CORPORATE DISTRIBUTIONS TAX REFORM: EXPLORING THE ALTERNATIVES

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Current law imposes materially different tax burdens on economically comparable yet formally distinct methods of distributing corporate profits to shareholders. The resulting behavioral distortions are significant. This article is a description and evaluation of several proposals for reforming the taxation of corporate distributions to eliminate this distortion. Four proposals are considered: (1) a new proposal that would tax pro rata distributions (dividends) like stock sales by allowing the taxpayer to recover a fraction of stock basis on the receipt of the dividend; (2) a proposal (by George Yin) to impose a uniform corporate-level tax on distributions of all types, including dividends and redemptions, and that would exempt stock sales from tax; (3) a proposal (by Marvin Chirelstein) to tax redemptions as though they were pro rata distributions followed by stock sales by the redeemed shareholders to the nonredeemed shareholders; and (4) mark-to-market taxation, under which all accrued gains would be taxed annually even without a stock sale or distribution. I compare the proposals along several dimensions, including the extent to which they warp incentives with respect to the form and timing of distributions, the timing of stock sales, and use of the corporate form. I also assess the flexibility of the various proposals in accommodating special rules for particular classes of shareholders, such as nonresidents and tax exempts.

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I. INTRODUCTION

The current system of corporate-shareholder taxation encourages corporations to return profits to shareholders using share repurchases — "redemptions" in tax jargon — rather than by paying dividends. In this article, I describe and evaluate several proposals for modifying the taxation of corporation distributions. All of the proposals I evaluate would eliminate the bias in favor of redemptions. Some of the proposals would make other important changes, such as eliminating the lock-in effect.

The four proposals considered are as follows. (1) A new proposal that would tax pro rata distributions (dividends) like stock sales by allowing the taxpayer to recover a fraction of stock basis on the receipt of the dividend. I call this proposal the exchange equivalent distributions (EED) tax. (2) A proposal made by George Yin that would impose a uniform corporate-level tax on distributions of all types, including dividends and redemptions, and that would exempt stock sales from tax. Yin calls this proposal the corporate distributions tax (CDT). (3) A proposal made by Marvin Chirelstein that would modify the tax treatment of redemptions. Chirelstein's proposal is built on the insight that every non pro rata redemption is substantively identical to the following two-step transaction: (a) a pro rata corporate distribution (dividend) followed by (b) a stock sale by the redeemed shareholders to the nonredeemed shareholders, to match the adjustment of ownership shares among the redeemed and nonredeemed shareholders that occurs in a redemption. Chirelstein's proposal is to tax non pro rata redemptions according to this decomposed form. (4) Mark-to-market taxation, under which all accrued gains would be taxed annually even without a realization event.

Most proposals for corporate-shareholder tax reform are more far reaching than the proposals on which I focus. A great deal of effort and attention has been devoted to proposals for corporate integration, that is, proposals designed to combine the corporate and individual income tax systems in a fashion that eliminates the double tax on corporate equity. The double tax on corporate equity creates a bias against using the corporate form and encourages debt (discourages equity) finance. It is by now clear, however, that corporate integration is politically unlikely. Integration has been proposed repeatedly, yet it has never been enacted.

Assuming integration will not happen, the question becomes whether more limited reform options are available and worthwhile. I
show that the answer is yes — there are a number of ways to eliminate the bias in favor of redemptions (and against dividends), and removing this bias would be worthwhile. One benefit of reforming the taxation of corporate distributions is that it would improve economic efficiency. Current law imposes materially different burdens on economically comparable yet formally distinct methods of distributing corporate profits to shareholders. The resulting behavioral distortions are significant. This is obvious to any reasonably well-informed observer of trends in corporate financial practice over the past thirty years. Every significant work on corporate tax reform has cited distorting effects on forms of corporate distribution as a major defect in current law.¹

A second benefit of removing the tax bias in favor of redemptions is that it would improve corporate governance. Corporate governance experts report evidence that managers sometimes use nonpublic information to time share repurchases to occur at bargain prices. This causes wealth to shift from the shareholders who sell to the continuing shareholders. The managers themselves often have disproportionately large representation in the group of continuing shareholders — as owners of stock outright and as holders of equity-compensation claims such as stock options.²

Managers have another self-interested reason to favor redemptions over dividends, one that does not depend on making redemptions at bargain prices. When a firm with outstanding stock options pays dividends, the value of the stock options is diminished,


since share price but not the strike price of the options goes down.\(^3\) If the firm instead redeems shares, share prices, and hence option values, are not affected, assuming the firm pays a fair price. This is because the reduction in corporate net assets that follows the redemption is accompanied by a reduction in outstanding shares, so value per share holds constant. Some have even suggested that more nefarious conduct by managers surrounds the choice of payout policy. For instance, Jesse Fried has speculated that some firms announce share repurchases they do not intend to execute to inflate share prices before managers unload their own shares.\(^4\)

Managers, of course, never admit that self-interest infects decisions regarding the form of corporate distributions. Instead, they give an explanation indicating that by using repurchases rather than dividends they are being faithful stewards for their shareholders. Historically the first, and best, explanation for why repurchases are actually in the shareholders’ best interest is tax savings. Repurchases are, under current law, usually a more tax efficient means of returning corporate earnings to the shareholders than paying dividends. The tax law thus supplies a plausible cover story. If bias in favor of redemptions were eliminated, this would no longer be true. This would increase the likelihood that corporate decisions regarding the form of distributions would be made in the shareholders’ interest.\(^5\)

The topic of this paper provokes fundamental questions about corporate-shareholder taxation, such as (1) whether it makes any sense to tax corporate distributions in the first place, and, if so, (2) whether the reason why it makes sense is relevant when assessing the merits of competing reform proposals. As to the first question, several theories have been advanced regarding why it is desirable in principle to retain a tax on corporate distributions, including the following: repealing the distributions tax will result in windfalls to those holding corporate equity; the distributions tax is the price of access to the

\(^3\) This is not true if the strike price is adjusted downward to reflect the dividend, but adjusting the strike price in this fashion would make compensatory stock options subject to the harsh I.R.C. § 409A deferred compensation rules under regulations that took effect in January 2009. Treas. Reg. § 1.409A-1(b)(3)(E) (2007).


\(^5\) To a significant extent, the 2003 reduction in the tax rate on dividends already accomplished this task. However, there is still a bias, albeit a smaller one than before, in favor of redemptions. Writing in the wake of the 2003 Act, Bill Bratton argued that rate parity for dividends and redemptions should be an occasion for outside monitors to begin asking hard questions about why, and in what circumstances, redemptions are superior to dividends. Bratton, supra note 2, at 849.
public equity markets; it is the only feasible (or best) way to impose tax on inbound equity investments by nonresidents; corporate income should be taxed when it is realized either by the corporation or its shareholders to limit tax deferral; the government is dependent on the revenue; and the distributions tax has, or at least appears to have, desirable distributive consequences.

Even those who find all of these rationales unpersuasive should be interested in a reappraisal of the corporate distributions tax for both pragmatic and conceptual reasons. The pragmatic reason is that the United States has taxed corporate distributions without interruption since 1936, and there is no indication this is likely to change any time soon. Given the staying power of this type of tax, it is worthwhile to consider how to minimize the economic inefficiency and administrative burdens that result from its application.

The conceptual reason is that retaining the corporate distributions tax is not incompatible with corporate integration, a reform presumably favored by someone who rejects all of the proffered justifications for retaining the distributions tax. For example, if corporations were permitted to expense their capital costs — in other words, if the corporate income tax were turned into a flow-of-funds tax of the sort envisioned in the Meade Report — the effective tax rate on corporate net income would be approximately zero. Corporate net income could then be assigned and taxed to the shareholders through a distributions tax. Similarly, if corporations were allowed a cost-of-capital allowance or a deduction for dividends paid, the effect would be to eliminate the normal return on equity from the corporate-level tax. These strategies for corporate integration would be improved by refining the distributions tax so that it is less distortive and more administrable. Even those who reject the idea that there

6 An extended form of this argument would be that to the extent the U.S. distributions tax on inbound equity investment is creditable in the investors' country of residence, the tax does not impose an incremental burden on investment and failing to impose the tax would just mean ceding revenue to the residence jurisdiction. This might make sense as part of a bilateral compromise, but it makes no sense to do this unilaterally. Department of the Treasury, supra note 1, at 195-98.


ought to be a double tax on corporate income should therefore be interested in ways the distributions tax can be improved.

Turn now to the second fundamental question posed above, whether the different theories or justifications for retaining an unintegrated corporate-shareholder tax system are relevant when assessing the merits of competing proposals. I readily accept the abstract proposition that the purpose underlying a rule is relevant when assessing if a rule is well designed, or when choosing among competing alternatives. The various theories or justifications for retaining an unintegrated corporate-shareholder tax system, however, are cast at a very high level of generality. The proposals I assess in this paper, by contrast, are quite particular. Several of the differences among the proposals, though important, are subtle. This dichotomy of focus — general theories and specific proposals — creates a situation where mapping the proposals onto the theories is largely unproductive.

Suppose, for instance, that the policymaker decides that the reason we should continue to have a distributions tax is because the government is dependent on the revenue. Knowing this cannot help in assessing the choice among the proposals, particularly if the choice is framed, as it should be, between revenue neutral alternatives. The same holds true for other theories, such as the idea that the distributions tax has, or appears to have, desirable distributive consequences. If this is true, say, because the burden of the tax is thought to be borne by shareholders who are mostly relatively well off, then the conclusion might be that some tax on distributions is worthwhile. The theory cannot, however, help policymakers answer second-order design questions such as whether one accounting mechanism for tracking investments in corporate capital would be less distortive or more administrable than another.

There are counterexamples. Take, for instance, the argument that we should maintain a distributions tax to prevent windfalls to holders of corporate equity that would occur if the tax were eliminated. This argument militates in favor of a distributions tax that takes into account shareholders’ individual tax positions. Suppose, for instance, that corporate stock yields a perpetual dividend stream of 10% before tax, and shares are owned by two representative shareholders High (who is subject to an effective marginal tax rate on dividends of 40%) and Low (whose effective marginal tax rate on dividends is 10%). If the dividends tax is modified so that these variegated rates are made uniform by supposing that reform splits the difference between High and Low so both face an effective marginal tax rate of 25% after the
reform, then the goal of preventing windfalls is not achieved. In this example High gets a windfall, and Low is a transition loser, since the reform increases High’s after-tax yield from 6% to 7.5%, and reduces Low’s from 9% to 7.5%. A reform that maintains the pattern of effective marginal tax rates that exist under current law, by contrast, would eliminate winners and losers in transition. This would be important to one who accepts the anti-windfall theory as justification for the distributions tax.

I proceed as follows: Part II describes the new proposal; Part III describes proposals by Yin, Chirelstein, and a proposal for mark-to-market taxation; Part IV evaluates the proposals; and Part V provides a brief conclusion.

II. REFORM PROPOSAL: TAX DIVIDENDS LIKE SALES

A. Objective

The basic objective of the proposal is to eliminate the bias in favor of stock sales, including redemptions taxed as sales, as compared with dividends. To eliminate the bias it is necessary to equalize effective tax rates. The first requirement for equal effective tax rates is equal nominal (statutory) tax rates on sales and dividends. My view, then, is that the move in the 2003 Act to equalize statutory rates on distributions and capital gains was a step in the right direction. (I am agnostic on the question whether 15% or some higher or lower rate is optimal; I am arguing for equivalent rates, not rates set at any particular level.)

Equalizing statutory rates, although necessary, is not sufficient to equalize effective tax rates. Under current law, differences in the rules regulating basis recovery mean that the effective tax rates on distributions and stock sales still differ. The objective of the rules proposed below is to ensure consistent timing of basis recovery for sales, redemptions, and dividends to the extent it is feasible to do so. Unfortunately, rules that result in perfect consistency in the timing of basis recovery for comparable sales, redemptions, and dividends would be difficult to implement and enforce. Allowing for some differences in the timing basis recovery for sales and dividends should be considered for the sake of administrative ease since the skewing of effective tax rates that results can be kept to a minimum.

I will refer to the proposal as the “exchange equivalent distributions” (EED) tax. Because all distributions — including but not limited to “dividends” in the Internal Revenue Code (Code)
section 316 sense — would be treated as exchanges, I expect that if my plan were implemented EEDs would simply be called "distributions," but I adopt this convention as a convenient way to explain a new idea.

B. Basic Mechanics

1. Allow Basis Recovery on Ordinary Dividends

Under the EED tax, all pro rata distributions and redemptions made by public companies would be treated as constructive stock sales and taxed under Code section 1001. The number of shares deemed sold in an ordinary dividend would equal (a) the amount of money or value of the property distributed divided by (b) the cum dividend market value of the issuer’s stock on the date of the distribution. As discussed in Part II.B.3, infra, extending the EED tax to nonpublic companies would be problematic because of the difficulty of valuing the stock of nonpublic companies. Under current law, taxpayers can get earlier basis recovery, the principal benefit conferred by the EED tax, by replacing dividends with redemptions. Firms now do this: the aggregate annual dollar volume of repurchases is now often greater than the volume of dividends paid.  

Under the EED tax, a refined tax concept of "dividend" and the attendant baggage such as earnings and profits accounting would be unnecessary. When, as now, sales and dividends are taxed at the same rate, the only function of earnings and profits accounting is to regulate the timing of basis recovery. Under the EED tax, the timing of basis recovery would depend on the timing of corporate distributions in whatever form, so, at least for purposes of applying Subchapter C to public companies, earnings and profits accounting would be obsolete.  

Also, Code section 302 and related sections, and the

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10 See Bratton, supra note 2, at 850–52 (finding that by 2000, listed companies paid out more money to their shareholders for repurchases than as dividends). See also Amy K. Dittmar & Robert F. Dittmar, The Timing of Financing Decisions: An Examination of the Correlation in Financing Waves, 90 J. FIN. ECON. 59, 76 (2007); Eugene Fama & Kenneth French, Disappearing Dividends: Changing Firm Characteristics or Lower Propensity to Pay?, 60 J. FIN. ECON. 3, 35–39 (2001) (discussing the increasing popularity of repurchases as an alternative to dividends).

11 The earnings and profits account is used beyond Subchapter C as a proxy for economic earnings. See, e.g., I.R.C. § 884 (branch profits tax). It may still be required for these other purposes, unless some alternative proxy, such as GAAP book income, could be substituted.

As noted above and as discussed in more detail below, it might be necessary to maintain some facsimile of current law for nonpublic companies. I suggest, however,
concept of a dividend-equivalent redemption, would be restricted to nonpublic companies.  

2. Stock Basis Accounting and Broker Basis Reporting

If pro rata distributions are taxed as constructive stock sales, which shares is the shareholder deemed to sell? If all of the recipient-shareholder’s shares have the same tax attributes (basis and holding period) then it does not matter. When this is not the case, however, some rule must be supplied to answer this question.

The stock basis accounting rule should be formulated with two objectives in mind. First, it should apply consistently to sales, redemptions, and distributions, which is necessary to equalize effective tax rates. Second, it should be compatible with broker basis reporting. Under broker basis reporting (set to take effect in 2011), brokerage firms will have to report to taxpayers and the Internal Revenue Service (Service) both the gross proceeds received on the disposition of a customer’s stock and the customer’s basis and holding period. With this information readily available, taxpayers will be able that earnings and profits accounting should be repealed even for nonpublic companies. See infra text accompanying note 22.

If the proposal were adopted, all of the rules in the Code and Regulations that police the dividend-redemption boundary line — the rules designed to prevent shareholders from bailing out earnings and profits at capital gains rates — would be inapplicable to public companies. In addition to I.R.C. § 302, the following Code sections would be affected: I.R.C. §§ 303, 304, 306, 312, 316(a), 317(b), 331, 334(b), 336, 346, 356(a)(2). I.R.C. §§ 331, 334(b) and 336 would be affected because there would be no need to distinguish between liquidating and nonliquidating distributions; liquidating distributions would be treated like all other distributions. In addition to repealing or drastically limiting the scope of these provisions, the circumstances to which the I.R.C. § 318 constructive ownership rules apply would be radically curtailed. There would be no need for any constructive ownership rules in Subchapter C other than in I.R.C. §§ 338 and 382 and for nonpublic companies (I.R.C. § 318 is invoked by Code sections outside of Subchapter C). For an explanation of why it might be desirable to continue to apply these rules, or some simplified version of these rules, to nonpublic companies, see infra Part III.A.3.

For stock acquired through December 31, 2010, brokers are required to file annual information returns with the Service showing the gross proceeds realized in stock sales, but not basis. I.R.C. § 6045(a). For stock acquired on or after January 1, 2011, brokers are required to report gross proceeds, adjusted basis, and holding period. See Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 403. Many brokerage firms now supply cost basis and holding period information to customers (but not the Service). As systems are put in place to accommodate broker basis reporting, all firms will have the ability to supply this service to customers, even for stock acquired before January 1, 2011 (assuming, as will typically be true, the
to self-administer the EED tax even though it imposes somewhat greater information requirements than current law. Perhaps more importantly, the Service will be able to discover through automated processes when taxpayers cheat by overstating their stock basis to minimize their gain (or maximize their loss) on stock sales. Awareness of this possibility will improve compliance.

Unfortunately, as we will see, finding a basis accounting rule that is compatible with broker basis reporting and treats distributions, redemptions, and stock sales consistently in all circumstances is difficult. The policymaker must trade off parity in the timing of basis recovery on the one hand against administrative simplicity on the other. As I illustrate below, one alternative (allowing for taxpayer choice) would treat distributions, redemptions, and stock sales the same in all circumstances. However, this alternative would be difficult to administer, although the administrative complexity might be manageable given computerized accounting. Another alternative, which I will refer to as the share-by-share convention, would strike the opposite balance — it would be simple to administer, but would not apply with perfect consistency to distributions, redemptions, and stock sales. I discuss the strengths and weaknesses of various approaches to stock basis accounting below. In my judgment, taxpayer choice and the share-by-share convention are the two most promising alternatives.

**Taxpayer Choice.** Under current law, when taxpayers actually sell shares they are given a choice regarding which shares they will be deemed to have sold in circumstances where they hold multiple blocks of stock with different per-share bases and different holding periods. In concept, this rule could be extended to the EED tax. The basis recovered on an EED would depend on which shares the shareholder selected as the ones sold in the deemed exchange; the basis of those shares would then be reduced to zero.

To illustrate, suppose a public company shareholder purchased 200 shares of stock in two blocks of 100 at different dates and at different prices. At Time 1 she purchased the first 100 shares for $100. At Time 2 she purchased another 100 shares for $200. At Time 3, when the stock is trading for $3 per share, the company pays a $.15 per share dividend. The shareholder's gross dividend would be $.15 × 200 = $30. If the shareholder's basis in the shares deemed sold exceeded the distribution, then a question arises whether a loss should be permitted. I discuss this issue below.

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14 Treas. Reg. § 1.1012-1(c) (1960).
15 If the shareholder's basis in the shares deemed sold exceeded the distribution, then a question arises whether a loss should be permitted. I discuss this issue below.
200 shares = $30. Under the EED tax, the taxpayer would be deemed to sell the fraction of her shares equal to the dividend received ($30) dividend by the cum dividend value of her shares (200 shares x $3 per share = $600), or one-twentieth of her shares. She holds 200 shares, so this is ten shares.

If she actually sold ten shares, the taxpayer would likely choose to sell from the high-basis block acquired at Time 2, and if the current law approach were extended to the EED tax, she could make this same choice. She would thus recover $20 of basis, which is the product of her per-share cost basis and the number of shares deemed sold ($2 x 10 = $20). Her taxable income would be $10 ($30 dividend received less $20 basis recovery) and her basis in the shares deemed sold would be reduced to zero. On future sale of those shares the full amount realized would be taxable.

Coordinating taxpayer choice with broker basis reporting would be difficult for taxpayers who hold different blocks of stock with different brokers. Suppose that the taxpayer in our example has accounts at Merrill Lynch and Charles Schwab. If the taxpayer bought the Time 1 block in the Merrill account and the Time 2 block in the Schwab account, and then received a dividend, both Merrill and Schwab would be expecting the taxpayer to recover five shares' basis from the block held at that firm. The taxpayer, however, would rather sell ten shares from the Time 2 block held at Schwab, since the shares held at Schwab have a higher basis than those held at Merrill.

The problem is not insoluble, but possible solutions get complicated. One solution is to establish a default rule that an equal fraction of every share held by the taxpayer is sold. This would allow brokers to report based on information already known, but allow the taxpayer to opt out of the default by following a certain protocol designed to prevent cheating. Here, the taxpayer would (a) inform Merrill that she was choosing to recover all of her basis from shares held at another firm and (b) inform Schwab that she has received a $15 EED on stock held at another firm but is choosing to recover basis on stock held at Schwab instead of holdings at that other firm. Merrill would be required to report the taxpayer as having received a $15 (five-share) EED on stock held at another firm for which she opted out of taxation and basis reduction. Schwab would report her as having received a $15 (five-share) EED on stock held at Schwab and a five-share EED on stock held at another firm, which the taxpayer opted to have treated as received on shares held at Schwab. The Service would then look out for taxpayers who opt out of taxation at one brokerage firm, but do not correspondingly opt into taxation at another firm.
Opting out without also opting in, if done knowingly, would be fraudulent.

All of this might be too much for the brokerage industry and the Service to manage successfully. If, however, the systems can be established to keep track of everything, including, critically, automated matching by the Service of opt-outs and opt-ins, then this is a promising approach because there would be perfect consistency in the timing of basis recovery for stock sales, redemptions, and dividends.

Convention. An alternative to taxpayer choice is to adopt a convention that would dictate which shares are deemed sold. Perhaps the simplest possibility would be to use FIFO, which is currently the default rule for taxpayers who do not make a specific identification.16 In this example, it would mean that the taxpayer would be deemed to sell ten of the 100 shares acquired at Time 1. Those shares had a basis of $1 per share, so a sale of ten of them for $30 would result in gain of $20 and, again, the basis of those ten shares would be reduced to zero.

There is actually a slightly more complicated convention — the share-by-share convention — that is more compatible with broker basis reporting than FIFO. Under the share-by-share convention, the shareholder would be deemed to sell one-twentieth of every share. Here, that would mean that the shareholder would recover $.05 of basis on each share purchased at Time 1 (the $1 per share cost times 1/20) and $.10 of basis on each share purchased at Time 2 ($2 per share cost times 1/20), for a total basis recovery of 100 × $.05 + 100 × $.10 = $15. The shareholder's gain on the dividend would thus be $30 − $15 = $15. She would be left with two blocks of 100 shares with per-share bases of $.95 (Time 1 block) and $1.90 (Time 2 block). Note that this is different from the result that would have been obtained on a stock sale or a redemption (where the taxpayer would have sold out of the Time 2 block, and reported $10, rather than $15, of gain).

To see why the share-by-share convention works better with broker basis reporting than FIFO or other conventions, carry on with the same example. Recall that the Time 1 block ($1 per share) is held at Merrill and the Time 2 block ($2 per share) is held at Schwab. When the taxpayer receives the $.15 per share dividend on her 200 shares, under FIFO all of the basis would be recovered from the Time 1 block held at Merrill. Importantly, however, Merrill would not know that the shares it holds for this shareholder were the first ones issued by the dividend-paying company she purchased. Neither would

Merrill know the aggregate number of shares the taxpayer is deemed to sell, since Merrill would not know her holdings at other brokerage houses. The same problem would arise under LIFO. The most direct way to surmount this difficulty would be to require taxpayers to disclose sufficient details regarding their portfolios to every brokerage with which they hold an account, but it is inconceivable that Congress would require this.

Under the share-by-share convention, by contrast, Merrill could make a determination about how much basis the taxpayer may recover on the shares held at Merrill based only on the taxpayer's basis in the shares held at Merrill. This is (usually) information Merrill already knows. The same would be true for Schwab. Hence, the share-by-share convention could be coordinated with broker basis reporting quite easily.

**Basis Averaging.** A more novel approach to share basis accounting would be to require taxpayers to average basis across fungible shares. The rule would be that basis for every share would equal the shareholder's total cost divided by the total number of shares held. Basis averaging would resolve quite simply which of the recipient-shareholder's shares are deemed to be sold in an EED - with basis averaging, it would not matter. All shares would have the same basis, and the effect of the dividend would be to reduce aggregate basis in all shares held following the dividend.

Determined taxpayers could plan around basis averaging. Avoidance techniques would include (1) holding shares both directly and through pass-through entities such as partnerships or S

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17 Complex issues surround broker basis reporting. The basic difficulties are: (a) that brokers do not have complete or perfect information regarding the tax attributes of the shares they hold; and (b) that brokers lack sufficiently complete information regarding their customers' tax positions to supply accurate information in certain situations that implicate complex basis accounting rules (e.g., I.R.C. §§ 1015(a), 1091(d)). Despite these difficulties, broker basis reporting is likely to improve compliance compared with current law.

18 There is already an average basis rule for mutual fund holdings. Treas. Reg. § 1.1012-1(e) (1960).

19 It actually would matter for one reason — holding period. The mutual fund basis averaging rule resolves the holding period issue in two ways. If the taxpayer elects to use the “double category method,” then basis is averaged across two pools of stock — shares held not more than one year and other shares — and the taxpayer may select the pool from which a given sale will be deemed to have occurred. Treas. Reg. § 1.1012-1(e)(3) (1960). Alternatively, the taxpayer may use the “single category method,” in which case there is only one pool and holding period is determined on a FIFO basis. Treas. Reg. § 1.1012-1(e)(4) (1960).
corporations; (2) issuing multiple classes of stock that differ from one another only slightly to exploit the difficulty of averaging basis across nonfungible shares; and (3) holding shares in accounts with different brokers to exploit the difficulty of averaging across accounts at different institutions. The first technique could be confronted with a look-through rule requiring averaging across shares held both directly and indirectly. The second technique might be frustrated, at least to some extent, by a rule broadly defining the “class of stock” concept for basis averaging purposes. This rule would be along the lines of the regulations implementing the one-class-of-stock requirement of Subchapter S, which disregards voting and economically trivial distinctions between or among superficially distinct classes. It is not clear that the third technique could be impeded; the difficulty is the same one that makes FIFO and broker basis reporting incompatible – no single broker has enough information to determine a given taxpayer’s average basis. Even if a broker does have sufficient information it would not know that it does, and it is unlikely that brokers can be made to share information with one another.

Comparing Alternatives. My view is that taxpayer choice is the best alternative if administration can be managed with automated systems. However, if not, the share-by-share convention should be considered for pragmatic reasons even though it results in some differences in the timing of basis recovery, as illustrated above.

If taxpayer choice is infeasible, thought should be given to combining the share-by-share convention and a more limited form of basis averaging. Taxpayers could be made to average their basis among all fungible shares held with a single broker, but not between or among brokerages. Under this rule, taxpayers with only one account would have no tax reason to prefer a redemption to a dividend and, for such taxpayers, the main goal of the EED tax would be achieved in full measure. This approach, however, might encourage taxpayers to open otherwise unnecessary additional brokerage accounts. It would also favor relatively rich taxpayers who are more likely to have multiple accounts as a matter of course.

3. Nonpublic Companies

Extending the EED tax to nonpublic companies would be unwise. The EED tax burden on distributions depends on the market value of corporate stock at the time of the distribution. In the absence of public trading as a measure of value, the system would not function smoothly. Distributee-taxpayers would have an incentive to low-ball
the value of their stock. This would maximize the ratio of basis to value and inappropriately accelerate basis recovery (in egregious cases to the extent of generating artificial losses).

In thinking about the valuation issue raised by nonpublic companies, it is useful to separate distributions into two categories: pro rata distributions (which could take the form of dividends or redemptions); and non pro rata distributions (which must necessarily take the form of redemptions). The valuation issue is far less severe for non pro rata redemptions because (1) there is an actual market transaction (stock sale to the issuer), and (2) there is reason to think that the transaction reflects arms-length pricing. Arms-length pricing is likely because the redeeming corporation is not the alter ego of the redeemed shareholders. (Were this true, then the redemption would be pro rata rather than non pro rata). Fidelity to the nonredeemed shareholders serves as a check on price manipulation. Allowing basis recovery for non pro rata redemptions as under current law, therefore, makes good sense.

Now turn to pro rata distributions (dividends or redemptions). If the company issues a dividend, then every shareholder will be better off from a tax standpoint if they collectively decide to low-ball the value of the company for purposes of determining how much basis they may recover. There is no sale of shares and thus no market transaction from which to gauge value. This is a clear circumstance where the EED tax would be difficult to enforce adequately. If, instead, the company repurchases shares on a pro rata basis, there is a sale of shares. However, since by definition no shareholder’s percentage interest in the company is altered, there is no commercial impediment to setting an artificially low value for the repurchase price. To accept uncritically the price paid in a pro rata redemption as market value would be to invite tax avoidance.

Distinguishing between pro rata distributions and non pro rata distributions is a difficult task that depends on defining the terms “pro rata” and “non pro rata,” and invoking ownership attribution rules and anti-abuse rules. The statutory provisions currently used for this function could be preserved for nonpublic stock. In a 1982 Study Draft, the American Law Institute explained how these rules could be improved and simplified.

If something like the current law rules is preserved for nonpublic companies, one change that would be desirable is the elimination of

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20 See supra note 12.
21 ALI 1982, supra note 1, at 417–27.
earnings and profits accounting from the system. All dividends (in the corporate law sense) and pro rata redemptions would be taxable in full. Basis recovery, including recovery of “disappearing basis” recycled from redeemed shares, would be precluded until complete termination of the shareholder’s interest. Whatever negligible benefits are derived from distinguishing between “dividends” (in the Code section 316 sense) and return of capital distributions is swamped by the administrative hassle and complexity of earnings and profits accounting.\textsuperscript{22}

In the end, the inability to extend the EED tax to nonpublic corporations is unfortunate, but relatively unimportant. First, the domain of these rules is shrinking with the size and number of nonpublic corporations subject to Subchapter C.\textsuperscript{23} Second, although current law is more complex than the EED tax, the current law rules governing distributions are at this point well understood, even if vague in some specific applications.

4. Recognition of Losses

A question arises whether taxpayers holding shares with basis in excess of value should be permitted to recognize tax losses on the receipt of EEDs. If the EED tax is, as I have suggested, limited to public companies, then losses should be permitted. The basic idea of the EED tax is to treat the receipt of an EED like a real sale, and tax losses are allowed on real sales. On the other hand, if the EED tax were applied to nonpublic companies, then one way to limit the benefit taxpayers gain by low-balling the value of their shares is to preclude loss recognition on EEDs.

5. Character and Capital Loss Limitations

The basic premise of the EED tax is that straight pro rata distributions, redemptions, and stock sales are comparable ways for the shareholder to cash out corporate equity investments, so they ought to be taxed alike. Under current law, however, gains on stock

\textsuperscript{22} For the ALI’s recommendation that earnings and profits accounting be abolished, see id. at 424.

\textsuperscript{23} See Staff of Joint Comm. on Taxation, 110th Cong., Tax Reform: Selected Federal Tax Issues Relating to Small Business and Choice of Entity 9 (Joint Comm. Print 2008). The rise of limited liability entities taxed as partnerships and expansion of the eligibility rules under Subchapter S are thought to be responsible for the shrinking domain of nonpublic corporations taxed under Subchapter C.
sales almost always produce capital gains and losses, whereas dividends historically have been classified as ordinary income. Assuming the tax rates on capital gains and dividend income are the same, an assumption on which the EED depends, the principal reason the capital-ordinary distinction matters is that the deductibility of capital losses is limited.\textsuperscript{24}

Writing in 1987, the last time the rates on dividends and capital gains were equated, Martin Ginsburg explained how to reconcile (a) the fact that stock sales and dividends represent alternative ways to extract the same economic return from corporate equity, and (b) the need to limit the deductibility of capital losses to prevent cherry-picking (i.e., opportunistically realizing losses on depreciated stock while deferring gains on appreciated stock).\textsuperscript{25} The idea is to treat dividend income as the equivalent of capital gain for purposes of applying the limitation on the deductibility of capital losses.\textsuperscript{26}

Suppose at the beginning of the year Ms. Rich buys $1 million worth of stock in each of two corporations, Up and Down. Down does poorly and by the end of the year, Rich's Down stock is worth $900,000. She sells it at a loss. Up does well, so well in fact that Rich's share of net income is $100,000. If Up distributes its net income to the shareholders by way of dividend, Rich will have $100,000 of income, but the income cannot be offset by Rich's $100,000 loss on Down.\textsuperscript{27} If instead Up retained its net income and Rich had sold her stock on the market (or back to Up in an exchange redemption), she would have been able to deduct the capital loss on Down in full. Because capital gains on stock sales and dividend income are both ultimately derived from corporate net income, it makes little sense to permit Rich to net

\textsuperscript{24} I.R.C. § 1211.


\textsuperscript{26} \textit{Id. at 43} (proposal II.C); see also \textit{Alvin C. Warren, Jr., Integration of Individual and Corporate Income Taxes} 702-04 (ALI 1993), reprinted in Michael J. Graetz & Alvin C. Warren, \textit{Integration of the U.S. Corporate and Individual Income Taxes: The Treasury Department and American Law Institute Reports} (1998). A more expansive version of the proposal, suggested by Ginsburg and endorsed by Warren, would allow taxpayers to deduct realized stock sale losses to the extent of gains and dividends, and then again to the extent losses exceed unrealized gains.

\textsuperscript{27} This assumes she has no other capital gains or losses and ignores the $3000 annual allowance under I.R.C. § 1211(b).
gains and losses but not dividends and losses. Ginsburg's proposal would correct this anomaly by allowing dividends received from Up to absorb capital losses on the sale of Down. 28

III. OTHER REFORM PROPOSALS

Several commentators have made proposals to reform the taxation of corporate distributions. In this Part, I will describe three such proposals and illustrate how they work. In Part IV, I will compare the EED tax and these other reform proposals along a number of dimensions.

A. Yin's Corporate Distributions Tax (CDT)

The corporation distributions tax (CDT), proposed by George Yin in a 1990 article in the Georgetown Law Journal, would be imposed on all nonliquidating distributions regardless of their form. 29 The CDT would also be imposed on liquidating distributions, but only after recovery of contributed capital. Contributed capital would be accounted for using a contributed capital account (CCA) maintained at the corporate level. The CCA would be increased by shareholders' cash contributions and the basis of contributed property. Gains and losses on stock sales would be tax-exempt. Shareholder stock basis would thus be irrelevant.

For most shareholders, the principal difference among the CDT, the EED tax, and current law boils down to when shareholders are permitted to recover their investment in corporate capital (represented either by the CCA balance or stock basis). Under the CDT, contributed capital may not be recovered until liquidation. Under the EED, tax basis recovery is allowed as soon as there is a corporate distribution, of whatever form, to the shareholder(s) (or a stock sale). The approach under current law is sometimes like the CDT and other times like the EED tax, depending on the form by which the shareholder cashes out her investment.

28 If losses on EEDs are permitted, see supra Part III.A.4, then when a shareholder has EED losses, they should, arguably, be subject to the capital gains netting rules, I.R.C. § 1222, and then to the loss limitation rule in I.R.C. § 1211(b).

To illustrate the basic mechanics of the CDT, consider the following example. A and B form X Corporation. A contributes $1. B contributes $2. X invests the $3 and earns a two-fold return. Then X distributes to A and B one-third ($3 of $9) of its net assets. Assuming a tax-exclusive CDT rate of 25%, the results would be as follows: the $3 gross dividend would break down into a $2.40 distribution to the shareholders and a $2.40 x 25% = $0.60 CDT payment; A would receive $2.40 x 1/3 = $0.80; B would receive $2.40 x 2/3 = $1.60; X would be left with net assets of $6.

To compare this example with a redemption, we must determine what X's stock is worth, so we know how much X pays for the shares it redeems. If the CDT liability owed on future distributions is capitalized into share prices, X's equity is worth somewhere between $7.80 and $7.20, depending on the value of X's CCA. Recall that the CCA cannot be recovered until liquidation. The CCA factors into share prices because the larger the CCA, the larger the net proceeds to shareholders on X's ultimate liquidation. X's tax liability on liquidation equals the product of (a) the CDT rate and (b) the difference between net asset value and the CCA balance.\(^3\)

If the parties value the CCA at zero (perhaps because they do not expect to recover the CCA in the foreseeable future), the present value of future CDT liability is $9 x 20% = $1.80, so equity value is $7.20, the low end of the range.\(^3\) If the parties assume the CCA is worth its nominal amount (perhaps because they expect to recover CCA currently), then the impending CDT liability is ($9 - $3) x 20% = $1.20, so equity value is $7.80, the high end of the range. To simplify things for the time being, I will assume that it is common knowledge between A and B that X will be liquidated in the current period, so that both A and B assign a value to the CCA based on its nominal amount. Later, I will relax this assumption.

From X's perspective, a redemption comparable to the $3 distribution described above would be a transaction in which X repurchases A's stake for its fair market value. For reasons just explained, the fair value of all of X's stock is $7.80, so A's stake is worth $7.80/3 = $2.60. If X redeems A's stake for $2.60, the CDT liability will be $2.60 x 25% = $0.65. This will leave X with net assets of $9 - $2.60 - $.65 = $5.75.

\(^3\) Tax liability will equal \((\text{NAV} - \text{CCA}) \times \text{CDT}/(1 + \text{CDT})\) = \((9 - \text{CCA}) \times 20\%\). The first term, net asset value (NAV) less CCA, is the tax base on which distributions tax must be paid. The second term is the tax-inclusive CDT rate.

\(^3\) The tax-exclusive CDT rate of 25% implies a tax-inclusive rate of 20%. See supra note 30.
Suppose X then liquidates, which is consistent with the parties’ expectation that CCA would be recovered currently. X’s CDT on liquidation is $(5.75 - 3) \times 20\% = .55$, leaving B with a net distribution of $5.75 - .55 = 5.20$. Although it might seem that X overpaid A to the detriment of B, this is not the case. X’s stock was worth $7.80 immediately prior to X’s redemption of A, so at that time B’s stake was worth $7.80 \times 2/3 = 5.20$, which matches the result for B under the redemption scenario.

Indeed, the results of this example are exactly like those of the dividend example, with the steps reordered. To see this, assume that in the dividend example the $3$ dividend is followed by a liquidation. The liquidating distribution would draw a CDT liability of $(6 - 3) \times 20\% = .60$, leaving X with $5.40 to distribute between A and B. A would receive $5.40/3 = 1.80$. When added to the $.80 dividend A received, A winds up with $2.60. B would receive $5.40 \times 2/3 = 3.60$. When added to the $1.60 dividend B received, B winds up with $5.20.

The results of these examples are summarized in Table 1.

<table>
<thead>
<tr>
<th>TABLE 1: DIVIDEND V. REDEMPTION COMPARISON UNDER CDT WHERE LIQUIDATION OCCURS IN CURRENT TAX PERIOD</th>
<th>Dividend</th>
<th>Redemption</th>
</tr>
</thead>
<tbody>
<tr>
<td>A, B, A + B</td>
<td>A, B, A + B</td>
<td></td>
</tr>
<tr>
<td>1. NAV pre dist.</td>
<td>3.00</td>
<td>6.00</td>
</tr>
<tr>
<td>2. Dist.</td>
<td>0.80</td>
<td>1.60</td>
</tr>
<tr>
<td>3. CDT (line 2 x 25%)</td>
<td>0.20</td>
<td>0.40</td>
</tr>
<tr>
<td>4. NAV post dist. (lines 1 - 2 - 3)</td>
<td>2.00</td>
<td>4.00</td>
</tr>
<tr>
<td>5. Liq. Dist., gross</td>
<td>2.00</td>
<td>4.00</td>
</tr>
<tr>
<td>6. CCA</td>
<td>1.00</td>
<td>2.00</td>
</tr>
<tr>
<td>7. CDT ([(line 5 - line 6) x 20%])</td>
<td>0.20</td>
<td>0.40</td>
</tr>
<tr>
<td>8. Liq. dist., net (line 5 - line 7)</td>
<td>1.80</td>
<td>3.60</td>
</tr>
<tr>
<td>9. Net received (line 2 + line 8)</td>
<td>2.60</td>
<td>5.20</td>
</tr>
</tbody>
</table>

Now consider how the CDT applies if we relax the assumption that X will be liquidated in the current period. The results for a redemption depend on how A and B value the CCA. If both A and B know that the company will be liquidated in one year and they agree to gauge the time value of the CCA using a discount rate equal to the prevailing after-tax rate of return — say 10% — then regardless of whether there is a dividend or redemption, the net cash received by each shareholder equals the results for a dividend, as set out in Table 2.
TABLE 2: DIVIDEND V. REDEMPTION COMPARISON UNDER THE CDT WHERE LIQUIDATION IS DEFERRED

<table>
<thead>
<tr>
<th>Dividend</th>
<th>Redemption</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>A</td>
</tr>
<tr>
<td>1. NAV pre dist.</td>
<td>3.00</td>
</tr>
<tr>
<td>2. Dist.</td>
<td>0.80</td>
</tr>
<tr>
<td>3. CDT (line 2 x 25%)</td>
<td>0.20</td>
</tr>
<tr>
<td>4. NAV post dist. (lines 1 – 2 – 3)</td>
<td>2.00</td>
</tr>
<tr>
<td>5. Liq. Dist., gross (FV(line 4))</td>
<td>2.20</td>
</tr>
<tr>
<td>6. CCA</td>
<td>1.00</td>
</tr>
<tr>
<td>7. CDT ((line 5 – line 6) x 20%)</td>
<td>0.24</td>
</tr>
<tr>
<td>8. Liq. dist., net (line 5 – line 7)</td>
<td>1.96</td>
</tr>
<tr>
<td>9. Net received (FV(line 2) + line 8)</td>
<td>2.84</td>
</tr>
</tbody>
</table>

On the other hand, it is conceivable that A will convince B that on X’s redemption of A’s stake, A’s share of X should be valued based on the then-present value of the CCA. A’s argument would be that continuing the business venture within X, rather than liquidating X, is B’s choice. The consequence of this choice is a reduction in the time value of the CCA, which, A would argue, should be borne by B, who could avoid this result by making a different choice (i.e. immediate liquidation). If B is persuaded, the aggregate results do not change, but the division of net assets between A and B does change.32

B. Chirelstein’s Proposal

In a 1969 article in the Yale Law Journal, Marvin Chirelstein proposed that share repurchases by public companies be treated as dividends to both the redeemed shareholders and the other shareholders alike, followed by sales by the redeemed shareholders.33 Under Chirelstein’s proposal, the tax results of dividends and redemptions would be brought roughly into line, but the aggregate tax burden on all shareholders would be somewhat greater for redemptions than for straight pro rata distributions, creating a bias against redemptions (the opposite bias from current law). Under Chirelstein’s proposal, Code section 302 and related sections would no longer apply to public companies.

To illustrate, suppose PublicCo has 1000 shares outstanding and

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32 A would net $2.86, and the decline in the time value of the CCA would fall solely on A.
that A and B each own 100 shares (10%) of PublicCo's stock. PublicCo decides to repurchase fifty (5%) of its shares at a total cost of $1000. All fifty of the repurchased shares are bought from B, who, prior to the redemption had a basis of $1500 in her PublicCo shares. A, who has a basis of $2500 in her shares, keeps all of her shares.

Under the proposal, both A and B would be deemed to receive $100 ($1 per share). This is the amount of the redemption distribution divided by the number of shares outstanding pre-redemption ($1000/1000 shares), times the number of shares held by each shareholder. On account of the deemed receipt, both shareholders' bases would be increased by $100 — A's to $2600 and B's to $1600. Assuming B's basis is spread evenly among her shares, she would realize $1000 - $1600/2 = $200 on the redemption sale. At the end of the day, B would have dividend income of $100, gain of $200, and post-redemption basis of $800; A would have dividend income of $100, and post-redemption basis of $2600.

Under current law, the redemption would be a nonevent for A tax-wise.34 A's fractional ownership in PublicCo would go from 100/1000 to 100/950, an increase of about 5.3%. Although A's fractional stake in PublicCo increases, since A did not exchange any of her stock for consideration, she realizes no gain. (Whether A enjoys economic income from the transaction depends on the relationship between PublicCo's total value and the price PublicCo paid B for her shares.) For B, the redemption would be taxed as an exchange.35 B would realize gain of $1000 - $750 = $250. B's post redemption basis would be $1500 - $750 = $750.

The results of this example under Chirelstein's proposal and current law are summarized in Table 3.

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34 This is probably true; there is a slight chance A would be taxed under I.R.C. § 305. Charles I. Kingson, The Nonenforcement of Section 305 Dividend Treatment, 119 TAX NOTES 749 (May 19, 2008).
35 I.R.C. § 302(b)(2).
On balance, Chirelstein’s proposal results in greater income being reported by all of the shareholders on redemption distributions ($1200 rather than $250; compare line 9 with the sum of lines 11 and 12). The main reason is that the full amount of the distribution is taxed just as a comparably-sized pro rata dividend would have been, with no basis recovery. The incremental tax will be offset by less future gain, since the shareholders receiving the deemed distribution enjoy a basis increase by the amount of their dividend inclusion (compare lines 10 and 13).

For the particular shareholder being redeemed, the resulting income and gain is at least as great as under current law, and it might well be greater as it is in the example. The reason it might be greater is that the deemed dividend results in a basis increase, and I have assumed that this increase would be spread among all of the shareholder’s shares, not concentrated on a subset. If, as in the example, the shareholder is then deemed to sell less than all of her shares, the gain on that sale will be only partially offset by the basis increase from the deemed dividend. (The remaining basis increase represents future tax savings, the time value of which will diminish.) If, on the other hand, the basis generated on the deemed dividend is concentrated on the shares the redeemed shareholder sells (which is necessarily true in a complete termination even without a specific

<table>
<thead>
<tr>
<th>FACTS</th>
<th>A</th>
<th>B</th>
<th>Others</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Pre-dist. holdings (no. of shares)</td>
<td>100</td>
<td>100</td>
<td>800</td>
<td>1000</td>
</tr>
<tr>
<td>2. Holdings’ value (line 1 x $20)</td>
<td>2000</td>
<td>2000</td>
<td>16,000</td>
<td>20,000</td>
</tr>
<tr>
<td>3. Pre-dist. basis</td>
<td>2500</td>
<td>1500</td>
<td>—</td>
<td>4000</td>
</tr>
<tr>
<td>4. No. of shares redeemed</td>
<td>—</td>
<td>50</td>
<td>—</td>
<td>50</td>
</tr>
<tr>
<td>5. Pre-dist. ownership share</td>
<td>10%</td>
<td>10%</td>
<td>80%</td>
<td>—</td>
</tr>
<tr>
<td>6. Post-dist. ownership share</td>
<td>10.5%</td>
<td>5.3%</td>
<td>84.2%</td>
<td>—</td>
</tr>
<tr>
<td>7. Change in ownership (line 6/line 5 — line 1)</td>
<td>5.3%</td>
<td>-47.4%</td>
<td>5.3%</td>
<td>—</td>
</tr>
</tbody>
</table>

| CURRENT LAW | | | |
| 8. Deemed dividend | — | — | — | — |
| 9. Gain | 0 | 250 | — | 250 |
| 10. Post-dist. basis | 2500 | 750 | — | 3250 |

| CHIRELSTEIN PROPOSAL | | | |
| 11. Deemed dividend | 100 | 100 | 800 | 1000 |
| 12. Gain | — | 200 | — | 200 |
| 13. Post-dist. basis | 2600 | 800 | 800 | 4200 |
rule), then, for the redeemed shareholder, the total of the dividend income and gain under Chirelstein’s plan would equal the total gain under current law. Chirelstein illustrates his plan with a complete termination — the one case in which the basis allocation issue need not be resolved — and he does not explain or illustrate how he envisions the basis increase on the deemed dividend will be allocated among each shareholder’s shares in other cases.

Any proponent of Chirelstein’s proposal would have to conquer the public relations difficulty that nonredeemed shareholders would be taxed even when they chose not to sell, “merely” because of the actions of others. The response to this concern is that this is what happens under current law in an economically identical transaction structured as a stock dividend to some shareholders and a cash dividend to other shareholders.

Suppose PublicCo paid a one-for-one stock dividend on its outstanding shares, except B received the cash value of the shares rather than stock. A and the other shareholders would pay even more tax than under Chirelstein’s proposal even though they did not cash out their investment. In particular, there would be a taxable $10 dividend per share to every shareholder receiving the stock distribution, and a corresponding basis increase. This result falls on the shareholders receiving stock “merely” because of the actions of B and PublicCo; had PublicCo paid B in stock like every other shareholder, no tax would have resulted for anyone.

Chirelstein’s rationale for limiting his proposal to public companies is that redemptions by public and nonpublic companies are fundamentally dissimilar. Generally speaking, publicly traded companies repurchase their stock for the same reason they pay dividends: to return funds to the shareholders. All shareholders “are free to participate in the distribution at their own discretion” so notions of constructive receipt favor using the two-step characterization at the heart of his proposal.

Redemptions by nonpublic companies, by contrast, are the byproduct of negotiation and agreement among the shareholders to adjust ownership and corporate control. Section 302 and related provisions were quite clearly drafted with the nonpublic company in mind. Chirelstein argued, basically, that the domain of these rules

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36 I.R.C. § 301(c), (d); I.R.C. § 305(b)(2).
37 Chirelstein, supra note 33, at 751-53.
38 Id. at 752.
should be limited to this sphere.\textsuperscript{30} In addition to the conceptual explanation offered by Chirelstein, there is a practical reason not to extend his proposal to nonpublic companies — doing so would raise valuation issues very similar to those raised by the EED tax.\textsuperscript{40}

\textbf{C. Mark-to-Market Taxation of Corporate Shareholders}

Several commentators have proposed replacing the current system of taxing corporate distributions and stock sales with a system that taxes accrued but unrealized appreciation in corporate stock.\textsuperscript{41} Under these so-called mark-to-market proposals, taxpayers would be required to include in income gain or loss accrued during the year, or during the period of their ownership if less than the full year. Mechanically, for shares held at year-end, a shareholder’s inclusion would be the ending value of her shares less her tax basis in those shares. The shareholder would increase her basis for mark-to-market income inclusions, to prevent double counting. For shares purchased mid-year, basis would equal the price paid in the mid-year purchase, so only gain or loss accrued between the purchase and year-end would be included. For shares sold mid-year, gain (loss) would be the amount realized (net sales proceeds) less stock basis, as under current law, so only gain accrued up until the mid-year of the sale would be taxable.

Some commentators advocating mark-to-market have not been specific on how corporate distributions, including regular dividends and redemptions, would be taxed. Joseph Dodge’s mark-to-market proposal is an exception. He explains that “[u]nder the mark-to-market system, all distributions in cash or in kind, including those pursuant to a redemption or partial liquidation, would be gross income to the shareholder; the resulting diminution of corporate assets would have a downward effect on value, and hence basis.”\textsuperscript{42}

\textsuperscript{30} Id. at 749–52.

\textsuperscript{40} See supra Part II.B.3.

\textsuperscript{41} Sometimes these proposals have been framed as replacements for the current program of taxing gains and losses on corporate stock and the tax on distributions, see e.g., David Slawson, \textit{Taxing as Ordinary Income the Appreciation of Publicly Held Stock}, 76 YALE L. J. 623, 624 (1967), and other times as wholesale replacements for the corporate income tax, see e.g., Joseph Bankman, \textit{A Market-Value Based Corporate Income Tax}, 68 TAX NOTES 1347, 1347 (Sept. 11, 1995); Michael S. Knoll, \textit{An Accretion Corporate Income Tax}, 49 STAN. L. REV. 1, 1 (1996); Victor Thuronyi, \textit{The Taxation of Corporate Income — A Proposal for Reform}, 2 AM. J. TAX POL’Y 109, 110 (1983).

\textsuperscript{42} Joseph M. Dodge, \textit{A Combined Mark-to-Market and Pass-Through
Treating pro rata distributions (i.e., dividends in the corporate law sense) in this fashion makes practical sense, but this approach would seem to present some difficulties for redemptions. Things would function more smoothly if redemptions were always treated as sales.

Consider the following examples. Suppose shareholder A owns corporation X stock worth $9 per share on December 31 of Year 1, and $10 per share one year later. Under the mark-to-market tax, A will owe tax of $1 per share on the appreciation during Year 2 even in the absence of a sale or distribution.

If instead X pays a $1 dividend during the year, and this reduces year-end net assets to $9 (rather than $10, as they would have been but for the dividend), then, as Dodge suggests, it makes sense to tax the dividend in full, implying the $1 dividend received on each share will be taxable in full (no basis recovery). This means the mark-to-market tax will be zero ($9 year end value – $9 basis = $0).

Now consider a comparable redemption. Assume that rather than paying a dividend, X redeems one-tenth of its shares on December 31 of Year 2, when its shares are trading at $10. If A began with ten shares and sold one in the redemption, then under my suggestion that redemptions be treated as sales, A would recover $9 of basis in the sale, implying $1 of gain ($10 redemption proceeds – $9 stock basis). The mark-to-market tax base on the shares not redeemed would be $9 in total ($1 per share), since following the redemption the shareholder holds nine shares, each of which appreciated by $1 during the year. In total, A would have $10 of gain, split between gain on the redemption and mark-to-market gain.

As summarized in Table 4, the taxpayer in each of the examples owes tax on $10 of gain (see line 10). In the first example (no distribution), it is all mark-to-market gain (line 9). In the second example (pro rata dividend), it is all attributable to the distribution


43 Under Dodge’s suggestion that all distributions — including redemptions — be taxable in full, A would recover no basis in the sale, implying $10 of gain on the redemption, but then the mark-to-market tax basis on the shares not redeemed would be zero. Following the redemption, A would hold nine shares with a basis of $90, which is equal to the December 31 of Year 2 value of A’s shares. The bottom line result using Dodge’s accounting rule is the same as under mine. Importantly, to apply Dodge’s rule, the shareholder must know that this particular stock sale is a redemption. From A’s perspective, however, there is no way to distinguish between sales to buyers other than this issuer and redemptions. Additionally, if this were a sale to a buyer other than an issuer, basis recovery would be permitted. Thus, Dodge’s rule, which assumes taxpayers can distinguish between cases where basis recovery is permissible and those where it is not, is impractical.
(line 6). In the third example (redemption), it is a combination of the two (line 6 + line 9). Assuming the effective rate on distributions and gains including mark-to-market gain is the same, there is no substantive tax difference in the tax treatment of the three forms.

TABLE 4: COMPARISON OF MARKET-TO-MARKET EXAMPLES

<table>
<thead>
<tr>
<th></th>
<th>No distribution</th>
<th>Dividend</th>
<th>Redemption</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. 12/31/Yr1 holdings (no. shares)</td>
<td>10 shs.</td>
<td>10 shs.</td>
<td>10 shs.</td>
</tr>
<tr>
<td>2. 12/31/Yr1 value of holdings</td>
<td>$90</td>
<td>$90</td>
<td>$90</td>
</tr>
<tr>
<td>3. Basis after Yr1 MTM inclusion</td>
<td>$90 ($9/sh)</td>
<td>$90</td>
<td>$90 ($9/sh)</td>
</tr>
<tr>
<td>4. Distribution</td>
<td>$10</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>5. Redemption</td>
<td>10</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>6. Tax base on dist./redemption</td>
<td>10</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>7. 12/31/Yr2 holdings (no. shares)</td>
<td>10 shs.</td>
<td>10 shs.</td>
<td>9 shs.</td>
</tr>
<tr>
<td>8. 12/31/Yr2 value of holdings</td>
<td>$100 ($10/sh)</td>
<td>$90</td>
<td>$90 ($10/sh)</td>
</tr>
<tr>
<td>9. Yr2 MTM tax base</td>
<td>$10 ($1/sh)</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>10. Total tax base (line 6 + line 9)</td>
<td>$10</td>
<td>$10</td>
<td>$10</td>
</tr>
</tbody>
</table>

Stock basis accounting issues similar to those complicating the EED tax would not arise under a mark-to-market regime. Under mark-to-market, every year the basis of every share would be reset to year-end value so there will usually be homogeneity in tax attributes among all shares held by every shareholder. This would be true even for shareholders who have multiple accounts with different brokers. This will not be true when a shareholder adds to her holdings mid-year and pays a price different from the ending price from the prior year. Even in this circumstance, however, there is no complication because under the mark-to-market tax (unlike the EED tax) dividends are not an occasion for basis recovery, so there is no need to determine which shares' basis should be adjusted on a pro rata distribution. The one issue that would come up when shareholders have blocks of stock with different bases (as when they add to a position mid-year) is which shares are considered to have been sold in the mid-year sale. This question could be answered straightforwardly, as it is under current law — the shareholder recovers basis on the share sold. This could be the share specifically identified by the shareholder, or it could be the share presumed sold under a convention such as FIFO.

Finally, note that although mark-to-market and integration of the corporate and individual income taxes are discrete policy changes, they are highly interdependent. If mark-to-market taxation were

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"Treas. Reg. § 1.1012-1(c) (1960)."
implemented without corporate integration, then "most of subchapter C would have to be rethought." For instance, the detailed rules for taxing corporate reorganization tie together corporate and shareholder tax consequences, but if mark-to-market treatment of shareholders were implemented without integration, the reorganization would, for tax purposes, be an insignificant transaction from the shareholder's perspective. After a thorough analysis of mark-to-market taxation both with and without integration, David Weisbach concluded that "without integration, it is not clear that marking to market stock is an improvement [compared to current law]." Moreover, mark-to-market taxation with integration presents its own set of perhaps insuperable challenges, such as how to tax nonresident and tax-exempt shareholders' aliquot share of corporate net income.

IV. EVALUATING THE ALTERNATIVES

In this Part, I will compare the EED tax and the other reform proposals along several dimensions. I will begin in Part A by assessing the extent to which the various alternatives are likely to distort taxpayer behavior, including distortions of corporate financial policy — specifically, the choice between dividends and redemptions, and the timing of distributions — and shareholder decisions regarding whether to sell stock. Then, in Part B, I will turn to the distortion at the margin between public and private companies, a distortion that might be aggravated by implementation of some of the alternatives (such as mark-to-market taxation, and to a lesser extent the EED tax and Chirelstein's proposal), but would not be affected by others (such as the CDT). Third, in Part C, I will describe the extent to which the alternatives can be made to accommodate different rules for special classes of shareholders (such as tax-exempts, foreign shareholders, and shareholders in low marginal brackets), and the difficulties presented by proposals that cannot accommodate special classes of shareholders.

46 Id.
47 Id. at 135.
48 Difficulties in accommodating nonresident and tax-exempt shareholders under mark-to-market taxation and the other proposals are discussed below. See infra Part IV.C.
A. Distortions in the Timing and Form of Distributions, and Lock-in

1. Current Law

Form of Distributions. Current law distorts the form of corporate distributions. The effective rate of tax on non pro rata distributions (redemptions) and certain extraordinary distributions is lower than for dividends, which encourages redemptions and discourages dividends. This distortion is eliminated by all of the reform proposals except Chirelstein’s.

Timing of Distributions. The prevailing view is that the current law dividends tax does not distort the timing of corporate dividends for most firms. The basic reason is that the current dividends tax is a cash flow tax — no basis recovery is permitted on the receipt of dividends. So long as the amount to be distributed increases at the market rate of return, the time value of the government’s tax claim — and hence the effective tax rate — remains constant.

Lock-in. Current law locks taxpayers into appreciated positions in corporate stock. For depreciated stock, the incentive is reversed. The reason is that by deferring realization of gains, taxpayers are able to reduce the effective tax rate on capital gains. In two limiting cases, taxpayers are able to reduce the effective tax rate on capital gains to zero. This occurs when appreciated stock is given to charity (and a deduction is allowed for the fair market value of the stock, without requiring the donor to realize any built-in gain) or when appreciated stock is held until death (and tax basis is reset to date of death value). This distortion, which is ameliorated by some of the reform proposals but not others, is thought to impose significant economic costs.

2. The EED Tax

Form of Distributions. The principal benefit of the EED tax is that it would eliminate the bias in favor of redemptions in preference

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49 This is true for “new view” firms that raise capital by retaining income, rather than by issuing shares. See generally Hans-Werner Sinn, Taxation and the Cost of Capital: The “Old” View, The “New” View, and Another View, 5 TAX POLICY AND THE ECONOMY 26 (David Bradford ed., 1991).

50 Alan J. Auerbach, Taxation and Corporate Financial Policy, in 3 HANDBOOK OF PUBLIC ECONOMICS 1252, 1259 (Alan J. Auerbach and Martin Feldstein eds., 2002).

51 I.R.C. §§ 170, 1014(a)(1).
Timing of Distributions. How the EED tax would alter firms' incentives with respect to the timing of distributions is a difficult and subtle question. One might conclude that the EED would introduce an effect that is conceptually identical to lock-in. This seems to follow from the fact that the EED tax would treat distributions like sales. Under this view, the benefit of deferring a distribution is the benefit of delaying imposition of the dividend tax until the end of the deferral period.

To illustrate, suppose A is the sole shareholder of X corporation with net assets worth $80 and that A's stock basis is $40. If the EED tax rate is 25% and A liquidates X, A will be left with $70.53. If this $70 is reinvested in a new corporation (call it Y), then in one year Y's net assets will be worth $77 (assuming a 10% return on corporate investments). If A then liquidated Y, she would owe tax of ($77 - $70) \times 25\% = $1.75, and would net $77 - $1.75 = $75.25. If instead A holds X for one year and then liquidates X, A would receive $88 (the net assets less $48 \times 25\% = $12 (tax due on liquidation), or $76 net. The taxpayer deferring her distribution winds up with $.75 more than the other taxpayer ($76 - $75.25).

This example appears to support the conclusion that deferring distributions is better than accelerating them. Notice, though, that in this example, the shareholder who receives the earlier distribution and reinvests in new equity is earning a lower after-tax rate of return than the shareholder who defers her dividend (she is earning 7.5%, whereas X's net assets appreciated by 10%). If the market drives together (expected, risk-adjusted) after-tax rates of return (a standard assumption) then the example paints a false picture.

To correct for this, replace the assumption that the shareholder receiving the earlier liquidation proceeds reinvests in stock with the assumption that she invests in bonds yielding 10% after-tax (assuming the bonds have the same risk profile as X stock). In this case the

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52 As discussed in Part II.B.2, supra, some of the alternatives for accounting for stock basis would result in complete parity as between dividends and redemptions; others would be somewhat imperfect in this regard, in which case the bias in favor of redemptions might not be eradicated completely, but it would be, at a minimum, drastically reduced.

53 This is the gross liquidation proceeds ($80) less taxes paid ([$80 - $40] \times 25\% = $10).

54 The rate of return for the liquidating shareholder is $75.25/$70 - 1 = 7.5%. The rate of return earned on the deferring shareholder's net investment is $88/$80 - 1 = 10%.
taxpayer will wind up with $77 in one year, which is one dollar better than the deferring shareholder. The explanation for this result is that the deferring shareholder waited one more period before recovering her stock basis. The one-dollar difference between the net cash received by the two shareholders is attributable to degradation in the time value of that stock basis during the delay ($40 [stock basis] × 25% [tax rate] × 10% [after-tax rate of return] = $1).

A difficulty with this second approach to assessing the incentive effects of the EED, which suggests accelerating distributions is tax efficient, is that shareholders’ after-tax returns on holding stock (or any asset subject to the realization rule) depends in part on their holding period. The reason the taxation of capital gains at realization creates a lock-in effect is that the taxpayer’s after-tax return goes up (effective tax rate goes down), all else equal, the longer the taxpayer delays sale. Not paying tax on the year-by-year appreciation in the market price of stock is like getting an interest-free loan from the government to the extent of the tax liability. The amount of the loan increases with the implicit gain on the shares. When the shares are sold the loan must be repaid.

It follows that the market cannot drive together “the” (expected, risk-adjusted) after-tax rate of return to holding corporate stock and the return to other assets (as though the return to holding stock were a clearly identifiable figure), because different shareholders with different holding periods will have different after-tax rates of return even when they invest in the same stock. What might be expected is that the market would drive together the (expected, risk-adjusted) return for the marginal investor in the stock of a given company based, in part, on that investor’s prediction regarding the pattern of corporate distributions and the investor’s prediction regarding their own holding period. If the corporate distributions that were paid during this shareholder’s ownership were more infrequent or smaller than expected (or both), then (all else equal) the shareholder’s after-tax return would be greater (assuming the unpaid dividends increase share value and that incremental value is recaptured on sale, made up for by larger, later distributions, or some combination of the two).

This analysis seems to resuscitate the conclusion that the EED tax discourages distributions, or at least that it encourages their deferral. However, the magnitude of the effect under this line of analysis would presumably be smaller, and countervailing considerations (such as meeting market expectations regarding the size and regularity of dividend payments) might be more likely to trump tax considerations in the formulation of corporate policy. In the end, whether this is true,
and, more generally, which of the competing views on the likely effects of the EED tax on distribution timing incentives is correct, cannot be conclusively resolved by theorizing — it is an empirical question.

Lock-in. The EED tax would exacerbate the lock-in effect as compared with current law. The reason is that the lock-in effect increases with built-in gain, and under the EED tax dividends decrease tax basis, which increases built-in gain.

3. The CDT

Form of Distributions. The CDT would not skew taxpayer incentives with respect to the form of distributions as the effective tax rate would be the same on distributions of every form.

Timing of Distributions. The CDT would not distort the timing of nonliquidating distributions. The reason is that, as applied to nonliquidating distributions, the CDT, like the distributions tax under current law, is a cash flow tax. As is generally true for cash flow taxes, the present value of the CDT burden on nonliquidating distributions is time invariant: if a nonliquidating distribution is deferred the tax base grows by an amount that precisely offsets the time value benefit of tax deferral.55

The CDT does, however, skew taxpayer incentives with respect to liquidating distributions. Tax basis is the usual reason for timing distortions in a realization-based system. Although stock basis plays no role in the CDT, an analogue concept, the CCA, does play a role — in liquidating distributions, the CDT base is reduced by the CCA balance. The resulting tax savings equals the product of the CCA balance and the tax-inclusive CDT rate. Given a tax-exclusive CDT rate of 25%, a company with $100 of net assets and a zero CCA balance could pay a $80 liquidating distribution net of its CDT liability of $80 \times 25\% = $20. If the same company had a $100 CCA balance, it could pay a $100 liquidating distribution since its CCA balance is worth $20.

Suppose, though, that the company with the $100 CCA balance waits one year before it liquidates and that during the delay its net assets increase by 10% after-corporate-tax. Its CDT liability will grow from $0 to $2. The reason is that the value of its CCA ($20 = $100 \times

55 Yin, supra note 29, at 1855–60. Time invariance requires: (1) a consistent distributions tax rate; and (2) equivalent after-tax rates of return on investments within and outside of corporate solution. Id. at 1856–57.
20%) is nominally fixed, but the value of net assets is not similarly fixed. The $2 incremental liability from the delay is the tax on the growth in net assets, which is taxable because it is not matched by a growth in the CCA balance.\textsuperscript{56} Another way to explain the same idea is that the time value of the CCA declines as the time until liquidation increases. Thus, sooner liquidation is better. This is Yin's interpretation.\textsuperscript{57}

The conclusion that sooner liquidation is better is correct if, as Yin assumes, the market equalizes after-tax returns across assets. If this does not occur, then the incentives could be different. Suppose A is the sole shareholder of X Corporation with net assets worth $80 and a CCA balance of $40. If A liquidates X, A will be left with $70. If this is reinvested in a new corporation (call it Y) then in one year Y’s net assets will be worth $77 (assuming a 10% return). If a buyer of A's Y stock were to assign full value to Y’s CCA, the buyer would be willing to pay A $77 - $7 x 25% = $75.25. A would not sell for less than this, since A could liquidate Y and obtain this sum. If, instead, A holds X for one year and then liquidates or sells X, A would receive $88 (the net assets) less $48 x 25% = $12 (the CDT due on liquidation), or $76 net. Thus, deferral improves the shareholder’s net by $.75. The reason this example implies a lock-in effect is that the shareholder who defers earns a higher (10%) rate of return than the other shareholder (who earns only 7.5%).

This last example is virtually identical to the example given above in the EED tax context to show that the EED tax could cause a lock-in effect.\textsuperscript{58} As under the EED tax, the incentive effects of the CDT with respect to liquidating distributions are contingent on whether (perhaps more precisely, how and to what extent) the market equalizes after-tax returns across assets.

\textit{Lock-in.} The CDT would not cause lock-in. This might seem obvious given that under the CDT stock sales are not subject to tax. On the other hand, sellers are likely to bear an implicit tax, a reduction in market value attributable to the CDT on future distributions. Since the distributions tax is nondistortive, however, the conclusion that the CDT does not bias the timing of stock sales holds true even when implicit taxes are considered.

\textsuperscript{56} $2 = $100 \times 10\% \text{ [growth rate]} \times 20\% \text{ [CDT rate]}.$

\textsuperscript{57} Yin, supra note 29, at 1887–94 (compare the present value of the shareholders' net return in examples 15B and 15C).

\textsuperscript{58} See text following note 53, supra.
4. Chirelstein

Form of Distributions. Under Chirelstein's proposal, dividends would be taxed more lightly than redemptions. Adoption of his proposals would thus flip the current law incentives with respect to the form of distributions.

Timing of Distributions. Chirelstein's proposal would not distort incentives regarding the timing of dividends, since there would be no change as compared with current law (which does not distort timing).

Lock-in. The lock-in effect that now exists would persist under Chirelstein's proposal, since there would be no change in the tax treatment of stock sales.

5. Mark-to-Market Taxation

Form of Distributions. Mark-to-market taxation would not distort the form of corporate distributions. As illustrated above, a redemption would be taxed more lightly than a dividend, but because the redemption reduces the number of shares outstanding, it results in a heavier mark-to-market tax burden on the shares still outstanding after the redemption. The incremental mark-to-market tax burden that follows a redemption (compared with a dividend) makes up the difference between the higher tax that would be imposed on a comparable dividend, and the lighter tax imposed on the redemption. This eliminates any tax bias.

Timing of Distributions. Because distributions reduce corporate net assets and stock price pro tanto, taxing distributions merely substitutes for the mark-to-market tax that would be imposed in the absence of a distribution. Thus, like current law and the CDT, but unlike the EED tax, a mark-to-market tax would not distort decisions regarding the timing of distributions.

Lock-in. A mark-to-market tax would eliminate lock-in, since accrued gains would be taxed even in the absence of a sale.
6. Summary

Table 5 summarizes the discussion in this part.

**TABLE 5: DISTORTIONS IN THE FORM AND TIMING OF DISTRIBUTIONS, AND THE TIMING OF STOCK SALES**

<table>
<thead>
<tr>
<th></th>
<th>Form of distribution</th>
<th>Timing of distribution</th>
<th>Lock in</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current law</td>
<td>Distortion—redemptions preferred to</td>
<td>No distortion</td>
<td>Distortion</td>
</tr>
<tr>
<td></td>
<td>dividends</td>
<td></td>
<td></td>
</tr>
<tr>
<td>EED tax</td>
<td>No distortion</td>
<td>Distortion—significance</td>
<td>Distortion—worse</td>
</tr>
<tr>
<td></td>
<td>unclear</td>
<td></td>
<td>than current law</td>
</tr>
<tr>
<td>CDT</td>
<td>No distortion</td>
<td>Nonliquidating—no</td>
<td>No distortion</td>
</tr>
<tr>
<td></td>
<td>distortion</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Liquidating—distortion</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Chirelstein</td>
<td>Distortion—dividends preferred to</td>
<td>No distortion</td>
<td>Distortion—same</td>
</tr>
<tr>
<td></td>
<td>redemptions (opposite of current law)</td>
<td></td>
<td>as current law</td>
</tr>
<tr>
<td>Mark-to-Market</td>
<td>No distortion</td>
<td>No distortion</td>
<td>No distortion</td>
</tr>
</tbody>
</table>

As the table makes clear, a mark-to-market regime would go furthest among the proposals in terms of eliminating the distortions that exist under current law — there would be no distortion in the form or timing of distributions, and the lock-in effect would be eradicated. This is a major benefit of adopting mark-to-market taxation. As discussed below, however, mark-to-market taxation could conceivably introduce a major new distortion at the boundary between public and private firms, and mark-to-market complicates the taxation of nonresident and tax-exempt shareholders. All things considered, it is ambiguous, and probably impossible to determine, whether a change to mark-to-market taxation would result in a net benefit.

The CDT also ranks high among the proposals given that the only significant distortion among those surveyed in this part pertains to liquidating distributions, which by definition occur once-in-a-lifetime. As discussed below (in Part C), however, the CDT would require a thoroughgoing revision of the taxation of inbound equity investments.
by nonresident taxpayers, and would amount to a significant tax increase on nonprofit and low-bracket shareholders. For these reasons, the practicality and political feasibility of the CDT is debatable.

The other options — current law, the EED tax, and Chirelstein’s proposals — are a mixed bag. Current law and Chirelstein’s proposal both distort everything discussed in this part aside from the timing of distributions, though arguably the way that Chirelstein’s proposal distorts distributions is less problematic than the way current law distorts them (current law favors redemptions, whereas Chirelstein’s proposals would disfavor them) given that the usefulness of redemptions as a non-tax planning tool for public companies is likely insignificant. Hence, Chirelstein’s proposal would seem to be an improvement as compared with current law, at least along the dimensions discussed in this part. The EED tax is neutral (or at least nearly so) as between dividends and redemptions, but distorts everything else. To conclude that the EED tax is a step forward in terms of the criteria discussed in this part, one would have to conclude that fixing the bias in favor of redemptions is a bigger benefit than aggravating the lock-in effect, and creating a new distortion in the timing of corporate distributions is a detriment. Whether this is true is an open question.

B. Distortions at the Public/Private Boundary

As noted, it would be difficult or impossible to apply several of the proposals to nonpublic companies for want of necessary price information. Specifically, neither the EED tax, Chirelstein’s proposal, nor mark-to-market taxation could be applied in the absence of a public market. The CDT, on the other hand, could be applied to public and private companies alike. Implementation of any of the schemes that must be limited to public companies will create a discontinuity in the treatment of public and private firms. The primary concern is that this discontinuity might cause more firms to go or stay private in an effort to minimize their shareholders’ taxes, rather than making decision regarding public listing for business or strategic reasons.

Under current law, there is a de facto discontinuity in the taxation of public and private firms, even though Subchapter C can and does apply to both public and nonpublic companies. In practice, most private firms avoid Subchapter C, and hence the corporate double-tax, by conducting business through pass-through entities (primarily LLCs,
limited partnerships, and Subchapter S corporations). Public companies, on the other hand, are forced into Subchapter C by section 7704 of the Code. Thus, there is a public/private boundary distortion under present law.

It is not clear that the discontinuity would be made worse by the EED tax, the CDT, or Chirelstein’s proposal, but it might well be aggravated by mark-to-market taxation. The reason that none of the proposals other than mark-to-market taxation are likely to aggravate the public/private boundary distortion is that none of the proposals (if implemented in a revenue-neutral fashion) would significantly alter the effective tax rate on corporate distributions. True, each of these proposals would eliminate incentives to make redemption distributions in lieu of dividends. However, if the tax savings owing to tax deferral under current law are significant for shareholders of firms that make redemptions, and if those savings would be precluded after implementation of a new system, then the overall rate on corporate distributions in the new system could be lowered without sacrificing revenue.

The reason that mark-to-market taxation might aggravate the public/private boundary issue where the other proposals do not is that, all else equal, selectively turning off the realization rule for corporate stock will increase the effective tax rate on stock, relative to other investments not marked to market. In particular, if nominal rates on stock and other investments not subject to mark-to-market taxation are equal, then effective rates would be equal only for those taxpayers who churn their entire investment portfolio each year.

David Weisbach has suggested that in a partial mark-to-market system such as the one contemplated here (where corporate stock is marked to market but other assets are taxed under the realization rule), the nominal rate on mark-to-market assets should be set equal to the effective tax rate on assets subject to tax on realization. This

59 Staff of Joint Comm. on Taxation, 110th Cong., Report on Tax Reform: Selected Federal Tax Issues Relating to Small Business and Choice of Entity, 8–9 (Joint Comm. Print 2008). The rise of limited liability entities taxed as partnerships and expansion of the eligibility rules under Subchapter S are thought to be responsible for the shrinking domain of nonpublic corporations taxed under Subchapter C.

60 There are exceptions. Firms with at least 90% “qualifying income” — defined to include interest, dividends, real property rents, certain natural resources income, and a few other types of income — are excepted from the rule that publicly traded firms are taxed as corporations. I.R.C. § 7704(a), (b).

61 Weisbach, supra note 45, at 101.
would equalize effective tax rates on average.

There are significant problems with this approach. First, the average effective tax rate on realization assets is difficult to measure accurately, and might change over time. Second, setting the mark-to-market rate equal to some estimate of this rate only creates parity on average.\(^6\) Lack of parity between the two systems for taxing investment gains for everyone other than the average taxpayer is likely to produce a clientele effect, or sorting of taxpayers. Taxpayers who intend to hold assets for longer than average will find their tax burden lower if they avoid stocks (hold realization assets); taxpayers with a shorter than average investment horizon will find their tax burden lower if they hold stocks (avoid realization assets).

If taxpayers respond to this set of incentives by gravitating towards the asset class (and accompanying tax rule) best suited to their investment horizon, then equalizing rates for corporate stock and other assets becomes exceedingly difficult. If the nominal mark-to-market rate is set using the average effective tax rate for investors in realization assets after taxpayers have sorted themselves by holding period, it would be a boon to investors in the mark-to-market group since their rate would be keyed to the effective tax rate enjoyed by buy-and-hold investors in the realization group. To prevent this, it seems better to set the mark-to-market rate based on information collected before any sorting takes place. For reasons explained next, however, the nominal mark-to-market rate will need to be periodically recalibrated, which seems to preclude this ex ante approach to measuring holding periods.

A third problem with equalizing effective tax rates is that the effective tax rate on realized gains and losses is a function of interest rates.\(^6\) Therefore, "rates [might] have to be adjusted on a regular basis to take into account significant changes in interest rates."\(^6\) It is not clear that legislative processes in the United States function smoothly enough to make the necessary adjustments in a timely or accurate fashion.

To sum up, there is a distortion at the public/private boundary under current law. It exists because nearly all public companies are subject to the corporate double tax, which is essentially elective for nonpublic firms. The status quo would continue without significant

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\(^6\) Id. at 101 n.15.


\(^6\) Weisbach, supra note 44, at 101 n.13.
change under the EED tax, the CDT, and Chirelstein's proposal, given that revenue neutral variations of these proposals would not significantly change effective tax rates on income accruing in favor of corporate equity. The mark-to-market tax, in contrast, might increase distortions at the public/private boundary by decoupling the effective tax rate on gains and losses on corporate stock compared with all other assets not marked to market.

C. Treatment of Tax-Exempt, Low-Bracket, and Foreign Shareholders

A significant fraction of equity capital supplied by U.S. investors is channeled through tax-deferred accounts (401(k) plans, etc.) and tax-exempt institutions. In December 2006, the Congressional Budget Office (CBO) estimated that the split of corporate equity held by U.S. residents among fully-taxable, tax-deferred, and tax-exempt investors was 58.4%, 5.8%, and 35.8%, respectively. Additionally, as of June 2007, nonresidents held 11.3% of the total outstanding equity issued by U.S. companies.

As discussed below, current law provides special rules for the taxation of taxpayers falling into each of these classes. Under some of the reform proposals, perpetuating current law's special rules could be accomplished without significant difficulty, whereas other reform proposals would make special treatment for tax-exempt, foreign, and low-bracket taxpayers infeasible. The CDT is particularly deficient in its ability to accommodate differentiation in taxpayer characteristics.

1. Current Law

**Tax-Exempt Shareholders.** Under current law, tax-exempt shareholders' tax exemption extends to both dividends and gains and losses on stock sales. Investment made through tax-deferred accounts (401(k) plans, etc.) are not taxed on receipt of dividends or on realized stock gains, but withdrawals from the accounts are taxed as ordinary income.

**Low-Bracket Shareholders.** Dividends and stock sale gains realized by low-income taxpayers are taxed at a reduced rate. In 2008 and 2009, the rate on dividends and gains is zero for taxpayers with

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taxable income of approximately $32,000 or less.

Foreign Shareholders. Foreign shareholders are taxed on dividends paid by U.S. companies at a 30% rate, subject to reduced treaty rate. The tax on outbound dividends is enforced through gross-basis withholding at the source. Foreign shareholders are usually not taxed on gains and losses on investments in stock of U.S. corporations, since gains and losses realized by nonresidents are considered foreign source gains and losses.

2. EED Tax

Tax-Exempt Shareholders. The EED tax would not change the current law treatment of corporate investment through tax-deferred accounts and by tax-exempt institutions. While the absence of any change for tax-exempts is self-evident, the situation for tax-deferred accounts deserves a brief explanation.

Both the receipt of distributions on corporate equity by a tax-deferred account and gains and losses on sale of shares are nonevents tax-wise for the account. Hence, the things changed by the EED tax — the account’s basis in its stock investments and the timing of the recovery of that basis — are irrelevant. Investment gains accruing within tax-deferred accounts, be they capital gains or dividend income, are taxed on distribution at the account owner’s marginal tax rate on ordinary income at the time of distribution. Given that the EED tax would not change the marginal tax rate applicable to accountholders’ ordinary income, the proposal would not directly affect tax-deferred accounts.

Though the current law treatment of tax-exempt and tax-deferred investors would not change, they might still be affected indirectly by a switch to the EED tax. Specifically, if the EED tax were implemented without changing tax rates, it would amount to a tax cut on corporate equity. Standard tax incidence analysis indicates that the pre-tax rate of return on corporate equity would likely go down. The pre-tax rate of return on other forms of investment would increase correspondingly as investment by taxable investors shifts into the corporate sector and the tax cut is capitalized into market prices.67 Consequently, the relative tax advantage enjoyed by tax-exempt and tax-deferred investors in the market for corporate equity might be

smaller under the EED tax than under current law.\textsuperscript{68}

\textit{Low-Bracket Shareholders}. The current preference for low-bracket shareholders could be perpetuated under the EED tax.

\textit{Foreign Shareholders}. To understand how foreign shareholders would be taxed under the EED tax, it is useful to take a detour through current law. Under current law, distributions other than redemptions are classified as dividends based on a corporate level attribute as earnings and profits. Generally, no information regarding shareholder attributes is required to distinguish taxable dividends from tax-free return of capital distributions. For this reason, imposing withholding tax on dividend payments is usually uncomplicated. There are, however, special cases when this is not true. Examples include: (1) distributions that are not, or might not be,\textsuperscript{69} dividends, in whole or in part, due to inadequate current or accumulated earnings and profits; (2) dividend-equivalent redemptions;\textsuperscript{70} and (3) share purchases by related corporations.\textsuperscript{71} The Service takes the position that withholding is required in these instances.\textsuperscript{72} Importantly, there are scenarios under current law where the company paying the deemed dividend cannot know of, let alone quantify, its withholding obligation. The Service's answer is that the dividend-paying company is required to withhold on the gross amount of the \textit{distribution} even if that might be greater than the gross amount of the \textit{dividend}.\textsuperscript{73} A nonresident whose distribution is reduced by excessive withholding may seek a refund.\textsuperscript{74}

If the current treatment of outbound dividends were perpetuated under the EED tax, the difficulty presented by these special cases under current law, where lack of information makes accurately assessing the withholding obligation difficult or impossible, would be pervasive. The problem is that the extent to which every distribution is taxable under the EED tax turns on shareholder basis. Since the corporation paying the distribution generally will not know the stock basis of the shareholder, however, collecting the EED tax through

\begin{itemize}
\item \textsuperscript{68} It follows that tax-exempts might resist a shift to the EED tax. This is similar to an observation I make below in the context of the CDT proposed by George Yin. See discussion \textit{infra} note 84..
\item \textsuperscript{69} For distributions made mid-year, it might not be clear whether there will be adequate earnings and profits at year-end and, consequently, whether and to what extent the distributions are classified as dividends.
\item \textsuperscript{70} I.R.C. § 302(d).
\item \textsuperscript{71} I.R.C. § 304.
\item \textsuperscript{72} Rev. Rul. 92-85, 1992-2 C.B. 69; Rev. Rul. 72-87, 1972-1 C.B. 274.
\item \textsuperscript{73} Rev. Rul. 92-85, \textit{supra} note 72.
\item \textsuperscript{74} I.R.C. § 1464.
\end{itemize}
withholding is problematic. Moreover, it is not feasible to collect the EED tax from nonresidents other than through withholding.

One solution to this difficult administrative issue would be an application of the strategy underlying the withholding tax approach used under current law. The Service could impose a withholding obligation on the distributing company at a rate that is somewhat below the nominal rate applicable to U.S. shareholders. The benefits of this approach are (1) that it would allow the U.S. to live up to its treaty obligations, and (2) raising the gross basis withholding rate on nonresident shareholders outside of treaty countries can be used to raise revenue (at the cost of undermining the "rough equivalence" rationale underlying the low-rate gross basis tax — if anyone still takes this rationale seriously). A more refined set of rules allowing for refunds of overwithholdings may or may not make sense depending on how low the withholding rate is set.

Another solution would be to charge nonresident shareholders' brokers with the obligation to withhold and remit the EED tax. Under current law, brokers are charged with withholding on dividends paid to nonresident shareholders. By the time broker basis reporting takes effect, brokers will have systems in place to track customers’ stock basis. Thus, it might be possible to implement the EED tax even with respect to outbound dividends. One difficulty with charging brokers with withholding, however, is that some brokers, in particular foreign brokers, might not be capable or trustworthy enough to handle the stock basis accounting.

One thing to keep in mind when assessing the application of the EED tax to nonresident shareholders is that most U.S. public companies have ample earnings and profits to support dividend classification for all of the dividends they pay. As a consequence, nonresident shareholders now pay gross basis tax on the full amount

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75 See Treas. Reg. § 1.1464-1 (1998). If broker basis reporting is adopted, then the problem might be solvable if the broker basis information can be shared with the dividend-paying company, or if the withholding obligation is shifted to the brokerage firm holding the shares and the cost basis data.


of their dividends (at 30% or a reduced treaty rate), even though the usual rate for individual U.S. shareholders is 15%. Thus, in an absolute sense, nonresidents would be no worse off than they are under current law even if, for the practical administrative reasons described above (i.e., lack of reliable basis information in the hands of the withholding agent, be it the dividend paying corporation or the nonresident shareholder’s broker), nonresidents are not allowed basis recovery.

Turn now to the treatment of gains and losses realized by nonresident shareholders. Absent a fundamental rethinking of U.S. taxation of inbound investment, gains and losses of nonresidents would be exempt from tax. This would reintroduce a bias against dividends in favor of redemptions as a method of distributing corporate profits. Logically, there are two ways to correct this bias, but neither is promising. One possibility would be to tax nonresident shareholders on stock gains and losses. This is infeasible in light of the U.S. treaty network. Most treaties include a provision like the one found in Article 13(6) of the U.S. Model Treaty, which provides that gains from the sale of investment property shall be taxed by the residence country only.78

The other possibility is to exempt outbound distributions from tax; that way neither sales by nor distributions to nonresident shareholders would be taxed. The benefit of the exemption approach is that it would preserve the parity in effective tax rates between dividends and gains for profits accruing for the benefit of nonresident shareholders. The Department of the Treasury (Treasury) considered a similar issue in its 1992 report on corporate integration and recommended against granting such a benefit by statute. Treasury reasoned that the issue ought to be addressed on a bilateral basis though treaty negotiations. The problem with granting relief unilaterally is that there is no assurance that the residence jurisdiction would tax dividends and gains or losses on sale symmetrically, implying that the U.S. might be ceding revenues to the foreign jurisdiction without any efficiency gain. “If a second level of tax is to be collected [by the residence country anyway], no obvious conceptual or practical reason exists why the source country [the U.S.] should sacrifice its claim to this tax revenue for the sake of consistency.”79

78 MODEL INCOME TAX CONVENTION ART. 13(6) (Dep't of the Treas. 2006) [hereinafter Income Tax Convention]. See also MODEL DOUBLE TAXATION CONVENTION ON INCOME AND CAPITAL ART. 13(5) (Org. for Econ. Coop. & Dev. 2003).

79 Department of the Treasury, supra note 1, at 196.
To sum up, under the EED tax, distributions to nonresident shareholders could be subject to a more or less refined withholding tax, depending on the availability of reliable basis information, as is generally true under current law, whereas gains and losses on stock sales would be exempt from tax. This dichotomous treatment would perpetuate the distortion that exists under current law where nonresident investors prefer earnings retention, or distribution via redemption, in favor of dividends. Perpetuating this distortion in the Code makes sense because it gives the Treasury a bargaining chip in treaty negotiations. If the U.S. exempted outbound dividends from tax unilaterally, there is no assurance that shareholders’ residence countries would implement symmetrical rules for dividends and stock sale gains losses. Consequently, as a practical matter, distortions are likely to remain irrespective of U.S. statutory law.

3. The CDT

_Tax-Exempt Shareholders._ Under the CDT, corporate earnings accruing in favor of tax-exempt shareholders would bear the distributions tax. The tax would be borne explicitly if profits were distributed. The tax would be borne implicitly if profits were reinvested, since the market value of corporate equity would be diminished by the future distributions tax liability.

The policy merit of imposing the economic burden of the distributions tax on corporate equity supplied by tax-exempt shareholders is questionable. If a tax-exempt investor regularly carries on a trade or business unrelated to the taxpayer’s exempt purpose, income from the trade or business will be subject to the unrelated business income tax (UBIT). If instead a tax-exempt investor buys stock in a company carrying on the same business, under the CDT the investor’s stake in the business will be subject to both the corporate tax and the distributions tax. If the UBIT rate is equal to the corporate rate, the distributions tax discourages tax-exempts from buying equities (encourages them to make direct investments).

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80 George Yin has argued that imposing a double tax on tax-exempts’ investments in corporate stock is justified. His view is that the corporate income tax is justified as a surrogate for the UBIT that would have been paid had the tax-exempt made a direct investment. The distributions tax is justified “as the price for utilization of [the] corporate form.” Yin, _supra_ note 29, at 1874.

81 I.R.C. §§ 512(a)(1), 513.

82 These rates are equal under current law. I.R.C. § 511(a)(1).

83 To illustrate, suppose a university endowment has $1 million to deploy and is
Unequal tax rates for taxable and tax-exempt investors do not affect one group's competitive position compared to the other; rather, the relevant question in assessing whether the playing field is level or tilted is whether the tax rates between or among competing projects for a given investor are equal or unequal. Taxing tax-exempt investors' equity returns at a higher rate than their direct investments tilts the playing field against them in the market for corporate equity.

Low-Bracket Shareholders. Under the CDT it would be infeasible to reduce the distributions tax rate on low-bracket shareholders. In defending this aspect of the CDT, Yin argued that the desirability of having low or zero brackets for impecunious taxpayers is not the only policy concern. The competing policy is “the need to implement a uniform tax burden on all corporate distributions.” In the absence of a uniform distributions tax, corporate decisionmaking will be disrupted because biases will be created for and against certain forms of distribution.

A difficulty with this argument is that taxes bias decisionmaking only when particular shareholders stand to gain or lose by the decision. Different tax burdens between or among shareholder groups do not have this effect if distributions to members within each group are taxed uniformly. Suppose dividends and redemptions are taxed the same as one another, but at different rates for different groups of considering two alternatives. It might purchase a direct stake in a widget factory unrelated to its tax-exempt purpose, from which it expects to earn a 15.4% return, before-tax. Alternatively, it might invest in a corporation that owns and runs the widget factory. The corporation is also expected to provide a 15.4% before-tax return. The endowment’s expected return from both investments is $154,000 before-tax, reduced to roughly $100,000 after tax (assuming a corporate and UBIT rate of 35%). Return to the direct investment is not taxed further, but return on the corporate investment is taxed again (implicitly or explicitly) under the CDT.


85 As noted above, the EED tax might produce a similar effect. See supra note 68 and accompanying text. Two differences between the CDT and EED tax along this dimension are (1) that under the CDT a burden is placed on equity supplied by tax-exempts, whereas under the EED tax some of the tax burden under current law might be lifted from equity supplied by taxable shareholders; and (2) that under the CDT the nominal burden on equity supplied by tax-exempts exactly matches the burden on equity supplied by taxable shareholders, whereas under the EED tax-exempts still enjoy a preference compared with taxable investors in the market for corporate equity, just not as large as the preference under current law. Because of these differences, I would not expect tax-exempts to lobby against the EED tax as strenuously as they as they are likely to lobby against the CDT.

86 Yin, supra note 29, at 1871.
shareholders. Suppose the tax rate on all distributions regardless of form is 40% for group A and 5% for group B. This system does not impose a “uniform” tax burden within Yin’s usage, but neither will it skew corporate decisionmaking regarding the form of distributions, since, by assumption, no shareholder can gain an advantage if the corporation alters the form of the distribution.

Yin also defends the imposition of a uniform rate on the ground that the CDT is an extra tax on corporate investment — perhaps as “the price of access to capital markets” — rather than a tax on income. As such, there is no apparent reason why the amount of the burden or charge should fluctuate with the income tax bracket of the shareholder involved. Regardless of whether the CDT is labeled a tax on “corporate investment” or “income” or something else, the burden will be borne by human beings. Justifying the tax by reference to benefits enjoyed by the corporate venture (e.g., access to the public markets or limited liability) does not support any particular distribution of the burden of the tax among human beings.

Foreign Shareholders. Though Yin does not include a discussion of the international tax implications of his proposal, he apparently favors imposing the CDT on foreign shareholders of U.S. corporations. Presumably the CDT would be imposed in lieu of the 30% withholding tax under current law. This change would have at least two important consequences. First, it would no longer be possible for the United States to set default (i.e., statutory, as opposed to treaty) tax rates on foreign shareholders at a high (currently 30%) rate and meanwhile set tax rates on domestic shareholders at another, lower (currently 15%) rate.

Second, under the CDT it would be impossible for the United States to live up to the agreements it has made with treaty partners for reciprocal reduction in dividend tax rates. The U.S. Model Income Tax Convention, reflecting the standard opening offer in treaty negotiations, indicates that the 30% withholding tax rate in the statute is reduced to 5% for inbound direct investment and 15% in other cases. Lately, the U.S. has been ratifying treaties exempting outbound dividends. The basic problem is that under the CDT the

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87 Id. at 1873.

88 Id. at 1873–74.

89 See id. at 1870–71.

90 Income Tax Convention, supra note 77, at art. 10(2).

91 The U.S. has recently ratified treaties providing for zero-rate dividend withholding with Belgium, Germany, Denmark, and Finland. Kristen A. Parillo, Zero Rate on Dividends Provides Leverage in Tax Treaty Negotiations, Treasury Official
distributing corporation itself is liable for the tax. Consequently, even assuming that the corporation has complete information regarding the eligibility of nonresident shareholders for reduced rates, using this information to reduce the corporation's tax burden would not redound to the direct benefit of the nonresident taxpayers. Instead, all taxpayers, including nonresident taxpayers, would get an indirect benefit in proportion to percentage ownership.

Treaty partners have made concessions, such as agreeing to strengthened limitations on benefits and information exchange provisions, in exchange for the U.S.'s promise to lower rates on outbound dividends. These treaty partners would not likely live up to their end of the bargain if the U.S. switched to the CDT without renegotiation.

4. Chirelstein

**Tax-Exempt and Low-Bracket Shareholders.** Chirelstein's proposal presents no special problems in terms of the treatment of tax-exempt shareholders. The hypothetical dividend paid to shareholders of record on the date of any redemption — the new wrinkle Chirelstein's proposal would add — could be treated like any other actual dividend, which means it could be exempt from tax when received by an exempt shareholder, or subject to a reduced rate when received by a low-bracket taxpayer.

**Foreign Shareholders.** Imposing a withholding tax on the hypothetical dividend, on the other hand, does present a logistical problem — how to withhold from a hypothetical payment. One possibility would be to use something like the rule used for interest withholding on OID bonds. The problem there is similar in that OID accruals constitute U.S. source interest income for foreign holders of bonds issued by U.S. borrowers, but withholding is impossible since there is no payment. The solution in that context is to enforce the withholding tax on sale or exchange of the OID bond, or on a payment on the bond such as at maturity. Whether this solution could be implemented for hypothetical dividends deemed to be paid on U.S. equity depends on whether financial intermediaries have sufficient information regarding the U.S. tax status (residency) of shareholders to identify when withholding is required, and a commitment to enforce withholding.

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92 Id.
5. Mark-to-Market Taxation

*Tax-Exempt and Low-Bracket Shareholders.* As with the EED tax, implementation of mark-to-market taxation would not present any particular difficulty with respect to tax-exempt or low-bracket shareholders. Tax-exempt shareholders could be treated as they are now, and low-bracket taxpayers could be required to mark their portfolios to market and report dividends and gains and losses just like everyone else, but then pay tax at a lower rate.

*Foreign Shareholders.* As was true for the EED tax treatment of outbound dividends, the basic problem in rationalizing the application of mark-to-market taxation to nonresident shareholders is that entrenched source rules treat economically comparable income items differently. Specifically, share appreciation on account of retained corporate profits is sourced by the shareholder’s residence, whereas dividends are sourced by the corporation’s residence.

Absent a fundamental rethinking of U.S. tax policy towards inbound portfolio investment, the mark-to-market tax could not be collected from nonresident shareholders. This is true for legal and practical reasons. The legal reasons are the background source rules, mentioned above, and treaty commitments that likely preclude the U.S. from taxing unrealized gains accruing in favor of nonresident shareholders.\(^9\) The practical problem is that if the U.S. tried to impose tax, it would be unsuccessful given that there is no payment from which to collect a withholding tax. Since the U.S. cannot collect the mark-to-market tax from nonresident shareholders, the question arises whether it should exempt dividends accruing in their favor. It should not, for the reason explained above — a background statutory rule of taxing outbound dividends gives leverage in treaty negotiations, and nothing is gained by unilaterally ceding the

\(^9\) I say that taxing mark-to-market gains is “likely” precluded since the treaties in place were not drafted with mark-to-market taxation in mind and it is not clear whether the mark-to-market tax should be classified as a tax on gains, and hence subject to Article 13(6), or instead as dividends, and hence subject to Article 10. Compare Income Tax Convention, *supra* note 77, at art. 13(6), *with id.* at art. 10. Logically, it seems proper to classify mark-to-market gains as a tax on gains, since that is what it is in substance. On the other hand, the definition of “dividends” in Article 10(5) is broad enough to include mark-to-market gains, and the Technical Explanation seems to reinforce this reading. *See id.* at art. 10(5). If mark-to-market gains are “dividends” within the meaning of treaties, which I regard as plausible though unlikely, then the U.S. could impose tax on nonresidents consistent with its treaty obligations. As discussed in the text, however, it is not clear how this tax would be enforced since there is no payment from which tax could be withheld.
6. Summary

Current law's dividends tax is formulated in a way sensitive to differences in tax status of foreign, tax-exempt, and low-bracket shareholders. The EED tax, Chirelstein's proposal, and mark-to-market taxation could also be made sensitive to these differences. By contrast, the CDT could not be made sensitive to such differences, at least not easily. Observing the schism between current law and the CDT with respect to such shareholders, Yin concluded that the CDT is nondistortive and that "the mechanics of imposing and collecting the tax are far simpler and more efficient than under current law." Although I agree that the CDT would be far simpler and more efficient than current law, my view is that designing corporate distributions tax in a way that accounts for differences in shareholder tax status has important advantages over the distributee-blind approach. Perhaps chief among these advantages is compatibility with the basic framework of U.S. taxation of inbound investments in corporate stock. To be sure, the EED tax, Chirelstein, and mark-to-market all present some complications in the taxation of foreign shareholders. I have endeavored to show, however, that workable solutions to the taxation of inbound stock investment can be found under these proposals.

Unfortunately, these solutions do not restore the economic rationality that is lacking under current law — most importantly, net profit that manifests as stock appreciation is not taxed to nonresidents, whereas dividends paid to nonresidents are taxed under current law and the various proposals. The EED tax, Chirelstein, and

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94 See supra text accompanying note 79.

95 In concept, something like the CDT could be collected at the shareholder level. This would facilitate the use of distributee-specific exemptions and rate reductions. The idea would be (a) to exempt stock sale gains from tax and (b) to tax in full with no cost recovery all redemption and straight pro rata distributions, aside from liquidating distributions, and possibly redemptions that terminate the redeemed shareholder's interest.

Martin Ginsburg came close to proposing such a system (his proposal was much like (b), but without (a)). Ginsburg et al., supra note 25, at 49–53. The difficulty with this approach is that taxpayers would likely plan around the distributions tax by selling stock on the eve of a distribution to buyers eligible for preferential distributions tax rates. Although Ginsburg acknowledged that this would be a problem, he did not explain how to fix it. Id. at 50–51 n.14.

96 Yin, supra note 29, at 1877.
mark-to-market are, however, compatible with our treaty commitments and they do not make distortions with respect to nonresident shareholders worse than they already are.

V. CONCLUSION

There are number of ways that the current system of taxing corporate distributions could be reformed, short of integration of the corporate and personal income tax systems. Unfortunately, the reforms that go furthest in terms of eliminating distribution-related distortions caused by current law (in particular mark-to-market taxation and the CDT proposed by George Yin) are incompatible with US international tax law (true for the CDT), would trigger a significant tax increase for tax exempt shareholders (true for the CDT), and would distort decisions regarding whether private companies should go public, or vice versa (true for mark-to-market taxation). Mark-to-market taxation might make sense as part of a more thoroughgoing reform of corporate-shareholder taxation (such as integration) but likely does not make sense if the reform goal is more modest.

If the CDT and mark-to-market taxation are set aside because of these difficulties, it leaves three choices: current law; the EED tax; and Chirelstein's proposal. Both the EED tax and Chirelstein's proposal would eliminate the bias in favor of redemptions, at the cost of introducing new biases. For instance, the EED tax would distort incentives with respect to the timing of distributions and exacerbate the lock-in effect, and Chirelstein's proposal would create a bias against redemptions. In my opinion, both the EED tax and Chirelstein's proposals would be an improvement as compared with current law, but I accept that others might have different opinions about the relative importance of the distortions eliminated and created by the various alternatives.

There are still more issues that should be considered in assessing corporate distributions tax reform, such as the treatment of intercorporate equity investments. Does it makes sense under the various proposals to implement a dividends received deduction, and if so, how should it be structured? Other issues include the compatibility of the reform proposals and the tax rules for regulated investment companies (mutual funds), and the tax treatment of stock dividends. This article has, however, begun the process of sifting through more or less practical alternatives to what is widely regarded as an overly complex, highly distortive tax regime. The distributions tax is
apparently here to stay, so it makes sense to continue to explore ways that the law can be made simpler and more efficient.