCTION

A recent survey indicates that the prohibition of online gambling goes against the will of the American people, with over 80% of respondents reporting being against the current ban.¹ Following “free choice,” the most strongly favored argument for lifting the ban was increased tax revenue for state and federal governments²—and for good reason. The federal government currently does not have sufficient funds to sustain projected long-term programs such as Social Security, Medicare, and Medicaid.³ And state governments are not performing much better, collectively owing more than \$4 trillion.⁴ Federal and state governments could continue to borrow money as they have to an unprecedented degree in recent years,⁵ but government

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¹ Only 18.9% of respondents favored an across the board ban of online gambling. *CasinoFYI Finds 81% of Americans Do Not Support Online Gambling Prohibition*, MARKETWIRED (July 17, 2012, 9:00 AM), <http://www.marketwired.com/press-release/casinofyi-survey-finds-81-of-americans-do-not-support-online-gambling-prohibition-1680743.htm> [hereinafter *CasinoFYI*]. When asked how online gambling should be regulated, 46.1% favored letting states decide, while 24.9% favored regulating and taxing it at the federal level. *Id.*

² The strongest arguments in support of legalization were free choice (45.1%), increased tax revenue (20.5%), the failure of prohibition (19.7%), job creation (9.2%), and the promotion of additional safeguards (5.4%). *Id.* The strongest arguments against online gambling were increased gambling addiction (31.8%), the potential for unfair or rigged games (28.9%), access by minors (22.4%), immorality (9.1%), and the potential for money laundering (7.9%). *Id.*

³ See LEONARD E. BURMAN & JOEL SLEMROD, *TAXES IN AMERICA: WHAT EVERYONE NEEDS TO KNOW* 17-18 (2013) (reporting the gap between promised benefits and taxes to be \$50 trillion in the next seventy-five years).

⁴ See *10 States With Enormous Debt Problems: Report*, HUFFINGTON POST (Aug. 28, 2012, 3:08 PM), http://www.huffingtonpost.com/2012/08/28/state-debt-report_n_1836603.html. The ten states with the worst debt problems (in billions) are California (\$617), New York (\$300), Texas (\$287), New Jersey (\$282), Illinois (\$271), Ohio (\$239), Pennsylvania (\$142), Florida (\$134), Michigan (\$124), and Massachusetts (\$102). *Id.* Vermont ranked “last” with only \$5.85 billion owed. *Id.*

⁵ See Veronique de Rugy, *How Much of Federal Spending is Borrowed for Every Dollar?*, GEORGE MASON U. MERCATUS CENTER (July 11, 2011), <http://mercatus.org/publication/how-much-federal-spending-borrowed-every-dollar> (federal debt); Tami

borrowing does not eliminate the problem; rather, it simply postpones the burden. There are ways for the government to raise revenue other than through taxation (printing money, for example); however, non-tax revenue often presents its own problems.⁶

Various governments throughout history have enacted many seemingly nonsensical taxes often in a desperate effort to either raise tax revenue or promote social change.⁷ In fact, the fifty states have continued this tradition by imposing unusual taxes with arbitrary distinctions on almost everything: nudity, fur, bagels, tattoos, playing cards, blueberries, and even litigation.⁸ Furthermore, states commonly impose many varying types of taxes, such as excise taxes,⁹ sin taxes,¹⁰ and Pigouvian taxes.¹¹ This being the case, many experts have begun urging for the adoption of a new voluntary tax that only affects those who choose to participate—the taxation of legalized online gambling.¹² Nelson Rose, a recognized gambling expert, has concisely explained the rationale behind this proposal: states “can’t cut services anymore, can’t raise taxes, so [the gambling tax] raises some money, particularly for states that are desperate.”¹³

This Article argues for the legalization of online gambling by emphasizing the potential tax revenue available for state and federal governments. Part I of this Article discusses the history of gambling in the United States, and the manner in which state

Luhby, *States Go Deeper into Debt*, CNN MONEY (July 30, 2010, 12:34 PM), http://money.cnn.com/2010/07/30/news/economy/state_debt_levels/ (state debt).

⁶ See, e.g., BURMAN & SLEMMOD, *supra* note 3, at 11–12 (printing money leads to inflation).

⁷ See *Strange & Unusual Taxes Throughout History from Around the World*, EFILE, <http://www.efile.com/unusual-strange-funny-taxes-throughout-the-world-and-history/> (last visited Feb. 12, 2014) (listing unusual taxes from Ancient Egypt to today).

⁸ Alan Farnham, *A Tax on Arrows? Nuttiest New Taxes*, ABC NEWS (Apr. 9, 2012), <http://abcnews.go.com/Business/strangest-taxes-50-states/story?id=16089204> (listing taxes on various items); see also Emma Beck, *Cutting That Bagel Will Cost You: Weird State Tax Laws*, USA TODAY (Mar. 31, 2013, 10:51 AM), <http://www.usatoday.com/story/money/personalfinance/2013/03/31/odd-state-tax-laws/1951911/> (listing taxes by state).

⁹ BURMAN & SLEMMOD, *supra* note 3, at 96 (defining “excise taxes” as consumption taxes on particular items, such as the taxation of diesel, tires, and airline tickets).

¹⁰ *Id.* (defining “sin taxes” as a subcategory of excise taxes that is specifically intended to discourage certain behavior, such as the taxation of alcohol, cigarettes, and gambling).

¹¹ *Id.* at 97 (defining “Pigouvian taxes” as taxation designed to reduce negative externalities, such as pollution, by setting the tax rate equal to the social damage caused).

¹² See, e.g., Jennifer Booton, *Online Gambling Won’t Solve State Debt Woes, But It Could Help*, FOX BUS. (June 25, 2012), <http://www.foxbusiness.com/technology/2012/06/22/online-gambling-might-not-solve-state-debt-but-it-could-help/> (quoting a tax specialist as saying “[a]lmost every state with few exceptions is struggling right now” and “[t]his is a source of tax revenue that people actually want to pay”).

¹³ *Id.*

and federal governments regulate it. Part II examines recent events that have altered the discussion, explains why the ban on online gambling has failed, and surveys states that already successfully tax gambling within their borders. Part III analyzes recent legislative attempts, considers the effects of legalization, and provides recommendations for moving forward.

I. WHAT HAS BEEN DONE?

Gambling is not a new phenomenon, dating back to antiquity.¹⁴ Dice have been recovered next to mummified bodies in Egyptian tombs,¹⁵ while the Chinese, Greeks, and Romans all were known to play games of skill and chance.¹⁶ A lottery was authorized in France in 1638, and casinos were legalized in the Republic of Venice that same year.¹⁷ In 1806, Napoleon legalized gambling clubs, raising millions of francs for the government.¹⁸ Gambling revenue has been used to finance numerous projects, such as the bridge over the Seine and the Continental Army of the American Revolution.¹⁹ In fact, when the English traveled to America they brought gambling with them, financing much of America's initial development through lotteries.²⁰ In more modern times, with the Internet proving to be the fastest growing mass transmission tool in history,²¹ it is no surprise that gambling has developed a foothold there, too.

¹⁴ See generally WILLIAM N. THOMPSON, *LEGALIZED GAMBLING: A REFERENCE HANDBOOK* 5 (2d ed. 1997). Interestingly, it has been argued that mankind's first real gamble dates back even further to Adam and Eve's choice to eat forbidden fruit from a tree in the Garden of Eden. VICKI ABT ET AL., *THE BUSINESS OF RISK: COMMERCIAL GAMBLING IN MAINSTREAM AMERICA* 4 (1985).

¹⁵ THOMPSON, *supra* note 14. Similarly, bone dice have been discovered in Native American ruins located in Arizona, New Mexico, and Utah. DAVID D. ALLEN, *THE NATURE OF GAMBLING* 35–36 (1952).

¹⁶ THOMPSON, *supra* note 14, at 5–6.

¹⁷ Charles T. Clotfelter, *Gambling Taxes*, in *THEORY AND PRACTICE OF EXCISE TAXATION* 84, 85 (Sijbren Cnossen ed., 2005).

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ ALLEN, *supra* note 15, at 44. The illegalization of lotteries in America did not begin until Pennsylvania and Massachusetts prohibited the sale of lottery tickets in 1833, with the last lottery company ceasing lottery ticket sales in 1890. *Id.* at 46. See generally THOMPSON, *supra* note 14, at 89–105 (providing a chronology of gambling history in the United States); THOMAS BARKER & MARJIE BRITZ, *JOKERS WILD: LEGALIZED GAMBLING IN THE TWENTY-FIRST CENTURY* (2000) (providing a history of gambling from the colonists to today).

²¹ JOHN LYMAN MASON & MICHAEL NELSON, *GOVERNING GAMBLING* 80 (2001). Radio did not reach fifty million users until it had been around for thirty-eight years, while it took television thirteen years to reach that same audience. *Id.* In contrast, the Internet reached fifty million users in only five years. *Id.*

A. State Regulation

Under their police powers, states have traditionally had almost unchecked authority to regulate gambling within their borders.²² The Supreme Court supported states' rights in *United States v. Edge Broadcasting Co.* when it stated that gambling is a vice that states have the right to ban, rather than a right that is constitutionally protected.²³ For this reason, the fifty states have taken various approaches to gambling, ranging from complete bans to full embraces.²⁴ For instance, while Delaware, Nevada, and New Jersey have recently legalized online gambling, in Hawaii and Utah all forms of gambling continue to be illegal.²⁵

B. Federal Regulation

In other areas of public policy, state and local governments are often restricted by conditions that the federal government puts on aid.²⁶ In regard to traditional gambling, however, the federal government has historically played the role of a passive observer.²⁷ For instance, the federal government stood by as a majority of states enacted lotteries, even those that were quasi-national such as Powerball and Big Game lotteries.²⁸ When the federal government has chosen to intervene, the legislation has been largely designed to support state law.²⁹

While federalism concerns are certainly valid in the context of traditional intrastate brick-and-mortar casino gambling, the argument is less applicable to online gambling—an activity that easily evades the regulation of a single state. Thus far, however, the federal government has failed to effectively determine its role in this area, even though *Wired Magazine* declared the Internet

²² See I. Nelson Rose, *Gambling and the Law: The International Law of Remote Wagering*, 40 J. MARSHALL L. REV. 1159, 1173 (2007).

²³ *United States v. Edge Broad. Co.*, 509 U.S. 418, 426 (1993).

²⁴ See *The United States of Gambling*, PEW CHARITABLE TR. (June 14, 2013), <http://www.pewstates.org/research/data-visualizations/the-united-states-of-gambling-85899483576> [hereinafter PEW] (providing an infographic of the gambling laws in all fifty states).

²⁵ *Id.*

²⁶ See, e.g., Kathryn A. McDermott & Laura S. Jensen, *Dubious Sovereignty: Federal Conditions of Aid and the No Child Left Behind Act*, 80 PEABODY J. EDUC. 39 (2005) (discussing the No Child Left Behind Act).

²⁷ See MASON & NELSON, *supra* note 21, at 79.

²⁸ *Id.*

²⁹ See CHARLES DOYLE, *INTERNET GAMBLING: OVERVIEW OF FEDERAL CRIMINAL LAW* (Susan Boriotti & Donna Dennis eds., 2003).

to be “gambling’s next frontier” back in 1995,³⁰ the same year the first gambling website opened.³¹

1. The Wire Act

The Federal Interstate Wire Act of 1961 (the “Wire Act”)³² prohibits the use of a wire communication to receive bets or to send gambling information.³³ For a violation of the Wire Act to occur: (1) the wire transmission must assist in the placing of a bet or wager, and (2) the defendant must have been engaged in the business of wagering during the time of the transmission.³⁴ Although the Wire Act has been applied to online gambling in the past,³⁵ a recent announcement by the Department of Justice (DOJ) limits its application to sports wagering.³⁶

2. The Travel Act

The Travel Act of 1961, which prohibits intentionally conducting unlawful activity using a facility of interstate commerce,³⁷ was enacted to help states effectively combat crime

³⁰ Evan I. Schwartz, *Wanna Bet?*, WIRED (Oct. 1995), http://www.wired.com/wired/archive/3.10/gambling_pr.html.

³¹ See *The Birth of Online Casino Gambling*, LEGISLATEGAMBLING.COM, <http://www.legislatetgambing.com/the-birth-of-online.html> (last visited Feb. 13, 2014).

³² 18 U.S.C. § 1084(a) (2012). See generally DAVID G. SCHWARTZ, CUTTING THE WIRE: GAMBLING PROHIBITION AND THE INTERNET (2005) (discussing how the Wire Act developed).

³³ The Federal Interstate Wire Act of 1961 states:

Whoever being engaged in the business of betting or wagering knowingly uses a wire communication facility for the transmission in interstate or foreign commerce of bets or wagers or information assisting in the placing of bets or wagers on any sporting event or contest, or for the transmission of a wire communication which entitles the recipient to receive money or credit as a result of bets or wagers, or for information assisting in the placing of bets or wagers, shall be fined under this title or imprisoned not more than two years, or both.

18 U.S.C. § 1084(a).

³⁴ *Id.*; see also Kiran S. Raj, *Drawing a Line in the Sand: How the Federal Government Can Work with the States to Regulate Internet Gambling*, 56 EMORY L.J. 777, 783 (2006) (stating the elements of the Wire Act); *Truchinski v. United States*, 393 F.2d 627, 630 (8th Cir. 1968) (same).

³⁵ See, e.g., *United States v. Cohen*, 260 F.3d 68, 76 (2d Cir. 2001) (“Cohen established two forms of wire facilities, internet and telephone, which he marketed to the public for the express purpose of transmitting bets and betting information . . . No matter what spin he puts on ‘transmission,’ his conduct violated the statute.”).

³⁶ See *infra* Part II.A.1.

³⁷ The Travel Act states:

Whoever travels in interstate or foreign commerce or . . . any facility in interstate or foreign commerce, with intent to . . . promote, manage, establish, [or] carry on . . . any unlawful activity . . . shall be fined under this title, imprisoned not more than 5 years, or both . . . “[U]nlawful activity” means . . . any business enterprise involving gambling, [or] liquor on which the Federal excise tax has not been paid . . .

18 U.S.C. § 1952 (2012).

that extended past their borders.³⁸ To prosecute an individual under the Travel Act, the government must prove that the defendant: (1) traveled interstate or used a facility of interstate commerce, (2) had the intention of promoting an unlawful activity, and (3) performed or attempted to perform an overt act in furtherance of the unlawful activity.³⁹ Ultimately, though, the Travel Act is antiquated in relation to the modern fight against online gambling. While courts have interpreted the term "facility" to include the use of the mail,⁴⁰ telephones,⁴¹ and newspapers,⁴² it remains unclear whether the Travel Act would apply to the use of wireless Internet.⁴³

3. Illegal Gambling Business Act

In an attempt to target organized crime,⁴⁴ Congress enacted the Illegal Gambling Business Act (the "IGBA")⁴⁵ as part of the Organized Crime Control Act of 1970.⁴⁶ The IGBA defines an illegal gambling business as any operation that: (1) violates state law,⁴⁷ (2) involves five or more persons, and (3) has been in continuous operation for more than thirty days or has gross revenue of \$2,000 in a single day.⁴⁸ The term gambling is defined as including, but not limited to, pool selling, bookmaking, slot machines, roulette, dice tables, lotteries, number games, and selling chances.⁴⁹ Seeing that most states currently have laws prohibiting online gambling,⁵⁰ the IGBA is a tool that can be used

³⁸ See *United States v. Nardello*, 393 U.S. 286, 290-91 (1969) (explaining the purpose of the Travel Act).

³⁹ See *United States v. Childress*, 58 F.3d 693, 719 (D.C. Cir. 1995) (stating the elements of the Travel Act).

⁴⁰ *United States v. Heacock*, 31 F.3d 249, 255 (5th Cir. 1994) (mailings).

⁴¹ *United States v. Villano*, 529 F.2d 1046, 1050-51 (10th Cir.) (telephones), *cert. denied*, 426 U.S. 953 (1976).

⁴² *United States v. Erlenbaugh*, 452 F.2d 967, 970-73 (7th Cir. 1971) (newspapers transported by train), *aff'd* 409 U.S. 239 (1972).

⁴³ See Mark B. Dubnoff, *State Bans on Internet Gambling May Be Unconstitutional*, 12 GAMING L. REV. & ECON. 207, 208-09 (2008) (arguing that the Travel Act does not apply to online gambling); Kraig P. Grahmann, *Betting on Prohibition: The Federal Government's Approach to Internet Gambling*, 7 NORTHWESTERN J. TECH. & INTELL. PROP. 162, 168 (2009) (same). But see Susanna F. Fischer, *Internet Gambling*, in 2 HANDBOOK OF INFORMATION SECURITY: INFORMATION WARFARE; SOCIAL, LEGAL, AND INTERNATIONAL ISSUES; AND SECURITY FOUNDATIONS 428, 435 (Hossein Bidgoli ed., 2006) (stating that commentators have argued the Travel Act should be interpreted broadly because it was enacted "to prohibit the use of interstate commerce for immoral or illegal purposes").

⁴⁴ H.R. REP. NO. 91-1549, at 1-2 (1970).

⁴⁵ 18 U.S.C. § 1955 (2012) ("Whoever conducts, finances, manages, supervises, directs, or owns all or part of an illegal gambling business shall be fined under this title or imprisoned not more than five years, or both.").

⁴⁶ Organized Crime Control Act of 1970, Pub. L. No. 91-452, 84 Stat. 922, 937.

⁴⁷ 18 U.S.C. § 1955(b).

⁴⁸ *Id.*

⁴⁹ *Id.*

⁵⁰ See PEW, *supra* note 24.

by the federal government to target online gambling operations—but it has its limitations. For instance, Congress intended for the IGBA to be used only against business-type operations that violated local state law,⁵¹ rather than individual bettors.⁵²

4. Unlawful Internet Gambling Enforcement Act

The Unlawful Internet Gambling Enforcement Act of 2006 (the “UIGEA”)⁵³ was added at the last minute as an unrelated rider to Title VIII of the SAFE Port Act,⁵⁴ which otherwise regulated port security.⁵⁵ The reported reasons for its passage were concerns about fraud, money laundering, pathological gambling, and underage gambling.⁵⁶ The UIGEA, however, does not directly regulate gambling; rather it prohibits any person from accepting money from someone who has engaged in “unlawful internet gambling.”⁵⁷ The UIGEA defines “unlawful internet gambling” as a bet or wager placed over the Internet that is unlawful under federal or state law.⁵⁸ The UIGEA,

⁵¹ See Richard P. Shafer, Annotation, *Requirement of 18 USCS § 1955, Prohibiting Illegal Gambling Businesses, That Such Businesses Involve Five or More Persons*, 55 A.L.R. FED. 778, 782 (1981).

⁵² See *United States v. Schullo*, 363 F. Supp. 246, 249–50 (D. Minn. 1973), *aff’d sub nom.* *U.S. v. Thomas*, 508 F.2d 1200 (8th Cir. 1975).

⁵³ Unlawful Internet Gambling Enforcement Act of 2006, 31 U.S.C. §§ 5361–67 (2012).

⁵⁴ Security and Accountability for Every Port Act of 2006, Pub. L. No. 109-347, 120 Stat. 1884.

⁵⁵ *Id.*; see also Edward Kim, *President Signs Bill Aimed at Limiting Online Gambling*, PBS NEWSHOUR (Oct. 13, 2006, 4:52 PM), http://www.pbs.org/newshour/updates/law/july-dec06/gambling_10-13.html.

⁵⁶ See Jonathon Conon, Comment, *Aces and Eights: Why the Unlawful Internet Gambling Enforcement Act Resides in “Dead Man’s” Land in Attempting to Further Curb Online Gambling and Why Expanded Criminalization is Preferable to Legalization*, 99 J. CRIM. L. & CRIMINOLOGY 1157, 1158 (2009).

⁵⁷ The UIGEA states that

[n]o person engaged in the business of betting or wagering may knowingly accept, in connection with the participation of another person in unlawful Internet gambling—(1) credit, or the proceeds of credit, extended to or on behalf of such other person (including credit extended through the use of a credit card); (2) an electronic fund transfer, or funds transmitted by or through a money transmitting business, or the proceeds of an electronic fund transfer or money transmitting service, from or on behalf of such other person; (3) any check, draft, or similar instrument which is drawn by or on behalf of such other person and is drawn on or payable at or through any financial institution; or (4) the proceeds of any other form of financial transaction, as the Secretary and the Board of Governors of the Federal Reserve System may jointly prescribe by regulation, which involves a financial institution as a payor or financial intermediary on behalf of or for the benefit of such other person.

31 U.S.C. § 5363 (2012).

⁵⁸ 31 U.S.C. § 5362(10)(a) (defining “unlawful internet gambling” as “to place, receive, or otherwise knowingly transmit a bet or wager by any means which involves the use, at least in part, of the Internet where such bet or wager is unlawful under any

however, includes many exceptions, such as games of skill,⁵⁹ fantasy sports,⁶⁰ and intrastate gambling.⁶¹

Despite the passage of the UIGEA, online gambling continues to grow in prevalence, especially among youth.⁶² The UIGEA's failure to accomplish its objectives stems from a lack of serious enforcement, vague terms,⁶³ numerous exemptions that imply a comprehensive online gambling ban was not intended, and the decision not to subject individual bettors to criminal penalties.⁶⁴

II. WHY SHOULD WE CARE?

A. Recent Events

1. The DOJ Announcement

For years, scholars and courts contested the reach of the Wire Act,⁶⁵ but in 2011 the DOJ announced that the Wire Act applied only to sports betting.⁶⁶ The announcement came after⁶⁷

applicable Federal or State law in the State or Tribal lands in which the bet or wager is initiated, received, or otherwise made").

⁵⁹ 31 U.S.C. § 5362(1)(A) (defining "bet or wager" as "the staking or risking by any person of something of value upon the outcome of a contest of others, a sporting event, or a game subject to chance, upon an agreement or understanding that the person or another person will receive something of value in the event of a certain outcome").

⁶⁰ 31 U.S.C. § 5362(1)(E)(ix) ("[B]et or wager . . . does not include . . . participation in any fantasy or simulation sports game or educational game . . .").

⁶¹ 31 U.S.C. § 5362(10)(B)(i) ("[U]nlawful internet gambling' does not include placing, receiving, or otherwise transmitting a bet or wager where . . . the bet or wager is initiated and received or otherwise made exclusively within a single State . . .").

⁶² See Dan Romer, *Internet Gambling Grows Among Male Youth Ages 18 to 22; Gambling Also Increases in High School Age Female Youth, According to National Annenberg Survey of Youth*, ANNENBURG PUB. POLY CENTER (Oct. 14, 2010), <http://editor.annenbergpublicpolicycenter.org/wp-content/uploads/Card-Playing-2010-Release-final.pdf>.

⁶³ See *Interactive Media Entm't & Gaming Ass'n v. Attorney Gen. of U.S.*, 580 F.3d 113, 114, 117 (3d Cir. 2009).

⁶⁴ See Conon, *supra* note 56, at 1159.

⁶⁵ See, e.g., *Establishing Consistent Enforcement Policies in the Context of Online Wagers: Hearing Before the H. Comm. on the Judiciary*, 110th Cong. 13–18 (2007) (statement of Catherine L. Hanaway, U.S. Attorney, Department of Justice) (insisting that under the Wire Act all online gambling by bettors was illegal); DOYLE, *supra* note 29, at 7 (stating that the case law interpreting the Wire Act is sparse and often conflicting).

⁶⁶ Memorandum from Virginia A. Seitz, Assistant Attorney Gen., Dep't of Justice, *Whether Proposals by Illinois and New York to Use the Internet and Out-of-State Transaction Processors to Sell Lottery Tickets to In-State Adults Violate the Wire Act* (Sept. 20, 2011) [hereinafter *DOJ Announcement*], available at <http://www.justice.gov/olc/2011/state-lotteries-opinion.pdf>; see also Nathan Vardi, *Department of Justice Flip-Flops on Internet Gambling*, FORBES (Dec. 23, 2011, 3:56 PM), <http://www.forbes.com/sites/nathavardi/2011/12/23/departement-of-justice-flip-flops-on-internet-gambling/> ("[T]he Department of Justice revealed that it had changed one of its most important and long-held positions on Internet gambling, stating that the federal Wire Act of 1961 only applies to sports betting.").

New York and Illinois, each seeking to enact state lotteries that would use out-of-state processors,⁶⁸ prompted the DOJ to resolve the possible conflict of law between the Wire Act and UIGEA.⁶⁹ Ultimately, the DOJ determined that it was not necessary to address this possible conflict; rather, it altered its interpretation to hold that the Wire Act applies only to sports wagering, not state lotteries.⁷⁰ This determination appears to have given approval to those states that wish to permit wholly intrastate, non-sports online gambling.⁷¹ For this reason, online gambling supporters hailed this announcement as a victory.⁷² As a result, a majority of experts agree that Congress is left with only two options: enact legislation of its own, or watch the states enact their own patchwork approach.⁷³

2. "Black Friday"

On April 15, 2011, the DOJ and the Federal Bureau of Investigation rocked the poker world⁷⁴ by disclosing its grand jury indictment of the three largest poker websites—PokerStars, Absolute Poker, and Full Tilt Poker—as well as their founders, payment processors, and a bank official.⁷⁵ Three defendants that

⁶⁷ In addition, the Fifth Circuit had also recently held that key statutory language in the Wire Act only referred to sports wagering. *In re MasterCard Int'l Inc.*, 313 F.3d 257, 262–63 (5th Cir. 2002).

⁶⁸ DOJ Announcement, *supra* note 66.

⁶⁹ See *supra* Parts I.B.1, I.B.4 (explaining that the Wire Act applies to intrastate activity, but the UIGEA does not).

⁷⁰ DOJ Announcement, *supra* note 66.

⁷¹ See Chad Holloway, *U.S. Department of Justice Opinion: Wire Act Only Applies to Sports Betting (Updated)*, POKERNEWS (Dec. 23, 2011), <http://www.pokernews.com/news/2011/12/us-department-of-justice-wire-act-applies-to-sporting-events-11711.htm>.

⁷² See Press Release, Poker Players Alliance, PPA Applauds DOJ Ruling: Online Poker Does Not Violate the Wire Act Calls on Congress to Act Quickly to Pass Federal Legislation (Dec. 23, 2011), available at <http://www.scribd.com/doc/76396794/Press-Release-PPA-Applauds-DoJ-Ruling-Online-Poker-Does-Not-Violate-the-Wire-Act-Calls-on-Congress-to-Act-Quickly-to-Pass-Federal-Legislation-12-2> (“[T]he leading poker grassroots advocacy group . . . today applauded the ruling by the U.S. Department of Justice that online poker does not violate the Wire Act.”).

⁷³ See GLOBAL GAMING EXPO, EXECUTIVE SUMMARY (2012) [hereinafter EXECUTIVE SUMMARY], available at http://www.americangaming.org/sites/default/files/uploads/docs/futurewatch/futurewatch_vol_10_exec_summ.pdf.

⁷⁴ See I. Nelson Rose, *Poker's Black Friday*, 15 GAMING L. REV. & ECON. 327, 327 (“The impact on the online gaming world was immediate and dramatic. Many players were panicked. ‘Headlines in the poker media say it all: “The Sh_t Hits the Fan,” “Poker Panic ‘11,” “Thunderstruck: The Day It All Changed for Online Poker.”’) (internal citation omitted).

⁷⁵ Press Release, U.S. Attorney S. Dist. of N.Y., Manhattan U.S. Attorney Charges Principals of Three Largest Internet Poker Companies with Bank Fraud, Illegal Gambling Offenses and Laundering Billions in Illegal Gambling Proceeds (Apr. 15, 2011) [hereinafter Black Friday Press Release], available at <http://www.justice.gov/usao/nys/pressreleases/April11/scheinbergetalindictmentpr.pdf>.

could be located in the United States were arrested.⁷⁶ The websites were charged with nine counts, including bank fraud, money laundering, and illegal gambling offenses.⁷⁷ The companies in question were accused of carrying out fraudulent transactional measures to circumvent the UIGEA's prohibition of money transfers from players to operators.⁷⁸ The federal government sought at least \$3 billion in forfeitures and penalties, and it seized approximately seventy-six bank accounts in fourteen countries that contained funds from the charged offenses.⁷⁹ In addition, five of the largest online poker sites had their domain names seized, which prevented players worldwide from using these websites.⁸⁰ Full Tilt Poker and PokerStars were able to use their domain names once again after they pledged to no longer serve U.S. players.⁸¹ Ultimately, however, Black Friday changed the landscape of online gambling. It resulted in a loss of marketing and advertising money, the loss of player sponsorship, lower competitor numbers for the World Series of Poker event, and major, reputable companies being replaced with small, black market operators.⁸²

3. *United States v. DiCristina*

On August 21, 2012, in *United States v. DiCristina*, the federal court for the Eastern District of New York overturned a defendant's conviction under the IGBA.⁸³ Lawrence DiCristina, a New York resident, had previously been convicted for operating a "No-Limit Texas Hold'em" game in the back of his warehouse.⁸⁴ The court, after conducting an extensive analysis, held that poker is a game of skill and therefore does not fall within the

⁷⁶ Rose, *supra* note 74, at 327. The online poker operators have since reached a settlement requiring the forfeiture of assets to reimburse "victims." Gary Wise, *PokerStars Settles, Acquires FTP*, ESPN (July 31, 2012, 5:25 PM), http://espn.go.com/poker/story/_/id/8218085/pokerstars-reaches-settlement-department-justice-acquires-full-tilt-poker. In addition, many of the individuals indicted have pled guilty and received reduced sentences. See, e.g., Chad Holloway, *Ray Bitar Pleads Guilty; Sentenced to Time Served and Must Forfeit Assets*, POKERNEWS (Apr. 15, 2013), <http://www.pokernews.com/news/2013/04/ray-bitar-pleads-guilty-sentenced-to-time-served-and-must-fo-14764.htm> (Ray Bitar, former Full Tilt Poker CEO); *Online Poker Middleman Pleads Guilty in NYC*, WALL ST. J. (Feb. 28, 2012, 4:39 PM), <http://online.wsj.com/article/APf9aa3157d00d4a128ab39dfb382d467e.html> (Ryan Lang, bank processor).

⁷⁷ Black Friday Press Release, *supra* note 75.

⁷⁸ *Id.*

⁷⁹ Rose, *supra* note 74, at 327.

⁸⁰ *Id.* at 329.

⁸¹ *Id.*

⁸² See Darren Rovell, *Insider Breakdown of Poker's Black Friday*, CNBC (Apr. 18, 2011, 3:06 PM), <http://www.cnbc.com/id/42649117/> (analyzing the effects of Black Friday).

⁸³ *United States v. DiCristina*, 886 F. Supp. 2d 164, 235 (E.D.N.Y. 2012).

⁸⁴ *Id.* at 168.

scope of the IGBA.⁸⁵ The court stated that the “fundamental question is not whether some chance or skill is involved in poker, but what element predominates.”⁸⁶ Relying on the “rule of lenity,”⁸⁷ the holding was based on the legal conclusion that the IGBA’s definition of gambling does not include games predominated by skill.⁸⁸ This ruling represented the first time a federal court had recognized poker as a game of skill,⁸⁹ and some authors at the time argued that it “may have blunted an arrow in the quiver of federal prosecutors.”⁹⁰

Perhaps predictably, on August 6, 2013, the Second Circuit overturned the lower court’s ruling.⁹¹ The court held that whether or not poker was expressly included in the IGBA was inconsequential, statling all that is required under the IGBA is that state law prohibit the activity.⁹² While the ruling will allow the DOJ to continue prosecuting poker operations under the IGBA, many in the gambling community maintain that there is a “silver lining”: the court did not reverse the lower court’s finding that poker is a game of skill, it merely held that fact to be inconsequential under an IGBA analysis.⁹³ According to Poker Player Alliance’s Executive Director John Pappas, that poker is a game of skill “is a key point distinguishing poker from the types of gambling games that Congress and state legislatures have often tried to prohibit” and the decision only furthers the “growing call for federal clarity on the definition of gambling.”⁹⁴

⁸⁵ *Id.* at 234–35.

⁸⁶ *Id.* at 231.

⁸⁷ *Id.* at 199–200. As the Supreme Court stated in *United States v. Bass*, when it is unclear what Congress has made criminal “it is appropriate, before we choose the harsher alternative, to require that Congress should have spoken in language that is clear and definite.” *United States v. Bass*, 404 U.S. 336, 347 (1971) (quoting *Rewis v. United States*, 401 U.S. 808, 812 (1971)). Therefore, “ambiguity concerning the ambit of criminal statutes should be resolved in favor of lenity.” *Id.* (quoting *United States v. C. I. T. Credit Corp.*, 344 U.S. 218, 221–22 (1952)).

⁸⁸ *DiCristina*, 886 F. Supp. 2d at 226–29.

⁸⁹ See Press Release, Poker Players Alliance, PPA Applauds Federal Court Ruling that Poker Is a Game of Skill and Not Illegal Gambling (Aug. 21, 2012), available at <http://theppa.org/press-releases/2012/08/21/press-release-ppa-applauds-federal-court-ruling-that-poker-is-a-game-of-skill-and-not-illegal-gambling-08212012/>.

⁹⁰ LINDA J. SHOREY & ANTHONY R. HOLTZMAN, WHEN IS GAMBLING NOT GAMBLING?: AN EXAMINATION OF *UNITED STATES V. DiCRISTINA* 7 (2012), available at <http://www.jd-supra.com/legalnews/when-is-gambling-not-gambling-an-examin-90466/>.

⁹¹ *United States v. DiCristina*, 726 F.3d 92, 106 (2d. Cir. 2013), cert. denied, 134 S. Ct. 1281 (2014).

⁹² *Id.* at 98–99.

⁹³ Matthew Kredell, *U.S. Appeals Court Overrules Decision in Lawrence DiCristina Poker Case*, POKERNEWS (Aug. 6, 2013), <http://www.pokernews.com/news/2013/08/u-s-appeals-court-overrules-decision-in-lawrence-dicristina-16052.htm>.

⁹⁴ *Id.*

4. States Growing Impatient

While efforts to pass a national bill have stalled, states appear to be racing to legalize online gambling.⁹⁵ As previously mentioned, several states have recently passed laws allowing online gambling within their borders,⁹⁶ and on April 30, 2013, Nevada officially launched the nation's first legal gambling website.⁹⁷ Other states, such as Delaware and New Jersey, quickly followed suit, launching their own websites later that same year.⁹⁸ In addition, lawmakers in California, Hawaii, Illinois, Iowa, Massachusetts, Mississippi, Pennsylvania, and Texas are reportedly considering similar proposals.⁹⁹ And, since states often look to neighboring states when facing a common problem,¹⁰⁰ this trend will likely continue. This state-by-state approach raises concerns, however, because a majority of experts agree that it will negatively impact potential online operators' businesses.¹⁰¹

⁹⁵ For a comprehensive list of recent state legislation, see STEVEN TITCH, *INTERNET GAMBLING: KEYS TO A SUCCESSFUL REGULATORY CLIMATE* app. A at 20–27 (2012), available at http://reason.org/files/internet_gambling_regulation.pdf.

⁹⁶ See Colleen Curry, *Pokerstars' Bid to Buy Casino Could Signal Gambling Gold Rush*, ABC NEWS (Mar. 12, 2013), <http://abcnews.go.com/Business/pokerstars-bid-buy-casino-signal-gambling-gold-rush/story?id=18702613>; Sue Zeidler, *Congress in a Race with States to Pass Online Gambling Law*, REUTERS (Mar. 8, 2013, 8:21 PM), <http://www.reuters.com/article/2013/03/09/net-us-onlinepoker-federal-idUSBRE92800M20130309/>.

⁹⁷ See Bill O'Driscoll, *Nevada Opens Door of Online Gambling with Poker Launch*, USA TODAY (Apr. 30, 2013, 1:08 PM), <http://www.usatoday.com/story/news/nation/2013/04/30/nevada-poker-online-gambling/2123213/>. Gaming is currently limited to poker, and players must be at least twenty-one years old and within the state's borders in order to participate. *Id.*

⁹⁸ Brett Collson, *Delaware Becomes First State to Launch Full-Scale Real-Money Online Gambling*, POKERNEWS (Nov. 8, 2013), <http://www.pokernews.com/news/2013/11/delaware-becomes-first-state-to-launch-full-scale-gambling-16741.htm> (noting that on November 8, 2013, Delaware became the second state to launch gambling websites); Colleen Curry, *Online Gambling Rolls the Dice in New Jersey Today*, USA TODAY (Nov. 26, 2013), <http://abcnews.go.com/US/online-gambling-rolls-dice-jersey-today/story?id=21016842> (noting that on November 26, 2013, New Jersey became the third state to launch gambling websites).

⁹⁹ See *2013 Legislation Regarding Internet Gambling and Lotteries*, NCSL (Dec. 20, 2013), <http://www.ncsl.org/issues-research/econ/2013onlinegaminglegislation.aspx>.

¹⁰⁰ See MASON & NELSON, *supra* note 21, at 14 (discussing diffusion theory as applied to state policy). Political scientists have found that a state is more likely to adopt a lottery of its own if the surrounding states have done the same. See Frances Stokes Berry & William D. Berry, *State Lottery Adoptions as Policy Innovations: An Event History Analysis*, 84 AM. POL. SCI. REV. 395, 410–11 (1990). For example, after Illinois created a lottery, neighboring states like Iowa, Indiana, and Wisconsin enacted lotteries of their own. See MASON & NELSON, *supra* note 21, at 38.

¹⁰¹ See EXECUTIVE SUMMARY, *supra* note 73 (reporting that a state-by-state approach would result in liquidity issues and a lack of consistent regulation).

B. Prohibition Is Not Working

Despite the passage of the UIGEA¹⁰² and the events of “Black Friday,”¹⁰³ ten million Americans were estimated to have gambled online in 2011.¹⁰⁴ That same year, Americans were estimated to have spent \$4 billion on online gambling,¹⁰⁵ while the global online gambling market saw revenue of over \$33 billion.¹⁰⁶ In addition, Americans are estimated to spend more than \$100 billion annually through offshore websites with no consumer protection or taxation benefits for the United States.¹⁰⁷ Just as the prohibitions of alcohol¹⁰⁸ and prostitution¹⁰⁹ have been dismal failures, the prohibition of online gambling does not prevent such activity.¹¹⁰ To the contrary, attempted enforcement simply exhausts valuable government resources, while requiring taxpayers to foot the increased bill.¹¹¹

Representative Jim McDermott (D-WA) summarized this issue at a recent hearing of the House Ways and Means Committee: “Prohibition hasn’t prevented the millions of Americans who want to gamble online from doing it. It has forced online gambling operators to work offshore, it has put consumers

¹⁰² See *supra* Part I.B.4.

¹⁰³ See *supra* Part II.A.2.

¹⁰⁴ Richard Grenell, *It’s Time to Tax Internet Gambling and Make It Legal*, HUFFINGTON POST (Nov. 8, 2011, 4:39 PM), http://www.huffingtonpost.com/richard-grenell/tax-internet-gambling_b_1082598.html.

¹⁰⁵ EXECUTIVE SUMMARY, *supra* note 73.

¹⁰⁶ MARKETLINE, GLOBAL ONLINE GAMBLING: MARKETLINE INDUSTRY PROFILE (2012) (analysis of the global market).

¹⁰⁷ See Michelle Hirsch, *Internet Gambling: Betting on New Tax Revenue*, FISCAL TIMES (May 20, 2010), <http://www.thefiscaltimes.com/Articles/2010/05/20/Internet-Gambling-Betting-on-New-Tax-Revenue#page1>.

¹⁰⁸ See Michael Lerner, *Unintended Consequences*, PBS, <http://www.pbs.org/kenburns/prohibition/unintended-consequences/> (last visited Feb. 12, 2014) (analyzing the negative consequences that resulted from alcohol prohibition). Furthermore, Mark Thornton, an economist, has stated that the alcohol prohibition was a disaster because [a]lcohol became more dangerous to consume; crime increased and became “organized”; the court and prison systems were stretched to the breaking point; and corruption of public officials was rampant. No measurable gains were made in productivity or reduced absenteeism. Prohibition removed a significant source of tax revenue and greatly increased government spending.

Guy Calvert, *The Government Should Respect Individuals’ Freedom to Gamble*, in GAMBLING: OPPOSING VIEWPOINTS 144, 153 (James D. Torr ed., 2002); see also Rose, *supra* note 74 (“It is important to remember that not only did Prohibition create modern organized crime, it did not stop people from drinking.”).

¹⁰⁹ See *The Prostitution Statistics You Have to Know*, LAWS.COM, <http://sex-crimes.laws.com/prostitution/prostitution-statistics> (last visited Feb. 10, 2014) (estimating that 10% of men have “purchased” a prostitute and that prostitutes suffer from a murder rate twenty times higher than the national average).

¹¹⁰ See Romer, *supra* note 62 (examining the increase in gambling among youth in recent years).

¹¹¹ See Calvert, *supra* note 108, at 153–54 (examining the “perils of prohibition”).

at risk, and it sends billions in dollars of revenue to other nations.”¹¹² He continued, “We tried prohibition in the 1920s and it didn’t work. This is the same case with gambling. Why not legalize it and tax it just like you do alcohol or cigarettes or a lot of other things?”¹¹³ The prohibition of online gambling has not, and will not, stop the activity; rather, it will simply push the activity overseas.¹¹⁴

C. States Already Tax Gambling

In 2011, brick-and-mortar casinos contributed \$7.93 billion in tax revenue to state and local governments, representing a 4.5% increase from the year before.¹¹⁵ H2 Gambling Capital, the leading data supplier regarding global gambling, projects that regulating most forms of online gambling in the United States would generate revenue of \$67 billion over five years.¹¹⁶ Other estimates that involve solely online poker reveal it is a \$6 billion a year business, providing states with an opportunity to take a piece of the pie.¹¹⁷ In addition, 47% of community leaders nationwide have reported that the introduction of casinos within their jurisdiction surpassed their expectations, and 70% have stated that casinos are a good source of tax revenue.¹¹⁸

For instance, in 2011, Pennsylvania trumped all other states with the most tax revenue from commercial casinos, collecting close to \$1.5 billion.¹¹⁹ Currently, for every dollar produced as revenue from slot machines, \$0.55 is returned to

¹¹² Hirsch, *supra* note 107.

¹¹³ *Id.*

¹¹⁴ See Tom W. Bell, *The Government Should Not Prohibit Gambling on the Internet*, in GAMBLING: OPPOSING VIEWPOINTS, *supra* note 108, at 164, 168–69 (explaining how online gambling can escape domestic prohibitions).

¹¹⁵ Booton, *supra* note 12; see also AM. GAMING ASS’N, 2013 STATE OF THE STATE: THE AGA SURVEY OF CASINO ENTERTAINMENT 6 (2013) [hereinafter STATE OF THE STATE], available at http://www.americangaming.org/sites/default/files/uploads/docs/aga_sos2013_fnl.pdf (comparing state tax revenue between 2011 and 2012).

¹¹⁶ Congressional Hearing Focuses on Need for Internet Gambling Regulation to Protect Consumers, SAFEANDSECUREIG.ORG (Oct. 25, 2011), <http://safeandsecureig.org/content/congressional-hearing-focuses-need-internet-gambling-regulation-protect-consumers/>.

¹¹⁷ Booton, *supra* note 12. Randy Fine, managing director of the largest management and consulting firm in the gaming industry, was quoted as stating, “I’ve heard estimates of online poker being a \$6 billion a year business, if a state could take a third, that’s \$2 billion.” *Id.*

¹¹⁸ Melissa Daniels, *PA Gambling Tax Revenue Highest in the Country*, PENNSYLVANIA INDEP. (June 1, 2012), <http://paindependent.com/2012/06/pa-gambling-tax-revenue-highest-in-the-country/>.

¹¹⁹ Matt Assad, *Pennsylvania Leads the Way in Casino Taxes*, MORNING CALL (May 29, 2012), http://articles.mcall.com/2012-05-29/news/mc-pennsylvania-gambling-casino-taxes-20120529_1_tax-rate-property-tax-rebates-tax-bill.

Pennsylvanians¹²⁰ for real property tax relief, economic development, tourism development, a volunteer fire company grant program, and a gambling addiction program.¹²¹

In Nevada, gambling was legalized in March of 1931 in response to the Great Depression.¹²² Since then, the state has arguably become the entertainment and gambling capital of the world, receiving a majority of its tax revenue from gambling taxation.¹²³ For instance, in 2012, Nevada received \$868 million in tax revenue with a maximum tax rate of 6.75%, which went to programs like education, problem gambling programs, and local governments.¹²⁴

That same year, New York acquired over \$822 million in gambling tax revenue, which went mainly to fund educational programs.¹²⁵ Thanks to New York's 68% tax rate, the state collected \$620 million in revenue from gambling during the first half of 2012 alone.¹²⁶ And since the first casino opened over a decade ago, gambling has generated approximately \$5 billion in tax revenue for the state.¹²⁷

Likewise, in 2012, Louisiana experienced almost \$580 million in tax revenue with a 21.5% tax rate, which helped to fund the city of New Orleans, public retirement programs, and the general fund.¹²⁸ In addition, over 40% of the police budget for the state comes from gambling taxes;¹²⁹ and in 2001, gambling

¹²⁰ *Gaming Benefits for Pennsylvanians*, PA. GAMING CONTROL BOARD, <http://gamingcontrolboard.pa.gov/?p=52> (last visited Feb. 12, 2014); see also *Pennsylvania*, AM. GAMING ASS'N, <http://www.americangaming.org/industry-resources/state-information/pennsylvania> (last visited Feb. 12, 2014).

¹²¹ *Pennsylvania*, *supra* note 120.

¹²² See *This Day in History: Nevada Legalizes Gambling*, HIST. CHANNEL, <http://www.history.com/this-day-in-history/nevada-legalizes-gambling> (last visited Feb. 12, 2014).

¹²³ *Id.*

¹²⁴ *Nevada*, AM. GAMING ASS'N, <http://www.americangaming.org/industry-resources/state-information/nevada> (last visited Feb. 12, 2014).

¹²⁵ *New York*, AM. GAMING ASS'N, <http://www.americangaming.org/industry-resources/state-information/new-york> (last visited Feb. 12, 2014).

¹²⁶ Carl Campanile, *Slots o' Luck Nets NY \$620M in Taxes*, N.Y. POST (July 24, 2012, 4:00 AM), http://www.nypost.com/p/news/local/slots_luck_nets_ny_in_taxes_sh7g72jAWEoM1ZHbu0qk5J.

¹²⁷ Since implementation in 2004, gambling in New York has generated \$4.6 billion in aid to education and over \$198 million in aid to local governments. *New York Gaming Association*, N.Y. GAMING ASS'N, <http://newyorkgaming.org/investing-education> (last visited Apr. 20, 2014) (education); *New York Gaming Association*, N.Y. GAMING ASS'N, <http://newyorkgaming.org/investing-gov> (last visited Apr. 20, 2014) (local governments).

¹²⁸ *Louisiana*, AM. GAMING ASS'N, <http://www.americangaming.org/industry-resources/state-information/louisiana> (last visited Feb. 15, 2014).

¹²⁹ *How Louisiana Wins*, LA. CASINO ASS'N, <http://www.casinosofla.com/how-louisiana-wins.asp> (last visited Feb. 15, 2014).

tax revenue helped fund a \$50 million teacher pay increase.¹³⁰ Overall, since 1994, riverboats have contributed over \$2.02 billion in state taxes and \$557 million in local taxes.¹³¹

In 2012, with a graduated tax rate ranging from 15% to 40%, Indiana received \$806 million in tax revenue. In 2009, gambling revenue accounted for about 5% of the state's general fund, and has been used to help fund economic development and local governments.¹³² Overall, since legalization in 1990, gambling taxation has brought in over \$10 billion for the state.¹³³

With a relatively low tax rate of 8% to 12%, the state of Mississippi received \$272 million in gambling revenue in 2012. This revenue helped fund programs such as housing, education, transportation, health care, youth counseling, and public safety.¹³⁴ Moreover, between 2006 through 2009 the state received over \$1 billion in revenue from gambling taxation.¹³⁵

When considering these numbers, it is important to remember that legalization will likely further increase the amount that consumers are willing to spend on gambling. For instance, in California, tribal casinos received legal status in 2000, and by 2004 their gross revenue had increased from \$1.4 billion to \$6 billion.¹³⁶ During that same period, however, revenue for casinos in Nevada remained steady, establishing that the new revenue source in California did not stem from depletions at competing casinos.¹³⁷ The legalization of online gambling would likely create a similar effect.¹³⁸ In fact, the United States market is expected to reach \$14 to \$17 billion

¹³⁰ *Id.*; see also Kay Bell, *Louisiana Gambling Could Fund Teachers*, BANKRATE (Mar. 15, 2001), <http://www.bankrate.com/brm/itax/state/20010315a.asp> (stating that teachers would receive, on average, a \$2,000 pay raise).

¹³¹ See *How Louisiana Wins*, *supra* note 129.

¹³² *Indiana*, AM. GAMING ASS'N, <http://www.americangaming.org/industry-resources/state-information/indiana> (last visited Feb. 15, 2014); see also IND. LEGISLATIVE SERVS. AGENCY, OFFICE OF FISCAL & MGMT. ANALYSIS, *INDIANA HANDBOOK OF TAXES, REVENUES, AND APPROPRIATIONS 3* (2009), available at http://www.in.gov/legislative/pdf/TaxHandbook09_online.pdf (providing an in-depth analysis of Indiana revenue for fiscal year 2009).

¹³³ See Christine Davies, *Indiana Eyes Casino Expansion*, POKER SITES, <http://www.uspokersites.com/poker-news/indiana-eyes-casino-expansion/419> (last visited Feb. 15, 2014).

¹³⁴ *Mississippi*, AM. GAMING ASS'N, <http://www.americangaming.org/industry-resources/state-information/mississippi> (last visited Feb. 15, 2014).

¹³⁵ See *Mississippi Tax Analysis: Gaming Industry Pays \$1 Billion over Last Three Years*, MISS. GAMING LAW (Dec. 28, 2009), <http://msgaminglaw.com/mississippi-tax-analysis-gaming-industry-pays-1-billion-over-last-three-years/>.

¹³⁶ See William R. Eadington, *The Future of Online Gambling in the United States and Elsewhere*, 23 J. PUB. POL'Y & MARKETING 214, 216 (2004).

¹³⁷ *Id.*

¹³⁸ For a brief discussion about cannibalization, see *infra* Part III.B.3.

annually by 2018, if Congress passes legislation legalizing and regulating online poker.¹³⁹

III. WHAT SHOULD WE DO?

A. Proposed Legislation

Multiple federal legislative proposals have recently attempted to deal with the online gambling crises, none of which have proven successful—yet.

In 2009, Representative Barney Frank (D-MA) introduced the Internet Gambling Regulation, Consumer Protection, and Enforcement Act.¹⁴⁰ The proposal was designed to roll back the UIGEA because, as Frank stated, “Americans ought to be free to do what they wish without this kind of intrusion.”¹⁴¹ The proposal, however, was not a free-for-all—it prohibited those who had previously violated the law from receiving licenses, banned sports betting, prohibited the use of credit cards to make bets, and required safeguards to prevent underage and compulsive gambling.¹⁴² The bill died in committee.¹⁴³

Likewise, Representative Jim McDermott (D-WA) introduced the Internet Gambling Regulation and Tax Enforcement Act in 2011.¹⁴⁴ The proposal required online gambling operators to pay a 2% tax to the federal government and a 6% tax to states,¹⁴⁵ earning the federal government an estimated \$42 billion over ten years.¹⁴⁶ Under this plan, revenue was slated to go to state social service programs, such as foster care and children’s health insurance.¹⁴⁷ However, the proposal depended on full house passage of Representative Frank’s proposal,¹⁴⁸ and ultimately died in committee.¹⁴⁹

¹³⁹ EXECUTIVE SUMMARY, *supra* note 73.

¹⁴⁰ H.R. 2267 (111th): *Internet Gambling Regulation, Consumer Protection, and Enforcement Act*, GOVTRACK.US, <http://www.govtrack.us/congress/bills/111/hr2267> (last visited Feb. 15, 2014) [hereinafter H.R. 2267].

¹⁴¹ Catherine Dodge, *House Panel Passes Measure to Legalize Some Internet Gambling*, BLOOMBERG (July 28, 2010, 9:00 PM), <http://www.bloomberg.com/news/2010-07-28/house-panel-passes-frank-backed-measure-to-legalize-some-internet-gambling.html>.

¹⁴² *Id.*

¹⁴³ H.R. 2267, *supra* note 140.

¹⁴⁴ H.R. 2230 (112th): *Internet Gambling Regulation and Tax Enforcement Act of 2011*, GOVTRACK.US, <http://www.govtrack.us/congress/bills/112/hr2230> (last visited Feb. 15, 2014) [hereinafter H.R. 2230].

¹⁴⁵ Dodge, *supra* note 141.

¹⁴⁶ Hirsch, *supra* note 107.

¹⁴⁷ *Id.*

¹⁴⁸ Dodge, *supra* note 141.

¹⁴⁹ H.R. 2230, *supra* note 144.

The next year, in 2012, Senator Harry Reid (D-NV) and Former Senator Jon Kyl (R-AZ) proposed the Internet Gambling Prohibition, Poker Consumer Protection, and Strengthening UIGEA Act.¹⁵⁰ Contrary to previous proposals, this bill would have strengthened the UIGEA for all gambling activity except poker and horse racing.¹⁵¹ In addition, it would have amended the Wire Act and the IGBA to apply to all forms of unlicensed online gambling.¹⁵² The proposal was set to tax online poker activity at a rate of 16%—the states were to receive 14% of this tax, while the federal government was to receive 2%¹⁵³—with the federal share being allocated to a regulatory agency tasked with oversight and enforcement.¹⁵⁴ The bill also required licensees to report and withhold online poker winnings in order to ensure that players paid applicable taxes on their winnings.¹⁵⁵ Ultimately, though, the bill was pronounced dead at the end of the 2012 lame-duck session of Congress.¹⁵⁶

Most recently, Representative Joe Barton (R-TX) introduced the Internet Poker Freedom Act of 2013,¹⁵⁷ which would establish the Office of Internet Poker Oversight within the Department of Commerce in order to license and regulate poker websites.¹⁵⁸ The proposed legislation references *United States v. DiCristina*¹⁵⁹ to bolster its argument that poker, as a game of skill, is inherently different, and therefore safer, than other forms of gambling.¹⁶⁰ The legislation would require poker websites to demonstrate that

¹⁵⁰ Matthew Kredell, *Summary Text of Reid-Kyl Internet Gambling Bill Goes Public*, POKERNEWS (Sept. 14, 2012), <http://www.pokernews.com/news/2012/09/summary-text-of-reid-kyl-internet-gambling-bill-13407.htm>.

¹⁵¹ *Id.*

¹⁵² *Id.*

¹⁵³ Nick Jones, *The Reid/Kyl Online Poker Bill Revealed*, POKERFUSE (Sept. 12, 2012), <http://pokerfuse.com/news/law-and-regulation/the-reidkyl-bill-revealed/>.

¹⁵⁴ *Id.*

¹⁵⁵ Michael Jones, *Summary of Reid/Kyl Online Poker Bill Surfaces*, PART TIME POKER (Sept. 13, 2012), <http://www.parttimepoker.com/summary-of-reidkyl-online-poker-bill-surfaces>.

¹⁵⁶ Todd Wilkins, *Reid-Kyl Bill Laid to Rest*, POKERSITES (Dec. 18, 2012), <http://www.pokersites.us/reid-kyl-bill-laid-to-rest/>.

¹⁵⁷ Representative Barton introduced similar legislation in 2011, but it never made it out of committee. See H.R. 2366 (112th): *Internet Gambling Prohibition, Poker Consumer Protection, and Strengthening UIGEA Act of 2011*, GOVTRACK.US, <http://www.govtrack.us/congress/bills/112/hr2366> (last visited Feb. 15, 2014).

¹⁵⁸ See Internet Poker Freedom Act of 2013, H.R. 2666, 113th Cong. § 103(b) (2013) [hereinafter H.R. 2666], available at <http://www.gpo.gov/fdsys/pkg/BILLS-113hr2666ih/pdf/BILLS-113hr2666ih.pdf>.

¹⁵⁹ See *supra* Part II.A.3.

¹⁶⁰ See Darren Heitner, *U.S. Government Seeks To Set Internet Poker Free . . . Through New Regulations*, FORBES (July 15, 2013, 9:45 AM), <http://www.forbes.com/sites/darrenheitner/2013/07/15/u-s-government-seeks-to-set-internet-poker-free-through-new-regulations/>; see also Anjeanette Damon, *Congressman Takes One More Run at Legalizing Online Poker*, LAS VEGAS SUN (July 17, 2013, 2:00 AM), <http://www.lasvegassun.com/news/2013/jul/17/congressman-takes-one-more-run-legalizing-online-p/>.

they have the appropriate safeguards in place—including age and jurisdictional verifications,¹⁶¹ and anti-cheating devices—before being offered a license.¹⁶² Those associated with an operation without a license would be subject to fines and/or imprisonment.¹⁶³ The bill would also prohibit the use of credit cards in order to prevent players from amounting large quantities of debt.¹⁶⁴ Lastly, a license would only be valid for five years,¹⁶⁵ allowing for repeated inquiry into, and verification of, the websites safeguards. Unlike previous proposals, Representative Barton's bill does not establish an overall tax rate; rather, authorities at the state level are left to make this critical determination.¹⁶⁶

Representative Barton's bill is currently being considered by a congressional committee, where it is projected to have a mere 2% chance of enactment.¹⁶⁷ Moreover, following his bill's failure, Senator Reid has publicly stated that he believes "the chances of legalizing online poker at the federal level are exceedingly slim."¹⁶⁸ Representative Barton, on the other hand, remains optimistic that some form of federal legislation is in our future, stating: "I can't say when that general mass will occur, but I can

¹⁶¹ Representative Barton's proposal would allow licensed websites to operate on a national level, with an opt-out provision for states that choose not to participate. See *Internet Poker Freedom Act Aims for Federal Regulation*, INDIAN COUNTRY (July 14, 2013), <http://indiancountrytodaymedianetwork.com/2013/07/14/internet-poker-freedom-act-aims-federal-regulation-150412>.

¹⁶² See Heitner, *supra* note 160.

¹⁶³ See *id.*

¹⁶⁴ See Matthew Kredell, *Rep. Joe Barton: U.S. Federal Online Poker Legislation Not Far Away*, POKERNEWS (July 18, 2013), <http://www.pokernews.com/news/2013/07/rep-joe-barton-federal-online-poker-legislation-not-far-away-15955.htm>.

¹⁶⁵ See Heitner, *supra* note 160. In June, Representative King (R-TX) introduced similar legislation entitled the Internet Gambling Regulation, Consumer Protection and Enforcement Act of 2013. *H.R. 2282: Internet Gambling Regulation, Consumer Protection and Enforcement Act of 2013*, GOVTRACK.US, <https://www.govtrack.us/congress/bills/113/hr2282> (last visited Feb. 15, 2014) [hereinafter *H.R. 2282*]. Like Representative Barton's bill, it would establish a federal regulatory scheme for online gambling websites and would punish those websites that operate without a proper license. Julian Hattem, *King, Capuano Looking for Online Gambling Bill Cosponsors*, HILL (July 31, 2013, 2:53 PM), <http://thehill.com/blogs/regwatch/legislation/314761-king-capuano-looking-for-online-gambling-bill-cosponsors> (discussing the contents of the bill). A chief difference is that it would legalize all forms of gambling, except sports betting. *Id.* However, like Representative Barton's bill, it is currently sitting in committee. *H.R. 2282, supra* (providing the status of the bill).

¹⁶⁶ See *H.R. 2666, supra* note 158; see also Nick Jones, *Barton's New Federal Online Poker Bill Introduced*, POKERFUSE (July 12, 2013), <http://pokerfuse.com/news/law-and-regulation/bartons-new-federal-online-poker-bill-introduced-12-07/>. Presumably, omitting an overarching tax rate is meant to entice otherwise hesitant states to participate rather than opt-out.

¹⁶⁷ See *H.R. 2666, supra* note 158.

¹⁶⁸ Damon, *supra* note 160.

say it will occur and that it won't be 20 years from now. It will be, if not next year, the year after or soon after that."¹⁶⁹

B. Striking a Balance

While raising revenue is an important governmental objective, it is not the only consideration. Accordingly, both proponents and opponents of legalized online gambling raise many public policy arguments in support of their positions. On the one hand, gambling serves as a form of entertainment that has been used to raise funds for many years.¹⁷⁰ On the other hand, gambling has been condemned as one of society's worst vices.¹⁷¹ Ultimately, industry experts are confident that effective safeguards exist that can be implemented to dissuade opponents' concerns.¹⁷²

1. Addiction

It was researcher Robert Detlefsen who perhaps summed it up best when he said, "We have alcoholics, shopaholics, and workaholics in our midst, and thus far we have not seen fit to ban the activities that cause these maladies. Why should gambling be different?"¹⁷³ In response, opponents of prohibition argue that online gambling is equivalent to "crack cocaine"¹⁷⁴ for those prone to excessive gambling,¹⁷⁵ because it makes gambling

¹⁶⁹ Kredell, *supra* note 164.

¹⁷⁰ See *supra* Part I, II.C.

¹⁷¹ See generally ALLEN, *supra* note 15, at 123-25 (arguing that gambling is a harmful activity that should be suppressed by the government); EDMUND BERGLER, *THE PSYCHOLOGY OF GAMBLING* 18-19 (1958) (arguing that gamblers are neurotic and weak individuals with an unconscious wish to lose). In many ways, though, the morality issue is beside the point—if gambling is a vice then that is a matter for religious groups, individuals, and each state to decide for itself. See Danny Sheridan, *The Government Should Not Ban Betting on College Sports*, in *GAMBLING: OPPOSING VIEWPOINTS*, *supra* note 108, at 180, 181 (arguing that the government should not ban betting on college sports because "in a free society people do these things, sometimes to excess").

¹⁷² EXECUTIVE SUMMARY, *supra* note 73.

¹⁷³ Timothy A. Kelly, *Chapter Preface: The Government Should Halt the Spread of Legalized Gambling*, in *GAMBLING: OPPOSING VIEWPOINTS*, *supra* note 108, at 130, 130.

¹⁷⁴ *Id.* at 139. One researcher stated, "As smoking crack cocaine changed the cocaine experience, I think electronics is going to change the way gambling is experienced." *Id.*; see also John Kyl, *The Government Should Prohibit Gambling on the Internet*, in *GAMBLING: OPPOSING VIEWPOINTS*, *supra* note 108, at 156, 163 ("It's the crack cocaine of creating new pathological gamblers."). Crack cocaine is purported to be the riskiest form of cocaine. *The Truth About Crack Cocaine*, FOUND. FOR A DRUG-FREE WORLD, <http://www.drugfreeworld.org/drugfacts/crackcocaine.html> (last visited Feb. 15, 2014). It is 75% to 100% pure, thereby reaching the brain more quickly and causing more rapid addiction. *Id.*

¹⁷⁵ The American Psychiatric Association has created three categories that classify individuals based on the severity of their gambling disorder. AM. PSYCHIATRIC ASS'N, *DIAGNOSTIC AND STATISTICAL MANUAL OF MENTAL DISORDERS (DSM-IV-TR)* 671 (4th ed. 2000). Level 3 gamblers are considered "pathological gamblers," suffering from a persistent and recurring failure to resist gambling behavior that is harmful to the

easy to do from the comfort of one's own home.¹⁷⁶ Numerous studies, however, have found that the prevalence rate of pathological gambling is only approximately 1% of the United States's population,¹⁷⁷ a prevalence rate much lower than that of alcohol abuse.¹⁷⁸ Furthermore, the prevalence rate of pathological gambling has remained steady even during periods of gambling expansion.¹⁷⁹ In addition to the low prevalence rate, the social costs of problem and pathological gambling on average are estimated to be only about \$900 per year, per gambler.¹⁸⁰

individual and others. *Id.* Level 2 gamblers experience problems with their gambling, but not to the extent that Level 3 gamblers do. *Id.* Level 1 gamblers are those individuals that gamble without experiencing adverse effects. *Id.*

¹⁷⁶ Kyl, *supra* note 174, at 158. Bernie Horn, the Executive Director of the National Coalition Against Legalized Gambling, stated that "[t]he internet not only makes highly addictive forms of gambling easily accessible to everyone, it magnifies the potential destructiveness of the addiction. Because of the privacy of an individual and his/her computer terminal, addicts can destroy themselves without anyone ever having the chance to stop them." *Id.*

¹⁷⁷ See, e.g., Howard J. Shaffer et al., *Estimating the Prevalence of Disordered Gambling Behavior in the United States and Canada: A Research Synthesis*, 89 AM. J. PUB. HEALTH 1369, 1373 (1999) (estimating that 1.29% of the adult population in the United States and Canada could be classified as pathological gamblers); Nancy M. Petry et al., *Comorbidity of DSM-IV Pathological Gambling and Other Psychiatric Disorders: Results from the National Epidemiologic Survey on Alcohol and Related Conditions*, 66 J. CLINICAL PSYCHIATRY 564, 564 (2005) (estimating that the lifetime prevalence rate of pathological gambling is 0.42%); Ronald C. Kessler et al., *DSM-IV Pathological Gambling in the National Comorbidity Survey Replication*, 38 PSYCHOL. MED. 1351, 1353 (2008) (estimating that 0.6% of the population could be classified as pathological gamblers, and 2.3% of the population could be classified as problem gamblers); see also PUB. SECTOR GAMING STUDY COMM'N, FINAL REPORT 35 (2000), available at <http://flog.govoffice3.com/vertical/Sites/%7BAAE2D2A5-8082-4BA9-9915-A43E05212106%7D/uploads/%7B1FBDCF-FC-AC56-4FBD-B16F-4CB51D5E0D22%7D.PDF> ("[T]here is no solid basis for concluding that the wider legalization of gambling . . . has caused a concomitant increase in pathological gambling. In fact, it appears that pathological gambling is quite rare . . . and does not appear to be increasing in frequency.").

¹⁷⁸ See Debra S. Hasin et al., *Prevalence, Correlates, Disability, and Comorbidity of DSM-IV Alcohol Abuse and Dependence in the United States: Results From the National Epidemiologic Survey on Alcohol and Related Conditions*, 64 ARCHIVES GEN. PSYCHIATRY 830, 837 (2007) (estimating the twelve-month prevalence rate of alcohol abuse to be 4.7% of the population and the lifetime prevalence rate of alcohol abuse to be 17.8%, with over 30% of the population suffering from some form of alcohol abuse or dependence at some time in their life). It is well known that alcoholism can result in the same negative consequences attributed to problem gambling; yet, we as a society have determined that alcoholism is best addressed on an individual basis, rather than through prohibition.

¹⁷⁹ See, e.g., WEFA GRP., A STUDY CONCERNING THE EFFECTS OF LEGALIZED GAMBLING ON THE CITIZENS OF THE STATE OF CONNECTICUT 9 (1997), available at http://www.ct.gov/dosr/lib/dosr/gamblingstudy_1997.pdf (finding that pathological gambling rates did not rise, and may have actually fallen, even after one of the largest casinos in the world was opened in the state); see also Serge Sevigny et al., *Links Between Casino Proximity and Gambling Participation, Expenditure, and Pathology*, 22 PSYCHOL. ADDICTIVE BEHAV. 295, 295 (2008) ("In a setting in which many types of gambling activities are available, casino proximity in itself does not appear to explain the rate of gambling-related problems.").

¹⁸⁰ See CMTY. RES. PARTNERS, THE SOCIAL IMPACT OF CASINOS: LITERATURE REVIEW AND COST ESTIMATES 3 (2010), available at http://fife.granicus.com/MetaViewer.php?view_id=2&clip_id=436&meta_id=29784.

It has been determined that many gambling addicts also suffer from other types of addictions.¹⁸¹ This supports the theory that pathological gambling is a manifestation of an underlying general addiction syndrome, which could manifest itself in an addiction to drugs, alcohol, food, shopping, or gambling.¹⁸² Ultimately, gambling addicts suffer from an addiction like any other and should seek professional help. The prohibition of gambling will do next to nothing to deter truly compulsive gamblers from gambling. In order to prevent an increase in problem gambling, however, additional safeguards should be implemented.

For instance, the Reno Model was developed as a practical application to analyze addiction research and uses a science-based strategic framework to guide responsible gambling policy, with the goal of reducing gambling-related harm in the community without excessively limiting gambling.¹⁸³ Furthermore, there are many responsible gaming features currently available that Congress could require the implementation of: limits on the amounts that can be deposited or bet over a certain period of time, warning signs for prolonged play or high expenditures, self-assessments, information about addictions and the probability of winning, clear displays of past expenditures, and self-exclusion from certain websites.¹⁸⁴ In addition, because online gambling has low overhead, websites are able to offer players high quality casino games at a lower cost, with about 75% of players spending less than \$50 during each gaming session.¹⁸⁵

2. Minors

Opponents of online gambling raise the concern that vulnerable minors will more easily be able to participate in illegal gambling activity from the their homes.¹⁸⁶ Fortunately,

¹⁸¹ See Howard J. Shaffer et al., *Toward a Syndrome Model of Addiction: Multiple Expressions, Common Etiology*, 12 HARV. REV. PSYCHIATRY 367, 368-70 (2004) (claiming that all addictive disorders follow the same development pattern, share similar risk factors, and result in similar consequences).

¹⁸² *Id.*

¹⁸³ See Alex Blaszczyński et al., *A Science-Based Framework for Responsible Gambling: The Reno Model*, 20 J. GAMBLING STUD. 301, 302 (2004).

¹⁸⁴ See Sally Gainsbury et al., *Consumer Attitudes Towards Internet Gambling: Perceptions of Responsible Gambling Policies, Consumer Protection, and Regulation of Online Gambling Sites*, 29 COMPUTERS HUMAN BEHAV. 235, 236 (2013).

¹⁸⁵ In addition to offering low-cost games, online gambling websites also offer better returns when compared to brick-and-mortar casinos. See TITCH, *supra* note 95, at 8.

¹⁸⁶ See Timothy A. Kelly, *The Government Should Halt the Spread of Legalized Gambling*, in GAMBLING: OPPOSING VIEWPOINTS 11, *supra* note 108, at 131, 138-39 (comparing online gambling to online pornography). Access to gambling equipment by minors is not a novel concern. State lottery opponents cite a Massachusetts survey that

this is a concern that is easily mitigated by requiring online gambling websites to implement procedures that will hamper such access. For instance, the government could require state-issued photo identification, along with a notarized statement of identification, before an account is opened.¹⁸⁷ After authorization, the website could issue a password for further protection.¹⁸⁸ With that said, just as underage individuals are able to obtain alcohol and cigarettes illegally, these methods are not fail-proof. Procedures such as these, however, will prevent access by all minors, except those who intentionally violate the law and should therefore be subject to strict punishment.

3. Cannibalization

It is important, when examining possible tax revenue, to look at the effect that legalizing online gambling will have on brick-and-mortar casino operations. Contrary to speculation, a recent survey found that online gambling may actually generate an increase in casino visitors: 8% of New Jersey respondents stated they would increase their casino visits in response to the legalization of online gambling, while only 4% stated they would visit a casino less often.¹⁸⁹ In addition, only 23% of experts believe that the legalization of online gambling will cannibalize business from existing casinos.¹⁹⁰ This is mainly because visitors widely report that non-gaming activities are an important part of the casino experience—namely fine dining, shopping, live entertainment, and recreational facilities, such as spas and pools.¹⁹¹ In fact, 26% of casino visitors report that they never or rarely gamble during their trips.¹⁹² There is clearly more to casinos than just gambling.

In the end, even if online gambling does displace traditional brick-and-mortar businesses, it would be because people overwhelmingly prefer online gambling as their chosen form of

found minors were able to successfully purchase lottery tickets within the state on 80% of their attempts. *Id.* at 137. Nonetheless, forty-three states continue to sell lottery tickets to the public. *Lottery Results*, USA.GOV, <http://www.usa.gov/Topics/Lottery-Results.shtml> (last visited Feb. 15, 2014).

¹⁸⁷ See BARKER & BRITZ, *supra* note 20, at 111.

¹⁸⁸ *Id.*

¹⁸⁹ See Kahlil S. Philander, *The Effect of Online Gaming on Commercial Casino Revenue*, 15 UNLV GAMING RES. & REV. J. 23, 24 (2011); see also Donald Wittkowski, *Poll: Online Gambling May Draw More to Brick-and-Mortar Casinos*, PRESS OF ATLANTIC CITY (Apr. 27, 2013, 12:31 AM), http://www.pressofatlanticcity.com/news/press/casinos_tourism/poll-online-gambling-may-draw-more-to-brick-and-mortar/article_133807c2-aef3-11e2-8fd2-0019bb2963f4.html.

¹⁹⁰ EXECUTIVE SUMMARY, *supra* note 73.

¹⁹¹ See STATE OF THE STATE, *supra* note 115, at 3.

¹⁹² *Id.*

entertainment. This is a matter of consumer taste, not a reason for the prohibition of competition. Furthermore, those businesses that would theoretically suffer from cannibalization could launch their own gambling website in conjunction with the in-person amenities they already offer.

4. Entertainment

The entertainment value of gambling is often lost in these debates, even though that is most often what motivates players to play. Gambling allows players to experience exhilaration and excitement, just as sporting events do. While gambling does involve the real prospect of losing money, the willingness to pay significant sums for entertainment is not exclusive to gamblers. For example, sports fans often spend several thousand dollars per year to call themselves season ticket holders.¹⁹³ Even though many people who gamble do not ultimately win, that does not make the activity “any more ‘wasteful’ or irrational than, say, playing video games, eating candy bars, or attending a hockey game. [Gamblers] play because they evidently get something out of it.”¹⁹⁴ In fact, 77% of casino visitors report receiving good value and entertainment for their money.¹⁹⁵

Often times, gambling is a form of adult entertainment enjoyed in moderation by those who can afford it. For instance, casino players are reported to be more educated and maintain a higher average household income than the general population.¹⁹⁶ Furthermore, contrary to popular belief, rather than withdrawing from society, “[g]amblers devote more time to opera, lectures, museums, nightclubs, dancing, movies, theater and

¹⁹³ See, e.g., *2014 Season Tickets*, DODGERS, <http://mlb.mlb.com/la/ticketing/season.jsp#pricing> (last visited Feb. 15, 2014) (listing Dodgers baseball season ticket prices as ranging from \$738 to \$9,020) (on file with publisher).

¹⁹⁴ Clotfelter, *supra* note 17, at 113.

¹⁹⁵ *2011 Report Shows Stable Commercial Casino Industry Following Three Challenging Years: Polling Data Profiles the Modern Casino Patron*, AM. GAMBLING ASS'N (May 4, 2011), <http://www.americangaming.org/newsroom/press-releases/2011-report-shows-stable-commercial-casino-industry-following-three>; see also STATE OF THE STATE, *supra* note 115, at 28 (reporting that almost 70% of casino visitors stated that they receive “excellent” or “very good” value for their money at a casino, compared to other entertainment activities).

¹⁹⁶ Calvert, *supra* note 108, at 148–50; see also STATE OF THE STATE, *supra* note 115, at 24 (finding that more than 52% of casino visitors have finished college, compared to only 46% of the overall survey sample). But see CLOTFELTER ET AL., STATE LOTTERIES AT THE TURN OF THE CENTURY: REPORT TO THE NATIONAL GAMBLING IMPACT STUDY COMMISSION 13 (1999), available at <http://govinfo.library.unt.edu/ngisc/reports/lotfinal.pdf> (finding that those purchasing lottery tickets were disproportionately African-American, poor, and uneducated).

active sports... [and] also socialize more with friends and relatives and participate more in community activities.”¹⁹⁷

C. Moving Forward

Gambling is hardly the type of danger that requires either heavy-handed federal interference or prohibition. In accordance with history, the states should be responsible for determining what forms of gambling, if any, legally take place within their borders.¹⁹⁸ This fundamental principle does not change with the advent of the Internet.¹⁹⁹ It must be acknowledged, however, that online gambling does make regulation an issue of national significance. While some argue that the international character of online gambling requires a global resolution,²⁰⁰ a clear federal approach is the more plausible first step. With this in mind, the role of the federal government should be limited to establishing, licensing,²⁰¹ and overseeing a national regulatory framework that allows states to opt-in to the extent that they choose.²⁰² The federal government’s “role should be likened to that of a sports referee—posting the rules of the game and mediating potential disputes between [those] players” who wish to play.²⁰³

The tax rate adopted could ultimately prove determinative of whether a national framework is successful. In the brick-and-mortar casino realm, lower taxes are associated with increased tourism, while higher taxes stifle development.²⁰⁴ A

¹⁹⁷ Calvert, *supra* note 108, at 149.

¹⁹⁸ When asked how online gambling should be regulated, 46.1% of respondents favored letting states decide, while 24.9% favored regulating and taxing it at the federal level. See *CasinoFYI*, *supra* note 1. Only 18.9% of respondents favored an across-the-board ban of online gambling. *Id.*

¹⁹⁹ For example, by legalizing and regulating online gambling, the government could require that licensed websites use security systems that screen out non-residents, protecting the interests of those states that wish to maintain their current bans. DAVID O. STEWART, AN ANALYSIS OF INTERNET GAMBLING AND ITS POLICY IMPLICATIONS 10-11 (2006), available at http://www.americangaming.org/sites/default/files/uploads/docs/white_papers/wpaper_internet_0531.pdf. Such a security system could include disclosure of address, confirmation of address through a commercial database, and confirmation of address through software that tracks the IPS address. *Id.*

²⁰⁰ See, e.g., Harley J. Goldstein, *On-Line Gambling: Down to the Wire?*, 8 MARQ. SPORTS L.J. 1, 51 (1997) (“In order to regulate Cyberspace, and prevent an international conflict of laws, a regulatory framework must be formed on the international level.”).

²⁰¹ Licensing and regulating online gambling would protect consumers who are currently placing a growing number of bets with offshore operators, by providing them with a safe and legal alternative.

²⁰² But see MASON & NELSON, *supra* note 21, at 93 (arguing for the criminalization of online gambling).

²⁰³ BARKER & BRITZ, *supra* note 20, at 112.

²⁰⁴ A 2011 article found that the rate of casino taxes is inversely correlated with tourism development, with a higher tax rate resulting in fewer jobs, fewer hotel rooms, less convention space, and fewer entertainment opportunities. William N. Thompson, *Casino Taxes—Accentuating the Negative*, 15 GAMING L. REV. & ECON. 599, 603 (2011).

similar principle applies to online gambling—higher tax rates on legal games will likely have the unintended consequence of driving players to illegal games, resulting in revenue loss. Likewise, if legal websites are to compete with illegal ones, then the taxation scheme must be favorable enough to entice them to participate.²⁰⁵ With that said, the tax rate ultimately adopted must be high enough to counter any perceived negative impacts, thereby persuading more states to opt-in to a federal program.²⁰⁶ Whatever tax rate is ultimately adopted, a smaller federal tax should be earmarked for costs related to enforcement and the development of better strategies to ensure compliance. At the state level, a larger tax should be set aside for local programs, such as ones that promote education, treat gambling addictions, or rectify cannibalization.

CONCLUSION

The legalization and taxation of online gambling will be insufficient to solve all of the current state and federal deficit problems—but it is a start. The fact is that a number of American citizens already participate in illegal gambling activity online, and will continue to do so. In addition to putting players in harm's way, this behavior results in a loss of tax revenue for state and federal governments, which are already struggling to make ends meet. While the advent of online gambling should not strip the states of the ability to determine if legal gambling occurs within their borders, the federal government is best able to establish a national framework and regulate the market. Ultimately, the tax rate adopted will determine the success of a federal scheme, which will require the consideration and balancing of multiple competing factors.

²⁰⁵ In Europe, where most forms of gaming are legal, it has been determined that a taxation rate of 15–20% on gross gaming revenue is seen as reasonable, where higher rates reduce applicants. See TITCH, *supra* note 95.

²⁰⁶ See, e.g., Wayne Parry, *Christie: Gambling Law Vetoed Until Tax Rate Increased*, CHRISTIAN SCI. MONITOR (Feb. 7, 2013), <http://www.csmonitor.com/USA/Latest-News-Wires/2013/0207/Christie-Gambling-law-vetoed-until-tax-rate-increased> (reporting that New Jersey's Governor Chris Christie vetoed a gambling law, in part, because the tax rate was too low).

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