A Proposed Tax
On Corporate Distributions

By GEORGE K. YIN

University of Florida College of Law;
Gainesville

Confronted with [the President's] effort to force a Republican tax bill through the House, [the Democrats] responded by "sweetening" [their] version of the bill with even more tax preferences in order to buy support. In the bidding war that followed, Democrats and Republicans both handed out tax breaks in a desperate grab for votes. The Democrats ... lost, but in the process, [they] found [themselves] backing a tax bill with ... tax breaks so generous that even ... lobbyists were stunned. "This is nothing short of astounding," said a surprised [lobbyist]. "If you'd told me a few years ago that the Democrats would propose this, I would have said you were out of your mind."


1. Introduction

As I write this, the fate of the 1989 tax bill(s) is still somewhat up in the air. Apparently, a majority of the Members of both Houses are in favor of reinstating some type of capital gains tax preference. Nevertheless, in a bedazzling display of power politics, the Senate Democrats have managed to assemble a sufficiently large minority contingent to block any substantive vote on the issue. The result, thus far, has been a most common phenomenon these days on Capitol Hill: stalemate.

Ordinarily, one might expect tax reformers to have cheered the Democrats' action. For surely the notion of a temporary capital gains rate cut, as approved by the House, must be viewed as someone's idea of a bad joke. It reminded me of a crack I sometimes make in my classes to the effect that because a capital gains rate increase and decrease both raise revenue, Congress should simply alternate raising and lowering the rate each year. We'd have the deficit eliminated in no time!

The Senate Democrats' achievement, however, has been tainted by the manner in which it was accomplished. In order to assemble and hold their working minority, they resurrected their stunningly unsuccessful 1981 strategy and agreed to a host of new tax breaks, including a "super IRA" proposal as well as a veritable

© 1989, George K. Yin

962 TAXES—The Tax Magazine
December, 1989

HeinOnline -- 67 Taxes 962 1989
orgy of other special provisions. Apparently, their motivation in sidetracking capital gains has been not so much to preserve tax reform or to protect the disc as simply to demonstrate their political muscle. It has made their effort something less than ennobling. As Yogi Berra is reputed to have said, “it’s deja vu all over again.”

About two years ago, not long after the repeal of the capital gains tax preference, I began thinking about ways to revise the tax system to take advantage of that change in the law. Reformers had long suggested that elimination of a capital gains preference would facilitate simplification of the law; it was time now to make that promise a reality. I focused on the issue of the taxation of the distributee in a corporate distribution, for so many of the rules in that area had developed as means to prevent the bailout of corporate earnings at capital gains rates. I recognized, however, the risk of such an endeavor; it would be just my luck that the moment I developed a proposal premised on the repeal of the capital gains preference, Congress would cause it to be stillborn by reinstating that preference.

I greeted with considerable delight, then, the discovery that the proposal described in this article, though born of the congressional opportunity created by the repeal of the capital gains tax preference, does not depend upon the survival of that repeal for its viability. Indeed, reinstatement of the preference actually makes this proposal even more attractive and essential. Thus, however Congress ultimately resolves the capital gains controversy, this proposal may be a fruitful one to pursue. It’s almost an academician’s nirvana.

In this article, I briefly outline a different method of taxing both corporate distributions and acquisitions: one that attempts to be simpler and more neutral than the present system. The proposal essentially extends the American Law Institute Reporter’s 1982 excise tax recommendation one step further by suggesting a uniform corporate-level tax generally on the amount of any and all distributions of earnings out of corporate solution: dividend and nondividend distributions alike, as well as liquidating and acquisition transactions having that effect. In addition, however, the proposal recommends elimination of both the tax to the recipient on the receipt of the dividend, nondividend, or liquidating distribution, and also the tax on any gain or loss resulting from the sale of corporate shares.

Part II of this article illustrates two problem areas caused by the deficiencies of the current method of taxing corporate distributions: one, concerning a complete redemption of a shareholder in a closely held corporation, undoubtedly a familiar issue; the other, involving the use of corporate debt, describes a situation where, perhaps, the corporate distribution rules have not heretofore been considered implicated. Part III then outlines the proposal and discusses a few of the important questions raised by it.

II. Two Illustrative Problems with Current Law

A. Redemption Distributions in a Closely-Held Setting. In general, a distribution in redemption of a corporation's stock is treated as a payment in exchange for such stock if the distribution meets certain alternative tests set forth in Section 302(b) of the Code. If the distribution fails to meet one of the alternative tests, then it is subject to the rules for ordinary distributions.

The theory of these rules is an attempt to address the tension between the tax treatment of ordinary distributions and that of stock sales. From the shareholder's perspective, a redemption transaction has traditionally been viewed as identical to a stock sale. The shareholder has been thought of as indifferent whether he sells his stock to another shareholder or back to the corporation. On the other hand, certain types of redemptions may also seem indistinguishable from an ordinary pro-rata dividend distribution.

1 Birnbaum, “Senate Panel’s Tax Measure Is Jammed with Billions of Dollars in Giveaways,” Wall St. J., October 5, 1989, p. A4. Their latest maneuver has been to strip the budget reconciliation bill of all extraneous provisions, but only time will tell whether Pandora’s box has already been opened.

2 The Reporter’s recommendation is set forth in American Law Institute, Federal Income Tax Project—Subchapter C: Proposals of the American Law Institute on Corporate Acquisitions and Dispositions and Reporter’s Study on Corporate Distributions 327–523 (1982). There has recently been issued a revised version of the Reporter’s proposals, which are contained in American Law Institute, Federal Income Tax Project—Subchapter C (Supplemental Study): Reporter’s Study Draft (1989). The concept for this article was developed with the earlier work in mind, but I also reference the later work throughout. The 1982 Reporter’s Study is hereinafter cited as “ALI Reporter’s 1982 Study,” whereas the later work is cited as “ALI Reporter’s 1989 Study.” Professor William Andrews served, and continues to serve, as Reporter to the project.

3 In his 1989 recommendations, the ALI Reporter has proposed, inter alia, a new minimum tax on distributions (“MTD”) that would be imposed on the distributing corporation in most nondividend distributions. ALI Reporter’s 1989 Study, supra note 2, at 54–80. The MTD would replace the excise tax, and would be accompanied by a nonrefundable shareholder-level credit to offset the shareholder’s tax arising from the distribution. In these respects, the Reporter’s latest recommendation moves in exactly the same direction as the one described in this article, although not as far, and with important differences in detail. The proposal contained in this article might be viewed as a purer model of what a corporate distributions tax might look like.

A more complete discussion of the issues presented by this proposal will be set forth in the full-length article on this subject to be published next year. See the asterisk footnote at the beginning of this article.

1 IRC Sec. 302(a)
2 IRC Sec. 302(d)
To resolve this tension, current law relies upon a series of increasingly complex analogies in trying to determine whether the redemption should be treated like the stock sale or the dividend. The touchstone of these analogies is generally the degree to which the shareholder surrenders or retains his interest in the corporation as a result of the transaction.\footnote{See generally Advisory Group Recommendations on Subchapters C, J and K of the Internal Revenue Code: Hearings Before the House Committee on Ways and Means, 86th Cong., 1st Sess. 364-66 (1959); Wolfman, “Some of the Attribution-of-Ownership Problems Involved in the Redemption of Stock Under the 1954 Code,” 33 TAXES—The Tax Magazine 382 (1955).}

For example, consider the tax treatment under current law of the following hypothetical transactions involving the complete termination of a shareholder’s interest in a closely-held corporation:

**Example (1A).** Mr. Smith, a 50 percent shareholder of Dinky Corporation, is distributed $1 million in complete redemption of all of his stock in Dinky;

**Example (1B).** Same as Example (1A), except that the other 50 percent of the corporation is owned by Mr. Smith’s son, Junior;

**Example (1C).** Same as Example (1B), except that following the redemption, Mr. Smith retains no interest as an officer, director, or employee of Dinky, and promises not to acquire any such interest;

**Example (1D).** Same as Example (1C), except that the Dinky stock owned by Junior was given to him by Mr. Smith four years prior to the redemption;

**Example (1E).** Same as Example (1D), except that the purpose of the gift of Dinky stock was to give Junior a financial stake in the corporation over which he was gradually assuming operational control.

Absent further facts, Mr. Smith is generally entitled to treat the distribution in Example (1A) as received in “exchange” for his stock in the corporation. Current law generally views a distribution that completely terminates a shareholder’s interest in the corporation as more analogous to a stock sale than an ordinary distribution.\footnote{IRC Sec. 302(b)(3).} This has historically meant that the distribution is taxable to Smith at preferential capital gains rates. Even in the absence of a capital gains preference, the “exchange” treatment entitles Smith to limit his gain to the amount of the distribution in excess of his basis in the stock redeemed.\footnote{IRC Sec. 1001(a).}

But in making the determination of whether a shareholder’s interest in a corporation has been completely terminated by a redemption distribution, the statute mandates that it is appropriate and necessary to consider the stock holdings of parties and entities related to the redeemed shareholder.\footnote{IRC Sec. 302(c)(1).} Hence, in a case such as Example (1B), where the remaining interest in the corporation after the redemption is held by Junior, a party deemed to be related to Mr. Smith, the statute reverses field and generally concludes that Smith has not had his interest completely terminated by the redemption.\footnote{IRC Sec. 318(a)(1)(A)(ii).} Indeed, his interest in the corporation is treated as not having been reduced at all. As such, ordinary distribution treatment is considered the proper analogy for the redemption distribution.\footnote{IRC Sec. 302(c)(2)(A)(i).} This has meant taxation of the distribution at ordinary income rates without any basis offset.

Congress further determined, however, that a strict application of the foregoing rule in cases such as the complete redemption of one member of a family-owned corporation would be too harsh. Thus, to relieve the potential hardship, the family attribution rules are permitted to be waived generally on the condition that the redeemed shareholder retain “no interest,” such as an interest as an officer, director, or employee, in the corporation following the redemption.\footnote{IRC Sec. 302(c)(2)(A)(ii) and (iii). Complex, special rules are provided in the case of a waiver by certain entities. IRC Sec. 302(c)(2)(C).} The redeemed shareholder also must not acquire any such interest anytime within the next 10 years, and must notify the IRS of any such interest acquired during that period (with an appropriate extension of the applicable statute of limitations).\footnote{H. R. Rep. No. 1337, 83d Cong., 2d Sess. 36 (1954); S. Rep. No. 1666, 83d Cong., 2d Sess. 45 (1954).} The goal is to provide some nominal lesser objection to the standards for insuring a bona fide severance of the redeemed shareholder’s involvement in the enterprise following the redemption, despite the existence of the related party owning the remainder of the corporation’s shares.\footnote{IRC Sec. 302(c)(2)(B)(ii).} Thus, assuming in Example (1C) that Mr. Smith has met those standards, “exchange” treatment again becomes the order of the day because the tie between Mr. Smith and his son is permitted to be broken.\footnote{IRC Sec. 302(c)(2)(B)(ii).}

Unwilling to leave well enough alone, however, Congress added certain additional rules. Under one of them, the statute requires, in effect, the second-guessing of the “objective” evidence and precludes waiver of the family attribution rules, even where no prohibited interest is retained or obtained within the forthcoming 10-year period, if the redeemed shareholder transferred stock of the corporation to a related party during the 10-year period preceding the redemption, and such stock is still owned by the related party after the redemption.\footnote{IRC Sec. 302(c)(2)(B)(ii).} The theory here is that...
the prior transfer of stock to the related party, which stock is still outstanding after the redemption, is an indication of the distributee’s continuing interest in the corporation following the redemption, despite the other, “objective” indicia that the distributee has really terminated such interest. Therefore, in Example (1D), the statute flip-flops once again, and the prior transfer of stock to Junior within the preceding 10-year period eliminates the possibility of family attribution waiver; Smith again is faced with ordinary distribution treatment of the redemption.

Finally, as further evidence of Congress’s almost psychotic ambivalence in this area, this last rule is viewed as too harsh and therefore does not apply in cases where a subjective tax avoidance purpose was not one of the principal reasons for the prior transfer. Hence, the facts in Example (1E) may permit Smith to salvage “exchange” treatment of the redemption after all.

What can we make of all of this? As an initial matter, it is quite clear that this “layering” of rule upon exception, and exception upon rule, presents a terribly complex statutory scheme. A variety of different inquiries must be made to determine the tax consequences of a common and straightforward transaction.

Moreover, within each layer are inherently amorphous elements that, taken together, contribute to a lack of predictability of result. We must know whether Smith is “related” to any of the remaining shareholders, but how should that concept be defined? In order to waive family attribution, Smith must retain no “interest” in the corporation following the redemption and must not acquire any such interest during the succeeding 10 years, but what constitutes a prohibited “interest” in a corporation, and how well can we police this issue over the 10-year period? We are told that prior transfers of stock by Smith within the preceding 10 years are relevant, but how well are we able to identify them? Finally, a prior transfer that is not for tax-avoidance purposes can be ignored, but how should we measure that standard?

At another level, we might ask ourselves whether the basic theory behind these rules and exceptions is sound. As indicated, the conceptual basis for the rules is that the degree to which Smith surrenders or retains his interest in the corporation following the redemption should be determinative of its tax consequences. But why is that? For example, if Smith had simply sold all of his stock to Junior, Smith would ordinarily obtain “sale or exchange” treatment on the sale despite the presence of a related party as the sole shareholder of the corporation following the sale, with all of the implications of a continuing interest in the corporation on the part of Smith that such a result might raise.

At still another level, we might well inquire why we are even considering the shareholder’s perspective in these alternative transactions. After all, a dividend distribution is not taxable to the recipient because of any increase in wealth resulting therefrom. The recipient is not “enriched” as a result of the dividend; rather, he has the exact same amount of wealth immediately before and immediately after the distribution—it is simply in different places. Thus, a dividend is taxable to the recipient based on the theory that the distribution produces a change in form in what the shareholder owns. It is the distribution of earnings out of corporate solution that triggers the tax. And from the corporation’s perspective, each of the foregoing examples has resulted in the same degree of depletion of earnings; why, then, should they be taxed differently? These types of conceptual inconsistencies

10-year period from a related party who continues to own stock in the corporation after the redemption. IRC Sec. 302(c)(2)(B)(l). Thus, had the transaction in the examples involved a complete redemption of Junior’s stock, with Smith continuing to hold his stock in the corporation following the redemption, the prior gift of stock to Junior would have precluded breaking the family attribution tie between father and son, and therefore prevented “exchange” treatment to Junior in the redemption.

IRC Sec. 302(c)(2)(B)(ii), last sentence.
This alternative method of buying out Smith’s interest presents the question whether Junior should be taxed—perhaps on a constructive dividend theory—when his father is completely redeemed by the corporation. Cf. Rev. Rul. 69-608, 1969-2 CB 42.
In Eisner v. Macomber, 1 ustc ¶32, 252 U. S. 189 (1920), the Supreme Court may have misunderstood this basic question. In holding for the majority that an ordinary stock dividend does not constitute taxable income, Justice Pitney argued in part that a stock dividend does not represent any enrichment to the recipient:
[A stock dividend] does not alter the pre-existing proportionate interest of any stockholder or increase the intrinsic value of his holding or of the aggregate holdings of the other stockholders before. The new certificates simply increase the number of the shares, with consequent dilution of the value of each share.
252 U. S. at 211. But this reasoning would also justify the exclusion from income of an ordinary cash dividend, something the Court presumably was not intending to suggest. See M. Chirelstein, Federal Income Taxation 73-74 (5th ed. 1988).
As a technical matter, this issue is finessed somewhat under current law. The statute provides that the actual amount of the reduction to corporate E&P as a result of the distribution depends on the tax treatment of the redemption to the redeemed shareholder. If the redemption is treated as a dividend distribution to the shareholder, the E&P account is reduced by the amount (Continued on following page.)

December, 1989

TAXES—The Tax Magazine

965
have produced controversies such as whether a redemption effected in conjunction with a “bootstrap” acquisition should be able to avoid dividend treatment despite the resulting elimination of all or a portion of the corporate earnings and profits account. In addition, current law permits a redemption to be taxed differently from an economically comparable transaction involving a pro-rata distribution to all shareholders followed by purchases and sales of stock between and among the shareholders.

B. Distributions and Corporate Debt. Consider the following two alternative scenarios concerning Z corporation, which has annual earnings (before taxes) of $1,500,000. Assume that Z pays corporate taxes at a flat 33 percent income tax rate, there are 100,000 shares outstanding of the corporation, and it has almost no debt on its balance sheet:

**Example (2A).** Inventor has been studying Z’s line of business for some time and is convinced that, with a little bit of retooling and some new capital, Z can easily expand into a related line of business and improve its profitability. The Board of Directors is persuaded by Inventor’s plans, and invites him to join the Board. Pursuant to those plans, the corporation issues $6,000,000 in 12 percent bonds and uses the new capital to expand into the related line of business. Inventor’s vision proves to be an accurate one. The new capital yields a 20 percent rate of profit (prior to taxes and return to investors), or an additional $1,200,000 in annual earnings. The annual income flow of the corporation may be illustrated by the following:

<table>
<thead>
<tr>
<th>Shareholders</th>
<th>Before</th>
<th>After</th>
</tr>
</thead>
<tbody>
<tr>
<td>$1,000,000</td>
<td>$1,320,000</td>
<td></td>
</tr>
<tr>
<td>Bondholders</td>
<td>0</td>
<td>720,000</td>
</tr>
<tr>
<td>Corp. income taxes</td>
<td>500,000</td>
<td>660,000</td>
</tr>
</tbody>
</table>

Total annual earnings: $1,500,000 $2,700,000

Earnings per share: $10.00 $13.20

If an overall capitalization factor of 7 is used, we can derive the following:

**Capitalized Values Before**

| Shareholders | $7,000,000 |
| Bondholders | 0 |
| Corp. income taxes | 3,500,000 |

Total: $10,500,000

**Approx. share price:** $70/share $86/share

As is evident, the approximate share price might be expected to increase from $70 to about $86 per share as a result of Inventor’s idea.

**Example (2B).** Assume, in the alternative, that Investment Banker (IB) has been studying Z’s balance sheet and he also has concluded that Z’s share price is undervalued. Unlike Inventor, however, IB’s idea does not involve any change or expansion to Z’s business. Nevertheless, the Board of Directors is convinced that IB’s plan is a sound one, and invites him to join the Board. Pursuant to IB’s plan, the corporation issues $6,000,000 in 12 percent bonds and uses the proceeds to buy back about two-thirds of the corporation’s shares at a price of $90/share, an almost 30 percent premium over the current fair market value of about $70 per share.

The annual income flow of the corporation before and after IB’s “vision” may be illustrated by the following:

| Redeeming shareholders | $659,000 | $0 |
| Continuing shareholders | 341,000 | 520,000 |

(Footnote 24 continued.)

of money and fair market value other property distributed. IRC Sec. 312(a) and (b). If, on the other hand, the redemption is treated as a distribution to the shareholder’s stock, then the E&P account may not be reduced by an amount in excess of the ratable share of E&P attributable to the stock redeemed. IRC Sec. 312(n)(7).

From a practical standpoint, this linkage of the amount of the adjustment to the corporate E&P account with the tax treatment of the distribution to the shareholders produces significant administrative difficulties. The corporation may well not know the tax treatment to its shareholders of a particular distribution, and may not be in a position to find out. Furthermore, the exact tax treatment may not be determined for many years subsequent to the distribution. Cf. IRC Sec. 302(c)(2).

From a conceptual standpoint, this difference in result, at least if viewed from the corporation’s perspective, makes little sense.

24 See, e.g., *Zena v. Quinlivan*, 54-2 ustc ¶9445, 213 F.2d 914 (CA-6); *United States v. Carey*, 61-1 ustc ¶9428, 289 F.2d 331 (CA-8).


26 The $3.20 boost in earnings per share simply reflects the additional 5.3 percent profit on the $6,000,000 investment after taxes and interest cost to bondholders are taken into account:

| Total return | 20.0% |
| Interest cost | 12.0% |
| Net return (before taxes) | 8.0% |
| Taxes (33%) | 2.7% |

27 After-tax profit

5.3% \times $6,000,000 = $320,000/100,000 shs = $3.20/share

28 The capitalization factor is used to obtain total capitalized values. The actual breakdown in the “After” column is then backed into: the bondholders are assumed to hold market rate bonds of 12 percent, so the value of their holdings is the face amount, or $6,000,000. The remaining value of $12,900,000 is then divided 5/3:5/3 between equity value and capitalized corporate income taxes.

29 This example is taken from *ALI Reporter’s 1989 Study*, supra note 2, at 17-21.
### December, 1989

**TAXES—The Tax Magazine**

#### BEFORE

<table>
<thead>
<tr>
<th></th>
<th>Before</th>
<th>After</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bondholders</td>
<td>0</td>
<td>720,000</td>
</tr>
<tr>
<td>Corp. income taxes</td>
<td>500,000</td>
<td>260,000</td>
</tr>
<tr>
<td><strong>Total annual earnings</strong></td>
<td>$1,500,000</td>
<td>$1,500,000</td>
</tr>
<tr>
<td>Total shares still outstanding</td>
<td>$100,000</td>
<td>$34,000</td>
</tr>
<tr>
<td>Earnings per share</td>
<td>$10.00</td>
<td>$15.30</td>
</tr>
</tbody>
</table>

If an overall capitalization factor of 7 is again used, we can derive the following capitalized values:

#### CAPITALIZED VALUES

<table>
<thead>
<tr>
<th></th>
<th>Before</th>
<th>After</th>
</tr>
</thead>
<tbody>
<tr>
<td>Redeeming shareholders</td>
<td>$4,613,000</td>
<td>$0</td>
</tr>
<tr>
<td>Continuing shareholders</td>
<td>2,387,000</td>
<td>3,000,000</td>
</tr>
<tr>
<td>Bondholders</td>
<td>0</td>
<td>6,000,000</td>
</tr>
<tr>
<td>Corp. income taxes</td>
<td>3,500,000</td>
<td>1,500,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$10,500,000</td>
<td>$10,500,000</td>
</tr>
<tr>
<td>Total shares outstanding</td>
<td>100,000</td>
<td>34,000</td>
</tr>
<tr>
<td>Approx. share price</td>
<td>$70/share</td>
<td>$90/share</td>
</tr>
</tbody>
</table>

As evident, share price is expected to increase to about $90 per share ($3,000,000/34,000) as a result of IB's plan.

Which scheme is the Board more likely to pursue? If they succeed, each plan will produce a significant boost in earnings per share and share price. One difference, however, is that Inventor's goal is contingent upon his plan actually working out; the business expansion must result in the increased profitability that he envisions. In contrast, IB's plan is relatively risk-free; he simply requires a shuffling of paper without any change to the underlying business. For this reason, it is quite possible that the Board, faced with these two alternatives, would opt for IB's idea rather than Inventor's.

What is going on in the second example? First, there is a shift in the share of annual earnings from one group of investors (the redeemed shareholders) to another group (the bondholders and continuing shareholders). In addition, there is a decrease in the share of annual income devoted to corporate income taxes (reduction of $240,000/year). Indeed, but for these two changes, nothing has really happened in the second example. There is no increase in efficiency or productivity. There is no "synergy." The boost in earnings per share and share price is, essentially, financed entirely by the savings in corporate taxes.

If Congress were offended by the potential raid on the Treasury occasioned by IB's plan, what might it do? A simple solution would be to treat some portion of the new debt as equity, with the result that the cost of the debt would no longer be deductible by the corporation. But a rule of that sort could conceivably affect the deductibility of interest paid or incurred by the corporation in Inventor's situation as well. Indeed, each scenario involves the same amount of debt and the same amount of interest. Yet, at least in Inventor's case, there does not seem to be any tax policy reason justifying disallowance of the interest deduction. The cost of the debt is simply an ordinary cost of doing business—a rental payment for the use of funds which produces the business income—and just as business rents are ordinarily deductible, so should this business interest be.

What else might Congress do? One difference between the two alternatives is the use to which the corporation applies the debt proceeds. In Inventor's case, the proceeds were retained by the corporation to finance the business expansion that generated additional income. In IB's alternative, the proceeds were promptly distributed out of the corporation in the share redemption. Thus, another option for Congress would be to disallow some portion of the interest deduction to the extent the debt proceeds are used for certain purposes, but not for others. A rule such as this, however, would be difficult to implement. Money being fungible, it is nearly impossible to determine to any degree of confidence the use to which loan proceeds are put.

There may, in fact, be an even better option for Congress. Another difference between the two scenarios is that IB's plan involves a distribution; Inventor's does not. Hence, because the

---

80 The assumption here is that because there has been no underlying change to Z's business, the total annual earnings of the corporation remains unchanged under IB's plan.

81 Although the "equity" share of earnings under IB's plan is reduced from $1,000,000 to $520,000, the number of outstanding shares has been reduced from 100,000 to 34,000. As a result, there is a dramatic increase in earnings per share to about $15.30 per share ($520,000/34,000).

82 The entries in the "Alter" column are derived in the same way as indicated above: first, overall value of $10,500,000 is determined based on a capitalization factor of 7; then the bondholders' share of $6,000,000 is backed out; finally, the balance of $4,500,000 value is split 75/25 between equity share and corporate income taxes.

83 An example of this approach is new Code Section 386, as proposed in the House Budget Reconciliation Bill of 1989, which treats certain high-yield original issue discount obligations as preferred stock. H. R. 3299 (as passed by the House), 101st Cong., 1st Sess. (1989), § 11202.


85 Of course, this doesn't stop the IRS from trying. Cf. Reg. § 1.163-8T.
debt aspects of the two plans are identical but the distribution aspects are not, it is fitting to try to fashion a tax rule which focuses on the distribution side of the transaction rather than the debt side. Indeed, the thesis of the proposal that follows is that if the "proper" tax is collected on the distribution portion of IB's transaction, its tax advantages would be largely eliminated.

III. A Uniform Corporate-Level Distributions Tax

A. Introduction. Under the present classical system of corporate income taxation, corporations are subject to tax on their earnings when realized. In addition, there is a "second" tax imposed on corporate distributions. This tax is imposed at the shareholder level, either upon receipt of a distribution of after-tax earnings from the corporation or upon the sale of corporate shares.85

Under current law, the imposition of the distributions tax is extremely haphazard in application. The amount of the tax in any given case turns largely upon the form by which the shareholder receives his proceeds, whether as a result of a liquidating or nonliquidating distribution, a dividend or nondividend distribution, or a sale of corporate shares. Current law has relied primarily on a series of competing analogies to determine the exact amount of tax in those cases. But consistency with one analogy has inevitably led to inconsistency with some other. Moreover, so long as the form of the transaction has been a determining factor, the tax consequences have been subject to manipulation. Finally, the amount of the distributions tax has also been affected by issues such as the tax status and bracket of the shareholder involved, and whether the shareholder recently inherited his stock in the corporation.

While current law is excessively complicated and internally inconsistent, its principal defect is that the various distinctions it draws between and among different transactions are totally devoid of substance. This has created a number of distortions. For example, it has subsidized the tremendous growth in recent years of share buyback transactions by public corporations.86 It has been a key factor involved in subsidizing many leveraged buyout transactions.87 It has created incentives as well for unleveraged corporate stock acquisitions 88 and other recent corporate financial strategies.89 In short, it has interfered with the decision-making process as to whether, when, and how a corporate distribution or acquisition should take place by creating tax incentives to defer or accelerate the transaction, or to effect it in one form rather than another. A properly designed distributions tax would be more neutral with respect to corporate distribution and acquisition policy.

Initially, one might conclude that it is futile to try to design a "neutral" distributions tax 90 in that any tax burden imposed on a distribution is bound to have the effect of deterring the making of the distribution. In other words, it would always be preferable to defer the distribution (and retain earnings) in order to put off the day of reckoning for the distributions tax. In fact, however, such is not the case; rather, a consistently applied distributions tax will be neutral over time so long as the rate of growth of the base for the tax (in the event of a deferred distribution) is the same as that of the net proceeds after payment of the tax (in the event of an immediate distribution).88

88 The reference to corporate "earnings," at least for distributions tax purposes, is used here generally to encompass the accrual concept of earnings, whether realized or unrealized by the corporation. Hence, a tax on gain from the sale of corporate shares attributable solely to asset appreciation at the corporate level is a tax on "earnings" even though not yet realized by the corporation.
93 By this I mean a tax that does not distort the economic decisions of whether, when, and how a distribution or acquisition is to take place.
For example, assume a uniform distributions tax of 30 percent and an annual before-tax rate of return, for investments held in or out of corporate solution, of 10 percent. At the beginning of a particular year, a corporation has $100 of earnings that it may choose either to distribute to its shareholders or to retain in corporate solution. Under these assumptions, what will be the consequences of those two choices after one year? Would it be preferable to distribute the earnings immediately to the shareholders or to retain the earnings in corporate solution and make the distribution at the end of the year?

Immediate distribution of the $100 causes the 30 percent distributions tax to be paid, leaving $70 for the shareholders to invest as of the beginning of the year. The 10 percent return yields $7 for them during the year. Hence, at the end of the year, the shareholders will have $77 before payment of any income taxes.

In contrast, if the distribution is deferred until the end of the year, the tax base for the deferred distributions tax grows to $110 (before corporate income taxes) by the end of the year, so that the 30 percent distributions tax for the year-end distribution will be $33. This alternative, therefore, will also net $77 to the shareholders by the end of the year. The same result occurs regardless of the actual period the distribution is deferred.

There is, of course, one factor missing from the foregoing example, and that is the effect of corporate and individual income taxes on the transaction. But that effect is quite simple to identify, for the rate of growth of the distributions tax base (in the event of a deferred distribution) must be the same as that of the proceeds after payment of the distributions tax (in the event of an immediate distribution) after all income taxes are taken into account. In other words, the after-(income) tax rate of return for both shareholders and the corporation must be the same. Or, in the above example, if the pretax rate of return of corporations and shareholders is assumed to be identical, then the applicable income tax rate for the two must also be the same.

If, therefore, the foregoing example is modified to assume the existence of an identical 30 percent corporate and shareholder income tax, the numbers change but the two alternatives remain economically equivalent. In the case of an immediate distribution of the $100, the shareholders’ $70 investment (after payment of the $30 distributions tax) will yield $4.90 after income taxes are taken into account, resulting in $74.90 to the shareholders at the end of the year. If the earnings are retained, the distributions tax base will grow to only $107 in one year after taking account of the corporate income tax, producing a 30 percent distributions tax of $32.10 and therefore netting the same $74.90 after all taxes to the shareholders.

The foregoing indicates that it is possible to design a distributions tax that is more neutral with respect to corporate distribution and acquisition policy. In particular, the example suggests that under certain circumstances, there is no tax advantage to deferring a corporate distribution, with the result that the tax treatment of the corporation would be unaffected by the tax.

Both 1982 and 1989 ALI Reporter’s studies attribute this result in part to the compensatory relationship between the distributions tax burden and the corporate income tax burden. As we shall see, however, the principle holds true independent of any relationship between the distributions tax and the corporate income tax.


All investments are assumed to have equal degrees of risk.

See infra note 47.

For this purpose, it is assumed that any distributions tax is separate and distinct from the regular income tax applicable to shareholders or corporations.

This assumption, of course, is not reality. Nevertheless, as a result of changes enacted as part of the Tax Reform Act of 1986, the current rate relationship is somewhat closer to satisfying this condition than at any time in recent history. The principal case under current law where this assumption is quite clearly erroneous is where the shareholder is in the zero tax bracket, but even in that case, the presence of the unrelated business income tax may tend to mitigate the difference in rates. The special considerations concerning the tax treatment under the proposal of distributions to tax-exempt shareholders are discussed in greater detail below. See infra the text accompanying notes 92-114.

Algebraically, the equivalence of these two alternatives after one year can be demonstrated as follows: Assume that X is the amount of earnings to be distributed or retained, r is the annual before-tax yield on corporate or shareholder investments, t is the corporate and shareholder income tax rate, and d is the distributions tax rate.

If there is an immediate distribution of X to the shareholder at the beginning of the year and investment by him of the after-tax proceeds, the shareholder will have at the end of the year an amount equal to:

\[ X - dX + r(X - dX) - t(rX - dX) = X - dX + (r - tr)(X - dX) = (1 - d)(1 + r - tr)(X) \]

In contrast, if there is a retention of X by the corporation for one year followed by a distribution to the shareholder at the end of the year of X plus the after-tax earnings on that amount, the shareholder will have at the end of the year an amount equal to:

\[ X + rX - t(rX) - d(X + rX - t(rX)) = (t - d)(X + rX - t(rX)) = (1 - d)(1 + r - tr)(X) \]

If the choice involves a comparison of the two options over a period of y years rather than just one year, each alternative results in an amount to the shareholders at the end of that period equal to:

\[ (1 - d)(1 + r - tr)^y(X) \]
despite the existence of an immediate tax burden on such distribution. In the example, the deferral of the immediate $30 distributions tax for one year has an after-tax benefit of $2.10. But that is exactly offset by the increased distributions tax burden of $2.10 (to $32.10) at the end of the year as a result of the larger distributions tax base created by the earnings retained in the corporation for the year and subject to the corporate income tax. Had there been no corporate income tax, or had corporate investments produced a higher before-tax yield than shareholder-level investments, it is evident that the deferral would have resulted in a real after-tax advantage.48

Two aspects of this are particularly important. First, critical to the above conclusion is the assumption that if there is a tax imposed on a corporate distribution, then the same rate of tax should be imposed no matter when and how the distribution takes place. To illustrate, assume the same facts as in the above example, except that the distributions tax rate is 30 percent for distributions at the beginning of the year, but only 25 percent for end-of-year distributions.

Under this variation, the “immediate distribution” option will still result in $74.90 after taxes to the shareholders by the end of the year. In contrast, the “corporate retention” alternative will require a 25 percent distributions tax of only $26.75, leaving the shareholders with $80.25 after taxes at the end of the year. In other words, by varying the level of the distributions tax depending upon the timing of the distribution, the law has created a bias in the decision of whether to retain or distribute corporate earnings.49

Second and perhaps equally important, the analysis does not depend upon there being any particular correlation between the level of distributions tax imposed if there is an immediate distribution, and the level of corporate income tax foregone on the distributed earnings. In other words, if the distributions tax is viewed as a tax that is separate and distinct from the corporate and shareholder income taxes, then the relationship described above will continue to hold true even though the distributions tax rate is different from the income tax rate applicable to shareholders and corporations.50 Indeed, to that extent, the “tollecharge” label that is sometimes attached to this analysis may be somewhat misleading.51 This may at first seem somewhat counterintuitive, but can be illustrated by assuming the same facts as in the basic example, except that the distributions tax rate is only 25 percent while the corporate and shareholder income tax rates remain at 30 percent.

48 This is not exactly true because it is conceivable that a higher before-tax yield on corporate investments might be offset by a higher corporate income tax, and vice versa. The basic assumption, therefore, is that the after-tax rate of return of the corporate and shareholder investments must be the same. To the extent the corporate after-tax return exceeds the shareholder after-tax return, there will be an advantage of retention over distribution. And the opposite is also true.

49 For a similar reason, if the distribution is in the form of a debt instrument, the distributions tax should be imposed on the present value of the instrument at the time of the distribution, rather than on the principal amount of the instrument at the time the instrument is satisfied. For example, assume the same facts as in the text (with a constant 30 percent distributions tax), except that there is available for distribution at the beginning of the year a $100 one-year note bearing a market rate of interest of 10 percent. Imposition of a $30 distributions tax at the beginning of the year (assuming the present value of the note is its principal amount) will reduce the amount of the note to $70, and the shareholder will have after-tax earnings of $4.90 on the note during the year. At the end of the year, the distribution of $70 principal in satisfaction of the note (without any further distributions tax consequences) will result in the shareholder having $74.90, the same amount described in the basic text examples.

In contrast, if there is a distribution of a $100 note at the beginning of the year without immediate imposition of a distributions tax, the shareholder will still have $77 after taxes on the note during the year. At the end of the year, satisfaction of the $100 note will yield $70 to the shareholder after payment of the $30 distributions tax, so the shareholder will end up with $77, not $74.90. In either case, the tax treatment of the transaction to the distributing corporation will be the same because its earnings tax principal amount will be exactly offset by the interest paid to the holder of the note. Compare Thurston, supra note 39, at 110-13 (distribution of debt instruments should trigger ALI excise tax only as the corporation satisfies the instruments).

50 In the formula set forth in note 47, supra, it is evident that the distributions tax rate (represented by “d”) and the shareholder and corporate income tax rates (represented by “c”) may vary independent of one another without affecting the basic equivalence of the two options. Cf. ALI Reporters 1989 Study, supra note 2, at 34-35 (Example (91)).

Compare Warren, “The Relation and Integration of Individual and Corporate Income Taxes,” 94 Harvard Law Review 719, 764-65 (1981) (equivalence can be achieved only if there were no tax on capital gains and the personal, corporate, and distributions tax rates are all equal). Professor Warren arrived at his conclusion because he was assuming the continued existence of a shareholder-level distributions tax equal to the shareholder income tax. Furthermore, he assumed that there is a discount in stock purchases to reflect the capitalization of future corporate income taxes and not the future distributions tax. Id. at 763 (Table 11, note a); compare infra note 61 and accompanying text. If, however, the shareholder-level distributions tax is replaced by a corporate-level distributions tax in all cases where there is an actual distribution, and the share discount reflects capitalization of the future distributions tax, it is evident that the distributions tax rate may vary independently from the shareholder and corporate income tax rate while still preserving the equivalent consequences of the corporate alternatives. Using Professor Warren’s abbreviations (“E” is the amount of earnings to be retained or distributed, “r” is the before-tax annual rate of return, “p” is the corporate and shareholder income tax rate, and “e” is the distributions tax rate), the “general result” for each of the following hypotheses is (1−p)(1−r)Er, Id. at 765 (Table 12).

51 The “tollecharge” explanation treats the distributions tax as the price or “tollecharge” for the liberation of the amount distributed from corporate solution. The liberation provides the benefit of removing the future corporate income tax burdens from the amount distrib-
Now, immediate distribution of the $100 causes only the 25 percent distributions tax, leaving $75 for the shareholders to invest. Investment at 10 percent yields $7.50, or $5.25 after payment of the 30 percent individual income tax. After one year, then, the shareholders have $80.25 after taxes.

If, instead, the corporation retains the $100, it will still earn $10, or $7 after payment of the 30 percent corporate income tax. Distribution of the $107 at the end of the year results in a 25 percent distributions tax of $26.75, again leaving the shareholders with $80.25 after taxes. As above, this relationship also holds true no matter what the actual period of the deferred distribution.

The reason for this can be explained as follows. The burden of the corporate income tax on a corporate investment is counterbalanced nicely by the burden of the shareholder-level income tax had the investment not been made in corporate solution, as we have assumed the same rate for those two taxes or, at minimum, that the after-tax rates of return for corporate and shareholder investments will be identical. Thus, the “extra” burden of a corporate investment is a function of the distributions tax, not the corporate income tax. And so long as the distributions tax rate remains the same throughout the period during which the distribution may be made, and the rate of growth of the tax base in the case of a deferred distribution is identical to the growth rate of the net after-tax proceeds if there is an immediate distribution, there is no advantage gained by either deferring or accelerating the distribution within that period.

In short, the desired neutrality can be achieved even though the distributions tax rate on earnings distributed is measurably different from the corresponding corporate income tax rate had the earnings been retained. Indeed, the same neutrality would be present, and shareholders would be indifferent as to whether the corporation makes a distribution or retains its earnings, even if the distributions tax were eliminated altogether. Hence, while this theory has been utilized to justify, and does support, the imposition of an additional tax burden in the case of nongroup distributions to parallel the consequences of a comparable shareholder sale transaction, the theory equally supports the reduction in the tax burden in the shareholder sale transaction to be consistent with the consequences of the nongroup distribution. As the examples indicate, the effect of changing the distributions tax rate consistently is merely to vary the overall tax burden on the corporate earnings.

But if there is to be a distributions tax, then a goal of neutrality demands its consistent application, in sharp contrast to current law. While it is of course true, in part because of the varying income tax rates of corporations and shareholders, that complete neutrality in the corporate decision making process cannot be achieved, such neutrality can be enhanced by a tax system that imposes the same rate of distributions tax no matter when or how the distribution is made.

The proposal described in this article is a step towards designing such a tax system. It assumes the continuation of our classical system of taxing corporations, including the continued imposition of some tax burden on corporate distributions. But it also assumes that an ideal used, and the offsetting cost of that benefit is the immediate distributions tax. If, in contrast, there is a retention rather than a distribution of the corporate assets, the distributions tax is deferred, but the cost of that deferral is the continuing corporate income tax burden on the retained assets. See Ali Report’s 1982 Study, supra note 2, at 348–51, 414–16; Ali Report’s 1989 Study, supra note 2, at 6–7, 31–32, 39, 45–46, 58, 61. This explanation is faulty to the extent it suggests some necessary correspondence between the distributions tax imposed and the corporate income tax thereby avoided. As described in the text, there is no such relationship that is required. Note, however, that it is necessary to assume that the corporate and shareholder income tax rates are the same, or at least that the corporate and shareholder after-tax rates of return on investment are identical.

As indicated in note 47, supra, the amount of after-tax proceeds to the shareholder at the end of y years is represented by the formula:

$ (1 + r − tr)^y \times X$

where X is the amount of corporate earnings available to be distributed at the beginning of the period, r is the annual before-tax yield on corporate and shareholder investments, t is the corporate and shareholder income tax rate, and d is the distributions tax rate. This is true regardless of whether the corporation makes an immediate distribution of the earnings at the beginning of the period, or retains the earnings and makes the distribution at the end of the period.

If d, the distributions tax rate, were zero, then the amount to the shareholder at the end of the period in either case would simply be:

$ (1 + r − tr)^y \times X$

The shareholder still would be indifferent as to whether the distribution takes place at the beginning or end of the period. Moreover, if X is thought of as an amount of capital available for investment by an individual at the beginning of the period, the same formula

$ (1 + r − tr)^y \times X$

represents the amount of after-tax proceeds to the individual after investment of the capital for the period of y years. This demonstrates that based on the stated assumptions, the additional burden of a corporate investment is a function of the distributions tax, and if there is no such tax, the after-tax proceeds of a corporate or individual investment are the same.

See Ali Report’s 1982 Study, supra note 2, at 427–40, where a corporate-level excise tax in the case of nongroup distributions is proposed. While this proposal does produce the desired neutrality, there is a theoretical argument that the overall resulting tax burden would be excessive. Cf. Beghe, “The American Law Institute Subchapter C Study: Acquisitions and Distributions,” 73 Tax Law 764–65 (1980).

If we again return to the formula set forth in note 47, supra, that describes the amount of after-tax proceeds to the shareholder at the end of y years generated by X amount of corporate earnings available for distribution at the beginning of the period, we can see that an increase in the distributions tax rate, d, simply operates to reduce the after-tax proceeds to the shareholder.

The possible rationale for this assumption is discussed below. See infra the text accompanying notes 57–83.
distributions tax within those parameters would have, to the greatest extent possible, a neutral impact on the corporate decision of whether and when to make a distribution or acquisition, and how it should be effected. An important distinguishing feature between this proposal and current law is that the tax on distributions is imposed at the corporate level rather than to the shareholders. There are meaningful advantages to this change in accomplishing the policy goal just described, as well as in implementing a rule structure significantly simpler than current law.

B. Outline of the Proposal. 1. General Rules. Under the proposal, on any nonliquidating distribution (dividend or nondividend) by a corporation, there is imposed upon the corporation a tax, termed a "corporate distributions tax" ("CDT"), on the full amount of the distribution. Assuming that the revenue to be raised by the tax in a distribution should equal that raised under current law by a distribution to a shareholder in the 28 percent tax bracket, the CDT rate is approximately 38.89 percent.

On any liquidating distribution by a corporation, the same tax is imposed, except that the tax base is reduced by the amount, if any, in the corporation's "contributed capital account" ("CCA").

On the receipt of any distribution, liquidating or nonliquidating, the distributee is not subject to tax. Furthermore, no tax is imposed on any gain or loss recognized on the sale of corporate shares.

2. Special Rules. a. Intercorporate Investments. Under the proposal, a taxable acquisition of stock by a corporate holder from a noncorporate holder is treated as a distribution by the acquiring corporation subject to the CDT. The tax base is generally the amount of the consideration paid by the acquiring corporation less any amount in the CCA of the acquired corporation.

No CDT is imposed in the case of a liquidating or nonliquidating distribution to a corporate holder of stock. During the period of time stock of a corporation is owned by a corporate holder, the CCA of the issuing corporation is always equal to its net asset value.

For purposes of these rules, the terms "corporate holder" and "noncorporate holder" have their normal meanings, except that a corporation that owns or acquires no more than a portfolio investment in stock is treated as a noncorporate holder of such stock. "Portfolio investment" is generally defined as any stock interest consisting of less than 80 percent of the voting power or value of the stock of the issuing corporation.

b. Distributions Pursuant to a Reorganization. No CDT is imposed on a distribution of stock or securities of a party to a reorganization to the same extent such stock or securities is permitted to be received tax deferred under current law. A distribution of boot pursuant to a reorganization is treated in the same manner as a nonliquidating distribution by the acquiring corporation.

c. Stock Dividends and Distributions of Stock of a Controlled Subsidiary. Except with respect to a straight pro-rata, common stock dividend, a distribution of stock of the distributing corporation is treated as a distribution of cash followed by a reinvestment in the distributing corporation of the proceeds by the shareholders. No CDT is generally imposed on a distribution of stock of a controlled subsidiary except where the distribution is a subterfuge or device for the immediate withdrawal and reconstitution of corporate earnings.

C. Discussion of Selected Issues. 1. Rationale for a Distributions Tax; Rate of the Tax. As we have seen, the desired neutrality with respect to corporate distributions is achieved by setting the CDT rate at zero. Although the tax is sometimes framed as a surrogate for the corporate income tax burden that would arise had there been no distribution out of corporate solution, it does not really serve that function. The prospective corporate income tax revenue that is forgone in the event of a distribution is counterbalanced by the shareholder income tax imposed on the future earnings arising from the amount distributed. But recognition of these relationships presents an important threshold issue: exactly what is the role of the tax on distributions, and should the tax be preserved? Integrationists might favor repeal of the tax as a means of equalizing the overall tax burden on corporate and noncorporate investments.

One explanation suggests that a distributions tax should be preserved to prevent windfall gains to existing shareholders. Under this view, the marketplace is able to capitalize the cost of

---

65 See supra note 52 and accompanying text.
66 See supra notes 50 and 51 and accompanying text.
68 See R. Goode, The Corporate Income Tax 68-71 (1931); Auerbach 1985, supra note 37, at 190; Auerbach, "Taxation, Corporate Financial Policy and the Cost of Capital," 21 Journal of Economic Literature 905, 923-26, 934 (1983); Bradford, supra note 42, at 3, 21; but cf. Peterba and Summers, "The Economic Effects of Dividend Taxation," Harvard Institute of Economic Res., Discussion Paper No. 1064 at 73 (1984). Professor Warren suggests that this rationale makes preservation of the distributions tax a "negative grandfather clause" for its purpose is just the opposite of typical grandfather clauses which attempt to maintain existing law in order to prevent unexpected losses to taxpayers. Cf. Warren, supra note 50, at 754. In that sense, this rationale is somewhat troubling as its logical implication might be to preclude Congress from being able to make just about any changes in the tax laws, either for or against taxpayers.

972 TAXES—The Tax Magazine December, 1989
anticipated taxes in share prices, and that an extra dollar of earnings retained by a corporation therefore increases the value of the corporation’s stock by something less than one dollar. Indeed, if the after-tax rates of return of corporate and shareholder investments are assumed to be the same, one dollar of additional corporate earnings may increase share price by exactly one minus the rate of tax on distributions. Thus, if new shareholders have already discounted their purchase price for the stock to reflect the anticipated distributions tax burden, then elimination of that burden would simply create a windfall benefit to them.

Under this theory, the “losers” are those investors who originally contributed assets to the corporation subject to the prospective distributions tax to arise upon withdrawal, or who owned stock when the distributions tax was first instituted (or increased). Some of the “loss” may also have been shared by the issuing corporation and its shareholders during those times. The bias is caused by the asymmetrical treatment between contributions to corporations (no tax deduction allowed) and distributions from corporations (tax imposed). It is the inability to deliver the benefit to the losers rather than to existing shareholders (who are assumed to have purchased their stock subsequent to those incidents) that creates the possibility of the windfall wealth redistribution.

To illustrate, consider an abstract example involving a corporation whose only assets consist of ten $1,000 bonds. Each bond provides an annual market-rate yield of 10 percent. In this situation, a prospective purchaser of 10 percent of the stock of the corporation would presumably pay less than the value of 10 percent of the assets of the corporation—i.e., less than the value of a single $1,000 bond—because after the stock purchase, the bonds will continue to be held in corporate solution. Hence, the value of the stock to the buyer would clearly be less than if he simply owned one of the bonds directly. Moreover, if it is assumed that the bonds will provide the same after-tax rate of return whether invested directly by the buyer or by the corporation, then the discount to be demanded by the buyer will reflect the anticipated distributions tax burden that will be incurred upon withdrawal of the bond from corporate solution: that is the “extra” burden that the buyer assumes by acquiring incorporated, as opposed to unincorporated, bonds. And retention of a distributions tax is therefore necessary to prevent a windfall to shareholders who have acquired their stock at such discounted prices.

One potential problem with this theory is the uncertainty under current law as to the amount of the distributions tax burden, which may depend upon when and how the distribution...
is effected, and to whom. Not all distributions are taxable as dividends. Also, not all dividends result in full tax consequences to the recipient of the distribution. Furthermore, not all shareholders are in the same tax bracket. But these questions basically only involve the calculation of the amount of the discount and therefore the appropriate rate for the distributions tax. Presumably, to accommodate the windfall concern, a distributions tax should be retained, but set at some blended rate to take account of all of the foregoing factors. Moreover, once the appropriate blended rate is identified, imposition of a uniform tax at that rate on all distributions, no matter how effected, should eliminate this uncertainty for the future.

Some might argue that the theory has no validity in those cases where the shareholder purchases his stock in anticipation of the continued retention by the corporation of its earnings as opposed to the distribution of such earnings out of the corporation. But as we have seen, assuming a uniform distributions tax and the identical after-tax rates of return on corporate and shareholder investments, the present value of the tax “cost” of a distribution is equivalent, regardless of whether there is an immediate distribution or a deferred one. Thus, even if the stock purchaser anticipates corporate retention rather than distribution of earnings, the discount demanded by him will presumably be unchanged.

A more troubling concern is the view that, at least after the repeal of the capital gains preference by the 1986 Act, there is no longer any potential windfall problem to worry about. Conceptually, the argument is as follows: share price is affected both by the discount demanded by the buyer to account for his future distributions tax burden and by the premium insisted upon by the seller to compensate for his taxes due on the sale of the stock. Thus, the potential windfall that might arise upon the elimination of the distributions tax is simply the amount by which the buyer’s discount exceeds the seller’s premium; put another way, it is a measure of the degree to which the dividend tax burden exceeds the stock sale tax burden. Where there is no longer any capital gains preference so that those two burdens are roughly equivalent, there is no remaining potential windfall problem: the 1986 Act has already let the windfall “horse” out of the barn.

One response to this view might be that share price is unaffected by the seller’s tax situation—there is no separate market for shares whose owners are highly taxed. Under this line of reasoning, share price is determined by taking into account underlying asset value and only

---


70 Some have suggested, however, that the focus on dividends may not be unreasonable, at least in the case of public corporations. See Mundstock, “Taxation of Intercorporate Dividends under an Unintegrated Regime,” 44 Tax Law Review 1, 29 n.163 (1988).

71 A corporate purchaser of stock that anticipates a dividend distribution would not necessarily demand the same discount as a noncorporate purchaser because of the existence of the intercorporate dividends-received deduction. IRC Sec. 243(a). This might present a problem in those cases where corporate purchasers dominate the market, for example, in the preferred stock market. Issuers of such stock may typically be able to offer a return inferior to that provided by comparable debt because of the unusual tax situation of the stock purchasers. Imposition of a uniform corporate distributions tax premised on the discount demanded by typical noncorporate buyers might therefore unfairly penalize the corporate holders of the preferred stock, the issuers of such stock, or both. It was largely for this reason that the ALI Reporter’s 1982 Study recommended a different, more liberal rule regarding valuation on previously issued preferred stock. ALI Reporter’s 1982 Study, supra note 2, at 390–400, 483, 504–06; compare Thurstor, supra note 39, at 114–17 (suggests that preferential treatment of preferred stock may be unnecessary). The 1989 study has modified this explanation, and indicates the reason for the special rule is that most holders of the preferred stock are corporate; thus, a distribution with respect to such stock does not produce any movement of funds out of corporate solution. ALI Reporter’s 1989 Study, supra note 2, at 64–65.

72 See Powell, supra note 60, at 371.

73 See supra note 42 and accompanying text.

74 See Auerbach 1979, supra note 61, at 441–42; Powell, supra note 60, at 373; Shoven, supra note 37, at 30–31; Warren, supra note 50, at 726–27.

Under this view, the sale price for stock might be thought of as equal to:

$$(1 - t)/(1 - k) \times E$$

where $t$ is the dividend tax rate, $k$ is the accrual equivalent capital gains rate, and $E$ is the net value of corporate earnings. For example, if the corporation consists solely of $100 of accumulated earnings and A, the sole shareholder of X, has a zero basis in his stock. In a world without taxes, A might sell his stock to purchaser B for $100. If, however, there is a dividend tax rate ($t$) of 50 percent, then B might demand a discount of that amount, reducing the sales price to about $50, to compensate for the future tax he will bear upon withdrawal of the $100 in earnings from the corporation. If, in addition, there is an accrual equivalent capital gains tax rate ($k$) of 20 percent imposed on the sale, then A might insist upon a premium over $50 to compensate him for the tax on the sale, and the ultimate price would be approximately $62.50. Sale by A at that price would not net him $50 after payment of his 20 percent stock sale tax, making him “whole.” B, of course, would insist upon the same premium when he disposes of his stock, and his purchaser would demand the same discount, assuming that tax rates are unchanged.

As is evident from the formula, if $t = k$, then there is no longer any discount, and stock price approximately equals net value of the corporate earnings. If $t$ was previously greater than $k$, then a windfall was obtained by those shareholders who held stock when those two rates became the same (assuming that the rate change was unexpected).
prospective tax burdens attached to the shares, which affect equally all buyers. But although it may be true that a rational buyer would not ordinarily pay more for shares depending upon the level of tax paid by the seller in the transaction, it is difficult to see why a rational seller would sell without recovering at least some portion of his transaction tax cost, especially where he could recover that cost by some alternative means. Moreover, if we assumed that all sellers bore more or less the same tax burden on the sale, would it still be fair to conclude that share price would be unaffected by the amount of that burden?14

A better response is that even in the absence of a special tax rate for capital gains, the realization doctrine still provides some degree of preference for the stock sale end of the transaction. Furthermore, the stock sale tax may not be borne in those cases where, for example, the seller is tax exempt or he has a high basis attributable to the application of Section 1014 of the Code. For these reasons, one might contend that there is still some amount of potential windfall created by complete elimination of the distributions tax burden.15

A more practical response, of course, is simply the revenue considerations involved including the distributional impact of repeal of the distributions tax. In that regard, any potential advantage obtained from repeal of the distributions tax must be weighed against the disadvantage caused by those provisions which would have to be enacted to replace the revenue produced by the present tax. Quite clearly, that comparison cannot be made in the abstract.

In any event, there is considerable irony in this line of inquiry. The proposal described in this article, originally developed as an outgrowth from repeal of the capital gains preference in 1986, may turn out to be less justified because of that repeal. Or, put another way, one might argue that the looming reinstatement of the preference by Congress (and therefore reinstitution of the potential windfall) makes this proposal more necessary and acceptable.17

A final question is whether, if there continues to be a windfall concern, it could be addressed through some other means such as a higher corporate income tax levy. In other words, could the distributions tax be repealed and replaced by a higher corporate income tax to offset the windfall benefit of the repeal to existing shareholders? The answer is no. Unless the increase in the corporate income tax rate were accompanied by a corresponding increase to the shareholder income tax rate, corporate earnings could be distributed free of any distributions tax liability and thereby escape the heavier corporate income tax burden. In short, far from creating a "neutral" tax system with respect to corporate distribution and acquisition policy, such a proposal would bias the decision-making process strongly in favor of immediate distributions and would do little to prevent the windfall to current shareholders.

Interestingly, this last point suggests that recent proposals to limit the deductibility of the interest deduction by corporations may be misplaced. The use of the interest deduction to shelter the future income stream of a corporate investment presumably could be replicated by the leveraging of the investment had it not been made by a corporation. Thus, the mere increase in the amount of corporate debt outstanding does not necessarily produce any windfall to existing shareholders, just as an increase to corporate income tax rates does not eliminate the potential

12 See ALI Reporter's 1989 Study, supra note 2, at 59-60.
13 In the ALI Reporter's 1989 Study, it is assumed that shareholders who sell their shares on the market bearing their own stock sale tax burden and obtain no relief through, for example, a premium price paid by the buyer. On the other hand, if they sell their shares back to the corporation, their stock sale tax is relieved through the credit generated by the payment by the corporation of a minimum tax on the distribution. See ALI Reporter's 1989 Study, supra note 2, at 56-61.
14 In addition, if share pricing were unaffected by the seller's tax, then a cut in that tax would presumably not change the volume of sales. Yet the recent controversy regarding the extent to which a capital gains tax reduction increases the number of realizations tends to belie that conclusion.
16 A partial counterargument here is that, as stated earlier, perhaps the appropriate measure of the buyer's discount is not the pure dividend-tax expectation but rather some blended tax burden to take into account the buyer's ability to withdraw funds from the corporation in the future without bearing the full dividend tax.
19 Regardless of what one stands on the capital gains issue generally, there is a great deal of merit to reintroduction of a reduced tax rate on gains from corporate stock sales. Under the proposal, it is specifically recommended that such gains not be taxed.
21 See Stiglitz, supra note 62, at 7 (because individual borrowing is a substitute for corporate borrowing and interest payments on individual borrowing are also tax deductible, the advantage of corporate borrowing is not the savings from the corporate income tax, but only the difference between such savings and the savings that would have accrued had there been individual borrowing instead).
windfall. Rather, the focus should be on whether the debt replaces existing equity without payment of the proper distributions tax burden.

2. Imposition of Distributions Tax at Corporate Level. The model for this proposal assumes the imposition of a tax upon the distribution of earnings out of corporate solution. But that tax could be imposed either at the corporate level to the distributing corporation or, as under current law, to the distributee upon receipt of the distribution.

Liquidity considerations do not provide a preference as to which party should be burdened with the tax. Current law offers an easy method of resolving liquidity concerns by generally imposing the tax only upon those who actually receive the distribution. But a tax imposed at the corporate level resolves the same concerns just as easily, as the amount of the tax simply reduces the amount of the distribution. The distributees receive a smaller distribution, but without any further tax burden to them. Mathematically, the revenue raised by a shareholder-level distributions tax at rate r on the amount received by a distributee (before payment of the tax) can be matched by a corporate-level tax at rate r/(1−r) on the amount distributed by the corporation (after payment of the tax).

Considerations involving the collection of the tax militate strongly in favor of imposing the burden at the corporate level. From a compliance standpoint, there is evidence of a substantial amount of underreporting or nonreporting of income that arises in the form of dividends and interest. Yet the public may not be willing to accept remedial measures, such as withholding, to insure a greater level of compliance. The proposal greatly simplifies this issue by shifting the burden of the tax from the shareholder to the corporation. Thus, the proposal is not simply a withholding mechanism whereby the distributees continue to be the taxpaying entities who must cope with the administrative nuisance of matching amounts distributed with amounts of tax withheld. With the corporation as the taxpaying entity, a tremendous amount of paperwork would be eliminated, while the likely collection of the tax will be greatly enhanced.

The conclusions stated in the text of course make no judgment whether there may be valid non-tax reasons, such as the increased threat of bankruptcy, to justify some congressional limitation on the use of corporate debt.

Section 305(b) and (c) of the Code operate as an exception to this where those provisions require an actual or constructive stock dividend to be taxed as a distribution of property subject to Section 301.

For example, a 28 percent shareholder-level tax on the gross amount of the distribution (before payment of tax) is equivalent to a corporate-level tax of approximately 38.89 percent on the net amount distributed by the corporation after its payment of the tax. Thus, if a corporation has $100 of earnings available for distribution to its shareholders, a 28 percent shareholder-level tax produces $28 of tax revenue. A 38.89 percent corporate-level tax produces exactly the same amount of revenue if the tax base is $72, the net amount distributed by the corporation after payment of the $28 corporate-level distributions tax (38.89% × $72 = $28). In either case, the shareholders wind up with $72 after taxes.

In 1982, the IRS estimated that there was a compliance rate of only 85 percent with respect to dividend income and only 89 percent with respect to interest income, in contrast to 99 percent compliance with respect to wage income. 1 S. Rep. No. 494, 97th Cong., 2d Sess. 228 (1982). This was estimated to result in an annual revenue loss in excess of $8 billion. Senate Comm. on Finance, 98th Cong., 1st Sess., *Explanation of Committee Amendment to H. R. 2973* at 3 (Comm. Print 1983) [hereinafter, *Explanation of Committee Amendment to H. R. 2973*].

The interest and dividend withholding provisions that were enacted by the Tax Equity and Fiscal Responsibility Act of 1982, P. L. 97-248, were repealed in 1983 by P. L. 98-67, §102, before the provisions ever went into effect, following considerable turmoil and controversy. Whether this action is reflective of the "public's" unwillingness to accept withholding is, however, unclear. One reason for the repeal was the "perception that withholding might impose undue burdens on conscientious taxpayers." *Explanation of Committee Amendment to H. R. 2973*, supra note 86, at 6. Yet this perception has been criticized as invalid. See LeDuc, "An Evaluation of Recent Taxpayer Compliance Legislation and Future Options," 20 Tax Admin. 11 (1983). Some have attributed the congressional action simply to "panic" spread by the "banking industry's campaign to combine misinformation with sophisticated mass mailing techniques." H. R. Rep. No. 119, 98th Cong., 1st Sess. 22 (1983) (supplemental views of Congressmen Dan Rostenkowski, Barber B. Conable, Jr., J. J Pickle, Fortney H. Stark, Thomas J. Downey, James M. Shannon, Robert T. Matsui, and Bill Frenzel).

The General Accounting Office recently reviewed one aspect of the backup withholding provisions enacted in 1982 and amended in 1983 in conjunction with the repeal of interest and dividend withholding. Under backup withholding, payees who fail to furnish an accurate taxpayer identification number are generally subject to withholding at a rate of 20 percent. IRC Sec. 3406(a)(1). The GAO discovered that of the over 400 million interest and dividend returns filed for tax year 1985, approximately 28.5 million contained missing or inaccurate taxpayer identification numbers, and that no withholding was taking place with respect to the overwhelming majority of those erroneous or incomplete returns. U. S. General Accounting Office, *Tax Administration: Accuracy of Taxpayer Identification Numbers on Information Returns Can Be Improved* 17-18 (September 1988).

976 TAXES—The Tax Magazine December, 1989
Aside from compliance issues, current law also places the collection of a uniformly determined distributions tax into question because of a variety of factors at the shareholder level that are extraneous to, and sometimes inconsistent with, the imposition of that tax. Historically, the most obvious bias in the determination of the distributions tax was the fact that certain distributions were eligible to be taxed at preferential capital gains rates. A uniform corporate-level distributions tax avoids this problem even if a preferential rate for capital gains is resurrected by Congress.

In addition, under current law, if the distributee has recently inherited his stock, it is possible for the distributions tax to be greatly reduced or completely eliminated. Yet if the inheritance occurs immediately after the distribution, the proper amount of distributions tax may well be collected. There is no particular policy reason supportive of a distinction such as this.

Another example is where the distributee is not a taxpaying entity, such as a charity, a pension fund, or a foreigner not subject to tax in this country. In that case, the distributions tax may well be nonexistent. A tax imposed at the corporate level is unaffected by considerations such as these, and insures that a distribution out of corporate solution results in the same level of burden no matter who is the distributee.

In short, aside from the clear compliance and paperwork reduction advantages of a corporate-level distributions tax, the principal reason in its favor is to implement better the policy of imposing a uniform level of tax, no matter how the distribution is effected. Of course, this "advantage" may also be its principal shortcoming. Specifically, some might object to a distributee-blind corporate-level distributions tax exactly on the grounds that it is insufficiently sensitive to the income tax status of the distributee. That issue is discussed in the following section.

3. Treatment of Tax-Exempt Investors. The proposal implements a uniform corporate-level tax on all distributions, regardless of the nature of the distributee. This raises special problems in the case of distributions to tax-exempt shareholders. For example, by indirectly imposing a tax burden on tax-exempt entities holding corporate stock, the distributions tax might be viewed as inconsistent with the policy behind the tax exemption. A related criticism is that such a tax fails to take account of tax rate differentials among the taxable shareholders of the corporation. What is the rationale for indirectly imposing the same pro-rata burden on all shareholders, without any mitigation for differences in their income tax status?

As a preliminary matter, it might be noted that there are competing policy concerns here—the desirability of having taxpayers in different income tax brackets, including the zero tax bracket, versus the need to implement a uniform tax burden on all corporate distributions—and that current law is hardly "neutral" with respect to these competing concerns. In effect, current law simply permits other policies to override the policy of imposing a consistent distributions tax. As noted, this may have the adverse effect of disrupting corporate decision-making by creating biases for or against the existence and form of a distribution.

In addition, the exemption from the distributions tax on the part of tax-exempt shareholders permits in certain circumstances the avoidance of that tax even by taxable shareholders. An example is where a taxable shareholder contributes his corporate stock to a charity, claims a charitable deduction, and the charity's interest is then completely redeemed. There does not seem to be any particular policy justification for this result.

Some might argue that a uniform corporate-level distributions tax is justified to the extent share price assumes a fully taxable distribution. For example, assume a distributions tax of 30 percent and the existence of no other taxes. Under the discount hypothesis, if share price fully capitalizes the eventual distributions tax, then the stock of a corporation whose only assets consist of $100 in accumulated earnings should trade at about $70. If the stock is available at that price to both taxable and tax-exempt purchasers, it might at first appear that the tax-exempt buyer, who is exempt from the distributions tax burden, will be able to purchase stock at a 30 percent discount. The result we have assumed is that the tax-exempt investor pays tax just as the taxable investor would, which is precisely the problem we are trying to avoid.

---

90 Cf. IRC Sec. 1014(a)(1).
91 Some might contend that if Section 1014 presents the policy problem, then that provision should be addressed directly. This proposal adopts a much more incrementalist view and attempts to remedy some of the anomalous results under Section 1014 in the corporate distributions area only. Congress has recently demonstrated a willingness to "chip away" at Section 1014 in exactly this manner. See, e.g., IRC Sec. 469(g)(2).
92 See, e.g., Section 512(b)(1) and (5), which excludes both dividends and gains from the sale of exchanges of property (other than inventory-type property) from the unrelated business taxable income of a tax-exempt entity.
93 The flattened tax rate structure enacted as part of the 1986 Act mitigates this concern somewhat. See IRC Sec. 1.
94 See Grove v. Commissioner, 73-2 ustc § 9591, 490 F. 2d 241 (CA-2); Carrington v. Commissioner, 73-1 ustc § 9370, 476 F.2d 704 (CA-5). The IRS has generally acquiesced to this result, and will continue to challenge such cases "only if the donee is legally bound, or can be compelled by the corporation, to surrender the shares for redemption." Rev. Rul. 78-197, 1978-1 CB 83. Charitable bailouts ordinarily can avoid that condition without difficulty. The 1986 Act has reduced the attractiveness of this transaction somewhat by treating the unrealized appreciation in the contributed stock as a preference item for purposes of the alternative minimum tax. IRC Sec. 57(a)(6). Even this tiny effort to squelch charitable bailouts, however, has been strongly opposed by charities and the Senate Finance Committee, in their joint "feeding frenzy" relating to the 1989 Budget Reconciliation bill, voted to repeal the rule for one year. H. R. 3299 (as approved by the Senate Finance Committee), 101st Cong., 1st Sess. (1989), § 6611(d).
tax, is thereby able to obtain a windfall. A corporate-level distributions tax could then be justified as a means of eliminating that windfall.  

The problem with that argument is that the same could be said with respect to most any investment made by a tax-exempt entity. A tax-exempt bond is presumably priced on the assumption that its yield will be taxable to the holders of the bond.  

A tax-exempt purchaser of the bond therefore could be said to obtain a “windfall” also. In fact, the “windfall” can be viewed as nothing more than the value of its tax exemption. 

A somewhat better argument may be that it is not appropriate simply to focus upon the distributee’s tax status. Any nondividend distribution may be reconstructed as a pro-rata distribution to all shareholders followed by purchases and sales of stock among those shareholders. The distributions tax, then, might be viewed as a substitute for the tax burden to all the shareholders had there been such a pro-rata distribution, and must take into account their collective tax status and not just that of the shareholders who are actually redeemed. But this view still does not completely explain why a full distributions tax burden should be imposed where there is a pro rata distribution and some of the shareholders are tax exempt.

Reconsideration of the nature of the corporate distributions tax itself provides another possible answer. As we have seen, the effect of the distributions tax is to impose an “extra” burden on corporate investment. What that tax represents, and why it is imposed, are certainly far from clear—some have justified it as the cost for the access to capital markets that corporate form often entails. But whatever the reason, the tax does not seem to represent a levy on “income”; it is more akin, perhaps, to a charge imposed at the time corporate form is utilized and which should be shared pro rata by all of those owning shares at that time. It is those shareholders who obtain the “benefit” of corporate form. Or, put another way, there is no apparent reason why the amount of the burden or charge should fluctuate with the income tax bracket of the shareholder involved. 

In that regard, the inability of the corporate income tax to take into account shareholder income tax rate differentials may be the true failing of the corporate tax system. Under current law, the marginal burden of the corporate income tax affects low-bracket shareholders relatively more than high-bracket ones.

94 See ALI Reporter’s 1989 Study, supra note 2, at 74.  
95 For this reason, issuers of tax-exempt instruments are able to reduce their yield below the market rate for comparable taxable instruments. See, e.g., Staff of the Joint Committee on Taxation, Tax Reform Proposals: The Treatment of State and Local Government Bonds (JCS-23-85), July 16, 1985, at 50-51. This has been criticized as an inefficient subsidy for the inability to reduce the yield to reflect the full tax benefit available to bondholders in the highest tax bracket. Id.; see Oliver, “Section 265(2): A Counterproductive Solution to a Nonexistent Problem,” 40 Tax Law Review 351, 402-08 (1985).  
96 See Chirelstein, supra note 26.  
97 See ALI Reporter’s 1989 Study, supra note 2, at 73-74.  
98 The ALI Reporter’s 1989 Study avoids part of this problem by exempting ordinary dividends from its minimum tax on distributions. According to the study, this is to permit the preservation of shareholder income tax rates in the case of such distributions. See ALI Reporter’s 1989 Study, supra note 2, at 7, 55, 62-63. But this exception seems to reflect the notion that a uniform tax burden should be imposed on all distributions, no matter how effected. As a result, the exception creates a bias in favor of the excepted form of distribution; indeed, far from simply removing the current law bias in favor of nondividend distributions and taxing them just like dividends, the exception actually results in the imposition of a dividend distribution that is more harsh than the one on ordinary dividends. 

Moreover, as a practical matter, the exception may reintroduce complexities thought eliminated by the distributions tax proposal. For example, if an ordinary dividend is to be exempt, should a distribution effected in the form of a nondividend, but with a dividend “effect” (as determined from the shareholder’s perspective), similarly qualify for the exception? Have we really eliminated the need for provisions such as Section 302 of the Code?

More generally, the exception ignores the view, discussed in the text, that the distributions tax, at least, is not an “income” tax, and that therefore, the income tax status of the distributee is really irrelevant to the measurement of the proper tax burden.


100 It is instructive that where the corporate income tax, rather than the distributions tax, is viewed as the “extra” burden on corporate investment, the corporate income tax has been described in the same manner as this. See Flint v. Stone Tracy Co., 220 U.S. 107, 151-52 (1911); Harberger, “The Corporation Income Tax: An Empirical Appraisal,” 1 H. Comm. on Ways and Means, Tax Revision Compendium 231 (1959). In that regard, the ALI Reporter’s original appellation of “excise tax” may be as accurate a term as possible.

101 For example, assuming a flat corporate income tax rate of 30 percent, a shareholder in the 15 percent tax bracket bears a total tax burden of 40.5 percent (30% + (15% x 70%)) of each dollar earned by the corporation. A shareholder in the 30 percent tax bracket bears a total tax burden of 51 percent (30% + (30% x 70%)) of corporate earnings. Thus, for each dollar earned by the corporation, the higher bracket shareholder has an approximately 26 percent (51 - 40.5)/40.5) greater tax cost than the lower bracket shareholder. In contrast, had the income been earned directly by the shareholders and not through a corporation, the higher bracket shareholder would have had a 100 percent (30% + (15% x 15)/15) greater tax cost. This illustrates that the corporate income tax creates a disproportionately greater marginal burden on lower bracket shareholders than upper bracket ones. See J. Pechman, supra note 77, at
porate income tax simply mirrors the shareholder-level income tax, there may not be any justification for that result. Had the shareholders invested directly in the income-producing activity rather than through a corporation, the tax rate differential would have been preserved with respect to the income generated. There does not appear to be any theoretical reason why that differential should be lost when the investment is made through a corporation instead.

Under this view, tax-exempt entities may be even less justified than low-bracket shareholders in criticizing the uniform distributions tax proposal because of the existence of the unrelated business income tax. It can be argued that a tax-exempt owning corporate stock should indirectly bear both the corporate income tax and the corporate distributions tax: the former as a surrogate for the unrelated business income tax that would arise had the tax-exempt invested directly in the corporate business activity, and the latter as the price for the utilization of corporate form.

Finally, there is an alternative, more pragmatic reason for imposing a uniform tax on all distributions, including those made to tax-exempt entities. If there were no unrelated business income tax, there would be a strong bias in favor of distributing earnings to tax-exempt shareholders as opposed to reinvesting those earnings in corporate solution. Tax-exempts presumably would be encouraged to sell their corporate portfolio stock investments and to own their unrelated business assets directly, with a resulting decrease in investment diversification. A tax imposed on the distribution might then serve the useful purpose of counteracting to some degree this bias.

In fact, of course, there is an unrelated business income tax, but it is not comprehensive. Various forms of passive investment income are exempt from the tax. A uniform corporate distributions tax therefore helps to make less attractive the distribution of passive income-generating assets out of corporate solution and directly into a tax-exempt investor’s hands.

A tougher case is presented if there were a comprehensive unrelated business income tax but even here, a uniform corporate-level distributions tax may be justified. Assume, for example, a situation where because of a comprehensive unrelated business income tax, the corporate income tax burden on an investment is comparable to a tax-exempt investor’s income tax burden on the same investment had it not been incorporated. The question is whether in that case, distributions to the tax-exempt investor should be free of the corporate distributions tax while distributions to taxable investors are subject to that tax. One might argue that if the

whole. See C. McLure, supra note 59, at 29-30; J. Pechman, supra.

Indeed, in a fully integrated corporate system, that presumably is exactly how the income would be taxed. See C. McLure, supra note 59, at 3.

See Bradford, supra note 42, at 2 (“the problem [of current law] . . . is not the extra tax imposed on distributions, but the divergence between shareholder and corporation tax rates on retained earnings”). The proposal generally assumes that the income tax rates of corporations and shareholders are the same. The discussion in the text suggests that this assumption should be an explicit policy goal.

IRC Sec. 511(a)(1).

This assumes, of course, the legitimacy of the unrelated business income tax. A different conclusion is reached if the unrelated business income tax is viewed as unjustified. See Bittker and Rahdert, “The Exemption of Nonprofit Organizations from Federal Income Taxation,” 85 Yale Law Journal 299, 316-26 (1976); Rose-Ackerman, “Unfair Competition and Corporate Income Taxation,” 34 Stanford Law Review 1017, 1036-39 (1982). Under that view, the indirect burden of the corporate income tax, and not the corporate distributions tax, may be the price for the use of corporate form. See Hansmann 1981, supra note 99.

In a subsequent article, Professor Hansmann has argued that the exclusion of passive investment income, and most particularly dividend income, from the unrelated business income tax should be preserved. His rationale is that earnings of a corporation owned by a tax-exempt would be subject to two taxes if the dividend exclusion were repealed, whereas the same earnings would be subject to only one tax (the unrelated business income tax) if the business were owned by the tax-exempt in an unincorporated form. See Hansmann, “Unfair Competition and the Unrelated Business Income Tax,” 75 Virginia Law Review 605, 625-26 (1989) [hereinafter “Hansmann 1989”). But, of course, the exact same point could be made with respect to taxable shareholders of a corporation. His rationale, therefore, simply supports repealing of the distributions tax altogether. If, for a variety of reasons, the distributions tax is to be preserved, the argument in the text suggests that the tax should be applicable to both taxable and tax-exempt investors.


Indeed, to the extent the tax serves this role, the “tollcharge” theory becomes more plausible. See supra note 51 and accompanying text. The tax might be thought of as approximating the present value of the future corporate income tax burden had the earnings not been distributed out of corporate solution. This toll-charge is appropriate because there is no offsetting future shareholder-level income tax burden on the earnings after the distribution.

Technically, of course, a uniform distributions tax is neutral, and therefore cannot offset a bias in favor of immediate distribution. A perhaps more accurate description of the role of the tax in this case is that it would increase the cost of the hemorrhage of earnings out of corporate solution.

The principal items are dividends, interest, annuities, royalties, rents, and gains from the sale or exchange of capital assets. IRC Sec. 512(b)(1)-(5), (5).

For example, under current law, there is a clear advantage for a corporation to distribute an asset such as a corporate bond directly to its tax-exempt shareholders.

By “comprehensive,” I mean a UBIT on all income other than items, such as dividends, potentially subject to the corporate distributions tax. The taxation of such items would then be controlled by the scope of the distributions tax.

December, 1989

TAXES—The Tax Magazine

979
overall “mix” of tax-exempt and taxable investors is relatively stable over time, then there is no bias created in favor of the distribution versus the retention of corporate earnings, even though distributions to tax-exempt investors escape the distributions tax altogether. But that analysis would be true only in the aggregate. On an individual firm-by-firm basis, as the composition of the firm’s investors changed over time, there would be incentives created to either distribute or to retain corporate earnings. And it seems evident that the proposal should attempt to take into account these firm-by-firm effects, rather than simply the overall impact.\[113\]

Of course, to the extent the corporate income tax is not made sensitive to shareholder tax rate differentials and a uniform distributions tax is nevertheless implemented, the marginal impact of the proposal for tax-exempt entities and low-bracket shareholders will be to increase their cost of holding corporate stock as opposed to comparable investments. At least in the case of tax-exempt, this may already be the case.\[112\] A possible remedy is to consider extending the unrelated business income tax to other forms of passive income as well.\[113\]

In conclusion, a uniform corporate-level distributions tax is an effective, nondistortive means of satisfying the policy goal of imposing a consistent rate of distributions tax burden, no matter how or when the distribution is made. Furthermore, the mechanics for imposing and collecting the tax would be far simpler and more efficient than under current law. A necessary concomitant to the imposition of the distributions tax at the corporate level, of course, is to discharge any tax liability to the distributee, and the proposal so provides.\[114]

4. Relationship to Integration Proposals. Finally, a few brief words about the relationship between a corporate distributions tax and various proposals for corporate-shareholder integration. At first glance, it might seem that the two concepts are polar opposites of one another: the distributions tax seems to “firm up” the existence of the two-tier corporate income tax system; in contrast, integration proposals are means to eliminate one of the levels of tax.

In fact, the distributions tax proposal might be viewed as a transitional method of bridging the gap between our current unintegrated corporate tax world and an integrated system. As noted, a rationale for existence of the distributions tax is to prevent the windfall that might otherwise accrue to existing shareholders if an integrated system were implemented at once. But that rationale only requires a distributions tax with respect to the “pre-effective date accumulated earnings base” (i.e., corporate earnings accumulated as of the effective date of the proposal plus any future earnings on those earnings) of a corporation. Put another way, no distributions tax would need to be imposed on the withdrawal of corporate earnings on post-effective date equity contributions.

The theoretically proper way of dealing with the foregoing is to segregate corporate earnings into two pots: earnings on post-effective date equity contributions and all other earnings. The withdrawal of earnings from the first pot could be free of the distributions tax; distributions from the other would be subject to the tax.\[115\] An alternative method of addressing this, conceptually unsound but viable, perhaps, from an overall standpoint, is not to distinguish between the two types of earnings but simply to phase out the distributions tax.\[116\] In this case, once the distributions tax is completely phased out, an integrated corporate tax system would remain, albeit a “backward” system, i.e., one that retains the corporate income tax but eliminates the tax on distributions. There are, I believe, meaningful advantages of such a system over more traditional forms of integration; that, however, is a subject for another day and another article.

\[113\] For example, on an overall basis, a tax provision that induces a takeover of corporation X might be thought of as neutral if the same provision also deters a takeover of comparably-sized corporation Y. But it is difficult to justify the existence of such a provision, at least from a neutrality standpoint, if its individual effects on X and Y are considered.


\[115\] A recent proposal to replace the corporate interest deduction with a shareholder-type credit would have an effect similar to making interest income subject to the unrelated business income tax (while leaving the corporate interest deduction unchanged). See Graetz, “The Tax Aspects of Leveraged Buyouts and Other Corporate Financial Restructuring Transactions,” 42 Tax Notes 721, 724-25 (1989).

\[116\] In contrast, the ALI Reporter’s 1982 Study did not accompany its excise tax proposal (to be imposed on the distributing corporation with respect to certain non-dividend distributions) with any relief to the redeeming shareholder. See ALI Reporter’s 1982 Study, supra note 2, at 401-86. But the Reporter’s proposal was made during a time when the redeeming shareholder would have been taxed at preferential capital gains rates. The 1989 study does offer relief to the distributee by means of a nonrefundable shareholder credit. See ALI Reporter’s 1989 Study, supra note 2, at 56-57.

\[117\] The ALI Reporter accomplishes this by permitting a limited deduction in the case of dividends paid on new equity. See generally, ALI Reporter’s 1982 Study, supra note 2, at 356-90; ALI Reporter’s 1989 Study, supra note 2, at 88-97. Note that this distinction is not simply the difference between pre- and post-effective date earnings of a corporation. Compare Taylor and Aidinoff, “Approaches to Debt: Is Integration the Answer?,” 67 Taxes—The Tax Magazine 931, 936 (1989).