



GEORGE YIN 

Improving the Design and Structure of Tax Law

TAX SCHOLARS FREQUENTLY USE INSIGHTS from economic theory and political science. But lawyers bring another critical ingredient to policy debates—an understanding of the institutional structures within which tax enforcement and compliance take place. George Yin, recently named chief of staff to Congress's Joint Committee on Taxation, brings a formidable mix of theoretical and institutional perspectives to his scholarship after leaving private practice to serve as Tax Counsel for the U.S. Senate Finance Committee. Yin notes, "Given our self-assessment system, it is critical in shaping a law to take account of the likely response of taxpayers, their advisors, and the government. What design will facilitate taxpayer compliance? How can we prevent taxpayers from achieving results unintended by the legislature? What design will facilitate enforcement but also curb governmental overreaching? How might taxpayer and government responses thwart the policy makers' allocative and other objectives?"

Yin's scholarship has focused on trying to answer such questions in several different areas of tax law. One example is the work he did as reporter to the American Law Institute's five-year project on the taxation of private business enterprises. The starting policy

goal was to collect a single tax on the income of such businesses. The difficult issue was choosing among the many possible designs.

Yin and his co-reporter, David Shakow, with the assistance of consultants from practice, the academy, and government, began by comparing the benefits of “entity” versus “conduit” taxation of the enterprise. Under entity taxation, the business entity itself is subject to tax, much like the corporate tax under current law, but the owners are not subsequently taxed. Under conduit taxation, the entity is not taxed. Instead, the entity determines the amount of its taxable income and other tax items and passes through this information to its owners, who pay tax directly on their share of the enterprise’s income. Initially, entity taxation seems far simpler because it focuses the tax collection responsibility on a single taxpayer—the entity—rather than dispersing it among multiple owners. But Yin and Shakow concluded that the simplicity of the entity approach was partly illusory because the proper tax liability would sometimes depend on the owners’ individual tax situations. They also worried about the undesirable consequences of drawing a sharp line between sole proprietorships and two-person businesses, including partnerships, limited liability companies, and corporations.

The conduit approach, however, posed its own dilemma. Yin explains, “The most developed system of conduit taxation is partnership taxation under subchapter K of the Internal Revenue Code. Our experience with these rules suggested that they were too complicated for many taxpayers, yet imprecise enough to be manipulated by sophisticated taxpayers. Simplifying the rules would in many instances make them even less precise and more manipulable. Conversely, reforming the rules to prevent tax avoidance would make them even more complicated.”

Under current law, this dilemma is increasingly resolved through the use of so-called “anti-abuse” rules, which treat taxpayers differently based upon their intent and other subjective factors. Yin and Shakow decided that less reliance on subjective factors would promote a more even-handed and predictable application of the law. Accordingly, they recommended enactment of two different forms of conduit taxation: a reformed version that prevented common manipulations, and a simplified version. The key feature was a set of eligibility rules that would prevent those tax-

payers who could take undesired advantage of the less precise simplified system from using that system. The report was published in *American Law Institute, Federal Income Tax Project: Taxation of Private Business Enterprises, Reporters’ Study* (1999) and Yin published a description of the basic theory and recommendations in “The Future Taxation of Private Business Firms,” 4 *Fla. Tax Rev.* 141 (1999).

Yin has also addressed the structure of the earned income tax credit (EITC) program, which provides cash benefits to low-income working households. Eligible households claim the credit by filing a tax return. The credit reduces any income tax liability and the amount of the credit in excess of that liability is paid in cash to the household, either periodically during the year or as a lump sum at year-end. The EITC program is a major federal commitment, providing over \$30 billion in benefits each year to households making up to approximately \$32,000.

When the program was marked for significant expansion during the early 1990s, Yin led a group of researchers formed to scrutinize its administration. The researchers first estimated that between 75 and 86 percent of eligible households actually participated in the program in 1990. Second, they found that an extraordinarily low percentage of households that did participate—less than one-half of one percent—obtained the cash benefit throughout the year as opposed to receiving one lump sum at the end of the year. This arguably made the benefit more like a bonus to the recipients at the end of the year rather than a meaningful income support payment or work incentive. Finally, they reported a noncompliance rate for the program of about one-third, meaning that of the roughly 12 million credits granted in 1990, about four million were awarded to ineligible households. (Subsequent research performed by the IRS and the General Accounting Office indicates that there was little improvement in either the participation or compliance rates for the EITC program during the 1990s.) Yin and the other researchers reported their findings and set forth proposed reforms to the program in “Improving the Delivery of Benefits to the Working Poor: Proposals to Reform the Earned Income Tax Credit Program,” 11 *Amer. J. Tax Policy* 225 (1994), and Yin was later invited to testify in Congress about proposals to reform the program. One of their most significant recommenda-

tions—a proposal to simplify the definition of a “child” for purposes of many tax provisions—was endorsed by the Treasury Department in 2002 and may make it into law in a future year.

In a separate article written with Jon Forman, Yin detailed a more expansive vision for reform of the EITC program. In “Redesigning the Earned Income Tax Credit Program to Provide More Effective Assistance for the Working Poor,” 59 *Tax Notes* 951 (1993), the authors proposed to divide the program into its two principal components: an incentive for the working poor and a benefit provided to households with children. They argued that the program’s “working poor” benefit, originally intended largely as a rebate of the Social Security taxes paid by low-income workers, could be provided much more efficiently by simply not collecting those taxes in the first instance. They proposed, therefore, to establish an exempt amount of wages below which no Social Security taxes would be due. To ease administration, the exemption would apply to the wages of *all* workers, whether or not low-income. The wage ceiling for middle- and upper-income wage earners would then be raised to recapture the benefits of the exemption from them. Once the “working poor” incentive was provided through the Social Security tax exemption, the authors recommended that the remaining benefit of the EITC program be provided through a tax credit for children (or, under current law, an expansion of the existing child credit).

The authors contended that such a revision of the program would help to remedy each of the administrative problems with the existing EITC program. For example, by providing the “working poor” incentive through a Social Security tax exemption, all eligible families would receive the benefit automatically in each paycheck. Beneficiaries would no longer need to obtain information, determine or assert eligibility, or even file a tax return. Nor would employers be burdened, except for the slight change to adjust for the exemption amount in calculating the amount of Social Security taxes to withhold. Moreover, the simplicity of the delivery system and the relative absence of any self-certifying features would almost assure a high level of compliance.

Despite these forays into the EITC and the taxation of private business entities, most of Yin’s scholarship has been devoted to the tax rules relating to public corporations. For example, in

“Corporate Tax Integration and the Search for the Pragmatic Ideal,” 47 *Tax L. Rev.* 431 (1992), he tried to identify the most practical way to eliminate the double taxation of corporate-source income and integrate the corporate and shareholder income taxes. Many policy analysts have recommended corporate tax integration, and it is a common feature of tax systems outside the U.S. In this country, however, integration proposals have been blocked by a range of objections, including concerns about its complexity and distortive effects.

In his article, Yin analyzed two recent proposals for integration: one contained in an *American Law Institute Reporter’s Study* and the other included in a Treasury Department report. The *Reporter’s Study* would have converted the existing corporate income tax into a withholding tax, which would effectively have made the shareholder-level tax the exclusive source of tax revenue from corporate-source income. In contrast, the Treasury Department proposal would generally have repealed the tax on dividends but kept the corporate income tax. Yin concluded that although each approach had its advantages, neither probably represented a satisfactory form of integration. The *Reporter’s Study* failed to provide a secure means of collecting revenue from corporate-source income in the absence of several controversial (and unlikely) changes to the law (including the direct taxation of otherwise tax-exempt entities). The Treasury’s approach offered a more secure method of obtaining that revenue, but in an inequitable and non-neutral manner.

Instead, Yin developed an intriguing and creative proposal to keep *both* the shareholder and corporate income taxes but to integrate them so that the total tax burden on corporate-source income is roughly comparable to that on noncorporate-source income. Yin argued, “What is important is the burden imposed, not the number of times a tax is levied.” He argued that two low-rate taxes on the same income may be a more efficient and effective means of collecting the revenue from corporate-source income than any single tax. In particular, he recommended enactment of a low, flat-rate corporate-level tax and a progressive shareholder-level surtax applicable to higher-income investors. Counterintuitively, he proposed achieving integration through double taxation. Yin’s proposals will be an integral part of the current debate on the Bush

Administration's recommendation to eliminate the tax on corporate dividends.

In recent years, Yin has focused in particular on corporate tax shelters. The current tax shelter phenomenon refers to aggressive and possibly illegal tax positions taken mainly by public corporations, as their corporate tax departments are increasingly viewed as additional profit centers. Many of the underlying transactions are contrived, in the sense that they serve no corporate purpose other than reducing taxes. The IRS has challenged a number of the tax positions, but most analysts believe they represent just the tip of the iceberg. In an effort to reverse the trend, the IRS has mandated greater disclosure requirements and the Treasury has requested legislation to do much more, possibly including enactment of a global anti-abuse rule.

In "Getting Serious about Corporate Tax Shelters: Taking a Lesson from History," 54 *SMU L. Rev.* 209 (2001), Yin reviewed the last "war" against tax shelters during the 1970s and 80s. He found that despite many changes in the law and the IRS's administrative practices, including changes similar to the ones currently being proposed by the government, shelters were not curbed until Congress enacted a broad, reasonably clear, outcomes-oriented set of rules known as the "passive activity loss" rules. By contrast, incremental reforms were counterproductive, involving small steps that simply led to more avoidance behavior and greater inefficiency. He therefore argued that if the corporate tax shelter problem is as serious as some claim, Congress should consider enacting a broad, outcomes-oriented rule that is unaffected by taxpayer purpose or intent or the other elements making up the taxpayer's transaction.

The article briefly discussed possible reforms, one of which may well gain currency in light of subsequent corporate governance scandals. Yin suggested requiring that public companies keep a single set of books for both financial reporting and tax purposes. He noted that such a rule would create a desirable tension for public companies that ordinarily prefer to report higher earnings for financial reporting purposes and lower earnings for tax purposes. Yin hopes to develop this idea further in future research. ↔

EXCERPT FROM:

Getting Serious About Corporate Tax Shelters: Taking a Lesson from History

George Yin

George Yin, University of Virginia

SUPPOSE PUBLIC CORPORATIONS are taxed each year on the amount of income they report for financial accounting purposes, as adjusted by tax rules authorizing specific deviations from a book income tax base. Thus, the *starting* tax base for public corporations would be their reported book income, but specific provisions could modify that result. If, for example, Congress deemed it desirable to allow different depreciation rules for book and tax purposes, different consequences from the exercise of nonqualified stock options, different treatment of foreign income, or any other book-tax differences, Congress would simply have to enact the particular adjustment. In the absence of any adjustment, however, a public corporation would pay tax on its book income. The potential advantage of shifting to a book income tax base *with adjustments* is to improve the transparency of the tax base: intended deviations from book income, but *only* intended deviations, would be permitted in calculating taxable income... Some preliminary thoughts [about this idea] are outlined below.

"GETTING SERIOUS
ABOUT CORPORATE TAX
SHELTERS: TAKING A
LESSON FROM HISTORY,"
54 *SMU L. Rev.* 209
(2001)

1. EFFECT ON CORPORATE TAX SHELTERS

ACCORDING TO THE TREASURY DEPARTMENT, a principal characteristic of corporate tax shelters is inconsistent treatment for financial accounting and tax purposes of the items resulting from the shelter. A shelter might be designed, for example, to produce a tax loss without any corresponding book loss. Indeed, public corporations generally do not find appealing tax shelters which result in consistent book-tax treatment because of the adverse effect of such shelters on their reported earnings. Although there is limited disclosure required of book-tax disparities for both tax and accounting purposes, the great number of differences permits much shelter activity to remain hidden from view.

The entire class of shelters with this common characteristic would end if corporations were taxed on their adjusted book income. By linking taxable income to book income, Congress would eliminate the ability of corporations to explore unintended and undesirable deviations between the two measures. Congress would gain greater control over the corporate tax base; intended book-tax disparities could be specifically authorized but unintended ones would essentially end. The rule would have similar characteristics to [the passive activity loss rules]: it would be broad, reasonably clear, and very outcomes-oriented, with tax consequences literally being determined by the “bottom line.” Tax results would not depend upon taxpayer intent, motive, or similar factors.

2. TAX POLICY CONSIDERATIONS

ASIDE FROM ITS POSSIBLE IMPACT on corporate tax shelters, is the rule consistent with sound tax policy? The rule requires public corporations to be taxed more closely on their economic income, if one assumes that income reported for financial accounting purposes is a closer approximation of that than taxable income. But how does the rule compare to current law from the standpoint of equity, efficiency, and administrative simplicity?

It is hard to assess the equity implications of the rule because they depend upon identifying who bears the burden of the corporate tax. For example, if corporation X pays more tax under the proposal than under current law, it is difficult

to determine whether that result is equitable without knowing who bears the burden of X's tax liability.

An efficiency objection arises if the rule is not even-handed in its application. Because corporations to some extent can manage the amount of financial earnings they report in a given year, a tax base based on book income would seem to violate a neutrality objective. Such a rule could allow similarly situated corporations to pay different amounts of tax, depending upon the earnings they decide to report in a given year.

On the other hand, to the extent reported earnings make a difference to investors—obviously, an uncertain assumption—financial accounting policy should promote uniform treatment of corporations. Thus, although the amount of earnings are to some degree manipulable by corporate management, similarly situated corporations may have an equal opportunity to engage in such manipulations. If this is true, then part of the efficiency objection should disappear. A corporation's choice regarding how it balances its desire to report high financial earnings and low taxable income would be similar to other choices it faces in operating its business. Tax rates can be adjusted to raise the desired amount of revenue based on the amount of earnings reported.

To be sure, certain corporations, particularly those in different industries, would no doubt have differing abilities to engage in earnings management. Thus, a tax based on adjusted book income would cause some distortion and inefficiency. What is unknown is whether this distortion would be greater than that of current law, which also taxes some corporations in different industries in different ways.

Moreover, balanced against that inefficiency would be the potential simplification gain from a tax on adjusted book income. The planning, compliance and administration costs of the current corporate tax are quite high. Tying taxable income to the amount of book income, even with a number of authorized adjustments, could be a major simplification and result in a reduction in costs.

3. ACCOUNTING POLICY CONSIDERATIONS

A TAX BASED ON ADJUSTED BOOK INCOME would motivate some corporations to report lower earnings simply to reduce their tax bill. Thus, the tax might have the adverse effect of degrading the quality of financial reporting. On the other hand, financial reporting is already degraded to some extent. Under current law, corporations obtain two different bites at the apple: they take advantage of ambiguities in the financial accounting rules to puff up the amount of their financial earnings, and take advantage of similar ambiguities in the tax rules to understate the amount of their taxable earnings. Further, they lobby Congress and the relevant administrative agencies to maintain and enlarge the ambiguities in each set of rules. Linking tax consequences more closely to book consequences eliminates one of those opportunities. Although adoption of the tax rule discussed here may ultimately result in lower reported earnings, it may be that such reports will represent more reliable assessments of the financial situations of the corporations than are currently provided.

4. LIMITATION TO PUBLIC COMPANIES

THE TAX ON ADJUSTED BOOK INCOME would only apply to public companies because of the potential discipline imposed by public markets on the amount of corporate earnings reported. But there is another reason to limit the proposal to public corporations—they probably represent the heart of the corporate tax shelter problem. According to the Treasury Department, the principal benefit of corporate tax shelters is the saving in corporate income taxes. Yet the very largest corporations, which are disproportionately public companies, pay the bulk of the corporate tax and therefore are likely to be the major players in corporate shelters. Private corporations taxed under subchapter C have many opportunities unavailable to public corporations to reduce or eliminate their corporate income by paying out their earnings in tax-deductible ways.

Moreover, under [existing tax] classification rules, new private ventures have an enhanced ability to avoid the corporate tax altogether in the future. This option is unavailable to public

firms. Thus, the existing difference between public and private companies for tax purposes affords an excellent opportunity to consider reforms that take advantage of the unique features of the firms in each sector to determine the simplest, most efficient way of raising taxes from that sector.

5. INTEGRATION

THE PROPOSED RULE REDEFINES the corporate tax base. Most major corporate integration proposals retain some form of corporate tax, with the shareholder tax being reduced or eliminated in some way. Thus, the proposal could be implemented consistently with almost any integration objective.

6. CROSS-BORDER CONSIDERATIONS

FOR U.S. CORPORATIONS with foreign subsidiaries, the principal question will be how to reconcile the different consolidation standards that currently exist for tax and accounting purposes. The tax rules could be conformed to the accounting rules, in which case U.S. corporations would be taxed currently on the earnings of their foreign subsidiaries. Alternatively, a specific book-tax deviation could be enacted to continue the current U.S. tax treatment of those earnings.

Taxing foreign corporations with U.S. operations would be a little trickier. If the domestic operations were carried out through a separate subsidiary, the subsidiary could be required to prepare financial statements in accordance with U.S. financial accounting rules and report U.S. taxable income accordingly. The same requirement might be imposed even if the domestic operations were carried out through a U.S. branch. Alternatively, the foreign parent corporation might be required to report its earnings using international accounting standards, with the U.S. portion of those earnings then being taxed by the U.S.

7. SUMMARY

MUCH HAS BEEN WRITTEN about the evolution of the corporate tax department from being a mere part of the overhead to a prof-

it center. In truth, well-run corporations have long viewed taxes as a cost which, within limits, should be minimized. Sharp tax accountants and lawyers have presumably always been valued corporate employees and advisors. What may be different, perhaps, is the extent to which corporations are now willing to go to achieve their tax minimization objectives. Fueled by rumors of a competitor's latest tax saving plan that aggressively exploits one of the many complex and possibly irrational features of the corporate tax law, corporate officers apparently feel more and more compelled to engage in the ["tax avoidance"] game. An adjusted book income tax may both simplify the law, thereby reducing the number of tax law opportunities that can be exploited, and make the remaining competition more open. Corporate executives would be able to have confidence that a competitor's reporting of higher earnings is not simply financed by some tax avoidance scheme not availed of by their own company; rather, the earnings would be accompanied by a tax bill commensurate to the amount reported. ❖

YIN BIBLIOGRAPHY

WORKING PAPERS:

"Estimating the Effective Tax Rates of the S&P 500."

"Taxing Corporate Divisions," 56 SMU L. Rev. _____ (forthcoming 2003).

BOOKS:

Federal Income Tax Project: Taxation of Private Business Enterprises: Reporters' Study (with D. Shakow) (American Law Institute, 1999).

Corporate Tax Reform: A Report of the Invitational Conference on Subchapter C (G. Yin & G. Mundstock, eds. and contributors) (American Bar Association, 1988).

The Subchapter C Revision Act of 1985, 99th Cong., 1st Sess. (S. Prt. No. 99-47) (1985) (principal draftsman and editor while on the staff of the Senate Finance Committee).

BOOK CHAPTER:

"The Story of Crane: How a Widow's Misfortune Led to Tax Shelters" in P. Caron, ed., *Tax Stories: An In-Depth Look at Ten Leading Federal Income Tax Cases* (Foundation Press, 2003).

"The Uncertain Fate of the Earned Income Tax Credit Program" in K. Brown & M. Fellows, eds., *Taxing America* (NYU Press, 1996).

SELECTED OTHER PUBLISHED WRITINGS:

"The Problem of Corporate Tax Shelters: Uncertain Dimensions, Unwise Approaches," 55 *Tax L. Rev.* 405 (2002).

"A Cautionary Note on the Use of Antiabuse Doctrines," 94 *Tax Notes* 1225 (2002).

"Tax Policy and Politics," 20 *ABA Tax Section Newsletter* 18 (2001).

"Reforming and Simplifying the Income Taxation of Private Business Enterprises" in U.S. Jt. Comm. on Taxn, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification* (Vol. III), JCS-3-01, p. 220 (2001) [with D. Shakow].

"Getting Serious About Corporate Tax Shelters: Taking a Lesson From History," 54 *SMU L. Rev.* 209 (2001). Abstract printed in 91 *Tax Notes* 1629 (2001).

"Using Book Earnings as the Default Tax Base for Public Corporations," 92 *Tax Notes* 135 (2001).

"The Future Taxation of Private Business Firms," 4 *Fla. Tax Rev.* 141 (1999).



"The ALI Reporters' Study on the Taxation of Private Business Enterprises," 85 *Tax Notes* 91 (1999).

"Making Sense of the Compaq Computer Case," 85 *Tax Notes* 815 (1999).

"Morris Trust, Sec. 355(e), and the Future Taxation of Corporate Acquisitions," 80 *Tax Notes* 375 (1998).

"The Taxation of Private Business Enterprises: Some Policy Questions Stimulated by the 'Check-the-Box' Regulations," 51 *SMU L. Rev.* 125 (1997).

"Simulating the Tax Legislative Process in the Classroom," 47 *J. Legal Educ.* 104 (1997).

"Can the Adverse Effects of Noncompliance Be Reversed?" 2 *The Community Tax L. Rep.* 5 (1997).

"President Bob Dole's Tax Policy," 72 *Tax Notes* 1438 (1996).

"Should Today's Fastest Growing Federal Assistance Program Be Roped In?" *The American Enterprise*, July/Aug. 1996, at 78.

"Reforming the Earned Income Tax Credit Program," 67 *Tax Notes* 1828 (1995).

"Accommodating the 'Low-Income' in a Cash-Flow or Consumed Income Tax World," 2 *Fla. Tax Rev.* 445 (1995).

"Improving the Delivery of Benefits to the Working Poor: Proposals to Reform the Earned Income Tax Credit Program" (with J. Scholz, J. Forman and M. Mazur), 11 *Amer. J. Tax Policy* 225 (1994).

"Summary of EITC Conference Proceedings," 11 *Amer. J. Tax Policy* 299 (1994).

"Making Charity a Chore," *Washington Post*, Dec. 28, 1993, at A-15.

"The Hollow Promise of the Earned Income Tax Credit," *Legal Times*, June 28, 1993, at 20.

"Redesigning the Earned Income Tax Credit Program to Provide More Effective Assistance for the Working Poor" (with J. Forman), 59 *Tax Notes* 951 (1993).

"Corporate Tax Integration and the Search for the Pragmatic Ideal," 47 *Tax L. Rev.* 431 (1992).

"Achieving Corporate Integration Through Double Taxation," 56 *Tax Notes* 1365 (1992).

"Of Indianapolis Power and Light and the Definition of Debt: Another View," 11 *Va. Tax Rev.* 467 (1991).

"A Different Approach to the Taxation of Corporate Distributions: Theory and Implementation of a Uniform Corporate-Level Distributions Tax," 78 *Georgetown L. J.* 1837 (1990).

"Of Diamonds and Coal: A Retrospective Examination of the Loss Carryover

Controversy," 48 *N.Y.U. Inst. on Fed. Tax'n* 41-1 (1990).

"A Proposed Tax on Corporate Distributions," 67 *Taxes* 962 (1989).

"LBOs, the Home Mortgage Interest Deduction, and Tax Policy," 42 *Tax Notes* 1011 (1989).

"Taxing Corporate Liquidations (and Related Matters) after the Tax Reform Act of 1986," 42 *Tax L. Rev.* 573 (1987).

"A Carryover Basis Asset Acquisition Regime?: A Few Words of Caution," 37 *Tax Notes* 415 (1987).

"General Utilities Repeal: Is Tax Reform Really Going to Pass It By?" 31 *Tax Notes* 1111 (1986).

"The Deficit Reduction Act of 1984: Some Small Steps Toward Corporate Reform," 25 *Tax Notes* 73 (1984).

"Supreme Court's Tax Benefit Rule Decision: Unanswered Questions Invite Future Litigation," 59 *J. of Tax'n* 130 (1983).

"Scope of Anti-Injunction Act Exceptions Limited by Investment Annuity Decision" (with D Woodward), 52 *J. of Tax'n* 166 (1980).