The London School of Economics and Political Science

The Taxation of Corporate Groups Under a Corporation Income Tax

An Interdisciplinary and Comparative Tax Law Analysis

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A thesis submitted to the Department of Law of the London School of Economics for the degree of Doctor of Philosophy

London, September 2010

Declaration

I certify that the thesis I have presented for examination for the PhD degree of the London School of Economics and Political Science is solely my own work other than where I have clearly indicated that it is the work of others.

I warrant that this authorization does not, to the best of my belief, infringe the rights of any third party.

Abstract

Corporate groups are notoriously difficult to tax. At the moment it is not clear whether corporate groups should be approached as single taxable entities, or whether a separate tax existence should be attributed to corporate group members. The current ambiguity generates a substantial deadweight loss. This study determines what may be the best approach to tax corporate groups, once the perspectives of government and corporate groups are taken into account. The study adopts an interdisciplinary approach, whereby elements, such as market imperfections, the economic, legal and functional nature of corporate groups and the rules of related regulatory fields, are brought into the investigation. The study is based on the US federal corporate income tax system, although, for certain issues, the UK tax system is analyzed. The study adopts a closed economy perspective. The study shows that the design and operation of the corporate income tax system is subject to several constraints and distortions, and argues that to simply look at how far a certain policy is from optimality may be insufficient to determine whether an incremental improvement occurs. The study proposes a new approach to corporate income tax policy whereby the pursuit of incremental improvements requires the minimization of transaction costs and other sources of deadweight loss and the taking into account of the collateral effects of the corporate income tax system, including its interaction with market imperfections, the behavioural and operational nature of business entities, the frictions imposed by other regulatory fields and corporate governance. Following this policy approach, the study concludes that treating corporate groups as single taxable entities is the best approach to tax corporate groups and recommends a revision of certain technical aspects of the current US and UK legislation for taxation of corporate groups.

Acknowledgements

This work was only possible due to the support of a large group of people. To start with, I would like to thank Dr Ian Roxan, my doctoral supervisor at the London School of Economics, for his invaluable guidance and continuous support during the several years it took me to produce this work. I would also like to express my gratitude to Professor John Avery Jones, from the London School of Economics, and Professor Peter Harris, from the University of Cambridge, for their detailed and critical reading of this work. A word of appreciation goes also to Dr Ann Mumford, Professor Malcolm Gammie, and Professor Paul Davies for their valuable input to the early materials that led to this study; and to Professor Leonard Terr, Professor José Engrácia Antunes, António Frada de Sousa, Professor Miguel Poiares Maduro, and Professor Rui Duarte Morais for their key support on the early stages of this project. Lastly, but certainly not least, I would like to thank my family and my friends. Besides Porfírio, Teresa, Sofia, Ducha, Paulo and Joana, I would like to leave a special word of appreciation to my enthusiastic and inspiring creative consultants, João Guimarães, Rui Silva and Ricardo Brito.

I also would like to express my deepest gratitude to the sponsors who made this work possible. First, the UK Chartered Institute for Taxation and the Harbour Charitable Trust (Avery Jones Award), which funded the early stages of the research. Second, the Portuguese Government and the European Union, which, through *Fundação para a Ciência e a Tecnologia*, exclusively funded the remaining stages of the research.

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List of Diagrams

List of Abbreviations

ALI – American Law Institute

BNA – Bureau of National Affairs

CIT – Corporate Income Tax

CNOL – Consolidated Net Operating Loss

CTA – Corporation Tax Act

ELA – Excess Loss Account

EU – European Union

E&P – Earnings and Profits

FA – Finance Act

Ft. – Footnote

HMRC – Her Majesty's Revenue and Customs

IBFD – International Bureau of Fiscal Documentation

ICTA – Income and Corporation Taxes Act

IFA – International Fiscal Association

IMF – International Monetary Fund

IRC – U.S. Internal Revenue Code

IRS – U.S. Internal Revenue Service

LDR – Loss Disallowance Rule

LLC – Limited Liability Company

MNG – Multinational Corporate Group

M&A – Mergers and Acquisitions

NBER – National Bureau of Economic Research

NCL – Net Capital Loss

NOL – Net Operating Loss

OECD – Organization for Economic Co-operation and Development

Rev. Rul. – Revenue Ruling

SSRN – Social Science Research Network

SRLY – Separate Return Limitation Year

TGCA – Taxation of Chargeable Gains Act

Treas. Reg. – Treasury Regulation

TIOPA – Taxation (International and Other Provisions) Act

VAT – Value-Added Tax

A. The Problem

Corporate groups are notoriously difficult to tax. Faced with the difficulty to deal with these entities, the tax legislator oscillates between the attribution of a separate tax existence to corporate group members and the treatment of corporate groups as single taxable entities.[1] This fuzzy approach to the taxation of corporate groups generates loopholes in the tax system and undermines its structural logic.[2] The arsenal of anti-abuse rules that currently plagues the US and UK tax laws provides a visible sign of the difficulty in dealing with these entities.[3] These rules make the CIT systems more complex and result in an increase of tax overhead costs, both for the government and the corporate groups.[4]

The current state of affairs creates problems not only for the government and society, but also for corporate groups, generating a substantial deadweight loss for the entire economic system.[5] At the moment it is not clear which is the best approach to tax corporate groups once their perspective and the perspective of the government is taken into consideration. In the light of the current state of affairs, the central research question that this thesis intends to answer is: *What is the best approach to tax corporate groups once both the perspectives of the government and corporate groups are taken into consideration?*

The answer to this central question presupposes the answer to three preliminary questions. First of all, how should research approach corporate taxation? Second, does it make sense for research to focus on potential improvements to the current CIT system or, in light of other potentially available alternatives, should it simply be discarded as a viable option to tax the corporate sector? Third, and fundamentally, assuming there is merit to the maintenance of a CIT system, how may research identify the reasons for the CIT system's

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[1] *See* discussion *infra* at pg. 77ff and pg. 140ff.
[2] *See* discussion *infra* at pg. 111ff.
[3] The situation is similar in most OECD countries. The arsenal of anti-abuse rules aimed at controlling corporate groups' potential for manipulation of the corporate tax system includes transfer pricing rules; thin-cap rules; complex ownership attribution rules; form over substance principles; etc. *See* discussion *infra* at pg. 118ff.
[4] By tax overhead costs this thesis means the amount of resources (including the value of time or labour) consumed in applying the tax system, through taxpayer or government activities such as tax planning, compliance, litigation, administration, and law making. *See* DANIEL SHAVIRO, *An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax*, 48 Tax L. Rev. 1 (1992) at 24.
[5] *See* discussion *infra* at pg. 131ff.

difficulty to tax corporate groups and define a path for improvement of the *status quo* that is beneficial both to the government and the corporate groups?

The next section will try to provide an answer to the first preliminary question posed. This demands an understanding of the nature of the subject under study. Once this thesis defines its methodological approach, it will then present its proposed structure to deal with the remaining research questions.

B. The Nature of Corporate Income Tax Law

CIT law is moulded by economic, political, social and ideological influences.[6] This permeability of CIT law to its historical and material context is a consequence of the important role it plays in the political and economic shaping of society. To determine the proportion of revenues to be transferred from the private sector to the public sector to fund public goods (through a particular definition of the corporate tax base and the corporate tax rate), which economic activities to encourage or discourage (through the introduction of particular incentives and disincentives in the corporate tax laws), or when and how to stimulate overall economic activity (namely, through the reduction of the tax charge on the corporate sector and its transference to other sectors of society) is an endeavour that results in tension among several sectors of society.

In practice, different actors with distinct behavioural tendencies and aims become deeply involved in the tax legislative process. The legislator, the tax authorities, political parties, corporate lobbies and interest groups act in constant tension regarding the definition of CIT's objectives and particular legislative shape.[7] Due to its important societal role, CIT's legislative process is particularly competitive, with these different internal cultural forces constantly trying to shape it according to their particular interests. The internal tension of these forces in the definition of the corporate tax laws is a central element in the definition

[6] *See, e.g.* AJAY MEHROTRA, *Mergers, Taxes, and Historical Materialism*, 83 Indiana Law Journal 881 (2008) at 955 ("[Tax] rules are a product not solely of economic ideas or legal logic, but also of changing social, political and economic conditions and interests – a product, that is, of *historical sequence* and *material context*."). Emphasis added. *See also* AJAY MEHROTRA, et al., The New Fiscal Sociology: Taxation in Comparative and Historical Perspective (Cambridge University Press. 2009).
[7] *See* ROBERT J. CLARK, *The Morphogenesis of Subchapter C: An Essay in Statutory Evolution and Reform*, 87 Yale Law J. 90 (1977) at 95.

of the corporate tax culture.[8] Historically, it has significantly contributed to turning the process of CIT reform into a controversial and piecemeal endeavour that has often generated genetically asymmetric and logically incoherent tax rules and principles.[9]

The imperfections of the economic system and the behavioural nature of the corporate taxpayer bolster the propensity for the internal asymmetry and the logical incoherence of the CIT system. CIT rules are implemented in an imperfect economy, *i.e.,* an economy with information asymmetries and transaction costs.[10] In this imperfect economy, valuation of assets, knowledge of the tax rules, compliance and administration have associated costs. These costs fundamentally determine the structure and operation of the CIT system.[11] For instance, a theoretically sound tax solution may often be too unpractical to be implemented due to the transaction costs involved in the valuation of assets, the transaction and agency costs generated by too burdensome compliance requirements, or the degree of sophistication of the tax authorities. Last, but certainly not least, the behavioural nature of

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[8] In this sense *see* id. at 95 ("The principal internal forces that have shaped the corporate tax culture derive from the motivations and aspirations of its different groups of participants. Each group – taxpayers, the Service, courts, and legislators – displays characteristic behavioral tendencies that are themselves cultural activities and part of the corporate tax culture as defined.").

[9] *See* MARTIN FELDSTEIN, *On the Theory of Tax Reform*, 6 J. Pub. Econ. 77 (1976) at 90-94 (noting how changes in tax systems are often slow, piecemeal and laced with political compromises); SIDNEY I. ROBERTS, et al., *A Report on Complexity and the Income Tax*, 27 Tax L. Rev. 325 (1972) at 339 ("[T]he tax law has not evolved gradually through the implementation of the lessons of history, but has evolved by a series of amendments superimposed upon each other, reflecting an immediate need for revenue, the popular demand for tax relief, the pressure of interested special groups or an effort to prevent some type of abuse."). *See also* SHAVIRO, *An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax, supra* note 4, at 11.

[10] For purposes of this thesis, transaction costs are defined as "conditions impeding the carrying out of mutually beneficial exchanges...such [as]... information costs, costs of negotiating and contracting, and costs imposed by ... regulations." *See* ROBIN PAUL MALLOY, Law and Economics: A Comparative Approach to Theory and Practice (West Publishing Co. 1990) glossary at 163. *See also* RICHARD A. POSNER, Economic Analysis of Law (Aspen Publishers 5th ed. 1998), 3.1, at 39. Note that the definition of transaction costs in the literature is not consensual. The literature uses inconsistent and widely varying definitions of transaction costs. *See e.g.,* OLIVER E. WILLIAMSON, *Transaction Cost Economics: The Governance of Contractual Relations*, 22 J. L. & Econ. 233 (1979) at 233 (the concept of transaction costs "wants for definition"); GIDEON PARCHOMOVSKY & PETER SIEGELMAN, *Selling Mayberry: Communities and Individuals in Law and Economics*, 92 Cal. L. Rev. 75 (2004) at 94 (transaction costs are "notoriously difficult to define"). *See also* CAROL ROSE, *The Shadow of the Cathedral*, 106 Yale Law J. 2175 (1997) at 2184-89 (distinguishing between Type I transaction costs that are incurred prior to bargaining and Type II transaction costs that arise after bargaining has begun); DOUGLAS W. ALLEN, *Transaction Costs, in* Encyclopedia of Law and Economics (Volume One: The History and Methodology of Law and Economics) (Boudewijn Bouckaert & Gerrit De Geest eds., 2000) at 913 (stating that two definitions prevail in the literatures: one that defines transaction costs as only occurring when a market transaction takes place; the other defining transaction costs as occurring whenever any property right is established or requires protection).

[11] *See* JOHN PREBBLE, *Why is Tax Law Incomprehensible?*, 4 British Tax Review 380 (1994) at 393 ("Tax law is founded not on principle, but on practicality."). On the contribution of these external constraints to the asymmetry and complexity of the CIT system *see* id. at 392 ("Income tax law will never exactly fit the economic activity to which it relates. The compromises and adjustments that must be made to make the system work mean that there can never be a single, coherent system of income taxation."). *See also* discussion *infra* at pg. 111 for the impact of these external world constraints on the shaping of the current CIT system's structure.

the corporate taxpayer, which is in a constant struggle to maximize profits, and, thus, to reduce tax payments, introduces an additional external constraint to the design and the operation of the CIT system, since in their effort to reduce tax payments, corporations often distort the envisaged effect of the tax rules.[12]

On top of these external world constraints, the limitations imposed by other regulatory fields constrain the design and operation of CIT rules. CIT, both for practical and historical reasons, is built on certain concepts and theoretical blocks developed in other disciplines.[13] This places strict limits on CIT's development and internal logic, in that the clarification of certain core CIT concepts, such as the definition of income, the principle of realization or the definition of corporate control, may only be operated with reference to other disciplines, such as economics, accounting and corporate law.[14] In addition, on its daily application, CIT is in constant operational interaction with other regulatory fields.[15] This introduces a further limitation to CIT's design and operation, in that, at least from an optimal point of view, tax rules should interact properly with other relevant regulatory fields.[16]

Further, CIT law is conditioned by internal constraints. The logic of CIT's fundamental postulates, such as the separate tax personality of corporate entities and the realization principle, strongly determines the design and operation of the CIT system.[17] As will be

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[12] *See infra* discussion at pg. 127ff.

[13] For instance, the realization concept derives in part from the accounting practice of when to include an increase in value on the balance sheet. *See* BORIS I. BITTKER & LAWRENCE LOKKEN, Federal Taxation of Income, Estates and Gifts (Warren Gorham & Lamont 3rd ed. 2005), 5.9, at 5-76 to 5-78 (explaining how a taxpayer's accounting method affects the realization of income); *see also* DAVID A. WEISBACH, *Formalism in the Tax Law*, 66 Univ. Chicago Law Rev. 860 (1999) at ft. 27 ("The realization requirement appears to be the result of ...a desire for conformity with accounting rules, which also have historical roots.") and MARJORIE E. KORNHAUSER, *The Origins of Capital Gains Taxation: What's Law Got to Do With It?*, 39 Sw. U. L. Rev. 869 (1985). Similarly, the Haig-Simmons concept of income developed in economics and the definition of control for tax law purposes is based on corporate law concepts. *See* discussion *infra* at pgs. 71 and 120.

[14] As will be discussed, this organic connection to other regulatory fields contributes to the formation of tax laws of incongruent logical shapes and in the development of certain characteristics, such as rigidity, formalism and a frequent asymmetric treatment of materially identical situations, which introduce a high level of complexity to the tax laws. *See* discussion *infra* at pg. 111ff.

[15] Namely, as discussed below, corporate law and accounting. Depending on the CIT system, the interaction may be weaker or stronger. *See, e.g.*, M. LAMB, et al., *International Variations in the Connections Between Tax and Financial Reporting*, *in* Accounting and Business Research (M. Lamb, et al. eds., 1998).

[16] *See* DAVID M. SCHIZER, *Frictions as a Constraint on Tax Planning*, 101 Columbia Law Review 1312 (2001). *See also* discussion *infra* at pgs. 58 and 76 on how the CIT system may be improved by optimizing the interaction between the tax system and other regulatory fields.

[17] CLARK, *supra* note 7, at 92 ("The corporate tax culture is...of endogenous origin. The pressures created by its own basic postulates have controlled its development."); DAVID A. WEISBACH, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, 84 Cornell L. Rev. 1627 (1998) at 1633 ("Many doctrines, such as the realization requirement, are fundamental building blocks of our tax system."). *See also* discussion *infra* at pg. 111

further discussed, the development of CIT law tends to occur in a cumulative way, with new concepts building upon these fundamental postulates.[18] These postulates, which due to the particularities of CIT's design process are often genetically incoherent, contribute to the asymmetric development of the CIT law.[19] Lastly, certain core CIT policy principles pose a final layer of constraint to the tax legislator, in that at the time of the reform, policy makers must consider the effect of proposed rules on core CIT principles such as efficiency, equity and the protection of existing property rights.[20]

In short, CIT law is influenced and constrained by a wide range of elements. These different influences and constraints, including the nature of the tax legislative process, market imperfections, the behavioural nature of the corporate taxpayer, the relationship with other regulatory fields and the logic from CIT's basic postulates, fundamentally determine the design and operation of the CIT system. The CIT system's propensity for internal asymmetry and logical incoherence reflects these different influences and constraints.

C. <u>The Methodological Approach</u>

CIT law is influenced and constrained by a wide range of elements. Therefore, the proper apprehension of the problem under study demands that these different influences and constraints are factored into the analysis. This, in turn, demands the adoption of an

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examining the impact of realization and separate tax corporate personality on the current CIT system's structure.

18 *See* CLARK, *supra* note 7, at 92 ("The present highly developed law of the taxation of corporations and shareholders is the product of a few basic decisions..."); id. ("[T]he corporate tax culture has developed from these principles in a cumulative, evolutionary way rather in a cyclical or random manner...This cumulative evolution...has had a fairly constant direction, and that direction has been toward legal rules of ever-increasing complexity and specificity[.]"). Historically, such evolution, however, tends not to be regular, in that it is also constrained by the historical materialism process described above and external world constraints. *See* id. at 95 ("By themselves, abstract principles cannot develop into a culture. In this obvious sense, corporate tax law has not been a mere unfolding of the logic of its postulates.").

19 *See* CHRIS EDWARDS, *Replacing the Scandal-Plagued Corporate Income Tax with a Cash-Flow Tax*, 484 Cato Institute Policy Analysis 1 (2003) at 9 ("A key problem is that the income tax superstructure has been built ever higher on a very problematic base."). *See also* SAUL LEVMORE, *Recharacterizations and the Nature of Theory in Corporate Tax Law*, 136 Uni. Pa. L. Rev. 1019 (1988), at 1061-1062 ("[I]t is virtually impossible to develop normative arguments about questions that arise as a result or in the shadow of...[CIT's]...basic starting points."); id. ("The nature of corporate tax law often defies normative argumentation...Corporate tax law is arbitrary because...it requires a specific recognition event before it taxes appreciation in asset values and because it regards corporations as taxable entities that are distinct from their shareholders"); DAVID A. WEISBACH, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, *supra* note 17, at 1637 ("[O]ne cannot use the purpose behind the realization doctrine to decide many of the most basic questions concerning the scope of the doctrine, or to resolve difficult borderline issues.); JOHN PREBBLE, supra *note* 11, at 390 ("[T]here are fundamental problems of principle with the income tax law."). *See also* discussion *infra* at pg. 111.

20 *See* MARTIN FELDSTEIN, *supra* note 9, at 90-94.

interdisciplinary approach whereby elements, such as market imperfections, the behavioural nature of the corporate taxpayer or the rules of related regulatory fields, are brought into the investigation. For this reason, this thesis will adopt an interdisciplinary approach to the study of corporate taxation, factoring into the analysis research from economics, corporate law and business management.[21]

Further, in light of the nature of CIT law, this thesis believes that it may be more productive to adopt an analytical perspective that starts from the analysis of the existing CIT system and takes into consideration its different influences and constraints, than to assume a clean plate perspective.[22] For this reason, this thesis will adopt a perspective of incremental change rather than a fundamental tax reform perspective.

The internal asymmetry and logical incoherence of the CIT system, coupled with the different influences and constraints that must be brought into the analysis, will require the thesis to engage in rather complex balancing processes. In order to facilitate these processes, this thesis will adopt an economic discourse. As will be demonstrated, the adoption of an economic discourse is an extremely valuable tool to allow for a clearer evaluation of the impact of the different elements involved in the analysis. Note that, although the thesis will adopt an economic discourse, the thesis will not engage in formal economic analysis. The thesis will use, instead, a heuristic approach.

Further, the thesis will adopt a closed economy perspective. Specifically, the core problems studied in this thesis are approached under the assumption that all corporate group members reside in the same domestic jurisdiction and that all the transactions that occur between corporate group members and other related and unrelated parties are domestic. This requisite approach allows for an accurate application of the interdisciplinary data,

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[21] *See, e.g.,* recommending an interdisciplinary approach to tax research, M. LAMB & A. LYMER, Interdisciplinary Research in Taxation: Research Approaches and Bibliographic Survey (The Institute of Chartered Accountants in England and Wales. 1999); S. JAMES, *Taxation Research as Economic Research*, University of Exeter Research Discussion Paper No. 01/07 (2001). *See also* C. NOBES & S. JAMES, The Economics of Taxation (Prentice Hall 7th ed. 2005)

[22] *See* MARTIN FELDSTEIN, *supra* note 9, at 90-94. Professor Feldstein defends that policy makers do not start with a clean slate in designing tax systems and contends that the optimal tax reform of an existing situation likely differs from the optimal structure if one were able to design a tax structure *de novo*. As discussed, this is due to several elements, such as the need to coordinate a potential revamp of the existing CIT system with the remaining relevant regulatory fields or the difficulties associated with the political process of tax design and promulgation. *See also* WEISBACH, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, *supra* note 17, at 1633 ("Policymakers need guidance in this second-best context which they encounter on a daily basis, in which change short of fundamental reform is being considered.").

especially from economics, and for a proper focus on the structural components of the problems identified.[23]

The analysis is based on the rules of the US federal corporate income tax system. For certain issues, a comparative analysis will follow. The comparative approach will be used to allow for a better focus on the conceptual structure that underlies the problem to be tackled.[24] This thesis will follow the functionalist comparative perspective. This perspective is followed since this thesis considers it the most appropriate theoretical standpoint to study corporate tax law.[25] The regime selected for most comparative analysis is the UK. This approach was taken because the tax systems of the US and the UK, due to their cultural, economic and legal similarities, allow for a higher precision of the research and for an easier transferability of its results.[26] Also, the selection of these two jurisdictions as a basis for research avoids potential language problems, which could endanger the reliability of the research results.[27]

For purposes of analysis, the CIT system will be segregated into two components. First, the *Standard CIT System*, which includes the rules for taxation of corporations *per se*,[28] with the exclusion of Tax Integration Solutions. Second, the *Tax Integration Solutions*, which include

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[23] Some of the economic research used in this study has assumed a closed economy setting.

[24] *See* W. BARKER, *Expanding the Study of Comparative Tax Law To Promote Democratic Policy*, 109 Penn State Law Review 102 (2005) (arguing that comparative analysis needs to confront the assumptions underlying tax law). *See also* VICTOR THURONYI, *What Can We Learn From Comparative Tax Law?*, 103 Tax Notes 459 (2004) (arguing that the purpose of comparative tax law is to focus on the elements that underlie legal thought, which are often inarticulated or taken for granted) and VICTOR THURONYI, Comparative Tax Law (Kluwer Law International. 2003).

[25] This thesis suggests that the criticisms generally made to the functionalist perspective (such as the fact that it does not take into account cultural diversity) are not as relevant in corporate tax law due its predominantly technical nature (as opposed to, for instance, family law) and to the common identity of most of the problems to which it is generally applicable (*i.e.*, corporate distributions, corporate restructurings, etc.). For description of functionalist perspective *see* KONRAD ZWEIGERT & HEIN KOTZ, Introduction to Comparative Law (Oxford University Press 3rd ed. 1998). For criticism to functionalist perspective *see* PIERRE LEGRAND & RODERICK MUNDAY, Comparative Legal Studies: Traditions and Transitions (Cambridge University Press. 2003). For the most recent discussion on comparative tax law analysis *see* CARLO GARBARINO, *Comparative Taxation and Legal Theory: The Tax Design Case of the Transplant of General Anti-Avoidance Rules*, 11 Theoretical Inquiries in Law 765 (2010) and OMRI Y. MARIAN, *The Discursive Failure in Comparative Tax Law* 58 American Journal of Comparative Law 415 (2010).

[26] *See* A. WATSON, Legal Transplants: An Approach to Comparative Law (University of Georgia Press 2nd ed. 1993) (author argues that comparisons may not be particularly worthwhile except when the legal systems are closely related); *see also* A. WATSON, *Legal Transplants and European Private Law*, 4.4 Electronic Journal of Comparative Law, available at http://www.ejcl.org/44/art44-2.html (2000). On the advantages of comparing the US with the UK tax systems *see, e.g.* W. BARKER, *A Comparative Approach to Income Tax Law in the United Kingdom and the United States*, 46 Catholic University Law Review 7 (1996); *see also* CEDRIC SANDFORD, Why Tax Systems Differ: A Comparative Study of the Political Economy of Taxation (Fiscal Publications. 2000).

[27] *See* R. SACCO, *Legal Formants: A Dynamic Approach to Comparative Law*, 39 The American Journal of Comparative Law 1 (1991).

[28] This excludes trusts, corporations treated as disregarded entities, partnerships, etc.

group taxation regimes and flow-through regimes. In turn, the analysis of each of these components of the CIT system is made in two distinct analytical stages, *i.e.,* mechanic and dynamic analysis.

The purpose of the mechanic analysis is to study the technical structure of the CIT system. The mechanic analysis is made utilizing a transactional approach. Specifically, tax rules are analyzed in terms of end result achieved by a corporation for each transactional route used and form adopted to transact with other corporations. This approach allows for a different angle of analysis of the tax rules, *i.e.,* it allows the analysis of the tax rules to be made from the perspective of their users. The dynamic analysis, in turn, aims at understanding the operation of the mechanic structure of the CIT system by studying its impact on taxpayer behaviour.

The analysis is not concerned with European Union tax law, transfer pricing and tax evasion issues. Besides not being central to the purposes of this research project, due to their breadth, each of these subjects would require its own separate treatment. Finally, the analysis deals solely with corporate income tax issues. It does not explore individual income taxes, indirect taxes, or stamp and real estate taxes issues.

D. <u>The Structure of the Thesis</u>

The thesis is divided into three parts. In part I, this thesis will investigate how to approach the central research question. First, the thesis will examine the core structure of the current CIT system and will determine the advantages and drawbacks of taxing the corporate sector through a CIT system. The analysis will be made assuming a world of costly contracting and political constraints. Based on the results from such analysis, the thesis will determine whether it makes sense for research to focus on potential improvements to the current CIT system or whether, in light of other potentially available alternatives, the current system should simply be discarded in its entirety. Subsequently, the thesis will examine the CIT system's impact on corporate behaviour. Once the thesis determines whether it is valuable to pursue further work on the current CIT system, identifies its core strengths and problems, and understands the determinants associated with its impact on corporate behaviour, it will suggest how the central research question should be approached.

In part II, following the policy guidelines developed in part I, the thesis will investigate how the Standard CIT System taxes corporate groups and the consequences of such taxation methodology. Following the same approach, in part III, the thesis will examine how Tax Integration Solutions tax corporate groups and will determine the consequences of that taxation approach. After taking into consideration the perspectives of the government and corporate groups, the thesis will conclude by suggesting how best to tax corporate groups.

A. The Core Structure of the CIT System

At its core, the current CIT system is a realization-based income tax separately levied on corporations at rates unrelated to those of shareholders. The next section will be dedicated to investigating these core structural characteristics of the current CIT system. The section will start by investigating the concept of realization, identifying its primary advantages and drawbacks in a world of costly contracting and political constraints. Then, it will analyze the implications of devising a CIT system based on the existence of a separate tax levied on corporations at rates unrelated to those of shareholders. The section will conclude by assessing, in light of other potentially available alternatives, whether further work on the current CIT system is justified and how it should be approached.

1. The Concept of Realization

The concept of realization is a fundamental building block of the current CIT system.[29] In general, under a realization-based CIT system, tax is only due when a transfer in the sense of a sale, an exchange or the receipt of proceeds, which constitute earnings rather than a return of capital, occurs.[30] That is, gain or loss is includable in a corporation's taxable income only when property and services are actually converted into cash.[31] Realization should always result in taxability provided that no non-recognition rule is applicable to the transaction.[32]

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[29] For an in-depth analysis of the impact of realization on the design of the mechanical structure of the current CIT system *see* discussion *infra* at pg. 111. Hereinafter, all references to "IRC Section" and "IRC Treas. Reg. Section" are to the United States Internal Revenue Code of 1986 and the regulations promulgated thereunder.

[30] Further, the property exchanged must be substantially different for realization to occur. *See Cottage Sav. Ass'n v. Commissioner, 111 S. Ct. 1503, 1508-09 (1991)* and IRC Treas. Section Reg. Section 1.1001-1(a). This requirement is satisfied so long as the two items "embody legally distinct entitlements," and thus is satisfied even where as an economic matter, or to the taxpayer, they are "substantially identical." *Cottage Savings, 111 S. Ct. at 1511. See also* SHAVIRO, *An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax*, *supra* note 4, at 12.

[31] *See* EDWARD A. ZELINSKY, *For Realization: Income Taxation, Sectoral Accretionism, and the Virtue of Attainable Virtues*, 19 Cardozo L. Rev 861 (1997) at 864. *See also* TERRENCE R. CHORVAT, *Perception and Income: The Behavioral Economics of the Realization* 36 Conn. L. Rev. 75 (2003) at 82.

[32] For purposes of this thesis, whereas realization refers to the occurrence of a taxable event such a sale or exchange, recognition refers to the nonapplication of nonrecognition rules, under which events that technically constitute realizations are treated, in effect, as if they had not occurred. *See* SHAVIRO, *An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax*, *supra* note 4, at 2 ("Recognition is the twin sister of realization, and both are necessary for tax consequences to arise."). *See also* discussion *infra* at pg. 101.

The erection of the CIT system on the realization pillar gives the tax system the characteristics of a hybrid income tax system, which blends elements of a transfer tax with an accretion tax and a consumption tax.[33] To start with, in light of the prominent role played by realization, the current CIT system is partly a transfer tax in that it works as a tax on the act of engaging in transactions such as sales and exchanges.[34] While transfer determines the moment when tax is due, accretion concepts, in turn, determine how much is levied at that moment. That is, while the timing of the tax liability is determined based on transfer tax concepts, its nominal amount is established based on accretion.[35] Further, the system blends accretion tax with consumption tax concepts, in that although it reaches income arising from capital, such as interest, just as an accretion tax would do, it fails, like a consumption tax, to currently tax unrealized appreciation in the value of assets.[36]

a. The Advantages of Realization

The hybrid income tax characteristics of the current realization-based CIT system present significant advantages in a world of costly contracting. To begin with, due to its characteristics of a transfer tax, the current CIT system is able to provide a costless and reliable valuation of the assets transferred and services provided in the corporate sector when parties are unrelated. The reliability of the valuation process is ensured by the economic dynamics that exist between buyer and seller in their effort to optimize their own individual profit on the transaction. Specifically, while the seller is interested in selling for the highest possible price, but is averse to disclosing it to the tax authorities in order to avoid high tax payments,[37] the buyer is interested in making the acquisition for the lowest possible value, but in disclosing it to the tax authorities by the highest possible amount in order to minimize its tax bill.[38] The end result is a sale or exchange for the highest possible

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[33] Id. at 11.
[34] Id. at 2.
[35] Id. at 11. *But see* id. at 2 ("The actual relative importance of the transaction tax and accretion tax elements...might be expected to vary both between sectors of the economy and over time.").
[36] Id. at 2. Nevertheless, certain rules in the corporate income tax may have nothing to do with any of these basic models. *See* WILLIAM D. ANDREWS & DAVID F. BRADFORD, *Savings Incentives in a Hybrid Income Tax*, *in* Uneasy Compromise: Problems of a Hybrid Income-Consumption Tax (Henry J. Aaron, et al. eds., 1988), at 270.
[37] On the general interest of corporations to reduce tax payments *see* discussion *infra* at pg. 45.
[38] This alignment of the buyer and tax authorities interests, vital to the proper working of the system, occurs because by reporting a higher acquisition amount the buyer is able to obtain a higher tax basis in the asset acquired or tax deductible expense on the services purchased, and, thus, a reduction in future tax payments. In agency terms, "the buyer's interest in maximizing his basis and deductions is aligned with the IRS's interest in the disclosure to it of the correct price paid to the seller." *See* ZELINSKY, *supra* note 31, at 902. *See also* id. at 881 ("[T]he moment of realization is the only time when the taxpayer and the tax collector have perfectly-aligned interests in maximizing the recognized value of the taxpayer's property.").

value, due to the pressure exerted by the seller, with a disclosure of the highest possible amount, as a result of the pressure made by the buyer. Therefore, realization benefits the interests of the tax authorities, in that the regular economic dynamics that operate between the parties on the transfer transaction ensure a proper tax result without the need for direct supervision of the transaction. By relying on the natural dynamics of the market, the tax system avoids the potentially significant transaction costs that would otherwise be required to adequately control the transaction.[39] In addition, the amount transferred is automatically calculated based on the fungibility of the property surrendered by the buyer, thereby avoiding additional transaction costs to value the property.[40]

Further, its hybrid income tax characteristics allow the CIT system to finance itself in a relatively cost-efficient way. Since the tax system fails, just as a consumption tax would, to tax unrealized appreciation in assets, the onus to find the necessary sources of funds to finance the tax system until realization occurs is placed on the government.[41] Since the government is able to secure loans more consistently and at a better rate than the majority of taxpayers, the tax system may be financed with lower interest and transactional costs.[42] In addition, the government, as a single, centralized borrower, benefits from sizeable economies of scale, in that to obtain the same funds through innumerable separate loans would result in much higher overall transaction costs.[43] In the context of today's capital markets, which are generally not willing to accept unrealized capital gains as collateral for borrowing, an alternative system based on pure accretion concepts should result in much higher transaction costs to ensure the overall liquidity of the tax system.[44]

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[39] *See* id. at 880 (Under a realization regime, "the tax system does not make its own independent assessment of value, with attendant expense to the public treasury. Instead, the tax system costlessly relies on the value negotiated by the taxpayer."). In addition, the taxpayer, on top of the tax authorities' supervision, often has the surveillance of other governmental authorities (*e.g.,* real estate transfers). That is, tax benefits also from frictions from other regulatory fields on certain transfers.

[40] *See* id. at 889 ("[F]rom the vantage of minimizing the transactions costs of valuation, the rule of realization, which costlessly uses the valuations automatically produced as incidents of cash and cash equivalent transactions, is superior to accretionism which requires expensive appraisals for many common forms of property.").

[41] *See* id. at 890.

[42] *See* id. at 891 ("[T]he Treasury is our society's most economical borrower; the rate at which the Treasury obtains funds is the accepted benchmark for risk-free interest. A relative handful of taxpayers can borrow at the Treasury rate; virtually none can borrow below it; most taxpayers obtain funds at considerably higher rates.").

[43] *See* id. at 891 ("An accretionist tax system would necessitate millions of separate loan transactions as taxpayers acquire the funds to discharge their tax obligations. We can only guess at the resulting costs - legal and appraisal fees, recording and other closing expenses, bank fees, and the taxpayers' time. We can, however, confidently predict that these costs will be considerable.").

[44] *See* CHORVAT, *supra* note 31, at 91-94 ("If taxpayers could accurately ascertain the value of an asset, banks and others with liquid assets would be willing to lend to them a sufficient amount to pay the taxes assessed due to the increased value, thus eliminating the liquidity problem. However, because such lending generally

The current realization-based CIT system also presents significant political advantages. As demonstrated in neurological and psychological research, requiring a realization event to measure taxable income is consistent with how individuals actually perceive income.[45] That is, from the taxpayer's psychological perspective, gains or losses are only potential gains or losses until a realization event occurs.[46] The intuitive acceptability of the tax system that naturally follows from its alignment with the taxpayer's psychological reality should aid taxpayer compliance.[47] In addition, at a more practical level, a realization-based CIT system should be easier to approve politically by avoiding the hardships imposed on the taxpayer by a pure accretion system, which most often forces the taxpayers to borrow in order to pay such taxes.[48] This political appeal of a realization-based CIT system is further enhanced by the lack of clarity that surrounds the question of incidence on this type of hybrid tax system, which makes its burden difficult to trace to individual taxpayers.[49]

A further advantage of the current CIT system is its reduced potential for manipulation when no related parties are involved. That is, the sale or exchange of an asset is generally a fairly significant event to unrelated taxpayers, sufficiently compelled or discouraged by non-

does not occur, this form of tax could cause substantial hardship."). *See also* WOLFGANG SCHON, *Tax and Corporate Governance: A Legal Approach, in* Tax and Corporate Governance (Wolfgang Schon ed. 2008) at 44. *But see* ZELINSKY, *supra* note 31, at 890 ("[U]nder an accretionist system, taxpayers can borrow to pay their tax or can use cash from other sources to satisfy their obligations to the fisc. Once taxpayers understand their liabilities under an accretionist regime, the argument runs, they will arrange their affairs to generate the cash necessary to pay their taxes.").

45 Neurological studies have demonstrated that the receipt of gains and anticipation of gains activate different areas of the brain and are very likely perceived differently by the taxpayers *See* CHORVAT, supra note 31, at 110-111.

46 In practice, investors do not seem to perceive a gain or loss as occurring until it is realized. At the very minimum, unrealized gains are treated as significantly less valuable than if they were currently realized. *See* CHORVAT, *supra* note 31, at 112.

47 *See* ZELINSKY, *supra* note 31, at 893.

48 *See* CHORVAT, *suprà* note 31. *See also* ZELINSKY, *supra* note 31.

49 *See* ALAN J. AUERBACH, et al., *Taxing Corporate Income in* Dimensions of Tax Design: The Mirrlees Review (J. Mirrlees, et al. eds., 2010) at 867 ("[C]orporate taxes may exist in part because of the political advantage of imposing taxes the burdens of which are difficult to trace through to individuals [.]"). The incidence question is still unsettled. In economic terms, it is unclear whether the corporate tax actually falls on shareholders. In certain cases, it may be shifted to consumers or labour. Most economists assume, however, that the tax falls at least partly on shareholders in the short run and on all capital providers in the long run. *See, e.g.,* MARTIN FELDSTEIN, *Incidence of a Capital Income Tax in a Growing Economy with Variable Saving Rates*, 41 Rev. Econ. Stud. 505 (1974) at 510-11; DON FULLERTON & GILBERT E. METCALF, *Tax Incidence*, NBER, Working Chapter No. w8829 (2002) at 20-23. *See also* ALAN J. AUERBACH, *Who Bears the Corporate Tax? A Review of What We Know*, NBER, Working Paper No. W11686 (2005) at 3 ("[T]he ultimate incidence of the [corporate income] tax remains somewhat unresolved."). For a recent work on the theme questioning the classic assumptions *see* WIJI ARULAMPALAM, et al., *The Direct Incidence of Corporate Income Tax on Wages*, Oxford University Centre for Business Taxation, Working Paper 09/17 (2009). For the classic work on the issue *see* ARNOLD HARBERGER, *The Incidence of the Corporation Income Tax*, 70 J. Pol. Econ. 215 (1962).

tax motives.[50] Finally, as will be discussed, the transactional basis of a realization-based CIT system gives it important advantages as an instrument for corporate behavioural control.[51]

b. The Problems of Realization

A realization-based CIT system presents, however, significant inefficiencies of its own. First, a realization-based tax system only works well provided both parties have differing economic interests. When both parties have an identical economic interest, such as when two corporations are subject to common control, the natural behavioural dynamics that sustain the system collapse.[52] This occurs because the differing economic interests that ensure adequate valuation, independent of government supervision, of the transferred property or rendered services are absent.[53] Further, due to the several distortions introduced to the principle of realization, in that not all realization events classify as taxable events, the system develops asymmetries that result in transactional discontinuities in the tax law and significantly contribute to its lack of a clear guiding rationale.[54] The negative impact of these distortions, which are for the most part a result of the political and economic constraints surrounding the CIT system,[55] tends to be magnified given the

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[50] *See* SHAVIRO, *An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax*, *supra* note 4, at 36 ("The sale or exchange of an asset often is a fairly significant event to the taxpayer, sufficiently compelled or discouraged on nontax grounds to reduce its tax elasticity."). For this reason, certain authors argue that a realization-based tax system may be defended also on pure efficiency grounds in that it supposedly introduces fewer distortions to taxpayer behaviour than alternative tax systems. For instance, Shaviro argues that the realization doctrine's inefficiencies may be greatly overstated. *See* id. at 6 ("I argue that, whether by accident or design, the realization and recognition rules in the Code have some tendency to promote efficiency. In particular, the tax system often bases liability on events, the occurrence of which is relatively inelastic, while providing nonrecognition for those the occurrence of which is relatively elastic."). *But see* discussion *infra* at pg. 42ff. Another interesting defence of realization is made by David Schizer. *See* DAVID M. SCHIZER, *Realization as Subsidy*, 73 N.Y.U. L. Rev. 1549 (1998) at 1552. Schizer argues that the realization requirement may have beneficial consequences because it taxes income from investment less than other income and, thus, works in practice as an investment subsidy. *See also* CHORVAT, supra note 31, at 96.

[51] *See* discussion *infra* at pg. 45ff.

[52] *See* discussion *infra* at pg. 117.

[53] Absent supervision, the valuation provided by related parties will likely be the one that provides a more advantageous result to the superior common interest of both parties, which is often contrary to the government interests. *See* discussion *infra* at pg. 126ff.

[54] Saul Levmore, for example, argues that corporate tax law, due to its reliance on realization, is "arbitrary" and "almost necessarily devoid of a normative foundation" and that "[t]here is, in short, no normative theory or rule that suggests the optimal number or coverage of recognition rules." *See* SAUL LEVMORE, *Recharacterizations and the Nature of Theory in Corporate Tax Law*, supra note 19, at 1061-1063. *See also* WEISBACH, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, *supra* note 17, at 1637 ("[T]he realization requirement applies to traded stock, even though traded stock is liquid and valuation is easy...Thus, one cannot use the purpose behind the realization doctrine to decide many of the most basic questions concerning the scope of the doctrine, or to resolve difficult borderline issues."). For the phenomenon of discontinuities in the tax law and a discussion of its overall impact *see* discussion *infra* at pg. 55.

[55] *See* NOEL B. CUNNINGHAM & DEBORAH H. SCHENK, *The Case for a Capital Gains Preference*, 48 Tax L. Rev. 319 (1993) at 327 ("It is clear...that Congress nominally has chosen a tax based on income and that deviations from that base are the source of much inefficiency and complexity. Although it is true that the

pattern of development of the CIT law.[56] This contributes significantly to the increase in complexity of the CIT laws.[57]

Further, realization may arguably introduce significant distortions to the regular *modus operandi* of economic agents, which may penalize their economic efficiency. In particular, realization is thought to possibly distort both the choice of investment and the choice of the moment to implement transfer transactions.[58] First, realization is thought to distort the choice of investment in that, since the taxation of gains from certain assets may be deferred indefinitely, such assets may be subject to a lower rate of tax even if they are subject to the same nominal rate.[59] Thus, assets with an identical pre-tax return may be favoured differently by investors. This distorts the regular investment dynamics of the market and, therefore, is considered by some to penalize the economy.[60] Second, a realization system may distort the choice of the moment to implement transfer transactions in that it may encourage corporations to retain assets beyond the optimal period (so-called "lock-in" effect) or to sell them before the optimal period (so-called "lock-out" effect). The type and magnitude of the behavioural distortion should generally vary depending on the tax attributes of the corporations in question and the type of assets transferred.[61] In general, since a potential built-in gain or loss on an asset is only includable in taxable income once a qualifying transfer occurs, corporations may anticipate, postpone or, in more extreme cases, cancel such transfer in order to obtain a better aggregate tax result. This may make investors less responsive to changes in the prospects of their investments, and, thus, reduce the ability of the market to shift capital to its most efficient use.[62]

An additional problem of realization is that, due to the transactional discontinuities that it introduces in the CIT system and due to the fact that it allows taxpayers to strategically time their realizations so as to minimize taxes due, it provides a significant encouragement

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current base is a hybrid, most deviations from the income tax base are explainable, either as being administratively required, or as promoting competing public policies."); DEBORAH H. SCHENK, *An Efficiency Approach to Reforming a Realization-Based Tax*, 57 Tax L. Rev. 503 (2004) at 503 ("[B]ecause of efficiency and equity concerns, a pure realization rule is indefensible in a system intended to impose a tax burden on capital. Since neither an accrual tax nor a pure realization rule is viable, the task for policymakers is to determine where along the continuum between the two to draw the line."). *See also* discussion *supra* at pg. 11ff.

[56] As discussed above, once a fundamental postulate such as realization is laid, the system will tend to develop cumulatively on top of such postulate. *See* discussion *supra* at pg. 13. *See also* discussion *infra* at pg. 111.

[57] For the negative consequences of the increase in complexity in CIT law *see* discussion *infra* at pg. 62ff.

[58] *See* discussion *infra* at pg. 42ff for in-depth discussion of this issue.

[59] *See* CHORVAT, supra note 31, at 88.

[60] *See* discussion *infra* at pg. 43ff.

[61] *See* discussion *infra* at pg. 53ff.

[62] *See* discussion *infra* at pg. 44.

for taxpayers to engage in tax planning. That is, since the taxpayer may obtain a very different tax result for an economically identical transfer depending on the type of transaction that it chooses to implement or the timing of the implementation of such transaction, tax planning generally presents a quite advantageous return.[63] Based on traditional neo-classical models, the taxpayer may generally be expected to engage in tax planning until the marginal value of the planning is equal to its cost.[64] Therefore, the cost of the realization principle may consist not only of lost revenue, but also in a distortion in the allocation of resources due to the increase in tax planning and the resulting waste of resources.[65] Lastly, as will be further discussed, the fact that realization requires the trigger of a qualifying transfer, such as a sale or an exchange, results in a significant dependency of the CIT laws on corporate law and property law concepts in order to determine when an actual transfer has in fact occurred.[66] This, in turn, introduces significant formalism and complexity into the CIT laws.[67]

2. *The Alternatives to a Realization-Based CIT System*

In light of the significant problems that the realization principle introduces to the CIT system, the question that arises at this point is whether there are available alternative tax systems that, overall, present more benefits to tax the corporate sector. In order to proceed to this determination, the next section will examine alternative forms of taxing the income generated in the corporate sector that mitigate or eliminate the impact of the realization principle on the corporate tax system.

a. Accretion-Based Taxation

The first option that eliminates, or, under some proposals, mitigates, the impact of the realization principle on the corporate tax system is taxation under mark-to-market or accretion-based taxation principles.[68] One alternative would be to totally eliminate the realization principle from the tax system as well as the existence of a separate tax for the

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[63] *See* discussion *infra* at pg. 127ff.
[64] *See* CHORVAT, supra note 31, at 88-91.
[65] Id.
[66] *See* discussion *infra* at pg. 112ff.
[67] Id.
[68] Certain commentators refer to the taxation of unrealized gains and losses as "accretion" taxation, while others label it "accrual" taxation or "mark-to-market" taxation. For purposes of this thesis, these three terms can be viewed as interchangeable. In the same sense *see* ZELINSKY, *supra* note 31, at 861.

corporate sector. Under this option, the taxation of income generated on the corporate sector would occur solely at the shareholder level, with shareholders being taxed on a periodic basis on the increase in value of their stock independently of realization.[69] Note that this method of taxation would require an adjustment where dividends are distributed. Either dividends would be taxed or would result in a reduction in the cost base of shareholdings.

Despite the substantial simplification that this type of proposal would introduce to the tax system, most commentators have concluded, however, that it would be unmanageable if applied globally. Fundamentally, the valuation costs involved and the liquidity costs to the taxpayers (especially those with large accrued income but no cash income) would make the system too burdensome from a transaction cost perspective and,[70] in principle, too difficult to approve politically.[71]

In recent years, in order to deal with these valuation and liquidity problems, economists and tax specialists developed several partial mark-to-market proposals. Their common denominator is that they do not totally eliminate the realization principle from the tax system, only mitigate its impact. One mitigation strategy would involve delaying taxation until realization, in order to allow for valuation through a market transaction, but impose an interest charge for earlier years' taxes (based on the assumption that the change in value accrued ratably) to eliminate the value of deferral.[72] This type of solution would rely on the

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[69] Property accretion could be taxed at regular intervals of a year or more without regard to realization, or, alternatively, taxation could occur annually assuming an annual rate of growth in the value of property. *See* SHAVIRO, *An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax*, *supra* note 4, at 5.

[70] *See* DAVID F. BRADFORD & U.S. TREASURY TAX POLICY, Blueprints for Basic Tax Reform (Tax Analysts 2nd ed. 1984) at 5, 81 (the study does not recommend taxation of gains as accrued because the administrative cost of annual asset valuations is considered prohibitive and because otherwise taxpayers might face problems in making cash tax payments when no cash had been realized); JAMES W. WETZLER, *Capital Gains and Losses*, *in* Comprehensive Income Taxation (Joseph A. Pechman ed. 1977) at 115, 120 ("[C]ompletely eliminating deferral means taxing on accrual, which must be ruled out because it would be extraordinarily difficult to value nonmarketable assets every year"). One additional significant obstacle is the failure to index. Adoption of a mark-to-market system without indexation would result in very high effective tax rates. Currently, deferral offsets the negative effect of inflation. *See* NOEL B. CUNNINGHAM & DEBORAH H. SCHENK, *The Case for a Capital Gains Preference*, *supra* note 55, at ft 107. *But see* id. at 347("While practical obstacles to an accrual system remain, it is likely that, in the long run, they can be surmounted."). *See also* ZELINSKY, *supra* note 31, at 880 ("An important theme of the contemporary literature on accretionism is that modern technology and techniques reduce [valuation] problems to manageable proportions, making annual appraisals of previously hard-to-value assets economical and precise.").

[71] *See* REED SHULDINER, *A General Approach to the Taxation of Financial Instruments*, 71 Tex. L. Rev. 243 (1992) at 246 ("Most, if not all of these problems [with taxing financial instruments] could be solved by . . . adopting mark-to-market accounting for financial instruments . . . [but] it is unlikely that Congress (or the financial community) will accept wholesale use of mark-to-market accounting.").

[72] *See, e.g.* ALAN J. AUERBACH, *Restrospective Capital Gains Taxation*, 81 Am. Econ. Rev. 167 (1991) at 168 (proposing a realization-based tax that imposes a higher rate on gains held for longer periods of time to

valuation and liquidity advantages of realization, while eliminating the distortions that it introduces due to deferral.[73] Alternatively, certain assets, which are easily valued (*i.e.,* primarily financial assets), could be subject to a pure market-to-market system, while others would continue to be subject to a realization system.[74] For instance, Professor Dodge suggested an interesting variation of this type of partial accretionism for the taxation of the corporate sector. Under Dodge's proposal, realization could be eliminated through a dual system that cumulated pass through taxation for closely held-businesses, and a mark-to-market taxation of shares in public corporations, which should present no problems of valuation or liquidity since they are publicly marketed.[75] Although from a pure transaction cost perspective this system is more advantageous than the current CIT system, it is not clear whether this type of selective accretionism would not introduce distortions and inequities to the tax system not very different from those currently existing.[76] Foreign and tax exempt shareholders could also pose serious administrative hurdles to this kind of proposal.

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mimic an interest-bearing tax deferral regime). For a critical review of interest-bearing tax deferral proposals, *see* NOEL B. CUNNINGHAM & DEBORAH H. SCHENK, *Taxation Without Realization: A "Revolutionary" Approach to Ownership*, 47 Tax L. Rev. 725 (1992) at 744-746.

[73] *See* discussion *infra* at pg. 42ff for in-depth analysis of such distortions.

[74] *See, e.g.* DAVID A. WEISBACH, *A Partial Mark-to-Market Tax System*, 53 Tax L. Rev. 95 (1999) at 96-97 (Weisbach would impose a lower rate of tax on those assets which are marked-to-market than on those which are eligible for a deferral under the realization system. The difference in rates would attempt to compensate for the average difference in effective rates due to deferral). *See also* DAVID J. SHAKOW, *Taxation Without Realization: A Proposal for Accrual Taxation*, 134 U. Pa. L. Rev. 1111 (1986) (describing a partial accrual tax system); JEFF STRNAD, *Periodicity and Accretion Taxation: Norms and Implementation*, 99 Yale Law J. 1817 (1990) (describing a practical method of implementing an accretion tax); NOEL B. CUNNINGHAM & DEBORAH H. SCHENK, *Taxation Without Realization: A "Revolutionary" Approach to Ownership, supra* note 72, at 727 (advocating a concept of realization that permits the taxation of gains as they accrue) and FRED B. BROWN, *Complete Accrual Taxation*, 33 San Diego Rev. 1559 (1996) at 1560-61 (considering a more complete accrual system that seeks to value and tax the most difficult-to-value assets (*i.e.,* non-marketed business interests and collectibles) on an annual basis).

[75] *See* JOSEPH M. DODGE, *A Combined Mark-to-Market and Pass-Through Corporate-Shareholder Integration Proposal*, 50 Tax L. Rev. 265 (1995). *See also* REUVEN S. AVI-YONAH, *Corporations, Society, and the State: A Defense of the Corporate Tax*, 90 Virginia Law Review 1193 (2004) at 1204 (highlighting the merits of this kind of proposal). A further potential alternative proposal to eliminate realization and its associated lock-in effect is a rollover provision for reinvestment of the proceeds on disposition of a capital asset. For a description of such a proposal, *see* CYNTHIA J. BLUM, *Rollover: An Alternative Treatment of Capital Gains*, 41 Tax L. Rev. 385 (1986).

[76] *See* ZELINSKY, *supra* note 31, at 915 ("[T]he efficiency of accretionism applied globally challenges powerfully the virtues of the rule of realization. But accretionism implemented selectively would engender the same kinds of distortions and inequities as the rule of realization."). *See also* DAVID M. SCHIZER, *Sticks and Snakes: Derivatives and Curtailing Aggressive Tax Planning*, 73 S. Cal. L. Rev. 1339 (2000) at 1400 ("[A]lthough moving our system towards mark-to-market accounting is promising if proper care is taken, every move toward mark-to-market is not inherently wise"); SCHENK, *An Efficiency Approach to Reforming a Realization-Based Tax, supra* note 55, at 504 ("Some steps toward accrual taxation and some attempts to tax appreciation before realization are not worth taking. Many responses to realization abuses simply change behaviour without raising revenue, creating deadweight loss.").

b. Consumption-Based Taxation

Another possibility to eliminate the realization principle is to structure the corporate tax system based primarily on consumption tax concepts. Several consumption-based proposals have been put forward during the last decades,[77] some retaining the existence of a separate tax on firms and others eliminating it outright.[78] Under the proposals that would levy a business-level tax, the tax would be imposed on a firm's net cash flow, instead of income or profits as in the previous models discussed. Specifically, under the most commonly proposed cash-flow tax model (an "R (real) - based" tax), receipts from the sale of goods and services less current and capital expenses would constitute the firm's tax base.[79] Further, under cash-flow accounting, firms would include receipts when cash is received, and deduct the full costs of materials, inventories, equipment and structures when they are purchased. Significantly, financial items such as interest, dividends and capital gains would not be included in income or allowed as deductions.[80] Alternative cash-flow tax models introduce variations to this basic framework, such as the so-called "R+F (real plus financial) base," where firms would instead take into account all flows of cash, other than

[77] Cash-flow taxes have been discussed in academic and policy circles for several years now. For a discussion of some of the most prominent academic and legislative proposals in the US since the 1970s, *see, e.g.,* CHRIS EDWARDS, *supra* note 19, at 32-35. In the UK *see, e.g.* ALAN J. AUERBACH, et al., *Taxing Corporate Income, supra* note 49. *See also* JACK M. MINTZ & JESUS SEADE, *Cash Flow or Income? The Choice of Base for Company Taxation*, 6 World Bank Research Observer 177 (1991) at 180.

[78] Certain consumption-based tax proposals would apply a comprehensive tax at the individual level without the need for a corporate-level tax. One model is the saving-deferred cash-flow tax proposal, which would replace the individual and corporate income taxes with a flat rate individual tax on a base of income less net savings. The result would be that business earnings would be taxed at the individual level when not reinvested by individuals. *See* STEPHEN ENTIN, *The Inflow-Outflow Tax - A Savings-Deferred Neutral Tax System*, Institute for Research on the Economics of Taxation (available at www.iret.org) (1998). A similar proposal is the model cash-flow consumption tax, which would eliminate the corporate-level tax and allow individuals a choice of two treatments for savings (*i.e.,* savings in qualified accounts would be deducted up front with withdrawals taxed later. Alternatively, savings could be made from after-tax earnings with the returns received tax-free). *See* DAVID F. BRADFORD & U.S. TREASURY TAX POLICY, Blueprints for Basic Tax Reform (U.S. Treasury Department. 1977).

[79] For instance, under one of the most prominent R-base tax proposals, the so-called "Hall and Rabushka" or "flat tax" model, taxation would occur at two levels: Individual and corporate level. Individuals would be taxed on wages and pension benefits at a flat 19 percent, with large exemptions provided, so as to avoid the regressive effect of this type of taxation. Further, individuals would not be taxed on interest, dividends, or capital gains. As for businesses, the corporate tax base would be defined by the total earnings (such as receipts from the sales of goods and services) reduced by the total expenditure of the company (such as purchases of materials, equipment, buildings and other expenses, including wages), *i.e.,* all sales made by the company minus all purchases it made, including the wages of employees, which would be taxed at the individual level. Businesses would pay a 19 percent tax on this tax base. In addition, businesses would disregard interest, dividends, and capital gains. *See* ROBERT HALL & ALVIN RABUSHKA, The Flat Tax (Hoover Institution Press. 1995).

[80] *See* MERVYN KING, *The Cash Flow Corporate Income Tax*, NBER, Working Paper No. 1993 (1986). *See also* MARTIN SULLIVAN, Flat Taxes and Consumption Taxes: A Guide to the Debate (American Institute of Certified Public Accountants. 1995) at 7.

to their own shareholders, when calculating their tax base.[81] Lastly, there are certain hybrid models, such as the McClure and Zodrow model, where individuals would be taxed under the Hall-Rabushka-style individual tax,[82] but firms would be taxed under a R+F cash-flow basis.[83]

Although none of these consumption-based models has ever been implemented,[84] they have repeatedly received considerable support from both academics and politicians.[85] Just recently, the UK's Mirrlees report proposed the substitution of the current UK CIT system with a R+F cash-flow tax.[86] After analyzing different possibilities of taxing corporations,[87] the report concluded that to tax only the economic rent accruing in the corporate sector through a destination-based cash-flow tax (*i.e.,* basically, a "destination-based value added tax but with labour costs deductible")[88] should deserve "serious consideration."[89] A cash flow tax certainly yields several advantages. Capital gains taxation, capitalization and the associated concept of "tax basis" are eliminated in this type of system, and with them, as will be discussed, a significant part of the complexity of the existing CIT system.[90] Further,

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81 *See, e.g.* HENRY AARON & HARVEY GALPER, Assessing Tax Reform (Brookings Institution. 1985) (Aaron and Galper propose an R+F based cash-flow tax on businesses within a comprehensive tax plan).
82 *See supra* note 79.
83 *See* CHARLES MCLURE & GEORGE ZODROW, *A Hybrid Approach to the Direct Taxation of Consumption, in* Frontiers of Tax Reform (Michael J. Boskin ed. 1996) at 76.
84 Nevertheless, in recent times, variations of this type of taxes are increasingly making inroads into taxation practice. On the whole these are variants that graft a single uniform tax rate onto the old tax bases. Basically, a similar tax rate is applied to all the components of income with no exemptions or reliefs allowed apart from a certain amount of personal allowance and strictly determined operating or business expenses. In recent times, some versions of such a flat income tax have been introduced in countries such as Estonia, Lithuania, Latvia, Russia, Serbia, Ukraine, Slovakia, Georgia and Romania. What all these have in common is that income is taxed at a uniform rate, with the abolition of tax exemptions and reliefs allowing for a broadening of the tax base and a consequent reduction in the tax rate. *See* MARINA KESNER-SKREB, *A Flat Consumption Tax Concepts*, 29 Financial Theory and Practice 205 (2005) at 205-208. *See also* JEFFREY OWENS, Fundamental Tax Reform: The Experience of OECD Countries (OECD. 2004); A. IVANOVA, et al., *The Russian Flat Tax Reform*, IMF, Working Paper No. WO/05/16 (2005).
85 *See* CHRIS EDWARDS, *supra* note 19.
86 *See* ALAN J. AUERBACH, et al., *Taxing Corporate Income, supra* note 49.
87 The report discusses corporate tax systems with different potential tax bases (*i.e.,* taxes on the return to equity investment, taxes on economic rent and taxes on the return to all capital) and of different geographical dimensions, comparing sourced-based taxation with residence-based and destination-based taxation. Id.
88 Proposals for cash-flow taxes tend to differ with regard to whether labour costs are deductible. When these costs are disallowed, the tax is a pure value-added tax, capturing the value added by both labour and capital at the business level. *See* CHRIS EDWARDS, *supra* note 19, at 32-33.
89 The report proposes a destination-based cash-flow tax, essentially a destination-based VAT, but with labour costs deductible and with border adjustments: imports would be taxed, but tax on exports would be refunded. The report puts forward a case for implementing a tax of this type on both real flows and on financial flows, on the grounds that this would also tax the economic rents generated by banks on lending to domestic borrowers. *See* ALAN J. AUERBACH, et al., *Taxing Corporate Income, supra* note 49, at 838-839.
90 *See* JACK M. MINTZ & JESUS SEADE, *Cash Flow or Income? The Choice of Base for Company Taxation*, *supra* note 77, at 180; MARTIN SULLIVAN, *supra* note 80, at 7; MERVYN KING, *supra* note 80. *See also* discussion *infra* at pg. 99ff. The bias against savings and distortions caused by inflation under the current CIT system would also be eliminated. *See* CHRIS EDWARDS, *supra* note 19, at 10.

certain important inconsistencies of the current realization-based CIT system, such as the different tax treatment of debt and equity, and the different rules imposed on corporations and other businesses, which, as will be further discussed, may often result in behavioural distortions, would be mitigated or eliminated.[91] Additionally, the broad base of a cash-flow tax would, in principle, need only a low tax rate to raise the same amount of revenue as the current corporate tax, and, thus, it would theoretically reduce the incentive for tax planning or tax evasion.[92] Finally, the supposed simplicity that characterizes the tax should lead to a reduction in the costs of tax compliance.[93]

However, a cash-flow tax presents several problems of its own. While it could potentially mitigate, or, in some cases, eliminate several problems of the current CIT system, it could also pose new problems to the tax system. Specifically, one problem with the basic R-base cash-flow tax is the separation of financial flows from nonfinancial flows, which may potentially create a new source of tax avoidance opportunities. For example, businesses may try to characterize normal sales receipts as interest in order to exclude them from taxation.[94] Further, financial businesses, such as banks and insurance companies, would require special rules since the R-based cash-flow tax does not include financial flows in the tax base.[95] As recently suggested by the Mirrlees report,[96] this problem could, however, be solved through the adoption of a R+F cash-flow tax basis.[97]

Also, a number of tax avoidance problems under the current tax system could continue to be a problem under some cash-flow taxes. For instance, transfer pricing would continue to be a problem under certain cash-flow taxes.[98] Once again, as proposed in the Mirrlees

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[91] The distinction between debt and equity is not totally eliminated under cash-flow taxation. The R-base requires a distinction to be made between real and financial flows and the R+F base requires the tax system to make a distinction between debt and equity. Nevertheless, the distinction is much less important than under conventional corporation taxes because only the economic rent arising from debt transactions would be taxed. *See* ALAN J. AUERBACH, et al., *Taxing Corporate Income, supra* note 49, at 887.

[92] *See* CHRIS EDWARDS, *supra* note 19, at 32-33

[93] Id. at 33 ("Economists generally agree that a business cash-flow tax would be simpler and more efficient than the corporate income tax.").

[94] Id. at 33-34.

[95] Id.

[96] *See* ALAN J. AUERBACH, et al., *Taxing Corporate Income, supra* note 49, at 839.

[97] Another option would be to simply exclude financial businesses under a new consumption-based tax system, as is the case under most US state retail taxes and certain VATs. *See* CHRIS EDWARDS, *supra* note _, at 34.

[98] *See, e.g.* the "Hall-Rabushka" style cash-flow tax, ROBERT HALL & ALVIN RABUSHKA, *supra* note 79.

report,[99] through the use of well-thought solutions, namely through the introduction of cash-flow taxes that are "border adjustable,"[100] this problem could be mitigated.

A more serious challenge would be to create transition rules to move from the current CIT system to a cash-flow system. A core problem is the treatment of the existing tax basis in assets, *i.e.,* the portion of the asset's cost not yet recovered by depreciation deductions.[101] That is, a very significant part of the costs of machines and buildings would be only partially written off at the time of the change of tax system.[102] To disallow the remaining deductions on these assets would impose unacceptable losses on taxpayers. The opposite solution, to allow complete and immediate deduction for these assets, should however involve a substantial short-term government revenue loss. The solution may rest in a middle-ground approach. A similar problem would be the fate given to the accumulated tax losses of businesses. Further, since most countries have implemented a CIT system to tax the corporate sector, certain problems of integration of an individual country's cash-flow system with the global community could arise, namely with regard to the international tax treaty network and the calculation of foreign tax credits. The higher social inequality that theoretically may result from the implementation of a consumption-based tax system presents an additional relevant problem.[103] Finally, despite its apparent simplicity, a cash-flow tax should also impose administrative problems of its own.[104]

In light of the relative virtues and problems of the different alternatives examined, the question that arises at this point is whether, overall, further work on the current CIT system is justified, or whether the current system should simply be discarded. Since some

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[99] *See* ALAN J. AUERBACH, et al., *Taxing Corporate Income, supra* note 49, at 883-886.

[100] A border adjustable tax would exempt exports from domestic taxation and symmetrically deny a deduction for imported inputs. CHRIS EDWARDS, *supra* note 19, at ft. 239.

[101] *See* id. at 34.

[102] *See* id. at 35 (estimates an amount in the range of trillions of dollars for the US).

[103] This is because consumption-based tax systems tend to develop regressive characteristics. *See* OECD, *Consumption Taxes: The Way of the Future?*, OECD Policy Brief (2007). Nevertheless, this problem may be ameliorated, to a certain extent, through the introduction of innovative solutions. For instance, under the Hall-Rabushka model, the employees pay tax on what they earn, but according to a progressive tax system. This progressiveness in the taxation of individuals is incorporated in the tax system through the setting of a personal allowance and the marginal tax rate. *See* ROBERT HALL & ALVIN RABUSHKA, *supra* note 79.

[104] The simplicity of the cash flow tax may, to a certain extent, be apparent in that, for instance, some critics state that there is no shortage of problems related to the actual definition of the scope of income and the determination of operating expenditure. *See* MARINA KESNER-SKREB, *supra* note 84, at 205-208. For a discussion of possible administrative problems with a flat tax *see, e.g.* DAVID A. WEISBACH, *Ironing Out the Flat Tax*, University of Chicago - John M. Olin Law & Economics , Working Paper No. 79 (1999). *See also* PARTHASARATHI SHOME & CHRISTIAN SHUTTE, *Cash-Flow Tax*, *in* Tax Policy Handbook (Parthasarathi Shome ed. 1995) at 172 and WILLIAM GENTRY & R. GLENN HUBBARD, *Fundamental Tax Reform and Corporate Financial Policy*, NBER, Working Paper No. 6433 (1998) at 29.

of the alternatives discussed would entail the elimination of a separate tax levied on the corporate sector, the next section will investigate the consequences of levying a separate corporate-level tax before proceeding to a final assessment.

3. *Taxing the Corporate Sector through a Corporate-Level Tax*

The corporate sector does not necessarily need to be taxed through a separate tax levied on corporations. As discussed above, there are systems available to levy taxes on the corporate sector that impose taxes only at the ultimate shareholder level, *i.e.,* on physical persons. In order to better assess the potential merits and weaknesses of the current CIT system, the next section will be dedicated to studying the consequences from levying taxes on the corporate sector through a separate corporate-level income tax.

a. Corporate-Level Taxation and the Firm's Agency Problems

Taxing business income by levying a separate tax on corporations, as occurs under the current CIT system, rather than exclusively through shareholder level taxes, gives rise to significant regulatory consequences. For purpose of this thesis, they will be classified as the "Reliability Effect," the "Deterrent Effect," the "Reversal of Clientele Effect" and the "Control Effect." As will be discussed, these consequences of CIT's existence as a separate corporate-level tax contribute to the reduction of the firm's agency problems and to the limitation and control of managerial power.

i. The Reliability Effect

Levying a separate tax on corporations provides a financial incentive for the state to invest in the verification of the reliability of the firm's disclosed information regarding its operations.[105] Consequently, due to the existence of the CIT system, two distinct auditing bodies generally supervise the reliability of the firm's disclosed information, *i.e.,* external auditors and the state.[106] The level of detail of tax information,[107] coupled with the strength

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105 *See* M. DESAI, et al., *Corporate Governance and Taxation*, NBER, Working Paper available at http://140.247.200.140/programs/olin_center/corporate_governance/papers/03.Dyck.taxation.pdf (2003) at 38 (CIT provides a "source of revenues that will entice the government to verify the accuracy of corporate income in a manner that only the government can.").

106 Id. at 5 ("[E]ffective tax enforcement makes hiding and diverting profits more difficult."). *See also* SCHON, *Tax and Corporate Governance: A Legal Approach*, *supra* note 44, at 60 ("[T]he mere existence of the corporate

of the state's supervision and enforcement mechanisms,[108] turn the state into an important and differentiated inspector of the reliability of the firm's disclosed information regarding its operations.[109] Significantly, the state has an incentive to verify the reliability of the disclosed information and to enforce its rights even when the cost of doing so is higher than the recompense it can derive. In other words, the state does not face a "free rider problem" in monitoring and enforcing its rights.[110] By auditing accounts or taking legal action against a corporation or corporate group, the state sets forth a case that induces other firms to behave.[111] This supervision activity of the government is of especial relevance for the protection of minority shareholders interests[112] and for the accuracy of small companies' books, which are often not legally obliged to have their accounts audited.[113]

ii. The Deterrent Effect

The firm's financial results often determine the amount of control shareholders exercise over, and payments made to, corporate managers.[114] Further, the financial results of the firm generally dictate its stock value and the willingness of investors to invest in it.[115] For these reasons, corporate management retains a natural interest in reporting the highest possible profits and the lowest possible amount of losses for financial purposes. The existence of a separate corporate tax levied on corporate profits works as a friction against this natural propensity, and, thus, as a deterrent against the disclosure of fraudulent

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tax...puts an extra layer of certification on the calculation of corporate profits, in addition to the control mechanisms applied by shareholders themselves and public accountants.").

107 Tax compliance obliges firms to disclose a significant amount of information regarding the operation of their business. In the US, apart from the information disclosed in the tax returns, this includes extensive transfer pricing compliance requirements (*see* IRC Section 482) and compliance with demanding anti-shelter regulations (*see* IRC Sections 6111 and 6112).

108 In general, the regulatory strength of the state is based on its quantity of administrative personnel, available information, legal power and availability and strength of sanctions.

109 *See* SCHON, *Tax and Corporate Governance: A Legal Approach*, *supra* note 44, at 60 ("As tax inspectors do not face the same collective action problems which shareholders encounter and – even more importantly – rarely are subject to the same conflict of interests as auditors are, the natural process of tax auditing proves to be helpful for the overall framework of corporate governance.").

110 *See* M. DESAI, et al., *Corporate Governance and Taxation*, *supra* note 55, at 38.

111 Id. (authors refer to this phenomenon as the "spillover" effect).

112 *See* SCHON, *Tax and Corporate Governance: A Legal Approach*, *supra* note 44, at 60 ("[T]he tax authorities are a major player when it comes to the protection of minority interests.").

113 *See* id. at 66 defending this argument for Germany.

114 *See* MYRON S. SCHOLES, et al., Taxes and Business Strategy: A Planning Approach (Pearson Prentice Hall 3rd ed. 2005) at 169 (arguing that compensation contracts for top managers are often based on accounting earnings).

115 Id. (claiming that analysts and investors use accounting numbers to price securities - both debt and equity – and arguing that managers might be concerned that reporting lower income may lead to lower stock prices and higher interest costs).

financial results.[116] The closer the relationship between financial accounting and tax accounting, and thus, the greater the potential for an effective cross-check, the stronger should be the tax friction.[117] That is, the higher the conformity between financial accounting and tax accounting,[118] the easier it should be for discrepancies between book income and taxable income to attract the scrutiny of the tax authorities.[119] Due to the penalties generally associated with wrongful tax disclosure,[120] the interest in understating profits (and overstating losses) for tax purposes should, therefore, work as a friction against the natural propensity to overstate profits (and understate losses) for financial purposes.[121]

iii. The Reversal of Clientele Effect

The clientele effect assumes that investors are attracted to different firm policies, including tax policy, and that when a company's policy changes, investors adjust their stock holdings

[116] *See* JEFFREY OWENS, *The Interface of Tax and Good Corporate Governance* 37 Tax Notes Int'l 767 (2005) at 768 ("Companies in some instances might try to inflate corporate profits for financial accounting purposes. If the financial accounting rules are also used to determine profits for tax purposes, with a resulting increased tax cost, the tax rules can act as a deterrent to profit manipulation.").

[117] *See* M. DESAI & D. DHARMAPALA, *Corporate Tax Avoidance and High-Powered Incentives*, 79 Journal of Financial Economics 145 (2007) (using the book-tax difference as a measure of potential tax sheltering). For the causes and the consequences of book-tax differences *see, e.g.*, G.B. MANZON & G. A. PLESKO, *The Relation Between Financial and Tax Reporting Measures of Income*, 55 Tax L. Rev. 175 (2002).

[118] In the US, several commentators have been arguing for greater conformity between financial and tax accounting rules, based on the associated reduction of compliance costs and the increased opportunities for monitoring. In Europe, the link between tax and financial accounts - although it takes varying forms and does not result in complete book-tax conformity - is more common. Despite the strong arguments in favour of conformity, there are also good reasons for certain divergences. Fundamentally, financial and tax accounting are based on very different concepts and cultures and fulfil different objectives. Freedman, for instance, argues that "the most likely outcome in any system, whatever the starting point, should be partial convergence." *See* JUDITH FREEDMAN, *Financial and Tax Accouting: Transparency and "Truth"*, *in* Tax and Corporate Governance (Wolfgang Schon ed. 2008) at 71. According to Freedman, separate rules could be preferable to a system that purports to integrate two sets of rules but does so without clarity. Far from removing opportunities for manipulation, the interaction of two very different systems could increase the available opportunities for obfuscation. *See* id. at 72. Freedman concludes that "rather than arguing for conformity, which would then be the subject of exceptions and, thus, lack of clarity, it would be better to accept that there are differences and to make these explicit and rooted in established principles." Id. at 78. *See also* JEFFREY OWENS, *The Interface of Tax and Good Corporate Governance*, *supra* note 116, at 768 ("[I]n some cases, the essentially conservative nature of financial accounting rules, aimed at the protection of creditors, may not be appropriate for determining the government's share of the company's operating results.").

[119] *See* MYRON S. SCHOLES, et al., Taxes and Business Strategy: A Planning Approach, *supra* note 114, at 170 (arguing that large differences between book income and taxable income can lead to greater scrutiny and audit adjustments by the IRS). *See also* C. BRYAN CLOYD, et al., *The Use of Financial Accounting Choice to Support Aggressive Stock Positions: Public and Private Firms*, 34 J. Acct. Res. 23 (1996) (reporting that managers believe that conformity results in lower tax audits).

[120] In certain cases, this may include criminal penalties.

[121] *See* M. DESAI & D. DHARMAPALA, *Tax and Corporate Governance: An Economic Approach*, *in* Tax and Corporate Governance (Wolfgang Schon ed. 2008) at 21 ("[A]t least for this sample of firms, the threat of IRS monitoring of their taxable income loomed larger than did investor monitoring of their financial statements....managers and investors appear to appreciate the role of a tax enforcement agency as a monitor of managerial opportunism.").

accordingly.[122] As a result of this adjustment, the stock price changes.[123] The existence of a separate tax on corporations should contribute to a significant reversal of this effect with regard to the tax factor. That is, if investors were to be directly taxed on the firm's income, the firm's tax policy would take on a distinct dimension for them. Shareholders would be more interested in controlling the operations of the firm in order to obtain a better individual tax result.[124] This could result in additional agency problems. Further, the firm's managers, who quite often are shareholders, would be more prone to act in a way most in line with their own tax circumstances or with the circumstances of the group of shareholders most willing to support them.[125]

iv. The Control Effect

As will be further discussed,[126] a separate corporate-level tax allows society to limit and, to a certain degree, to control managerial power.[127] CIT limits managerial power in that levying a separate tax on corporations slows down the accumulation of corporate resources, which constitute the base of managerial power.[128] In addition, through the different incentives and disincentives it introduces to corporate activity,[129] CIT may work as a tool to control corporate behaviour and, thus, to channel the use of corporate assets to uses considered valuable to society.[130]

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122 *See* EDWIN J. ELTON, et al., *The Ex-Dividend Day Behavior of Stock Prices; A Re-examination of the Clientele Effect: A Comment*, *in* Investments: Portfolio Theory and Asset Pricing (Edwin J. Elton & Martin Jay Gruber eds., 1999).

123 Id.

124 *See* SAUL LEVMORE & HIDEKI KANDA, *Taxes, Agency Costs, and the Price of Incorporation*, 77 Virginia Law Review 211 (1991) at 213 ("[T]he separate tax on corporations 'equalizes' shareholders preferences for corporate transactions even though shareholders are in diverse individual tax circumstances").

125 Id. This line of argument, although applying only to publicly traded corporations, has merit in light of the substantial revenue levied over these corporations under the existing CIT. *See* AVI-YONAH, *Corporations, Society, and the State: A Defense of the Corporate Tax*, *supra* note 75, at 1208.

126 *See* discussion *infra* at pg. 45ff.

127 *See* AVI-YONAH, *Corporations, Society, and the State: A Defense of the Corporate Tax*, *supra* note 75, at 1244 ("My basic argument is...that the corporate tax is justified as a means to control the excessive accumulation of power in the hands of corporate management, which is inconsistent with a properly functioning liberal democratic polity.").

128 *See* id. 1247.

129 Tax tries to control the firm's behaviour through several incentives and disincentives, including deductibility vs. non-deductibility, credits and exemptions, recognition vs. non-recognition, deferral of recognition vs. acceleration of recognition and relative tax rates. *See* discussion *infra* at pg. 46.

130 *See* AVI-YONAH, *Corporations, Society, and the State: A Defense of the Corporate Tax*, *supra* note 75, at 1255 ("Corporate taxation is an important regulatory tool and an important element in managing the delicate balance between corporations, society, and the state.").

b. Traditional Arguments for Defence of Corporate-Level Taxation

On top of these regulatory considerations, there is a set of traditional rationales commonly found in the tax literature to defend the existence of a corporate-level income tax. To begin with, a separate corporate-level income tax is an important backstopping instrument for personal income tax.[131] In a tax system with personal income taxation, a corporate-level income tax is a rather convenient and effective device to collect income tax on shareholders. First, without a corporate-level tax, individuals could avoid taxation by earning their income through corporations. That is, absent some type of accrual or anti-avoidance mechanism,[132] tax could be deferred until a dividend was distributed or stock was sold. This, in turn, would provide a strong incentive for the indefinite retaining of non-taxed earnings at the corporate level. Second, CIT offers an easier way of collecting taxes on corporate income.[133] This occurs due to the reduced number of corporations, when compared to the number of shareholders, and because corporations offer an easier way of collecting relevant financial information.[134] In addition, certain shareholders, namely those foreign and tax exempt, may often be hard to reach otherwise. Thus, a corporate-level CIT works as a rather efficient withholding mechanism for personal income taxation.[135]

Further, although the current CIT system is not completely non-distortionary in that, in addition to economic rent, it taxes the normal return to capital; it does tax economic rents in a more efficient way than some other alternative tax regimes.[136] There are considerable efficiency advantages in taxing such rents at the corporate level, since taxes imposed on economic rents levy income from the private sector without distorting private economic

[131] *See* R.M. BIRD, *Why Tax Corporations?*, International Centre for Tax Studies. University of Toronto. WP 96-2 (1996) at 1 ("[S]o long as the main form of personal taxation is a personal income tax, some form of corporation income tax will be a necessary part of the tax system.").
[132] *See* discussion *infra* at pg. 142ff for examples of accrual mechanics. Another possibility is the use of anti-avoidance provisions such as the US Accumulated Earnings Tax (*see* IRC Section 531) or Personal Holding Company Regime (*see* IRC Section 541).
[133] *See* ALAN J. AUERBACH, et al., *Taxing Corporate Income, supra* note 49, at 867.
[134] *See* R.M. BIRD, *Why Tax Corporations?*, *supra* note 131, at 10 ("The key to effective taxation is information, and the key to information in the modern economy is the corporation.").
[135] *See* id. at 9.
[136] To tax only economic rent requires all expenses to be deducted from taxable income when incurred. The current CIT system, therefore, has distortionary elements that should in principle affect the cost of capital and corporate finance decisions. *See* ALAN J. AUERBACH, et al., *Taxing Corporate Income, supra* note 49, at 842. For this reason, recent proposals for reform of the corporate tax systems, such as the proposal recently suggested by the Mirrlees report, aim to tax only the economic rent element of corporate profits. Id. *See also* R.M. BIRD, *Why Tax Corporations?*, *supra* note 131, at 5.

decisions.[137] Other traditional defences of the current corporate-level CIT system include the arguments that corporate tax is a reasonable user fee for services provided by the government to corporations,[138] that the tax allows the government a partial return on its implicit partnership investment in risk taking,[139] or that the corporate tax offers a way of offsetting the social costs imposed by corporations because of their limited liability.[140] Although none of these traditional arguments are particularly strong, in total they do provide an additional defence for the existence of a separate corporate-level income tax system.[141]

2. *Taxing the Corporate Sector in an Imperfect World*

As discussed in the previous sections, the corporate sector may be taxed in different forms. Fundamentally, using the realization principle as a touchstone, two basic sets of options are available. First, a set of options, which taxing either income or net cash flow, eliminates the realization principle. These taxation options may or may not involve the existence of a corporate-level tax. Second, a set of options that maintains the realization principle and that, likewise, may or may not involve the existence of a corporate-level tax.[142]

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137 *See* R.M. BIRD, *Why Tax Corporations?*, *supra* note 131, at 5. *See also* ALAN J. AUERBACH, et al., *Taxing Corporate Income, supra* note 49, at 842 ("Taxing only economic rent can be considered desirable since it is non-distortionary, leaving the (normal) return earned by the marginal investment free of tax.").

138 Fundamentally, corporations may generally benefit from government actions (*e.g.,* in providing the basic legal and institutional framework and physical infrastructure within which market activity takes place, in educating the labour force, and in maintaining a high and stable level of economic activity). *See* AVI-YONAH, *Corporations, Society, and the State: A Defense of the Corporate Tax*, *supra* note 49, at 1207. *See also* REBECCA RUDNICK, *Who Should Pay the Corporate Tax in a Flat Tax World?*, 39 Case W. Res. L. Rev. 965 (1989) at 985-986 (author argues that the corporate tax can be justified as a payment for the greater liquidity afforded by access to the public equity market). *See also* LEE, *Entity Classification and Integration: Publicly Traded Partnerships, Personal Service Corporations, and the Tax Legislative Process*, 8 Va. Tax Rev. 57 (1988) at 97 (author views corporate tax as appropriate user fee because corporations exploit foreign markets and therefore rely on the country's military power in order to ensure stability in those markets). *But see* AVI-YONAH, *Corporations, Society, and the State: A Defense of the Corporate Tax*, *supra* note 75, at 1206 for objections to this type of defence.

139 J. STIGLITZ, *The Corporation Tax*, 5 J. Pub. Econ. 303 (1976) (regarding tax as levy on pure profits and entrepreneurship, and as partial return on an implicit government partnership in risk taking).

140 Limited liability, however, is also enjoyed by certain entities, such as limited partnerships in the US, which are not subject to the CIT system. *See* JULIE ROIN, *Unmasking the "Matching Principle" in Tax Law*, 79 Virginia Law Review 813 (1993) at 832. *See also* AVI-YONAH, *Corporations, Society, and the State: A Defense of the Corporate Tax*, *supra* note 75, at 1206 ("[S]ome of the benefits conferred by government also flow to non-incorporated businesses not subject to tax. [Also] there is no correlation between corporate income and the benefits provided, since the same benefits apply (and in the case of limited liability, apply more forcefully) to corporations that lose money.").

141 *See* R.M. BIRD, *Why Tax Corporations?*, *supra* note 131, at 1 ("Although none of the possible rationales for taxing corporations is particularly strong, in total it is clear that we not only should but must impose some explicit taxes on corporations.").

142 *See* ALAN J. AUERBACH, et al., *Taxing Corporate Income, supra* note 49, for an alternative, economic-based, typology of CIT systems based on the type of tax base, *i.e.,* taxes on the return to equity investment, taxes on economic rent and taxes on the return to all capital.

The options discussed that eliminate the realization principle, as well as the imposition of a separate corporate-level tax, include accretionism taxation and certain consumption-based proposals. Although a pure accretionist regime is attractive due to its simplicity, it should be unmanageable if applied globally. Further, this type of system, due to its absence of a corporate-level tax, would eliminate important regulatory functions of the current CIT regime, namely the reliability, deterrent and control functions. The same is true for certain consumption-based proposals that propose to eliminate corporate-level taxation.[143] These consumption-based proposals, in their outright substitution of the current personal and corporate income system with a sole consumption-based system, should also, in principle, result in a less equitable tax system.

A different alternative would be to get rid of realization, but maintain a corporate-level tax, as would occur under the cash-flow tax proposals. Although a cash-flow tax levied at the corporate level has several advantages, it also has important drawbacks. Further, it is not clear whether there would be a loss of the reliability and deterrent functions currently found in the present corporate tax system. This should depend on the specific form of implementation of this tax and the type of tax compliance associated with it. However, since tax is imposed on net cash flow, the potential for cross-checking of tax and financial accounting should, in principle, be more reduced. While the reversal of the clientele effect ensured by the current CIT system should be maintained, it is not clear what would be the behavioural control potential of this type of tax when compared with the current CIT system.

The second set of options available to tax the corporate sector would entail maintaining the realization principle as a keystone of the tax system. One possibility would be to maintain the realization principle, but to eliminate the existence of a corporate-level tax. Under this option, shareholders could be directly taxed on the income they receive from corporations, be it at the moment of receipt of dividends or of recognition of capital gains on the sale of their stock. The double taxation of corporate profits would be eliminated and the simplicity of the regime would be considerable. However, since taxes could be deferred until a dividend was distributed or stock was sold, individuals could avoid taxation by earning their income through corporations. This, in turn, would provide a strong incentive for the indefinite retaining of non-taxed earnings at the corporate level. Also, this type of system

[143] *See supra* note 78.

should be administratively complex due to the large number of shareholders involved, especially in the case of public corporations, and to the difficulty in obtaining relevant financial information for all of them. Further, since individual taxation would be directly dependent on the managerial decision of when to make shareholder distributions or to reorganize the corporation, there would be a worsening of the clientele effect. That is, individual shareholders would be more interested in controlling the operations of the firm in order to obtain a better individual tax result. Further, the firm's managers, who are quite often shareholders, would be prone to act in a way most in line with their own tax circumstances or with the circumstances of the group of shareholders most willing to support them.

Alternatively, shareholders could simply be taxed on a pass-through basis, recognizing the income derived by the corporation as if it was its own. Although, as demonstrated by the current CIT system, the implementation of such a system should pose no special problems for closely-held businesses, it should be administratively impractical and technically complex in the case of large public corporations. The current complexities of pass-through regimes, such as the US IRC Subchapter S or Subchapter K provisions, should serve as a precise indicator of the potential complexities involved in this type of system, where a large mass of shareholders, including foreign and tax exempt, are involved (*i.e.,* allocation of tax losses, deductions, etc.). Also, this system should worsen the clientele effect, should introduce liquidity problems for certain shareholders, and should reduce the deterrent, reliability and control effects of the current CIT system.

A further option to tax the corporate sector would be to maintain the current core structural elements of the CIT system, that is, the realization principle and a separate corporate-level tax.[144] As discussed, the hybrid income tax characteristics of the current realization-based CIT system present significant advantages in a world of costly contracting. Further, the current CIT system provides considerable regulatory benefits, namely the reliability, deterrent, control and reversal of clientele effects, thereby

[144] A final option is to tax the corporate sector through taxes imposed exclusively at the corporate level, such as the comprehensive business income tax (CBIT) proposal. Under CBIT, neither dividends nor interest would be deductible by businesses. In addition, individual taxes on interest, dividends, and capital gains would be repealed. All businesses, corporate and noncorporate alike, would be taxed under the same rules. Although such a tax reform would be comprehensive, the CBIT would retain certain problems of the current CIT system, including capitalization, inflation-caused distortions, and a bias against savings and investment. *See* CHRIS EDWARDS, *supra* note 19, at 32. *See also* U.S. TREASURY, Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once (Government Printing Office. 1992).

contributing to the reduction of the firm's agency problems and to the limitation and control of managerial power. A realization-based CIT system presents, however, significant deficiencies.

Overall, from the analysis undertaken, this thesis concludes that there are certain options that would entail the elimination of the realization principle from the corporate tax system that merit further consideration. Specifically, the selective accretionism proposal that cumulates a dual treatment for closely-held companies and public corporations, and the cash-flow R+F based tax with border adjustments, are interesting and potentially viable substitutes for the current CIT system that warrant further work and development. Based on the analysis undertaken, the areas that deserve further consideration regarding selective accretionism are the study of the distortions and inequities that a dual corporate tax system may impose on the tax system, the investigation of potential administrative solutions to solve the problems that foreign and tax exempt shareholders could pose to this kind of system and the clarification of its potential regulatory consequences.

Of even stronger potential may be the R+F based tax with border adjustments. However, the implementation of this type of corporate tax system requires an in-depth study of the solutions to be given to the integration of an individual country's cash-flow system with the global community, and to the treatment of the existing tax basis in assets and the accumulated tax losses of businesses. In addition, the potentially regressive nature of this type of tax system, its potential administrative problems, and the clarification of its regulatory impact, should merit further analysis.[145]

Despite the merits of these alternative proposals to tax the corporate sector, the current CIT system presents, as discussed above, significant virtues in a world of costly contracting and political constraints. Furthermore, of all the systems analyzed, the current CIT system is the system that presents the strongest regulatory potential. Significantly, it is the system

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145 It should be underlined that the implementation of each analyzed tax system represents different policy choices. For instance, the potential implementation of the selective accretionism system should result in a potentially significant reduction of transaction costs of the tax system but it would completely eliminate its current regulatory functions. Similarly, the implementation of a cash-flow tax system, due to its impact on the taxation of investment and savings, may potentially result in a more regressive tax system despite its potentially significant transaction cost advantages. A specific country's policy regarding international investment (*i.e.,* capital import neutrality, capital export neutrality, national neutrality or capital ownership neutrality) should also be considered since each of these systems, and their possible variations, may involve a different type of interaction with the global economic reality. In sum, the selection of the best system to tax the corporate sector involves not only a technical analysis, as here undertaken, but also important political reflections on the particular shaping of the economy and society of a specific country.

that we currently have. Since a fundamental change to the corporate tax system is costly, complex, and politically controversial,[146] it may reasonably be expected that the current CIT system will remain in place for a considerable period of time.[147] Thus, potential improvements that may be made to the *status quo* should be very helpful.[148] For these reasons, this thesis believes that research focusing on the optimization of the current CIT system should be rather useful.[149] Therefore, the thesis will focus its efforts on the study of the current CIT system.

As demonstrated in this section, and as will be further discussed, most of the current CIT system's deficiencies reside on its theoretical pillars. Due to the nature of CIT's process of development, these deficiencies tend to be amplified due to the bulk of legislation that subsequently builds on such structural pillars. Thus, based on the analysis undertaken, the current CIT system should be approached by taking into consideration the following problems:

1. The deficiencies of the system when related parties are involved;
2. The asymmetries that result in transactional discontinuities;
3. The encouragement provided for taxpayers to engage in tax planning;
4. The distortions introduced to the regular *modus operandi* of economic agents that penalize their economic efficiency; and
5. The formalism and the complexity of the CIT law.

In addition, it would be important to factor into the analysis the current system's specific strengths, namely its regulatory potential. In light of the fair amount of research currently

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146 On the different issues associated with the design and operation of a corporate tax system, such as the controversial and piecemeal nature of the tax legislative process or the interaction with other regulatory fields and with the business environment, including the interaction with the global community, *see* generally discussion *supra* at pg. 11ff.

147 *See* SCHOLES, et al., Taxes and Business Strategy: A Planning Approach, *supra* note 114, at 20 ("[O]ur current tax system is unlikely to change dramatically in structure.").

148 In the same sense *see* WEISBACH, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, *supra* note 17, at 1633 ("Policymakers need guidance in this second-best context which they encounter on a daily basis, in which change short of fundamental reform is being considered.").

149 Several commentators have also reached this conclusion, including ZELINSKY, *supra* note 31; SHAVIRO, *An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax*, *supra* note 4; DEBORAH H. SCHENK, *An Efficiency Approach to Reforming a Realization-Based Tax*, *supra* note 55; R.M. BIRD, *Why Tax Corporations?*, *supra* note 131; and AVI-YONAH, *Corporations, Society, and the State: A Defense of the Corporate Tax*, *supra* note 75.

being undertaken on the Reliability Effect and the Deterrent Effect, this thesis believes that further work should focus on the Control Effect.[150]

Based on these considerations, the next section will be dedicated to investigating two closely related elements associated with the impact of the CIT system on corporate behaviour, namely, the distortions it introduces to the regular *modus operandi* of corporations and its control potential. Once the thesis has understood the determinants associated with the impact of the current CIT system on corporate behaviour, it will then suggest how to approach the central research question.

B. <u>The Corporate Income Tax and Corporate Behavioural Control</u>

1. The Structural Distortions

The realization-based nature of the CIT system may introduce distortions to the regular *modus operandi* of corporations. At this stage, this thesis is merely concerned with those distortions that may arise as a consequence of the interaction of a realization-based CIT system with market forces, that is, the "Structural Distortions." This excludes the potential behavioural distortions associated with the classification of a payment as deductible or non-deductible and with the classification of a transaction as a recognition or non-recognition event.[151] In particular, for purposes of this thesis, Structural Distortions refer to those distortions introduced to the behaviour of corporations that arise as a necessary side effect of the adoption of a realization-based CIT system in a market-based economy. The current CIT system may introduce Structural Distortions at the following levels:

1. The timing of transactions;
2. The level of after-tax return on assets;
3. The level of risk-taking; and
4. The level of transaction costs incurred by firms.

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150 For the current research on the reliability and deterrent effects *see, e.g.,* WOLFGANG SCHON, Tax and Corporate Governance (Wolfgang Schon ed., Springer 2008).; DESAI & DHARMAPALA, *Corporate Tax Avoidance and High-Powered Incentives, supra* note 47; and OWENS, *The Interface of Tax and Good Corporate Governance, supra* note 116.
151 For the potential distortions associated with these asymmetries *see infra* discussion at pg. 48ff.

As previously discussed, under a realization-based CIT system, a potential built-in gain or loss on an asset is only includable in taxable income once a qualifying transfer occurs.[152] Accordingly, by anticipating or postponing an asset transfer, the taxpayer may effectively control when to include such asset's built-in gain or loss on its taxable income. Thus, a realization-based CIT system may distort the timing of transfer transactions, in that it may encourage corporations to retain assets beyond the optimal period ("lock-in" effect) or to sell assets before the optimal period ("lock-out" effect).[153] The type and magnitude of the behavioural distortion should generally vary depending on the tax attributes of the corporation in question and the type of asset transferred.[154]

Further, since the taxation of gains from certain assets may be deferred indefinitely, such assets should be subject to a lower rate of tax even if they are subject to the same nominal rate.[155] Thus, assets with an identical pre-tax return may have differing after-tax returns and be favoured differently by corporations.

In addition, a realization-based CIT may impact the level of corporate risk taking. As will be discussed in more detail, in principle, pure neutrality towards risk should not be possible under a realization-based CIT system. The characteristics of the loss offset system should dictate whether the CIT enhances or reduces the risk-taking capabilities of corporations.[156] While, theoretically, the adoption of an unlimited loss offset regime should increase the level of risk-taking, the adoption of a severely restrictive loss offset regime should tend to decrease the level of risk-taking.[157]

Finally, due to its realization-based nature, CIT affects the level of transaction costs incurred by firms. In particular, by making the taxpayer's decisions regarding what to sell or

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[152] *See* discussion *supra* at pg. 19.

[153] *See* SHAVIRO, *An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax*, *supra* note 4, at 5 ("Taxes triggered by the act of transfer...are inherently distortive...they straightforwardly influence taxpayers to avoid transfers that yield taxable gain, and to engage as soon as possible in transfers that yield deductible loss."). *See also* CHORVAT, *supra* note 31, at 89.

[154] *See* discussion *infra* at pg. 127ff.

[155] *See* CHORVAT, *supra* note 31, at 80 ("[N]ot all ... income is taxed at the same rate under a realization tax system, because the longer the asset is held, the longer the tax on any gain or loss is deferred, which lowers the effective rate of tax on income from that asset.").

[156] *See* EVSEY D. DOMAR & RICHARD A. MUSGRAVE, *Proportional Income Taxation and Risk-Taking*, 58 The Quarterly Journal of Economics 388 (1944) (authors argue that whether an income tax system with a realization requirement encourages or discourages risk depends on how the system treats losses). *See also* discussion *infra* at pg. 191ff.

[157] As will be discussed, due to the different types of restrictions introduced to the loss offset mechanism and to its interaction with other elements of the CIT system, the assessment of CIT's impact on risk taking is far more complex than may at first be envisaged. *See* discussion *infra* at pg. 191ff.

to retain more complex, and by creating additional legal issues for taxpayers to consider, CIT increases regular business transaction costs by adding a further element that must be taken into consideration whenever two parties decide to contract.[158] This includes information costs to determine applicable rules (including lawyer's fees and financial professional advice), compliance costs and tax planning costs.

These Structural Distortions may affect the investment and financing preferences of corporations and result in deadweight loss for the economy. First, since the CIT system allows taxpayers to strategically time their realizations to minimize taxes due, it may make investors less responsive to changes in the prospects of their investments, thereby reducing the ability of the market to shift capital to its most efficient use at the most optimal time. Further, it may provide significant encouragement for taxpayers to engage in tax planning. Both of these aspects may result in deadweight loss for the economic system.[159] Second, since assets with an identical pre-tax return may be favoured differently by investors due to the different after-tax return that results from deferral, deferral may alter taxpayer preferences between investments that generate current or deferred compensation, and between appreciating assets and assets which generate current cash returns.[160] This may alter regular investor preferences regarding investments and may yield negative economic consequences. Third, the potential impact of the CIT system on corporate risk-taking may affect the optimal level of risk-taking in an economy.[161] Finally, the increase in business transaction costs may reduce the ordinary frequency of transactions and, thus, the ability of an economy to allocate capital to its most efficient uses, generating deadweight loss.[162]

In sum, there are certain distortions introduced by a realization-based CIT system that operate independently of the legislator's intent or action. They occur as a natural and necessary side-effect of the adoption of the realization principle as a basis for corporate income taxation. Accordingly, the study of the behavioural impact of the tax rules under a realization-based CIT should depart from the premise that the "playing field" is already distorted, not only due to natural market imperfections, but also due to the *Structural*

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[158] *See* SHAVIRO, *An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax*, *supra* note 4 at 24.
[159] *See* discussion *infra* at pg. 131ff.
[160] *See* ZELINSKY, *supra* note 31, at 914.
[161] *See* discussion *infra* at pg. 171ff.
[162] *See* discussion *infra* at pg. 131ff.

Distortions that result from the mere adoption of a realization-based CIT as a basis for corporate taxation.

2. *The CIT and Corporate Behavioural Control*

As discussed, one important advantage of a realization-based CIT system is its potential for behavioural control. First of all, this potential for control is due to its corporate-level nature. Although shareholder-level taxation may potentially impact corporate behaviour,[163] it does so in an indirect, more obscure and less targeted form.[164] Secondly, it results from the adoption of the realization principle as a foundation stone of the CIT system. A realization-based CIT system operates on a transactional basis,[165] with tax consequences generally determined on a separate basis for each transfer and for each taxpayer.[166] This transactional nature of the CIT system allows for targeted behavioural control, in that, for instance, by classifying a particular transfer as a recognition or a non-recognition event, or by allowing or by not allowing for deductibility of the associated payments to one or both parties, the legislator may determine with relative precision preferred routes of corporate action. Finally, the behavioural nature of the corporate taxpayer yields the CIT system's control potential. That is, behavioural control through the CIT law is attainable because of the corporate taxpayer's interest to reduce its tax bill,[167] in certain cases even with outright disregard for ethical and public opinion concerns.[168]

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[163] *See, e.g.,* discussion *supra* on tax clientele effect at pg. 34. *See also* discussion on impact of shareholder-level taxes on the firm's dividend policy at STEVEN A. BANK, *Dividends and Tax Policy in the Long Run*, 2007 University of Ilinois Law Review 533 (2007).

[164] *See, e.g.,* JOHN R. GRAHAM, *Taxes and Corporate Finance: A Review*, 16 The Review of Financial Studies 1075 (2003) at 1075 ("Many issues remain unresolved...including understanding...whether corporate actions are affected by investor-level taxes."). *See also* discussion *infra* at pg. 48ff.

[165] *See* discussion *infra* at pg. 105ff for in-depth analysis of transactional basis of a CIT system.

[166] Although there are certain cases where tax consequences may be determined on an aggregate transactional basis (*e.g.,* through a judicial re-classification of several transactions as a sole transaction under the step-transaction doctrine), those cases constitute the exception rather than the norm under CIT systems.

[167] *See* SCHOLES, et al., Taxes and Business Strategy: A Planning Approach, *supra* note 114, at 4 ("Most taxpayers around the world pay no more tax than they believe they must and they spend nontrivial resources to arrange their affairs to keep the tax bite as painless as possible. It is precisely this behaviour that provides tax policy with so much potential as a means to achieving a variety of societal goals."); SHAVIRO, *An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax*, *supra* note 4, at 5 ("[A]mong well-informed informed and conventionally self-interested taxpayers, only those with sufficiently important competing nontax goals will fail to follow the tax-preferred course of action.").

[168] *See* PETER C. CANELLOS, *A Tax Practitioner's Perspective on Substance, Form and Business Purpose in Structuring Business Transactions and in Tax Shelters*, 54 S.M.U.L. Rev. 47 (2001) at 47 ("Corporations are increasingly willing to treat taxes as a cost to be avoided, with the efficacy of avoidance increasingly being measured purely in monetary, probabilistic terms with only passing attention to ethical and public perception concerns."). *But see* SCHON, Tax and Corporate Governance, *supra* note 150 (arguing that certain corporations are increasingly aware of ethical and public perception concerns regarding tax avoidance).

In face of the corporate taxpayer's behavioural nature, the keystone for corporate behavioural control is the corporation's tax bill.[169] That is, the encouragement or discouragement of a certain corporate conduct through CIT law is fundamentally based on the alteration of its after-tax cost.[170] In particular, the instruments available for behavioural control may be grouped in two major categories depending on whether their end result is to increase or to decrease the corporate tax bill: a first set of instruments that decreases the corporate tax bill, thereby encouraging a certain course of action, which includes deferral, exemptions, exclusions, deductions, credits and preferential tax rates (*i.e.,* so-called "tax expenditures"); and a second set of instruments that increases the corporate tax bill, therefore being used to discourage certain conduct. It comprises recognition, limitation of deductibility on otherwise deductible expenses, reclassification of otherwise non-taxable transactions,[171] and aggravated tax rates (*i.e.,* so-called "tax penalties") (Hereinafter, tax expenditures and tax penalties are both referred to as "Behavioural Control Instruments"). An additional device for corporate control, unrelated to the corporation's tax bill, is the imposition of penalties directly on the corporation's management.

The Behavioural Control Instruments may be introduced both at the corporate-level and the shareholder-level. As discussed, their introduction at the corporate-level (*i.e.,* through CIT) should allow for a more efficient behavioural targeting than at the shareholder-level (*i.e.,* through personal income taxes). That is, the technical alternatives available at the corporate-level should generally allow for a more refined targeting of the control measures than those available at the shareholder-level.[172] For instance, when a transfer occurs, the Behavioural Control Instruments may be introduced on the tax attributes associated with the transferred property, both at the level of the transferor corporation (*e.g.,* immediate inclusion of the potential built-in gain or loss in the property transferred or, instead,

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[169] *See* ARNE FRIESE, et al., *Taxation and Corporate Governance - The State of the Art, in* Tax and Corporate Governance (Wolfgang Schon ed. 2008) at 371 ("[T]ax provisions directed at influencing behaviour ...achieve this goal by limiting favourable tax consequences or threatening increased tax costs if a certain conduct is not consistent with the government's policy.").

[170] Some commentators note that certain firms may also be motivated by other concerns, namely, reputation issues. *See* SCHON, Tax and Corporate Governance, *supra* note 150.

[171] Namely, through the use of tax law principles such as substance over form or business purpose.

[172] In the case of the typical corporation where there is separation of ownership and control, the use of personal taxes to influence corporate behaviour should always be an indirect way of influencing corporate behaviour.

deferral of such inclusion,[173] thus granting a temporary tax benefit to the transferor corporation),[174] and the transferee corporation (*e.g.,* allow the transferee corporation to have a cost basis in the property, or instead, a carryover basis), as well as on the payment received, both at the level of the transferor corporation (*e.g.,* exempt or exclude from the tax base the payment received from the transferee in exchange for the property transfer) and at the level of the transferee corporation (*e.g.,* classify payment made to the transferor corporation as a deductible payment or as a non-deductible payment, in its entirety or partially).[175]

Even when no transfer occurs, other Behavioural Control Instruments of relative accuracy are available, such as, the granting of amortization deductions on acquired property, either at regular or accelerated depreciation rates;[176] or the use of relative tax rates, either across different taxpaying units, across different tax periods for the same taxpayer, or across different economic activities for the same taxpayer and during the same time period.[177]

In contrast, intervention at the shareholder-level induces corporate behaviour indirectly by changing the taxation of its shareholders on the corporate income that accrues to them. Also, the quantity of available behavioural instruments is more limited. For example, important Behavioural Control Instruments, such as direct transactional intervention or the granting of depreciation deductions for machinery and other business assets, are unavailable. Further, by avoiding entering into the corporation-shareholder relationship to encourage or to discourage a certain conduct, CIT law evades potential agency problems.[178]

173 Each treatment will generally give rise to different tax consequences at the level of the transferee corporation.

174 This benefit may be made permanent if the taxpayer refrains from subsequently transferring the property through a taxable transaction or ensures that the conditions required to be afforded non-recognition treatment are not violated or cease to exist.

175 This targeted control potential allowed by the CIT system due to its transactional basis and the separate tax treatment of the taxpayers and property involved in the transaction, involves a certain degree of complexity in that the treatment of the property transferred and the payment received in return, both at the levels of the transferor and transferee corporations, must be properly coordinated to avoid a malfunctioning of the CIT system.

176 This Behavioural Control Instrument is generally implemented in order to privilege the investment in a certain class of assets.

177 SCHOLES, et al., Taxes and Business Strategy: A Planning Approach, *supra* note 114, at 11.

178 *See* discussion *supra* at pg. 34.

In sum, the Behavioural Control Instruments available at the corporate-level should allow for a more direct and refined targeting of the control measures than those available at the shareholder-level.[179]

4. The Types of Possible Behavioural Control

There is a substantial amount of research demonstrating the impact of the Behavioural Control Instruments, introduced both at the corporate-level and the shareholder-level, on corporate behaviour. Specifically, existing research has demonstrated that the use of these instruments may impact the decisions of corporations regarding their financial structure,[180] organizational form and ownership,[181] general investment decisions,[182] and corporate

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179 *See* ARNE FRIESE, et al., *Taxation and Corporate Governance - The State of the Art, supra* note 169, at 412-413 defending the same type of approach for the imposition of personal penalties ("If penalties are imposed on the corporation as a whole, the shareholders will ultimately bear them, as the penalties will reduce their returns...the effect of penalties in this case is very indirect. They primarily affect the shareholders and these effects have to be translated into incentives for managers...a more direct way of affecting the agent's actions is to apply penalties directly to them. This short-cuts the principal-agent relationship."). *See also* id. for advantages, disadvantages and practical issues of applying penalties directly to managers.

180 *See* ALAN J. AUERBACH, et al., *Taxing Corporate Income, supra* note 49, at 858 ("The observed reaction of borrowing to tax incentives confirms that the tax treatment of debt and equity influences corporate financial decisions [.]"); DAVID F. BRADFORD, Untangling the Income Tax (Harvard Univ. Press. 1999) at 105 ("The tax system...exerts strong incentives effects on the corporation's financial choices."). *See also* GRAHAM, *Taxes and Corporate Finance: A Review, supra* note 164 (reviewing specialized literature and arguing that research often finds that taxes affect corporate financial decisions); JEFFREY K. MACKIE-MASON, *Do Taxes Affect Corporate Financing Decisions?*, 45 The Journal of Finance 1471 (1990) at 1472 (author provides clear evidence of substantial tax effects on financing decisions); JULIAN S. ALWORTH, The Finance, Investment and Taxation Decisions of Multinationals (Basil Blackwell. 1988) (demonstrating the influence of taxation on corporate financial policy); ALAN J. AUERBACH, *Taxation and Corporate Financial Policy*, NBER, Working Paper No. 8203 (2001) (discussing the impact of taxation on corporate financial policy).

181 *See* M. DESAI, et al., *Taxation and the Evolution of Aggregate Corporate Ownership Concentration* NBER, Working Paper No. w11469 (2005) (arguing that taxation can significantly influence patterns of equity ownership); STEVEN A. BANK & BRIAN R. CHEFFINS, *Tax and the Separation of Ownership and Control*, *in* Tax and Corporate Governance (Wolfgang Schon ed. 2008) at 157 ("[T]ax can help to explain ownership structures in large companies in a particular country."). *See also* R. GORDON & J. MACKIE-MASON, *How Much do Taxes Discourage Incorporation?*, 52 Journal of Finance 477 (1997) (discussing impact of taxes on incorporation); A. GOOLSBEE, *Taxes, Organizational Form and the Deadweight Loss of the Corporate Income Tax*, 69 Journal of Public Economics 143 (1998) (discussing the behavioural responses to tax incentives surrounding the choice of organizational form).

182 *See* DAVID F. BRADFORD, Untangling the Income Tax, *supra* note 180, at 112 ("The corporation tax system...creates strong pressures on the composition of corporate investment."); id. at 108 ("The effect of existing rules is to provide very different incentives to undertake different sorts of investment...according to the different characteristics of projects."); DANIEL B. THORNTON., *Managerial Tax Planning Principles and Applications*, *in* Critical Perspectives on the World Economy, Vol. 4 (Simon R. James ed. 2002) at 119 ("[B]usiness decisions affect taxes and taxes affect business decisions."); GRAHAM, *supra* note 164, at 1076 ("Taxes can affect...restructurings, payout policy and risk management...Some studies have documented that....asset sales are structured in response to tax considerations, and that corporate bankruptcy and highly levered restructurings have tax implications."). *See also* MYRON S. SCHOLES & MARK A. WOLFSON, *The Effects of Changes in Tax Laws in Corporate Reorganization Activity*, 63 Journal of Business Finance S141 (1990) (authors present evidence that CIT law has an impact on M&A activity); ALAN L. FELD, Tax Policy and Corporate Concentration (Lexington Books. 1982) (author demonstrates influence of taxation on corporate concentration).

governance.[183] However, most existing research has not concluded undisputably on CIT's impact on corporate behaviour.[184] Fundamentally, while most of the research concluded that CIT impacts several areas of corporate behaviour, research has not been able to determine whether such effects are due mostly, or exclusively, to CIT provisions. That is, CIT generally has an impact on corporate behaviour, but the precise determination of the extent of such impact is clouded with doubt in most cases.[185]

Overall, based on the results from such research, the CIT system may potentially be used to pursue pure economic policy goals as well as corporate governance objectives. Although the pursuit of both policy aims may be achieved using similar Behavioural Control Instruments, each intervention retains different elements and implications that must be taken into consideration. Further, existing research demonstrates that both types of intervention raise complex interaction problems. Specifically, incentives and disincentives based purely on economic rationales often have corporate governance implications, and vice versa.[186]

Based on the governmental intention, economic intervention may be implemented directly, through an intentional use of Behavioural Control Instruments to pursue economic policy objectives, or indirectly, as a side-effect of corporate governance driven Behavioural Control Instruments. By the same token, corporate governance effects may arise as a consequence of direct intervention, through an intentional use of Behavioural Control Instruments to pursue corporate governance objectives, or through indirect intervention, that is, as a consequence of economic-driven Behavioural Control Instruments.

5. The Interaction Problems of CIT Behavioural Intervention

A major problem of behavioural intervention through the CIT law stems from the interaction between the effects caused by the different types of possible interventions and

183 *See, e.g.* OWENS, *The Interface of Tax and Good Corporate Governance, supra* note 116, at 768 ("The tax rules can ... have an implicit regulatory function that is similar in some respects to rules that are directly focused on corporate governance issues."). *See also* SCHON, Tax and Corporate Governance, *supra* note 150.
184 *See* discussion *infra* at pg. 52ff.
185 *See, e.g.* GRAHAM, *supra* note 164, at 1075 "(Many issues remain unresolved...including understanding whether tax effects are of first-order importance..."); DAVID F. BRADFORD, Untangling the Income Tax, *supra* note 180, at 201 ("[W]e do not have a full understanding of the way tax rules affect corporate behaviour."). *See also* GOOLSBEE, *Taxes, Organizational Form and the Deadweight Loss of the Corporate Income Tax, supra* note 181, and ALAN J. AUERBACH, et al., *Taxing Corporate Income, supra* note 49.
186 *See* discussion *infra* at pg. 50ff.

the natural distortions of the "playing field." The interaction of economic intervention and corporate governance intervention with the necessary side-effects of a CIT system generates a first interaction problem. As discussed, a set of indirect economic and regulatory effects arise due to the mere adoption of a realization-based CIT system. These effects, necessary by-products of the adoption of a realization-based CIT system, should be conceptualized as part of the existing playing field for both types of intervention.

Specifically, the mere adoption of a realization-based CIT to tax corporations should necessarily result in a set of economic consequences that this thesis previously classified as *Structural Distortions*. Further, the implementation of a realization-based tax system through a corporate-level tax should have as an offshoot certain regulatory consequences that, for the most part, consist in policing corporate malfeasance, namely, the Reliability Effect and the Deterrent Effect.[187] The playing field for the introduction of Behavioural Control Instruments is distorted due to these necessary side-effects of the adoption of a CIT system, and, thus, any type of intervention should take these pre-existing elements into consideration before trying to encourage or to discourage a certain corporate conduct. For example, a Behavioural Control Instrument geared at increasing the investment in a certain class of assets may be distorted by the CIT system's pre-existing tendency for lock-in and lock-out behaviour, or its tendency to alter the after-tax return on certain assets.[188]

An even more complex interaction problem relates to the fact that a direct intervention with a pure economic rationale may often have corporate governance implications, and vice versa. Consider the case when certain forms of income are given preferential tax treatment through the use of a Behavioural Control Instrument, in order to pursue a pure economic aim. For example, the legislator may opt to give preferred treatment to income in the form of capital gains on shares, as opposed to dividend distributions, with the pure economic aim of increasing the quantity of funds available for direct corporate-level investment. For example, this type of shareholder-level direct intervention could be made by imposing an extra tax on distributions, thereby discouraging corporate distributions and encouraging retentions, at least in the case of middle-aged corporations.[189] In turn, more or less distributions should impact where cash is located (*i.e.,* firm vs. shareholder level), and,

[187] *See* discussion *supra* at pg. 32ff.
[188] *See* discussion *supra* at pg. 42ff.
[189] *See* BANK, *Dividends and Tax Policy in the Long Run, supra* note 163. *See also* OWENS, *The Interface of Tax and Good Corporate Governance, supra* note 116, at 768.

thus, should induce different types of investments.[190] Specifically, the company should be freer to make investment decisions concerning the retained funds, without the restraints of direct market discipline. Therefore, in this case, the economic objective of strengthening direct corporate-level investments could be achieved, at least for middle-aged corporations.

However, this direct economic-led intervention could shape the shareholders' attitude to corporate control, in that with low taxation of capital gains and few distributions (or highly taxed distributions) shareholders might have an incentive for "flight and not fight" behaviour.[191] That is, if problems of corporate performance arose, the existence of a preferential tax treatment could make it much simpler and cheaper for shareholders to just sell the shares rather than try to improve corporate conduct.[192] Further, the increase of cash available for managers without direct market control could increase the firm's agency problems.[193] Thus, in this case, a direct economic-led intervention using the CIT system could lead to indirect negative corporate governance consequences. This situation should not be uncommon and other examples may be thought of, for instance, when preferential treatment is given to certain transfers through the Behavioural Control Instrument of recognition and non-recognition.[194]

Lastly, the interaction of CIT interventions with market forces may be problematic, in that certain interventions which may theoretically result in a negative distortion may, in effect,

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190 Arguably, if the funds were first distributed to the shareholders, who would then have the ability to decide whether to reinvest in that company or another company, a more efficient allocation of funds might be achieved. *See* OWENS, *The Interface of Tax and Good Corporate Governance, supra* note 116, at 768. *See also* JOINT ECONOMIC COMMITTEE, Dividend Tax Relief and Capped Exclusion, available at http://jec.senate.gov/_files/DividendTaxRelief.pdf. 2003) (arguing that, with the reduction of dividend taxes, paying dividends rather than retaining earnings would become a more attractive proposition for companies, would promote a more efficient allocation of capital and give shareholders, rather than executives, a greater degree of control over how a company's resources are used.).

191 OWENS, *The Interface of Tax and Good Corporate Governance, supra* note 116, at 768.

192 Id.

193 As noted by Bank, the elimination of direct market discipline may increase the firm's agency costs that arise as a result of the separation of ownership and control. Managers are self-interested agents, and therefore do not always act in the best interests of their principal, the shareholders. The argument in favour of dividends is that manager-shareholder interests will become better aligned by reducing the cash managers could use to engage in self-serving projects. Managers will be forced to seek funding for such projects in the capital markets where they will be subject to the discipline of outside monitoring. *See* BANK, *Dividends and Tax Policy in the Long Run, supra* note 116. *See also* RANDALL MORCK & BERNARD YEUNG, *Dividend Taxation and Corporate Governance*, 19 J. Econ. Persp. 163 (2005) (arguing that the reduction of managers' control over retained earnings reduces the temptation for managers to engage in excessive corporate expansion using retained earnings). For a good background on the firm's agency problems *see* EUGENE F. FAMA, *Agency Problems and the Theory of the Firm*, 88 J. Pol. Econ. 288 (1980); MICHAEL C. JENSEN & WILLIAM H. MECKLING, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. Fin. Econ. 305 (1976).

194 *See, e.g.* discussion *infra* at pg. 137ff regarding the corporate governance impact of recognition vs. non-recognition treatment for certain intra-group transactions.

yield a positive economic effect or a corporate governance effect. For instance, certain interventions using Behavioural Control Instruments which theoretically seem negative may generate positive consequences that ameliorate or eliminate a natural market imperfection. Consider the preference given on the deductibility of debt over dividend payments at the corporate-level. Tax theorists often argue that, as a principle, tax law should abstain from creating arbitrary distinctions since they give rise to economic inefficiencies.[195] However, it has been demonstrated that an increased commitment to pay interest may reduce the firm's agency problems. For instance, Jensen and Meckling emphasize the role of debt in facilitating greater insider ownership of firm equity. With greater ownership, insiders care more about the firm's performance.[196] Thus, in this case, a seemingly negative Behavioural Control Instrument may result in positive consequences by contributing to the reduction of the firm's agency problems.

Quite often the design of tax rules does not take these interaction problems into account.[197] Based on the analysis undertaken, the effective use of CIT to control corporate behaviour should, from an optimal point of view, require a coordination of the different types of intentional influences and non-intentional influences of CIT, with a strong working knowledge of market forces and the distortions introduced by the simple adoption of a realization-based CIT system.

6. *The Firm's Reaction to the Behavioural Control Instruments*

Existing research has demonstrated that the use of Behavioural Control Instruments may impact the decisions of corporations regarding several aspects of their operation. However, most of the existing research has not yet concluded indisputably the precise determination of the extent of such impact. The difficulty incumbent to arriving at definitive conclusions on this issue may be due to the interaction problems described above as well as to the several variables that impact the operation of Behavioural Control Instruments.

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[195] *See, e.g.* WEISBACH, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, *supra* note 17.
[196] *See* MICHAEL C. JENSEN & WILLIAM H. MECKLING, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, *supra* note 193. *See also* MICHAEL C. JENSEN, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 American Economic Review 323 (1986).
[197] *See, e.g.,* OWENS, *The Interface of Tax and Good Corporate Governance*, *supra* note 119, at 768 ("The tax rules for certain transactions, responding to tax principles and considerations, are often structured without taking their impact on corporate governance issues into account [.]").

Specifically, based on existing research, the firm's behavioural reaction to the tax rules may vary depending on the following circumstances:

a. The current and expected future tax position of the taxpayer;

b. The degree of substitution to the specific tax provision, which may vary depending on:

   - The existence and direct cost of alternative transactional routes;
   - The drafting of the particular tax provision;
   - The existence of tax law restrictions;
   - The relative importance of competing non-tax goals;
   - The existence of frictions in other regulatory fields;
   - The risk-taking profile of the firm;
   - The firm's organizational design; and

c. The stage of development of the firm.

a. The current and expected future tax position of the taxpayer

The impact of the Behavioural Control Instruments should vary significantly depending upon the current and expected future tax position of a taxpayer. Specifically, whether the taxpayer expects to be at a taxable gain or loss position at year end may impact how the taxpayer chooses to structure a transaction, *i.e.,* as a taxable transaction or a non-taxable transaction, as well as the timing of its implementation. By the same token, the accumulated tax attributes of the taxpayer, such as tax loss carryovers, especially when close to expiry, may fundamentally alter this decision.[198] That is, the taxpayer should react differently to the Behavioural Control Instruments depending upon the specific tax attributes that are more advantageous to its particular tax position. For instance, the incentive to adopt a certain conduct provided by the deductibility of a payment, or the non-recognition of a specific transaction involving built-in gain assets, may be made totally irrelevant to a taxpayer who is in a loss position with a substantial amount of tax losses to be expired. For such taxpayer, those specific Behavioural Control Instruments may have no impact whatsoever.

b. <u>The degree of substitution to the specific tax provision</u>

An additional element that may impact the effect of the Behavioural Control Instruments is the capacity of the corporate taxpayer to substitute transactions, and, therefore, to fail to adopt the conduct that the tax legislator tried to induce through the introduction of a specific Behavioural Control Instrument. When a taxpayer substitutes a transaction, instead of implementing the transaction that it would in principle implement based on its regular business considerations - and which tends to be the basis upon which the legislator defines the actions of Behavioural Control Instruments - the taxpayer implements an alternative transaction. In principle, the alternative transaction should lead to a similar economic result, but with a differing, more advantageous tax treatment.[199] Based on current research, the desire to find substitutes for a transaction to reduce the tax bill should be presumed a normal behavioural pattern of the corporate taxpayer.[200] The problem of substituting a transaction is that the taxpayer will find an alternative, which may neutralize the expected behavioural effect of the Behavioural Control Instruments. The degree of substitution of a CIT system generally varies depending on several items, namely its degree of continuity, the direct costs of the substitution, the existence and relative strength of tax law restrictions or non-tax law frictions, the risk-taking profile of the firm, the firm's organizational design and the corporate tax rate.

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[198] In this sense *see, e.g.* DAVID F. BRADFORD, Untangling the Income Tax, *supra* note 180, 112 ("The incentives bearing on a corporate decision are very different according to the current and potential future gain or loss positions of the company for income tax purposes.").
[199] Depending on the extent of the tax benefit allowed by the substitution and the relative strength of the economic interest underlying the transaction, there may be situations in which the taxpayer foregoes its initial economic interest merely to obtain a substantial tax benefit. This type of extreme behaviour falls, however, in the realm of tax evasion, a subject not directly tackled on this thesis.
[200] *See, e.g.,* CUNNINGHAM & SCHENK, *The Case for a Capital Gains Preference*, supra note 55, at 351-353 ("Any tax, except a head tax, imposed on any item or activity, prompts taxpayers to investigate alternatives or substitutes to avoid the tax.").

The degree of continuity of the tax law depends directly on how the tax system faces the line-drawing problem. When line-drawing is too discontinuous, a minor change in transactional form may generate a substantially different tax result.[201] Therefore, a discontinuous law may make the Behavioural Control Instruments relatively ineffective or totally ineffective.[202] Discontinuity in tax law may stem from several elements, namely excessive formalism or rule-based tax law.[203] In particular, the excess of formalism in tax law lends to inefficient line-drawing because artificial categories, which correspond to an identical economic reality, are established based on legal principles and rules.[204] As a result, the taxpayer, without changing the economics of a transaction, merely by altering its legal characteristics, can often produce a very different tax result. [205]

Further, the drafting of the particular tax provision may enhance or discourage substitution. Specifically, when tax provisions are enacted in the form of rules, minor changes in transactional form often create substantial changes in tax liability.[206] That is, rules tend to create discontinuities,[207] in that they create a bright line between two types of transactions.[208] Thus, a minor change in the transaction often causes a significant change in tax consequences (*e.g.,* characterization of an instrument as debt or equity).[209] Standards are "fuzzy at the borders," reducing this problem (*i.e.,* rules are more uniform and standards less uniform).[210] In terms of behavioural impact, when there is a discontinuity in the tax

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201 *See* discussion *infra* at pg. 105ff.

202 *See* WEISBACH, *Formalism in the Tax Law, supra* note 13, at 873 ("A discontinuous law…may have very different behavioural effects than a continuous law [.]"). *See also* DAVID A. WEISBACH, *An Efficiency Analysis of Line Drawing in the Tax Law,* 29 Journal of Legal Studies 71 (2000).

203 Due to CIT law's formalism, often different formal transactions, with different tax results, lead to same or similar economic result. *See* discussion *infra* at pg. 105ff.

204 *See* WEISBACH, *An Efficiency Analysis of Line Drawing in the Tax Law, supra* note 202, at 71 ("[L]ines should be drawn so that a transaction or item is taxed like its closest substitutes.").

205 Due to the characteristics of a realization-based tax, the current CIT system has an innate propensity for discontinuity. *See* discussion *infra* at pg. 111ff.

206 For example, a "B" reorganization in the US may be made taxable by the mere introduction of some cash in the reorganization. *See* US IRC Section 368 (a)(1)(B).

207 *See* WEISBACH, *Formalism in the Tax Law, supra* note 13, at 874. ("[R]ules will tend to be discontinuous while standards will not."). *See also* id. at 873 ("Standards, ex post, are also discontinuous, in that a marginal change to a transaction can alter the application of the law. So, the courts or administrators who give content to standards have no greater ability to avoid the line drawing problem than the legislator who gives content to rules. However, ex ante, the taxpayer only knows probabilities. A small change in facts will only change the probability a little, creating a continuous change in the law from an ex ante perspective.").

208 *See* id. at 873 ("No matter how nuanced a rule is, it will create a bright line between the two types of transactions. Moving one step to the left will cause a large change in tax consequences. In this sense, rules are discontinuous.).

209 As a consequence, rules are generally over and underinclusive relative to underlying norms. Standards better conform to the purpose underlying the law but they are more uncertain. *See* id.

210 *See* id. at 871 ("Another way to articulate the rules/standard problem in the tax law is to note that rules apply to their complete domain even if at the borders they are inaccurate…standards are fuzzy at the borders, reducing this problem.").

rules, taxpayers sufficiently close to the discontinuity may be expected to move to the lower tax regime, if transaction costs are inferior to the tax savings and associated risk.[211]

Further, the corporate taxpayer generally takes into consideration the direct costs of the substitution. These costs include legal fees to restructure a transaction, accounting fees, filing costs and similar costs.[212] The larger the tax benefit that the taxpayer may extract from substituting the transaction, the higher must these costs be in order to deter the taxpayer from substituting.[213]

The existence of tax law restrictions provides an additional variable to substitution. Imposed by the tax law, these restrictions constrain behaviour, generally backed up by fines and other sanctions with the intent of deterring taxpayers from substituting a transaction in socially undesirable ways.[214] For example, a tax law requiring the investor to assume a certain level of risk, or to personally participate in an activity in order to use a transaction or structure, may often dissuade substitution.[215]

The existence and relative strength of non-tax law frictions constitute another fundamental variable to substitution. When a taxpayer structures a transaction, beyond considering its tax consequences, it also takes into consideration other non-tax law factors, which in many cases may be considered more important by the taxpayer than the mere tax consequences.[216] Non-tax law frictions encompass a set of transaction costs and other negative consequences that may result from the implementation of the substitute transaction.[217] These external frictions, together with the direct costs from substitution

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[211] *See* id. at 874.
[212] *See* DEBORAH H. SCHENK, *An Efficiency Approach to Reforming a Realization-Based Tax*, *supra* note 55, at 509.
[213] *See* id. 509 ("Unless the costs of the substitute transaction are significantly higher, they may have little or no bearing on the ability to substitute."); SCHIZER, *Frictions as a Constraint on Tax Planning*, *supra* note 16,, at 1323 ("The larger the tax benefit from substitution, the higher the costs must be to deter substitution."); SCHOLES, et al., Taxes and Business Strategy: A Planning Approach, *supra* note 114, at 90 ("The classical investment model would predict that an investor will engage in tax planning so long as the marginal cost is less than the benefits derived.").
[214] *See* SCHOLES, et al., Taxes and Business Strategy: A Planning Approach, *supra* note 114, at 9 ("By tax-rule restrictions, we mean restraints imposed by the taxing authority that prevent taxpayers from using certain tax arbitrage techniques to reduce taxes in socially undesirable ways."). *See also* THORNTON., *Managerial Tax Planning Principles and Applications*, *supra* note 182, at 150 ("Whereas frictions such as agency costs and transaction costs discourage tax arbitrage automatically, restrictions do so through legal prohibitions, backed up by fines and other sanctions.").
[215] *See* DEBORAH H. SCHENK, *An Efficiency Approach to Reforming a Realization-Based Tax*, *supra* note 55, at 509.
[216] Id.
[217] This terminology has been originally coined by Scholes. SCHOLES, et al., Taxes and Business Strategy: A Planning Approach, *supra* note 114, at 9 ("By frictions, we mean transaction costs incurred in the marketplace that make implementation of certain tax planning strategies costly.").

discussed above, generally reduce the after-tax return on the investment, and, thus, depending upon the magnitude of the extra costs and other negative consequences involved, may powerfully deter the substitution of transactions.[218]

In particular, there are ways of structuring transactions, which, despite reducing the potential tax costs generally associated with a specific transaction, result in a substantial increase of collateral transaction costs and in other negative consequences, be it for the taxpayer or another party involved.[219] When such costs and other negative consequences outweigh the advantages of the substitution, the taxpayer may decide not to substitute the transaction.[220] Several types of external frictions to the tax law exist. The most important are the taxpayer's business preferences and legal and accounting constraints.[221]

The taxpayer's business preferences include factors such as risk, timing (*i.e.,* how long taxpayers must hold an asset or wait before taking a particular step), complexity, preferences about capital structure or organizational design.[222] When these business preferences are strong, and it is difficult to switch to a perfect substitute without requiring a change in preferences, these business preferences may constitute powerful frictions to substitution.[223] For instance, in certain cases, taxpayers will choose better governance over tax reduction,[224] and, thus, a strategy that requires an organizational form that is less effective at constraining agency costs (*e.g.,* a limited partnership instead of a corporation), or that results in a significant increase in internal transactional complexity and organizational rigidity, may be discarded despite its tax advantages.

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218 *See* DEBORAH H. SCHENK, *An Efficiency Approach to Reforming a Realization-Based Tax*, *supra* note 55, at 509 ("Together with the direct costs, external frictions...reduce the after-tax return on the investment ...These costs can be thought of as an implicit tax on the remaining realization-based opportunities...The implicit tax would be the net cost because many of the transactions costs may be deductible."); SCHOLES, et al., Taxes and Business Strategy: A Planning Approach, *supra* note 114, at 111 ("We can see that frictions have the same effect on investment returns as implicit taxes.").
219 *See* SCHIZER, *Frictions as a Constraint on Tax Planning*, *supra* note 16, at ft. 35.
220 *See* Id. at 1321 ("[T]he cost imposed by the friction must outweigh the tax benefit.").
221 In addition to these two categories of frictions, Schizer indicates a third one, *i.e.,* the state of technology and markets *See* id. at 1326.
222 Id. at 1326.
223 *See* DEBORAH H. SCHENK, *An Efficiency Approach to Reforming a Realization-Based Tax*, *supra* note 55, at 512.
224 *See* SCHIZER, *Frictions as a Constraint on Tax Planning*, *supra* note 16, at 1328-1330. *See also* SCHOLES, et al., Taxes and Business Strategy: A Planning Approach, *supra* note 114, at 167-176.

Also, legal and accounting constraints may provide an effective deterrent to substitution.[225] In particular, legal restraints external to the tax law may render certain tax advantageous transactions more costly or risky. In certain cases, they may even result in an outright prohibition to implement the transaction.[226] For instance, certain legal regimes may impose certain substantive preconditions for the transaction to be legally binding for all the parties involved or to avoid legal penalties. The potential incurrence of "credit risks" can also deter substitution, in that the enforcement of a legal right, especially against a party with no assets, can be costly.[227]

A similar kind of dissuasion to substitution may result from accounting constraints. Specifically, the desire of corporations to keep earnings high may work as a powerful friction, in that transactions that lower taxes tend to decrease earnings.[228] Thus, quite often a firm may be put in a position of having to choose between lower taxes or higher earnings. Several research studies have demonstrated that, when put in this position, many firms choose to forego the tax benefit for the privilege of higher earnings.[229] Even when substitution decreases taxes but does not result in a change to earnings, the accounting friction may deter, in that many managers fear that the lack of book-tax conformity may prompt special scrutiny from the tax authorities.[230] The relative strength of each of these frictions to impede substitution should vary from taxpayer to taxpayer at any time.[231] In

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225 Legal and accounting constraints may be quite effective because they are important for nontax reasons and are difficult to avoid. *See* SCHIZER, *Frictions as a Constraint on Tax Planning*, *supra* note 16, at 1328-1334. Schiezer notes that legal and regulatory regimes are influential in four ways: by imposing substantive preconditions, agency costs, credit risk, and by regulatory and financial accounting rules that may impede other parts of the taxpayer's business. Id.

226 Id. at 1328-1330.

227 Id.

228 *See* DEBORAH H. SCHENK, *An Efficiency Approach to Reforming a Realization-Based Tax*; *supra* note 55, at 510-511.

229 *See* id. at 510. For a discussion of the reasons why managers might trade off tax benefits to avoid financial reporting issues, *see* SCHOLES, et al., Taxes and Business Strategy: A Planning Approach, *supra* note 114, at 141-42. *See also* id. at 129 (noting efficient tax planning requires identifying and weighing nontax costs (such as lower earnings) against tax benefits). Some literature over the past years has attempted to identify the nontax factors that firms will trade off against tax factors. Empirical work has revealed that firms, particularly publicly held companies, often choose higher earnings. It is suggested that, in part, they do so because of capital market pressure: That is, they fear that investors will be unable to distinguish poor performance from decreased income resulting from tax strategies. The central argument is that public firms would find it much more difficult to communicate tax planning strategies to their shareholders because a public disclosure might trigger scrutiny by the tax authorities. As a result, they choose earnings management over tax management. Apparently, in some cases, firms may even pay taxes on phantom earnings in order to fraudulently boost earnings. *See* generally DEBORAH H. SCHENK, *An Efficiency Approach to Reforming a Realization-Based Tax*; *supra* note 55, at 511.

230 *See* DEBORAH H. SCHENK, *An Efficiency Approach to Reforming a Realization-Based Tax*; *supra* note 55, at 510. *See also* discussion *supra* on reliability function of a corporate-level tax at pg. 32ff.

231 *See* SCHIZER, *Frictions as a Constraint on Tax Planning*, *supra* note 16, at 1326.

general, frictions may be expected to provide a strong dissuasion to substitution when their overall negative consequences exceed the tax benefit at stake.[232]

A final set of conditions to substitution is the risk-taking profile of the firm, its organizational design and the corporate tax rate. To begin with, how the specific firm perceives the odds of an audit may impact its willingness to substitute a transaction, especially when substantial tax risk is involved.[233] Furthermore, a firm's organizational design may impact the way it reacts to the tax rules.[234] For instance, due to the formalism of CIT law, the flexibility of a business entity to restructure its internal ownership structure may give it increased flexibility to substitute. As will be discussed, this phenomenon is especially acute with corporate groups, in that the ability to use the corporate veil of its affiliates and the possibility to more easily structure complex internal transactional flows (*e.g.,* structuring of indirect transactional flows instead of direct transactional flows) gives them wide flexibility for substitution in light of the nature of the CIT law.[235]

Lastly, as the corporate tax rate increases, the incentive to substitute should also increase.[236] That is, the higher the benefit the taxpayer may have from substituting a transaction in the form of a reduced tax bill, the more it will be interested in finding an alternative transactional route to substitute the transaction.

In sum, in certain cases, the envisaged effects of the Behavioural Control Instruments may be neutralized or distorted by the capacity of the corporate taxpayer to substitute transactions, and, therefore, to fail to adopt the conduct that the tax legislator tried to induce through the introduction of a specific Behavioural Control Instrument.

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232 David Schizer has offered a methodology by which various frictions can be evaluated for their likely success in supporting targeted reform. He labels the valuable frictions as "discontinuous" and those that have no social value as "continuous." The former is one that would cause the taxpayer or a counterparty to suffer a "dramatic and unavoidable decline in utility [that] would exceed the tax benefit at issue." *See* id. at 1325.
233 *See* JOSEPH BANKMAN, *The New Market in Corporate Tax Shelters*, 83 Tax Notes 1775 (1999) at 1776.
234 *See* SCHOLES, et al., Taxes and Business Strategy: A Planning Approach, *supra* note 114, at 155-169 (demonstrating how organizational design affects the way firms respond to taxes).
235 *See* discussion *infra* at pg. 122ff.
236 As the tax rate increases, the avoidance incentive also increases. It long has been recognized that there is a revenue maximizing rate for most taxes, a point at which, if the tax rate were increased, the tax would generate less revenue than if it were left unchanged. The revenue maximizing rate declines with the ease of avoidance. *See* CUNNINGHAM & SCHENK, *The Case for a Capital Gains Preference*, *supra* note 55, at 351-353.

c. <u>The stage of development of the firm</u>

The effect of the Behavioural Control Instruments on the corporate taxpayer may also depend on the corporate taxpayer's stage of economic development.[237] Existing research demonstrates that different stages of development are characterized by particular financing constraints and investment dynamics,[238] which, in turn, affect the way firms respond to certain Behavioural Control Instruments. Based on existing research, three broad categories may be established, namely, new firms, middle-aged firms, and large, established corporations.[239]

Specifically, while new firms tend to have little or no access to capital markets, the marginal source for middle-aged firms tends to originate in the public market (*i.e.,* middle-aged firms tend to have access to capital markets and no significant retained earnings).[240] Yet, in the case of large, established corporations, since they tend to have high bond ratings and a ready supply of retained earnings, much, if not most, capital investment is funded by debt or retaining earnings instead of new equity.[241] Thus, middle-aged firms, that is, firms that fall between the two extremes of the infant firm and the longstanding firm, tend to be the most likely to issue new shares.[242]

As the recent discussion on the impact of the taxation of dividends on corporate behaviour demonstrates, the consequences of these differences for tax policy may be quite substantial.[243] For instance, middle-aged firms need to pay dividends despite the tax cost in order to attract investors,[244] while for large, established corporations dividends tend to be residual payments, used as the main method of distributing cash only after exhausting

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[237] *See* ALAN J. AUERBACH, et al., *Taxing Corporate Income, supra* note 49, at 864 ("[I]t is important to distinguish the effects of taxation on existing companies and new ones."); BANK, *Dividends and Tax Policy in the Long Run, supra* note 163, at 569 ("[F]irms are different depending upon their stage of development.").

[238] *See, e.g.,* ALAN J. AUERBACH, et al., *Taxing Corporate Income, supra* note 49, at 864 ("While existing corporations may finance their expansions through retained earnings, new corporations must establish an equity base and may face a higher cost of capital as a result.").

[239] *See* BANK, *Dividends and Tax Policy in the Long Run, supra* note 163.

[240] *See* id. at 572

[241] *See* id. at 556

[242] *See* id. at 569.

[243] *See, e.g.,* BANK, *Dividends and Tax Policy in the Long Run, supra* note 163, and ALAN J. AUERBACH, et al., *Taxing Corporate Income, supra* note 49.

[244] *See* BANK, *Dividends and Tax Policy in the Long Run, supra* note 163. This is explained by the fact that dividends have unique benefits to investors. One such benefit is the dividend's ability to signal profitability to both current and potential shareholders. By definition, distributing a dividend indicates the presence of current or accumulated earnings and profits. Beyond that, however, a special dividend can also be used to inform shareholders about some significant event that differentiates the firm from its competitors, and an increase in a firm's regular dividend can signal some permanent increase in profitability. Id.

potential investment opportunities.[245] Thus, the impact of Behavioural Control Instruments on the taxation of dividends should be very different on each firm category.

In sum, due to these different variables, it remains quite difficult to predict whether a certain Behavioural Control Instrument will have the desired behavioural effect across the board for all corporate taxpayers. The same rule may work as an incentive or restriction for different taxpayers situated in different positions. In addition, certain entities, which are not the target of the tax provision at stake, may change behaviour merely to qualify for the benefit allowed by a certain Behavioural Control Instrument.[246] The difficulty incumbent to accurately predicting the effect of the Behavioural Control Instruments is further complicated by the interplay that occurs among the several variables discussed.[247] For instance, the strength of an external friction may vary depending on the degree of continuity of the CIT law, just as the current and expected future tax position of a corporate taxpayer may be closely intertwined with its stage of development and associated financing constraints. Lastly, understanding and measuring the effect of the Behavioural Control Instruments is made more challenging by the inter-temporal difficulty to measure their behavioural effects. That is, the effect of a tax change may vary with time, and, thus, the immediate impact of a tax change may be significantly different from its impact over the course of time.[248] Overall, these differing variables that condition the behavioural response of the corporate taxpayer to the tax rules may contribute to the discrepancy in results often found in the available research and reveal the difficulties incumbent to efficiently controlling corporate behaviour across the board for all taxpayers.

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[245] *See* id. at 557.

[246] *See* SCHIZER, *Frictions as a Constraint on Tax Planning*, *supra* note 16, at ft. 29 ("Wasteful planning can arise not only when taxpayers avoid a reform, but also when they deliberately qualify. For instance, sometimes a reform imposes treatment that is unfavorable in the context that reformers are considering, but is unduly generous in some other context unknown to reformers. The reform thus prompts taxpayers to change their behavior to become eligible for a regime, not to avoid it."). *See also* SCHIZER, *Sticks and Snakes*, *supra* note 76, at 1345-46.

[247] *See* THORNTON., *Managerial Tax Planning Principles and Applications*, *supra* note 182, at 147 ("[There is an] interplay between unrestrained market forces (which lead to implicit taxes), frictions (such as agency costs and transaction costs) and restrictions (such as tax rules) [.]"). *See also* SHAVIRO, *An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax*, *supra* note 4, at 32 (Shaviro notes that the effect of tax rules on corporate behaviour depends on "how strongly . . . the taxpayer [is] constrained by the friction" and "what alternative routes with different tax consequences . . . the taxpayer [can] use").

[248] *See* GEREMIA PALOMBA, *Firm Investment, Corporate Finance, and Taxation*, IMF Working Paper WP/02/237 (2002) at 4 ("[T]he effect of a tax change varies with time...reductions in corporate profit taxes increase firm investment, but this is only a temporary effect...to confine the attention to the immediate impact of taxes...may be, therefore, misleading. Indeed, the intertemporal aspects can make a great deal of difference to the way we think about corporate tax policy."). *See also* BANK, *Dividends and Tax Policy in the Long Run*, *supra* note 163 (discussing different inter-temporal effect of reductions of tax rate in the taxation of dividends at the shareholder level).

As a result of their interaction problems and of the numerous variables that condition their application, it is difficult to predict the behavioural effects of Behavioural Control Instruments. A further drawback of behavioural intervention is that it may introduce substantial complexity to the tax system and, thus, increase its deadweight loss.[249]

In particular, the use of Behavioural Control Instruments may result in three different types of complexity, namely transactional, rule and compliance complexity. Transactional complexity refers to the hardships associated with altering behaviour to benefit from the preferred routes of action defined by the legislator through the Behavioural Control Instruments.[250] Transactional complexity arises because, due to the indiscriminate use of Behavioural Control Instruments, economically similar activities may have different tax consequences as a result of essentially irrelevant distinctions among activities or transactions. For instance, whether to be allowed a deduction on a certain payment or a tax deferral on a specific property transfer may be made dependent on a minor formal or substantive requirement. These asymmetries in tax treatment generally result in transactional discontinuities in the tax law.[251] In turn, discontinuity tends to increase the degree of substitution of the CIT law, and thus, beyond causing taxpayers to base economic decision-making at least in part on tax considerations, as opposed to the underlying economic factors, it generally leads to an increase in the costs incurred by taxpayers to search for and adopt substitute transactions.[252] This tax-minimizing behaviour, in turn, breeds additional complexity from tax reformers and legislators who respond with measures designed to circumvent the latest tax manoeuvres.[253]

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[249] Complexity in the tax law is susceptible to various definitions. Relatively consensual definitions include the following: "Either a reasonably certain conclusion cannot be determined despite diligent and expert research by an able and honest practitioner, or a reasonably certain conclusion can be determined only after an expenditure that is excessive in time and dollars." ROBERTS, et al., *A Report on Complexity and the Income Tax, supra* note 9, at 327; or "[A] complex tax system would be one where neither taxpayers nor the revenue authority could identify a taxpayer's tax liability with an appropriate degree of certainty at reasonable cost, not could that liability be cheaply and easily satisfied, nor enforced." GRAEME S. COOPER, *Themes and Issues in Tax Simplification, in* Critical Perspectives on the World Economy, Vol. 2 (Simon R. James ed. 2002) at 421.

[250] *See* WEISBACH, *Formalism in the Tax Law, supra* note 13, at 860.

[251] *See* discussion *infra* at pg. 105ff.

[252] DEBORAH H. SCHENK, *An Efficiency Approach to Reforming a Realization-Based Tax, supra* note 55, at 516.

[253] DAVID F. BRADFORD, Untangling the Income Tax, *supra* note 180, at 266-267.

The use of Behavioural Control Instruments tends also to result in rule complexity, that is, an increased challenge to interpret the tax rules.[254] Specifically, the proliferation of Behavioural Control Instruments in the CIT law quite often leads to complex substantive rules with intricate inter-relationships, characterized by unclear variations in the tax treatment of transactions not differing substantially.[255] The use of complex statutory terminology aggravates this complexity problem.[256] This ambiguity in rules increases compliance costs through the need for a team of professional tax preparers, lawyers, and accountants, and, in the long-run, may increase the frustration and cynicism of the taxpayer.[257]

Finally, the use of Behavioural Control Instruments may result in compliance complexity. Compliance complexity refers to the problems taxpayers encounter in ensuring their ongoing compliance with the rules.[258] It includes the difficulties faced by taxpayers, such as keeping records, choosing forms and making necessary calculations.[259] The need to provide adequate proof of the fulfilment of the formal and substantive requirements commonly associated with Behavioural Control Instruments, as well as of the anti-abuse rules generally associated with them, should add another level of complexity.[260]

Due to complexity, it is more expensive for the taxpayer to determine what rules and regulations are applicable to a specific transaction, to determine the ensuing tax consequences and to comply with them.[261] At some point, the transaction costs fostered by the lack of certainty become so prohibitive that the planned action does not occur, because

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254 *See* WEISBACH, *Formalism in the Tax Law*, *supra* note 13, at 860.
255 *See* STANLEY S. SURREY, *Complexity and the Internal Revenue Code: The Problem of the Management of Tax Detail* 34 Law and Contemporary Problems 673 (1969).
256 The complexity arising as a result of a deficient drafting of the tax rules has been analyzed in great detail by the plain language movement. This literature stresses the importance of the expression, design and presentation of legislation as documents intended to communicate information to the reader. *See* GRAEME S. COOPER, *Themes and Issues in Tax Simplification*, supra note 249, at 255. For a good discussion of the theme *see* MENAHEM PASTERNAK & CHRISTOPHE RICO, *Tax Interpretation, Planning, and Avoidance: Some Linguistic Analysis* 23 Akron Tax Journal 33 (2008). *See also*, as a practical demonstration of this movement, the UK's Tax Law Rewrite Project at www.hmrc.gov.uk/rewrite/ (the aim of the Tax Law Rewrite Project is to rewrite the UK's primary direct tax legislation to make it clearer and easier to use, without changing the law).
257 *See* MICHAEL J. STEPEK, *The Tax Reform Act of 1986: Simplification and the Future Viability of Accrual Taxation* 62 Notre Dame L. Rev. 779 (1987) at 791-792.
258 *See* WEISBACH, *Formalism in the Tax Law*, *supra* note 13, at 860.
259 *See* DAVID F. BRADFORD, Untangling the Income Tax, *supra* note 180, at 266-267. The obligation imposed on the taxpayer may require the taxpayer to perform substantial tasks and incur significant costs beyond the amount of tax to be collected. This is the realm of compliance costs literature. Its most prominent scholar is Cedric Sandford. This literature attempts to estimate the deadweight loss of the tax system. *See* generally CEDRIC SANDFORD, Tax Compliance Costs Measurement and Policy (Fiscal Publications. 1995).
260 *See* discussion *infra* at pg. 119ff.
261 *See* JAMES A. FELLOWS, *Nonrecourse Debt and Real Estate: The Issues of Tax Basis*, 26 Real Est. L.J. 270 (1998) at 271.

the "expected benefits of the action are less than the sum of the costs of implementing the action plus the transactions costs of determining its legal outcome."[262] This problem should be especially acute with regard to new and small firms.[263] If the firm does not undertake the planned action, society's wealth lowers, as the firm thrusts aside an otherwise productive activity.[264]

Finally, the transaction costs incurred by the government in writing and enacting the laws and regulations upon which the tax system is built, and in enforcing the laws and regulations when it perceives a lack of compliance, should substantially increase in light of the complexity of the tax law.[265] In sum, behavioural intervention tends to introduce substantial complexity into the tax system, which most often results in substantial deadweight loss.

8. Other Negative Consequences of Behavioural Control

Beyond the increase in complexity of the tax system, the use of Behavioural Control Instruments may breed other negative consequences. In particular, two problems of especial relevance and interest merit consideration, namely, the impact of Behavioural Control Instruments on the firm's organizational arrangements and their interaction with general market dynamics.

Existing research has demonstrated that organizational arrangements arise because of asymmetrical distribution of information among economic agents.[266] That is, different ways of organizing economic activity give rise to differences in transaction costs.[267] Further, it has also been demonstrated that different ways of organizing economic activity may give

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262 Id. at 271. *See also* BIRD, *Why Tax Corporations?*, *supra* note 131, at 1 ("[U]ncertainty as to the precise tax implications of various corporate decisions may act as a general deterrent to investment."); COOPER, *Themes and Issues in Tax Simplification*, supra note 249, at 244 ("[W]hen faced with complexity (in the sense of an uncertain outcome), all taxpayers are risk-avoiders and will try to eliminate the risk arising from uncertain tax outcomes, even if it means abandoning the transaction altogether.").
263 *See* BIRD, *Why Tax Corporations?*, *supra* note 131, at 1 ("[T]he complexity of corporate taxes may impose significant costs and barriers to expansion of new and small firms...").
264 *See* JAMES A. FELLOWS, *Nonrecourse Debt and Real Estate: The Issues of Tax Basis*, *supra* note 261, at 271.
265 Together, these costs can be a very substantial burden on the economy. See KNEAVE RIGGALL, *Comprehensive Tax Base Theory, Transactions Costs, and Economic Efficiency: How to Tax Our Way to Efficiency*, 17 Va. Tax Rev. 295 (1997) at 320.
266 *See* SCHOLES, et al., Taxes and Business Strategy: A Planning Approach, *supra* note 114, at 155. *See also infra* discussion on economic nature of corporate groups at pg 77ff.
267 Id.

rise to different sorts of agency problems.[268] Finally, and interestingly, existing research has demonstrated that different ways of organizing economic activity may give rise to differences in tax costs.[269] This means that an efficient organizational arrangement, from a perspective of transaction costs and agency, may not necessarily minimize tax costs as well. For instance, the implementation of tax strategies often requires shifting income. Since shifting income may require considerable coordination, tax rules may induce a greater degree of centralization of management than would otherwise be optimal.[270] This is relevant in that in order to benefit from the advantages of Behavioural Control Instruments certain firms may need to alter their organizational arrangements. Thus, as will be further discussed,[271] the firm may adopt organizational arrangements that are sub-optimal from a transaction cost and agency perspective in order to benefit from the advantages of Behavioural Control Instruments or to avoid their application. As will be discussed, this type of behaviour should result in deadweight loss.[272]

Further, there are certain consequences of the interaction of Behavioural Control Instruments with general market dynamics that merit special attention. The core of the problem is the following: when two assets give rise to identical pre-tax cash flows, but, as a result of Behavioural Control Instruments, the cash flows from one of such assets is taxed more favourably, taxpayers will generally bid for the right to hold such tax-favoured asset. As a result, the price of the tax-favoured asset will increase relative to the price of the tax disfavoured asset. As Scholes explains, "given differences in tax treatment, if after-tax returns are to be equalized, then before-tax rates of return must differ across the assets."[273] That is, more lightly taxed investments require lower before-tax rates of return than do more heavily taxed investments. As a result, investors pay tax explicitly on heavily taxed investments and pay taxes implicitly on lightly taxed investments through lower before-tax rates of return.[274] Thus, implicit taxes arise because the before-tax investment returns

268 *See* JENSEN & MECKLING, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, supra* note 193. *See also* JENSEN, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers, supra* note 196.
269 *See* SCHOLES, et al., Taxes and Business Strategy: A Planning Approach, *supra* note 114, at 155.
270 Id. at 167. *See also* THORNTON., *Managerial Tax Planning Principles and Applications, supra* note 182, at 142 ("Agency costs, generally the costs of people not trusting each other, often get in the way of tax planning. Indeed, in seeking tax savings, taxpayers often spawn new mutations of agency costs.").
271 *See* discussion *infra* at pg. 132ff.
272 Id.
273 SCHOLES, et al., Taxes and Business Strategy: A Planning Approach, *supra* note 114, at 119.
274 Id.

available on tax-favoured assets are less than those available on tax-disfavoured assets. This reduced yield represents an implicit tax.[275]

In sum, tax rules may affect the firm's organizational arrangements, and the before-tax rates of return on assets, *i.e.,* the rate of return earned from investing in an asset before any taxes are paid.[276] This alters regular market dynamics and may produce deadweight loss.

9. *CIT's Behavioural Control Instruments vs. Direct Subsidies*

Due to interaction problems, uncertainty as to behavioural impact, complexity and other negative consequences, CIT law may not be the best method available to induce corporate conduct. In many cases, direct subsidies may provide a more efficient policy instrument to achieve the same objectives, in terms of associated transaction costs and behavioural impact. In many cases, direct subsidies should have higher targeting potential and lower associated transaction costs than tax incentives.

In particular, direct subsidies tie the incentives or disincentives to the specific category of economic actors, activities or geographic regions that should be caught by them.[277] In contrast, CIT law, applicable to the masses of corporate taxpayers, may not allow for such refined targeting unless substantial complexity is built into the tax system. [278] Also, in many cases, direct subsidies should provide a more efficient option from a transaction cost perspective. Specifically, although it is debatable whether the direct costs of promulgation and publicity are lower with direct subsidies,[279] the indirect costs of tax intervention should be higher than those associated with direct subsidies, because of the costs associated with the increase in the tax system's complexity (*i.e.,* higher promulgation costs due to the

[275] Id. at 6.
[276] Id. at 2.
[277] EDWARD YORIO, *Equity, Efficiency, and the Tax Reform Act of 1986*, 55 Fordham L. Rev. 395 (1987) at 423.
[278] Id. at 423.
[279] Certain commentators argue that tax incentives may be more efficient than direct subsidies due to their lower transaction costs for dissemination of information. The core of the argument is that tax incentives enable the government and citizens to utilize the existing tax system, at relatively low marginal cost, to disseminate and obtain information about government policies. There are, however, strong reasons to doubt that tax incentives actually reduce transaction costs. As Yorio notes, "for taxpayers who have a network for obtaining information about direct subsidy programs, the marginal costs of digesting information about a new subsidy are probably no higher than the costs of assimilating similar information about a tax incentive." *See* EDWARD YORIO, *supra* note 277, at 427. Moreover, if the government already disseminates information about direct subsidies through an existing communication channel and has previously identified the potential beneficiaries of such subsidies, the marginal costs to the government of disseminating information about new subsidies should, in principle, be lower than the costs of communicating information about a similar tax incentive to all taxpayers. Id.

increase in rule interaction problems; increased compliance costs; increased administration and enforcement costs, etc.) and the increased tax planning that stems from the asymmetries in the tax law produced by Behavioural Control Instruments.[280] Finally, the use of Behavioural Control Instruments may produce significant non-intended negative consequences and, due to the several variables that condition their application, be subject to a significant degree of uncertainty with respect to their intended behavioural effects.[281] Thus, the major problem with direct subsidies appears to be political. The lack of transparency to the electorate surrounding the introduction of incentives and disincentives through the tax system may make it more attractive from a political perspective.[282]

10. CIT and Corporate Behavioural Control

Behavioural intervention using the CIT law has drawbacks. Medicines also have side-effects. Whether their desired effects are superior on a specific case to their side-effects and whether there are no better options available in the case at hand remain determinative. This thesis believes that this should also be the case with behavioural intervention using the CIT law. *Behavioural Control Instruments should only be used when their advantages far outweigh their negative impact and there is no other available solution that may provide a better overall result.*[283] In particular, based on the discussion undertaken, there are several important conclusions to bear in mind when considering the use of the CIT system for corporate behavioural control.

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[280] Id.

[281] *See* id. at 410 (Yorio notes that a tax incentive may stimulate excessive production of a tax-favoured good or service and/or stimulate their excessive consumption, causing a misallocation of resources and a decline in overall utility. Further, due to its application across the board for all taxpayers, a tax incentive may provide benefits that greater than those required to accomplish the government's objective). *See also* discussion *supra* at pg. 53ff.

[282] *See* FRIESE, et al., *Taxation and Corporate Governance - The State of the Art, supra* note 169, at 393-395 ("[A] lack of transparency can ... be brought forward against tax provisions as regulative tools. Direct regulation has a much more visible impact [.]"); EDWARD YORIO, *supra* note 277, at 421 ("[T]ax expenditures are more likely to escape rigorous cost-benefit analysis than direct subsidies.").

[283] *See* reaching similar conclusions BIRD, *Why Tax Corporations?, supra* note 131, at 12 ("There is no obvious reason why taxes and tax reliefs should be excluded from the set of policy implements that governments use to achieve their various distributive and allocative goals. Of course, such policies may entail costs and may fail to achieve their goals, but tax policies are no different from others in these respects, and it seems unreasonable, and indeed nonsensical, to expect any government to take a vow of non-interference."); SCHOLES, et al., Taxes and Business Strategy: A Planning Approach, *supra* note 114, at 21 ("We can make the tax system simple only if we abandon using it as a means of achieving desired social policies....but...it is not obvious that these tax rule changes are desirable, since the alternative means of implementing policy may well be both more costly and less effective."); GEORGE MUNDSTOCK, *Taxation of Business Intangible Capital*, 135 U. Pa. L. Rev. 1179 (1987) at ft. 14 ("[T]here is no reason, per se, to believe that a slight reduction in the tax system's effect on behaviour will increase efficiency.").

First, the use of CIT law for behavioural intervention should only occur when direct subsidies are not a better option.[284] In many cases, direct subsidies should have a higher targeting potential and lower associated transaction costs. Further, the use of Behavioural Control Instruments may produce significant non-intended negative consequences and, due to the several variables that condition their application, may be subject to a considerable degree of uncertainty regarding their intended behavioural effects.

Second, if considered that in a specific situation tax intervention may be more adequate than direct subsidies, the introduction of Behavioural Control Instruments should be as effective as possible. That is, tax intervention should achieve the desired behavioural effects with as few associated distortions and costs as possible. Although there are certain variables that are outside the control of the legislator, such as the present and expected tax position of the taxpayer, the legislator has a certain degree of control over others. Specifically, the introduction of Behavioural Control Instruments should take into consideration:

a. The tax provision's degree of continuity. The degree of continuity of the tax law is directly dependent on how the tax system faces the line-drawing problem. As discussed, when line-drawing is too discontinuous, a minor change in transactional form may result in a substantially different tax result. Therefore, a discontinuous law may make the Behavioural Control Instruments relatively or totally ineffective. Discontinuity in tax law may arise due to several elements, namely its excess of formalism or an excessively rule-based tax law. For this reason, for CIT law drafting it remains important to push in the direction of line-drawing based on economic reality, and to favour the use of standards or rules backed up by general anti-abuse provisions.

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284 In the same sense *see* EDWARD YORIO, *supra* note 277, at 422 ("The critical issue is not whether tax expenditures are occasionally inefficient, but whether in a particular case a tax expenditure would be more or less inefficient than a direct subsidy in accomplishing the government's objective."). Note, however, that some commentators defend that no governmental intervention should occur, independently of whether it takes the form of tax benefits or direct subsidies. The basic argument tends to be couched in terms of government failure (*i.e.,* governmental intervention is vulnerable to failure due to factors such as imperfect information, market distortions, etc). *See, e.g.,* JULIAN LE GRAND, *The Theory of Government Failure*, 21 British Journal of Political Science 423 (1991). Although there is merit to this line of argument, leaving the market by itself is also no better option since market failures should also naturally occur. Obviously, this denotes a clear political option defending the role of the state as regulator in the economy.

b. The importance of tax law restrictions and the affirmative use of non-tax law frictions. Tax law restrictions are an important instrument at the reach of the legislator to dissuade substitution. For example, a tax law requiring the investor to assume a certain level of risk or to personally participate in an activity in order to use a transaction or structure often dissuades substitution. Further, non-tax law frictions work as a powerful deterrent to the substitution of transactions. While the taxpayer's business preferences are outside the control of the legislator, the interaction of tax law with other regulatory fields is an area that presents significant potential for behavioural control. In particular, it is important to analyze the interaction of Behavioural Control Instruments with the frictions imposed by other regulatory fields, and, wherever possible, make an affirmative use of them.[285]

c. Focus on corporate-level intervention and avoid shareholder-level intervention. As discussed, the introduction of Behavioural Control Instruments at the corporate-level should allow for more efficient behavioural targeting than at the shareholder-level. Intervention at the shareholder level induces corporate behaviour indirectly and has a more limited quantity of behavioural instruments available. Further, by avoiding entering into the corporation-shareholder relationship to encourage or discourage a certain conduct, CIT law avoids creating potential agency problems.

d. As the corporate tax rate increases, the incentive to substitute should also increase. That is, the higher the benefit the taxpayer may have from substituting a transaction in the form of a reduced tax bill, the greater the interest in finding an alternative transactional route to substitute the transaction. Thus, the tax legislator should privilege taxation using broad tax bases with low corporate tax rates.

e. A firm's organizational design may impact the way it reacts to the tax rules. For instance, the flexibility of a business entity to restructure its internal ownership may give it an increased flexibility to substitute. As will be discussed, this phenomenon is especially acute with corporate groups in that the ability to make use of the corporate veil of its affiliates, and the potential to more easily structure complex internal transactional flows, gives them a wide flexibility for substitution in light of the nature of the CIT law. Thus, as will be further discussed below, CIT law should

[285] *But see infra* discussion on problems of using non-tax law frictions at pg. 76.

privilege a non-uniform approach to taxation and design provisions properly adapted to the economic and legal nature of the entity at hand.[286]

f. Short carryover periods may lead to higher distortionary behaviour. In the cases of substantial expiring tax attributes, the taxpayer may change the timing of transactions or even implement transactions whose sole purpose is to take advantage of those tax attributes. Thus, in order to avoid distorting taxpayer decisions, the tax legislator should privilege long carryover periods for tax attributes.

g. Take into consideration the pre-existing distortions of the playing field, namely those resulting from adoption of a CIT system and market forces. CIT interventions occur in a distorted playing field, not only due to natural market imperfections, but because the adoption of a CIT system produces necessary economic and regulatory consequences. A good knowledge base and better understanding of such consequences is required to introduce more effective Behavioural Control Instruments.

Finally, *pursue economic-biased policies under these limitations but eliminate corporate governance-biased intervention and be mindful of potential indirect corporate governance implications of economic-biased policies.* To use Behavioral Control Instruments to directly pursue both economic-biased objectives and corporate governance-biased objectives would lead to a tax law of daunting complexity and, based on the analysis undertaken, would with great probability result in interaction problems between the two types of intervention. For this reason, this thesis proposes that Behavioral Control Instruments directly pursue only economic-biased objectives. This option to privilege economic-biased objectives for direct intervention is based on the fact that while the use of Behavioral Control Instruments may, subject to the limitations discussed above, pursue certain economic-biased objectives with relative accuracy, in most cases that does not occur with the pursuit of corporate governance-biased objectives. In most cases tax law is simply not sophisticated enough to pursue such kind of objectives.[287]

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[286] *But see infra* discussion on certain drawbacks of non-uniform approach at pg. 75.

[287] *See e.g.,* FRIESE, et al., *Taxation and Corporate Governance - The State of the Art, supra* note 169, at 393-395 ("[I]t is difficult to link the tax measures to specific fact patterns that allow a differentiation between beneficial and harmful behaviour. Furthermore, the analyzed measures tend to have uncertain effects and to pursue conflicting interest…Tax rules are generally not sophisticated enough to reflect whether or not a certain

Thus, as far as corporate governance is concerned, CIT's role should be restricted to ensuring that its provisions, namely those resulting from economic-biased intervention, do not result in indirect negative corporate governance implications,[288] and to profiting from the corporate governance advantages that naturally result from its mere existence. As discussed, the implementation of a realization-based tax system through a corporate-level tax should have as an offshoot certain regulatory consequences that, for the most part, consist of policing corporate malfeasance, namely, the Reliability Effect (*i.e.,* control of company's accounts) and the Deterrent Effect (*i.e.,* control of management's wrongdoing). This, plus the attention to indirect corporate governance effects of economic-biased policies, should be as far as tax should go on this issue. As a rule, CIT law should abstain from direct and purposeful action on corporate governance matters.

C. A New Policy Approach

1. *A New Policy Approach to CIT*

As the analysis has demonstrated, the design and operation of the CIT system remains subject to several constraints and distortions. Thus, to simply look at how far a certain policy is from optimality in order to determine whether an incremental improvement occurs may be insufficient. As explained under the theory of the second-best, the introduction of an improvement towards optimality will not necessarily result in an overall improvement if the underlying context is itself imperfect.[289] Therefore, to determine whether a proposed reform moves us closer to the Haig-Simons ideal, or, by that matter, any other normative tax policy ideal, may not be sufficient to ensure a successful incremental change to CIT.[290] By the same token, the application of optimal tax research

conduct is actually detrimental to the companies' interest [.]"); id. ([T]ax provisions are in most cases not suitable for influencing corporate governance [.]"). *See also* BANK, *Dividends and Tax Policy in the Long Run, supra* note 163, at 572 ("[A]ttempting to resolve corporate governance concerns through tax changes may be futile or even counterproductive.").

288 In a similar sense *see* FRIESE, et al., *Taxation and Corporate Governance - The State of the Art, supra* note 169, at 365 ("[T]ax rules should in principle be drafted in a way that ensures that they do not encourage behaviour of management that is in conflict with the interests of the shareholders or the company itself[.]"); id. at 393-395 ([R]ather than ineffectively attempting to influence management conduct by tax norms the legislator should eliminate provisions of the tax system that allow the management to act without control of the shareholders when control of the management behaviour seems necessary."); OWENS, *The Interface of Tax and Good Corporate Governance, supra* note 116, at 768 ("[It is important to ensure] that tax rules do not encourage behaviour that is contrary to the interest of the company and/or its shareholders.").

289 For the theory of the second best *see* R.G. LIPSEY & KELVIN LANCASTER, *The General Theory of Second Best*, 24 Rev. Econ. Stud. 11 (1956).

290 In the same sense *see* DEBORAH H. SCHENK, *An Efficiency Approach to Reforming a Realization-Based Tax*; *supra* note 55, at 519 ("In a second best world...it makes no sense to focus on whether a particular reform moves

may be insufficient to ensure a successful incremental change.[291] In sum, based on the analysis undertaken, to simply look at how far we are from optimality may be insufficient to ensure an incremental improvement.

For that reason, the path this thesis proposes to determine whether incremental improvements are indeed improvements consists in *looking for more efficient tax solutions and, then, go further by identifying the distortions and their interactions associated with the operation of the CIT system, and factor them into tax policy analysis.*[292]

For this purpose, this thesis defines efficiency as the minimization of transaction costs and other sources of deadweight loss. Following Shaviro, this includes the minimization of substitution effects (*i.e.,* changes in taxpayer decisions or behaviour due to the tax system) and tax overhead costs (*i.e.,* the amount of resources, including the value of time or labour, consumed in applying the tax system, through taxpayer or government activities such as tax planning, compliance, litigation, administration, and law-making).[293] Based on the analysis

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us closer to a normative definition of income since that approach contributes nothing helpful in determining whether a reform is warranted"). *See also* WEISBACH, *Line Drawing, Doctrine, and Efficiency in the Tax Law, supra* note 17, at 1628 ("[T]raditional tax policy concerns, such as whether something is 'income' within the Haig-Simmons definition, are neither helpful nor relevant to most disputes."); LEVMORE, *Recharacterizations and the Nature of Theory in Corporate Tax Law, supra* note 19, at 1061 ("The nature of corporate tax law defies normative argumentation.").

291 This is because of the limitations of its theoretical models, which usually depart from the assumption of perfect markets and no externalities. Further, the application of the existing optimal tax research has not yet focused appropriately on CIT issues. In particular, the impact on behaviour and utility of CIT is still fairly unknown. Also, CIT is strongly determined by administrative and compliance issues, an issue generally not explored by optimal taxation due to difficulty to model these items. *See* C. HEADY, *Optimal Taxation as a Guide to Tax Policy: a Survey,* 14 Fiscal Studies 1 (1993). *But see* Slemrod's theory on optimal tax systems, JOEL SLEMROD, *Optimal Taxation and Optimal Tax Systems,* 4 Journal of Economic Perspectives 157 (1990) at 158 ("[The theory of optimal tax systems] embraces the insights of optimal taxation but also takes seriously the technology of raising taxes and the constraints placed upon tax policy by that technology. A theory of optimal tax systems has the promise of addressing some of the fundamental issues of tax policy in a more satisfactory way than the theory of optimal taxation.").

292 On the defence of efficiency as the most appropriate way to deal with tax issues *see, e.g.,* CUNNINGHAM & SCHENK, *The Case for a Capital Gains Preference,* supra note 55, at 370-72 ("In [a second best] world, efficiency is the touchstone."); DAVID A. WEISBACH, *An Efficiency Analysis of Line Drawing in the Tax Law, supra* note 202, at 74 ("Doctrinal issues of the sort that tax policy makers face on a daily basis can and should be grounded in efficiency."); DEBORAH H. SCHENK, *An Efficiency Approach to Reforming a Realization-Based Tax, supra* note 55, at 519 ("Since any reform will result in treating some equals equally and some differentially, efficiency should control."). As previously discussed, this thesis identifies the distortions and their interactions associated with the operation of the CIT system through an interdisciplinary and evaluative approach. *See supra* pg. 15.

293 The definition of efficiency for purposes of this thesis is based on the work developed by Dan Shaviro. *See* SHAVIRO, *An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax, supra* note 4, at 4 ("The efficiency norm that I use is that of minimizing excess burden, or the deadweight loss generated by the tax system."); id. at 24 ("The standard tax efficiency norm of minimizing excess burden implies two principal objectives. The first is minimizing substitution effects, or changes in taxpayer decisions or behaviour due to the tax system. The second is minimizing ...the amount of resources ...consumed in applying the tax system [.]"). *See also* WEISBACH, *Formalism in the Tax Law, supra* note 13, at 870 ("Efficiency in the tax law is measured by whether the law raises revenue without creating adverse incentives."); HARVEY S. ROSEN, Public Finance (McGraw-Hill/Irwin 6th ed. 2001) at 284-303 (noting that a tax is efficient if it raises revenue with a

undertaken, this thesis proposes that this efficiency objective may be pursued, among other means, by looking for the tax treatment best aligned with the particularities associated with the nature of each category of business entities.[294] There are a number of classification criteria that could be used for this purpose, such as firm maturity or corporate structure. This thesis will focus on corporate structure.

In addition, in order to adequately factor into the analysis the different distortions and their interactions associated with the operation of the CIT system the following guidelines should be observed:

- As a general rule, the use of the CIT system to implement policy objectives other than raising cash should be minimized;

- Take into consideration the pre-existing distortions of the playing field, including the Structural Distortions, market imperfections, and the regulatory effects of the CIT system;

- Focus on corporate-level intervention and avoid shareholder-level intervention;

- Ensure that the tax intervention does not result in indirect negative corporate governance implications and profit from the corporate governance advantages that naturally follow from CIT's existence. In this regard, the elimination of transaction costs and other sources of deadweight loss should be pursued only when it does not adversely affect CIT's regulatory functions. Otherwise, when regulatory functions are at stake, go through a cost-benefit analysis before eliminating transaction costs and other sources of deadweight loss;[295]

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minimum of behavioural distortions and other sources of deadweight loss). As may be noted, tax scholars often use efficiency in a manner different from that used by law and economics scholars, who generally refer to Pareto efficiency or Kaldor-Hicks efficiency. *See* DEBORAH H. SCHENK, *An Efficiency Approach to Reforming a Realization-Based Tax*; *supra* note 55, at 507.

[294] This suggestion is added to the traditional advices of using standards for CIT law drafting and privilege broad tax bases in CIT design.

[295] *See* DAVID M. DRIESEN & SHUBHA GHOSH, *The Functions of Transaction Costs: Rethinking Transaction Cost Minimization in a World of Friction*, 47 Ariz. L. Rev. 61 (2005) at 103 ("If a particular transaction cost serves no function at all, it constitutes waste and deserves elimination.").

- To the extent consistent with the tax policy objectives, minimize the negative impact of tax rules on the operation of business entities. This requires that the objectives and needs of business entities are adequately taken into consideration in the process of policy design;

- Favour long carryover periods for tax attributes; and

- Analyze the interaction of the CIT system with the frictions imposed by other regulatory fields and consider the possibility of making an affirmative use of such frictions.

Lastly, following the efficiency standard above, this thesis is not concerned with equity issues. Following other commentators, this thesis believes that equity issues may be better dealt with at the shareholder's level, *i.e.,* with personal income taxation rules or, alternatively, with adjustments to the CIT rate structure (*i.e.,* different tax rates applicable to different classes of corporate taxpayers).[296]

2. *Issues raised by the New Policy Approach*

This thesis argues that the design of tax rules properly adapted to the specific nature of each category of business entities should minimize the deadweight loss associated with the CIT system and more effectively control the collateral effects of the tax rules on the operation of the firm. The consequences of adopting this type of non-uniform approach to corporate taxation remain an important point to consider.

A uniform taxation system, *i.e.,* a sole tax system for all types of business entities ignoring their maturity or corporate structure, has some considerable advantages.[297] Fundamentally,

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[296] *See* DEBORAH H. SCHENK, *An Efficiency Approach to Reforming a Realization-Based Tax*, *supra* note 55, at 519 defending that efficiency should be privileged in a second-best world ("Whether horizontal equity has any meaning in designing a tax system, it has far less meaning in a second-best world. That is because it is impossible to tax equals equally where there is a deviation from the base that cannot be eliminated (in this case, the realization rule). Therefore it is very difficult to say whether any change in a second-best world promotes the equal treatment of equals. Since any reform will result in treating some equals equally and some differentially, efficiency should control."). *See also* DAVID A. WEISBACH, *An Efficiency Analysis of Line Drawing in the Tax Law*, *supra* note 202, at 74 (defending that decisions regarding redistribution should be left for adjustments to the rate structure).

[297] A tax system may also approach the taxation of types of income in a uniform or non-uniform basis. Specifically, the tax system may tax income in a uniform manner by imposing the same rules on all income;

a uniform corporate tax system covering all different types of business entities should eliminate differential tax rates between investment vehicles, and, by this token, minimize the tax distortions on taxpayer behaviour in the selection of investment vehicles. Although this type of approach to taxation has a strong intuitive appeal, research has demonstrated that it should not produce economically efficient results.[298] Further, this type of approach may not be simpler since complexity may arise from the lack of specific guidance in the tax rules. Whether such system works remains in dispute. Finally, timing and income characterization issues would remain, and, thus, most of CIT's complexity should remain unchanged.

Conversely, the design of a CIT system with differing structural rules for different business entities should allow for a higher adaptability of the tax system to the nature of the economic actor and, thus, as will be demonstrated, contribute to the reduction of deadweight loss.[299] That is, a non-uniform tax system allows for a better adaptability of the tax law to the underlying economic and business reality of the real world of transaction costs, information asymmetries and agency costs.[300] However, it does raise some important issues. Specifically, it may involve significant interaction costs due to the body of rules that are necessary for the different tax regimes to interact with each other and ensure that by making hybrids of different regimes, taxpayers do not distort their original policy intent.[301]

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tax certain types of income differently by having rules for determining the amount of income subject to tax that vary by the source of income or tax certain types of income differently by applying varying tax rates to the income. *See* ERIC M. ZOLT, *The Uneasy Case for Uniform Taxation*, 16 Va. Tax Rev. 39 (1996) at 52. This issue, however, is not directly relevant for our analysis and, thus, will not be directly explored here.

298 *See* id. at 60. *See also* id. at 44 ("A uniform tax system will produce optimal results only if certain heroic assumptions are satisfied: there are no externalities or other market imperfections, different types of income have similar elasticities, and the administrative costs in collecting and enforcing taxes do not vary by type of income.").

299 *See* id. at 60 ("Support for nonuniform taxes rests on at least three factors. First, efficiency gains may be obtained from nonuniform taxes because taxes distort and individuals react differently to taxes imposed on different sources of income. Second, nonuniform taxes may be desirable because they address market imperfections such as externalities. Third, administrative considerations may support nonuniform taxes.").

300 *See* id. at 108 ("[N]either economic theory nor equity considerations require uniform treatment...Efficiency gains arise because selective use of nonuniform taxes may reduce tax-induced distortions. ...Nonuniform tax rules may also be useful in addressing externalities or other market imperfections. Finally, administrative considerations may support different tax treatment for different types of income.").

301 Consider, for example, the serious interaction problems of the US Consolidated Return regime with the US regime for taxation of partnerships and disregarded entities. Broadly, US taxpayers take advantage of the tax rules for taxation of partnerships and disregarded entities in order to manipulate abusively the US Consolidated Return regime. *See, e.g.*, describing several planning strategies, TERRILL A. HYDE, et al., *The Use of Partnerships and LLCs in Structuring Consolidated Groups in* Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings (Practising Law Institute ed. 2005); BRYAN P. COLLINS, et al., *Consolidated Return Planning and Issues Involving Disregarded Entities, in* Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings (Practising Law Institute ed. 2005). As Weisbach notes, "the more complex tax law gets, the greater the number of interactions among the rules and the more complex the law must be.

Furthermore, several tax regimes create an incentive for tax planning and may induce potential distortions on the choice of investment vehicle and organizational structure. Despite these drawbacks, in light of the very significant advantages associated with this type of approach, this thesis will follow a non-uniform approach to CIT design with regard to business entity categories.[302]

Further, this thesis recommends an affirmative use of non-tax law frictions in tax policy. However, the legislator should be aware that the use of frictions has associated costs. In particular, in order to make an affirmative use of frictions, the legislator will need to incur information-gathering costs in order to familiarize itself with the details of the other regulatory areas that may be used as frictions (*e.g.,* corporate law, accounting, etc.).[303] In addition, it must consider whether the particular friction at stake has the potential to block all possible avoidance strategies that may be devised by the taxpayer, not just the particular transaction under analysis.[304] Further, there are certain *ex post* costs associated with the use of frictions. Since all regulatory areas are generally subject to change, the legislator will need to track legislative changes to know that the friction at stake remains valid, *i.e.,* that the provisions at stake remain in full force and effect.[305] Finally, the legislator should be aware that, just like Behavioural Control Instruments, frictions have the potential to be underinclusive or overinclusive and they may spawn negative distributional effects since certain taxpayers may be more able than others to avoid that particular friction.[306]

This thesis will now apply this proposed policy approach to study the taxation of corporate groups. The following section will start by analyzing the fundamental economic, legal and functional characteristics of corporate groups. Based on such analysis, this thesis will then identify the problems that may arise when groups are taxed under the Standard CIT System.

The number of interactions is approximately proportional to the square of the number of rules." WEISBACH, *Formalism in the Tax Law, supra* note 13, at 871.

302 In a similar sense *see* ALAN J. AUERBACH, et al., *Taxing Corporate Income, supra* note 49, at 867 ("[The] heterogeneity in behavioural responses suggests a need for flexibility in the design of tax reforms ... to allow treatment to vary among firms and individuals according to circumstances."). *See also* BANK, *Dividends and Tax Policy in the Long Run, supra* note 163, at 572.

303 *See* DEBORAH H. SCHENK, *An Efficiency Approach to Reforming a Realization-Based Tax; supra* note 55, at 515-516; SCHIZER, *Frictions as a Constraint on Tax Planning, supra* note 16, at 1334-1337.

304 Id.

305 *See* DEBORAH H. SCHENK, *An Efficiency Approach to Reforming a Realization-Based Tax; supra* note 55, at 514; SCHIZER, *Frictions as a Constraint on Tax Planning, supra* note 16, at 1334-1337.

306 *See* SCHIZER, *Frictions as a Constraint on Tax Planning, supra* note 16, at 1334-1337.

A. The Nature of Corporate Groups

This thesis argues that the design of tax rules properly adapted to the specific nature of each category of business entities should minimize the deadweight loss associated with the CIT system and more effectively control the collateral effects of the tax rules on the operation of the firm. Based on this insight, the purpose of the following sections is to examine the economic, legal and functional nature of corporate groups in order to subsequently identify the potential sources of deadweight loss and other collateral effects that may arise when corporate groups are taxed under the Standard CIT system.

1. *The Economic Nature of Corporate Groups*

This section will examine the distinction between firm and market in economic literature, and will assess the extent to which such distinction may be applicable to characterizing the internal economic dynamic of corporate groups.

a. Beyond the Classic Distinction of Firm and Market

The original distinction between the firm and the market as governance structures dates back to Coase's seminal work "The Nature of the Firm."[307] The Coasean insight is that firms exist in those situations where the market is inefficient due to its implicit operational costs.[308] Coase suggests that by forming a firm and allowing the "entrepreneur" to direct its resources, these costs may be reduced or, in some cases, eliminated.[309] Accordingly, under

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[307] *See* R. H. COASE, *The Nature of the Firm*, 4 Economica 386 (1937). *See also,* for further development, OLIVER E. WILLIAMSON & SIDNEY G. WINTER, The Nature of the Firm: Origins, Evolution, and Development (Oxford University Press. 1993).

[308] These costs include the costs of finding the most competitive supply price or of negotiating and writing enforceable contracts for each exchange transaction. Id.

[309] This is fundamentally because of the firm's efficiency to cope with market uncertainties. Specifically, since in an uncertain world not all eventualities can be foreseen, contracts are necessarily incomplete and need to be re-negotiated from time to time. Instead, in the firm, the entrepreneur may "acquire the legal rights of all the parties" and the rearrangement of activities may be operated not on the basis of "a rearrangement of rights by contract, but as a result of an administrative decision as to how the rights should be used." This replacement of a series of market contracts with a sole, broad contract for each factor results in more flexibility and, therefore, better ability to deal with uncertainty. This, in turn, results in reduction of transaction costs. *See* R. H. COASE, *The Nature of the Firm*, *supra* note 307, at 400.

the classical Coasean theorem, a firm will arise whenever the internal organization of transactions allows for the reduction of market costs.[310]

This crucial insight has been developed by subsequent researchers.[311] In particular, Williamson notably synthesized the reasons for market failure in the formula of "bounded rationality, opportunism, and asset specificity."[312] Broadly, Williamson suggests that whenever an asset is highly specific its value will be significantly reduced if it is put to uses other than those for which it is suited. Consequently, a supplier that invests in a highly specific asset to satisfy its client demands will be effectively "locked into" a transaction. Similarly, a buyer engaged in an asset specific transaction will face significant difficulties to obtain alternative sources of supply on favourable terms. This contractual dependency is problematic in that, due to the behavioural characteristics of the economic agent (*i.e.,* opportunism and bounded rationality), it presents very strong inducements to opportunism. Indeed, the party with the strongest bargaining power can easily (and often will) profit of the weakest party's dependence on the contractual relationship.

Williamson argued that if all these three conditions are present in a transaction, then the costs they impose may mean that the standard market mechanism of free exchange cannot operate efficiently.[313] According to Williamson, it is within these situations that the firm as a governance structure usually steps in due to its superior organizational and control characteristics.[314] Specifically, Williamson suggests that "*classical market contracting* will be

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310 R. H. COASE, *The Nature of the Firm: Meaning, in* The Nature of the Firm: Origins, Evolution and Development (Oliver E. Williamson & Sidney G. Winter eds., 1993) at 48.

311 *See, e.g.,* A. ALCHIAN & H. DEMSETZ, *Production, Information Costs and Economic Organization*, 62 American Economic Review 777 (1972) (analysis of hierarchy as a coordinating mechanism) and B. KLEIN, et al., *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 Journal of Law and Economics 297 (1978) (developing notion of contractual incompleteness as basis for the comparative advantage of the firm in relation to the market).

312 *See* OLIVER E. WILLIAMSON, The Economic Institutions of Capitalism (Free Press. 1985). *See also* OLIVER E. WILLIAMSON, Markets and Hierarchies: Analysis and Antitrust Implications: a Study in the Economics of Internal Organization (Free Press. 1975).

313 Id. at 30-32.

314 This advantage of the firm derives from its more diverse and sensitive control mechanisms for enforcing internal activities. Specifically, not only does the firm have a more economical and lawful access to the information required to perform more accurate own-performance evaluations than can a buyer, but its incentive and penalty instruments are more refined. *See* OLIVER E. WILLIAMSON, Corporate Control and Business Behavior (Englewood Cliffs. 1970). *But see* H. DEMSETZ, *The Theory of the Firm Revisited, in* The Nature of the Firm: Origins, Evolution and Development (Oliver E. Williamson & Sidney G. Winter eds., 1993) (Demsetz is not persuaded that asset specificity has the explanatory power that Williamson ascribes to it). *See also* NEIL KAY, *Corporate Governance and Transaction Costs, in* Corporate Control and Accountability (Sol Picciotto ed. 1993) (Kay argues that Williamson's approach makes it difficult to deal with issues such as domestic or international diversification involving horizontal expansion and economies of scope); C. N. PITELIS, *Transaction Costs and the Historical Evolution of the Capitalist Firm*, 32 Journal of Economic Issues 999 (1998) (Pitelis also identifies certain theoretical flaws in transaction costs analysis).

efficacious wherever assets are non-specific to the trading parties; *bilateral or obligational market contracting* will appear as assets become semi-specific; and *internal organization* will displace markets as assets take on a highly specific character."[315]

That is, Williamson claims that there are several institutional arrangements available to govern transactions between economic agents and that each of them is designed in response to a specific set of transactional considerations with the objective to minimize the overall cost of implementing transactions. Importantly, beyond the two primary institutional arrangements for resource allocation, the firm and the market, Williamson suggests that a range of "hybrid" organizational structures of "*bilateral or obligational market contracting*" may be devised and implemented whenever deemed more efficient as transaction-cost-economizing governance structures. Thus, in the same way that market transactions assume a multitude of forms, ranging from simple spot market transactions to complex long-term contracts, firms can adopt governance structures that put together different blends of hierarchy and contract principles depending upon the transactional considerations at stake. As Williamson noted, "there are a variety of distinguishable different transactions on the one hand and a variety of alternative governance structures on the other. The object is to match governance structures to the attributes of transactions in a discriminating way,"[316] that is, in a transaction-cost-economizing way.

This comparative institutional perspective is fundamental to grasp the nature of the corporate group. As will be demonstrated, the corporate group is essentially a "hybrid" of market and organization, contract and hierarchy, or better, "an organized market...which replicates within its internal boundaries the structures of both firm and market."[317] Thus, this theoretical perspective sheds light on the nature of the corporate group as a specific institutional arrangement which has been designed under a precise set of transactional considerations with the aim of efficiently minimizing the overall costs of implementing transactions. The thesis will now inquire into the nature of these transactional considerations.

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[315] *See* OLIVER E. WILLIAMSON, *The Modern Corporation: Origins, Evolution, Attributes*, 19 The Journal of Economic Literature 1537 (1981) at 1548, emphasis added.
[316] Id. at 1544. *See also* OLIVER E. WILLIAMSON & INTERNATIONAL CENTER FOR ECONOMIC GROWTH, Comparative Economic Organization: the Analysis of Discrete Structural Alternatives (ICS Press. 1994).
[317] *See* GUNTHER TEUBNER, *Unitas Multiplex: Corporate Governance in Group Enterprises*, *in* Regulating Corporate Groups in Europe (D. Sugarman & G. Teubner eds., 1990) at 82; s*ee also* GUNTHER TEUBNER, *The Many-Headed Hydra: Networks as Higher-Order Collective Actors*, *in* Regulating Corporate Groups in Europe (D. Sugarman & G. Teubner eds., 1990).

b. Unitary Economic Direction and Organized Internal Markets

Corporate group members submit to a unitary business policy.[318] This unitary business policy, which covers most business areas (including marketing, production and sales, research and development, financial and labour policy), submits group members to a global business strategy whereby assets, profits and personnel are transferred to those affiliates where the return on capital is highest (for comparable risks).[319] This allocation of the overall group resources to those members that can earn the highest rate of return has two crucial - and interrelated - consequences to the group. First, it allows the group to maximize its overall profitability (since its resources are always being put to their highest economic use) and, second, it generates a competitive market dynamic among its constituency.[320]

The internal economic dynamic that results from the interaction of these two phenomena gives the corporate group the characteristics of an "internal" or "organized" market.[321] That is, the different operating units of the corporate group effectively compete against each other for communal group resources in a struggle coordinated by the price mechanism: each corporate member must provide to the collective entity the highest possible return on a specific resource to keep it. However, this competition does not have the same characteristics of the one found in the open market. In the "organized internal market,"[322] the collective interest is also present. Thus, an individual unit may compete with other group members only up to the point in which its individual interests collide with the collective interest of overall profit maximization. In addition, although quasi-market principles dictate the location of group resources, it is the hierarchical decision of the headquarters that effectively allocates them to the individual group member.

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318 *See* RICHARD CAVES, Multinational Enterprise and Economic Analysis (Cambridge University Press 2nd ed. 1996); DEREK F. CHANNON & MICHAEL JALLAND, Multinational Strategic Planning (Macmillan. 1978); MICHAEL BROOKE & H. LEE REMMERS, The Strategy of Multinational Enterprise (Pitman 2nd ed. 1978); PHILLIP BLUMBERG, The Law of Corporate Groups - Problems of Parent and Subsidiary Corporations under Statutory Law of General Application (Little. 1989); TOM HADDEN, *Inside Corporate Groups*, 12 International Journal of the Sociology of Law 271 (1984).

319 Id.

320 Id. *See also* TEUBNER, *The Many-Headed Hydra: Networks as Higher-Order Collective Actors,* supra note 317.

321 *See* TEUBNER, *Unitas Multiplex: Corporate Governance in Group Enterprises*, *supra* note 317, at 82 (The modern corporate group is "an organized market...which replicates within its internal boundaries the structures of both firm and market.").

322 This thesis has adopted this terminology since it considers that it better encapsulates the internal economic dynamics of modern corporate groups.

c. The "Chameleon-like" Governance Structure

In order to ensure the constant maximization of overall profits in the "organized internal market," the corporate group possesses a mechanism of self-regulation and control, based on the "double orientation" of the actions of its members. That is, in the context of a group, "individual actions...are simultaneously and cumulatively oriented both to the common goal and to the individual goals of the members"[323] with "no normative primacy of one orientation or the other."[324] As a consequence of the absence of a higher ranking guiding principle, the pondering of a corporate member's "dual-oriented" action will always involve a certain degree of decision-making subjectivity.

In this subjective process of pondering decisions according to equally ranking individual and collective interests lies the main mechanism of the corporate group for self-regulation and self-control. That is, the subjective balance of interests operated in each individual decision of group members allows the group, as a collective whole, to constantly control its constituent parts (in that incentives or disincentives may be introduced through discriminate decision-making) and to continually adapt itself to the outside environment (in that each corporation may alter the overall internal dynamic of the group through the balance of interests it introduces in each action that it takes). Thus, this internal decision-making system turns the corporate group into a "multi-stable" enterprise with an ever changing internal governance structure. [325]

Due to the action of this decision-making system, the corporate group's governance structure may assume an indeterminate variety of forms and characteristics, depending on the blending of market and hierarchy, contract and organization, strategically implemented at each moment. In particular, research demonstrates that there may be significant variation in management policies, subject to factors such as the group's size,[326] industry sector,[327] organization of production lines,[328] or degree of diversification.[329] By the same token,

[323] *See* TEUBNER, *The Many-Headed Hydra: Networks as Higher-Order Collective Actors, supra* note 317, at 50.
[324] Id. at 51.
[325] *See* TEUBNER, *Unitas Multiplex: Corporate Governance in Group Enterprises, supra* note 317, at 84.
[326] *See* JOSÉ ENGRÁCIA ANTUNES, Liability of Corporate Groups: Autonomy and Control in Parent-Subsidiary Relationships in US, German and EU Law (Kluwer Law. 1994) at 191-208.
[327] *See* W. EGGELHOFF, *Patterns of Control in US, UK and European Multinational Corporations*, 15 J. Int. Bus. Studies 73 (1984). *See also* BROOKE & REMMERS, The Strategy of Multinational Enterprise, *supra* note 318.
[328] *See* ROBERT J. ALSEGG, Control Relationships Between American Corporations and Their European Subsidiaries (American Management Association. 1971) (In general, groups organized along product lines

factors such as the nationality of parent and subsidiary,[330] the subsidiary's size,[331] overall performance and age,[332] the legal and economic characteristics of the parent-subsidiary relationship[333] or the group's economic, social and legal environment,[334] may also affect the management policies. Thus, as a general rule, fixed characteristics of management policies may be found only in the very limited realm of a concrete parent-subsidiary relationship and a concrete business decision of an individual corporate member.[335]

In sum, the internal economic dynamics of corporate groups lies beyond the traditional distinction of firm and market insofar as they remain a hybrid of the firm and the market (*i.e.,* an "organized internal market"). In this "organized internal market," the open transferability of assets and income between group members guarantees that the group's resources are constantly being put to their highest economic use and, thus, ensures the economic viability of the corporate group. In order to ensure the constant maximization of overall profits in the "organized internal market," the corporate group possesses a mechanism of self-regulation and self-control based on the double orientation of the actions of its members. Due to this internal decision-making system, the corporate group's governance structure may assume an indeterminate variety of forms and characteristics, depending on the blend of market and hierarchy, contract and organization, strategically implemented at each moment. Thus, as a general rule, fixed characteristics of management policies may be found only in the very limited realm of a concrete parent-subsidiary relationship and a concrete business decision of an individual corporate member.

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generally retain greater central authority over decisions on key personnel; by comparison, those organized along geographical lines are a federation of corporations with a high degree of local autonomy).

329 *See* JOSÉ ENGRÁCIA ANTUNES, *supra* note 326, at 191-208.

330 *See* A. NEGHANDI & MARTIN WELGE, Beyond Theory Z: Global Rationalisation Strategies of American, German and Japanese Multinational Companies (JAI Press. 1984) (There is evidence that significant variations in management policies may occur depending on the country of location of the parent corporation, due to diverse management traditions, and of the subsidiary, due to factors such as country and political risk or capital market and supply conditions). *See also* ERRAMILLI, *Nationality and Subsidiary Ownership Patterns in Multinational Corporations*, 27 Journal of International Business Studies 225 (1996).

331 *See* D. CRAY, *Control and Co-Ordination in Multinational Corporations*, 15 J. Int. Bus. Studies 85 (1984).

332 *See* CHRISTOPHER TUGENDHAT, The Multinationals (Penguin. 1973) at 11.

333 The legal nature of the intercorporate control relationship may assume different forms, each with potentially different characteristics of decision-making centralization (wholly or majority-owned subsidiaries, joint ventures, contractual linkages such as licensing, subcontracting, management contracts, etc). Also, the economic interdependence between the components of the corporate group (often measured in terms of intercorporate flows of goods, services and capital) is generally considered to play a decisive role in the degree of decision-making centralization. *See* JOSÉ ENGRÁCIA ANTUNES, *supra* note 326, at 191-208.

334 *See* OECD, Structure and Organisation of Multinational Enterprises (OECD. 1987).

335 In this sense *see* JOSÉ ENGRÁCIA ANTUNES, *supra* note 326, at 191.

2. *The Legal Nature of Corporate Groups*

This section will examine the characteristics of the legal personality of a single corporation, how it is affected by intercorporate control and to what extent the concept of legal person may be extended to the corporate group.

a. The Distortions to the Legal Structure of a Corporation Introduced by Intercorporate Control

Under the classical corporate law paradigm, self-sufficiency and self-governing characterizes a corporation.[336] That is, the corporation, endowed with legal personality, exercises sovereignty over its decisions. As a self-sufficient and self-governed legal person, the corporation owns assets and liabilities and possesses organs which allow it to form its own will. However, the sovereign nature of the corporation is distorted when it is controlled by another corporate entity and, thus, submitted to an external (and potentially differing) interest.[337] In this situation, the controlled corporation may lose its status as a self-determined entity and become an entity subject to an alien hierarchical structure that favours a higher collective interest over its own.[338]

In particular, the existence of a unitary economic direction in the group (crucial for its existence as an "organized internal market") may relegate the particular economic interest of a subsidiary in support of the common objective of overall profit maximization. In addition, because a corporate group does not possess a formal organizational structure, and, thus, generally builds its structure using the organs of its members as if they were its own, intercorporate control tends to result in significant distortions to the original attributes of the corporation's organs. These distortions jeopardize the foundations of the corporation's legal personality.[339]

In particular, the main distortions to the corporation's organizational structure tend to occur at the level of the board of directors and the general meeting of shareholders. Basically, there is a dissipation of the legal powers of the general meeting of shareholders

336 *See* JOSÉ ENGRÁCIA ANTUNES, *supra* note 326, at 56-64. *See also* MELVIN EISENBERG, The Structure of the Corporation - A Legal Analysis (Little Brown. 1975); J. FARRAR, Company Law (Butterworths 4th ed. 1998).
337 Id.
338 *See* TEUBNER, *Unitas Multiplex: Corporate Governance in Group Enterprises*, *supra* note 317, at 82ff.
339 *See* JOSÉ ENGRÁCIA ANTUNES, *supra* note 326, at 64-80.

and an associated enhancement of the real powers of the board of directors.[340] In contrast to the classic corporate law paradigm where the general meeting of shareholders is the "supreme organ of the organizational hierarchy endowed with sovereign powers on major issues of corporate life," in an affiliated corporation the board of directors tends to be the core decision-making organ.[341] This "strengthened" board of directors acts strictly in accordance with the directives of the headquarters, and, thus, possesses a mere limited sovereignty over the corporation's decisions and existence.[342]

Thus, due to the group's unitary economic direction and to the group's "appropriation" of the corporation's organizational structure, the corporation that is a member of a corporate group possesses, in practice, only limited ownership rights over its assets (instead of an autonomous patrimonial endowment) and relies on organs of other group corporations for many of its decision-making capabilities (instead of relying on its autonomous organizational structure).[343] This distorts the foundations of the corporation's legal personality (*i.e.,* its capacity of action and its legal capacity),[344] and gives rise to a different type of property rights within the groups, the so-called "organizationally-bound" property rights.[345]

b. The Corporate Group as a Legal Person

As a consequence of the distortions introduced by intercorporate control, over the past decades, jurisprudence and legal doctrine have widely debated the possibility of attributing legal personality to the corporate group. In the courts, the discussion has usually revolved around the controversies of the so-called "disregard of the corporate entity" or "piercing the corporate veil" jurisprudence.[346] In the doctrine, the debate has centred on the

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340 Id.

341 *See* JOSÉ ENGRÁCIA ANTUNES, *supra* note 326, at 56-80. This organizational mutation is confirmed by theories on the evolution of the modern enterprise that describe it as a constellation of corporate sub-units whose direction and coordination is achieved through a hierarchical network headed by managers. *See* ALFRED D. CHANDLER, Strategy and Structure: Chapters in the History of American Enterprise (MIT Press. 1962) at 30. *See also* ALFRED D. CHANDLER, The Visible Hand: the Managerial Revolution in American Business (Harvard University Press. 1977) at 320; MELVIN EISENBERG, *The Legal Role of Shareholders and Management in Modern Corporate Decision-Making*, 57 Univ. Cal. L. Rev. 1 (1969).

342 *See* JOSÉ ENGRÁCIA ANTUNES, *supra* note 326, at 99-108.

343 Id.

344 Id.

345 See TEUBNER, *supra* note 317.

346 These jurisprudential approaches (in the UK and the US, respectively) operate on the basis of a rule-exception system: the courts start their analysis with the presumption that the separate legal personality of affiliate corporations is to be respected for all legal purposes and are only prepared to disregard this rule in the most exceptional cases and circumstances. *See* PHILLIP BLUMBERG, *The American Law of Corporate Groups*,

possibility of attributing legal personality to the corporate group based on its purported nature as a unitary enterprise.[347] Despite the strong jurisprudential and doctrinal debate, corporate groups have not been afforded formal legal personality.[348] Among the different obstacles to such personification, the issues of limited liability and international coordination of legal regimes remain most fundamental.[349]

Broadly, it is claimed that limited liability is a rule of allocation of risks and costs originally designed for the individual corporation,[350] which is significantly distorted by the phenomenon of intercorporate control.[351] Although it has been widely recognized that this distortion gives rise to significant negative consequences (due to the ability of the headquarters to ring-fence liability at the level of selected parts of its business),[352] it has been suggested that it constitutes a primary reason for the existence of corporate groups and, thus, that its elimination through the legal personification of corporate groups would seriously compromise the viability of these entities as business enterprises.[353] Additionally, it has been argued that the attribution of legal personality to corporate groups is not feasible in a world with national legal systems overwhelmingly resting on entity law.[354]

Due to these problems, legal analysis of corporate groups has concluded that "neither of the two simplest approaches to the legal status of corporate groups – the maintenance of

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in Corporate Control and Accountability (Sol Picciotto ed. 1993). *See also* F. WOOLDRIGE, Groups of Companies - The Law and Practice in Britain, France and Germany (Institute of Advanced Legal Studies. 1981).

347 *See* A. BERLE, *The Theory of Enterprise Entity*, 47 Columbia Law Review 343 (1947).

348 This is the rule in most jurisdictions. *See* JOSÉ IRUJO, *Trends and Realities in the Law of Corporate Groups*, 6 European Business Organization Law Review 65 (2005); *see also* D. SUGARMAN & GUNTHER TEUBNER, Regulating Corporate Groups in Europe (Baden-Baden. 1990); JOSÉ ENGRÁCIA ANTUNES, supra note 326; JANET DINE, The Governance of Corporate Groups (Cambridge University Press. 2000).

349 *See* JOSÉ ENGRÁCIA ANTUNES, *supra* note 326.

350 As Blumberg notes, "limited liability triumphed in the United States at a time when corporations lacked the power to acquire and hold shares of other corporations unless expressly granted by special statute or charter provision." PHILLIP BLUMBERG, The Multinational Challenge to Corporation Law: The Search for a New Corporate Personality (OUP USA. 1993), at 52. This has also been the rule in most other jurisdictions. *See* JOSÉ ENGRÁCIA ANTUNES, supra note 326.

351 Broadly, it is suggested that the limitation of the liability of the controlling shareholder has no justification on the basis of the lack of control over the corporation's business (*i.e.,* there is no separation between management and control). Id. *See also* ALFRED D. CHANDLER, *supra* note 341.

352 It is suggested that the ability of the headquarters to, in practice, affirmatively elect to ring-fence liability at the level of selected parts of its business, allows the headquarters to externalize beforehand the costs of potential risks associated with more risky ventures and thereby avoid product, environmental or tort liability exposure. This creates undesirable social costs and increased market inefficiency, an outcome that is in absolute contrast to the general economic rationale of any system of allocation of enterprise risks. See PHILLIP BLUMBERG, *Limited Liability and Corporate Groups*, 11 Journal Of Corporation Law 573 (1986). *See also* JOSÉ ENGRÁCIA ANTUNES, supra note 326; Dine, *supra* note 348.

353 *See* JOSÉ ENGRÁCIA ANTUNES, *supra* note 326, at 158-206.

354 Id.

the traditional view that each constituent company in the group must retain an entirely separate legal personality, and the recognition of the group as a legal entity in its own right which submerges that of its constituent companies – is likely to prove either workable or acceptable."[355] Therefore, more recent legal theory focuses on more innovative approaches to the corporate group, assuming as a starting point that the tension between the "autonomy" of the subsidiaries and "control" of headquarters is a "constituent principle" of corporate groups.[356]

c. The Corporate Group as a Polycorporative Network

Departing from the assumption that the legal personification of the corporate group is not feasible and based on the theoretical foundations of *autopoesis* legal theory,[357] Teubner proposed an original conceptualization of the corporate group as a "polycorporative" entity composed by a "network of intersystemic relationships between autonomous action centres," *i.e.,* a "*unitas multiplex*."[358] Teubner conceptualizes the corporate group as a new type of social actor, "a higher-order *autopoetic* social system,"[359] whose specific nature is reflected, as discussed above, in the dual character of its actions,[360] and in the specificity of its property rights.[361] Within this "higher-order" social system, the direct hierarchical control that traditionally defines an organization is substituted by an indirect "contextual" control of self-directed subunits.[362] This relative autonomy of the subunits, in turn, creates specific group's internal dynamic (*i.e.,* so-called "*eigen*-dynamics"). That is, due to its decentralized structure, the corporate group enters into a process of "self-referential relationship...observing itself and using this self-observation to control itself."[363] The dual

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355 TOM HADDEN, *supra* note 318 at 343.
356 *See* JOSÉ ENGRÁCIA ANTUNES, supra note 326, at 158-206; *see also* TEUBNER, *Unitas Multiplex: Corporate Governance in Group Enterprises*, *supra* note 317, at 82ff.
357 *Autopoesis* is a theoretical paradigm developed in biology which conceptualizes biological systems as units which repeatedly reproduce "their elements from their own elements." This theory was originally applied to the social sciences by Niklas Luhmann. Teubner based his work with *autopoesis* on Luhmann's *autopoetic* concepts. For a description of the main aspects of *autopoesis* in legal theory *see* M. KING, *The "Truth" About Autopoesis*, 20 Journal of Law and Society 218 (1993). *See also* A. BECK, *Is Law an Autopoetic System?*, 14 Oxford Journal of Legal Studies 401 (1994).
358 *See* TEUBNER, *supra* note 317.
359 Id.
360 *See* discussion *supra* at pg. 84.
361 Teubner defines the nature of the controlled subsidiary's property rights as "organizationally bound property rights." That is "the allocation of control rights within the firm ...[is]... arranged ... according to efficiency viewpoints oriented towards the interests of the 'corporate actor', which is different from that of any participant." *See* TEUBNER, *Unitas Multiplex: Corporate Governance in Group Enterprises*, *supra* note 317, at 82ff.
362 Id.
363 Id.

character of the group's actions and the specificity of its property rights, in turn, make possible the existence of its "organized market."[364] These fundamental traits distinguish the corporate group from previous forms of enterprise and make its conceptualization as a legal person totally misplaced. As Teubner suggests, "the group not as 'corporate actor' but as 'polycorporative network' is the formula that perhaps best characterizes the new qualities of the group as a developmental stage of industrial organization."[365]

In sum, the corporate group should be conceptualized not as a legal person or individual corporate actor, but as a polycorporative network with a specific type of property rights and operational characteristics. Further, in light of corporate law's limitations, tax policy should depart from the assumption that the corporate group will not be considered, under normal circumstances, a legal person in its own right. Thus, for the purposes of this thesis, it will be assumed that the legal personification of the corporate group and, thus, its selection as a taxpayer in its own right, is highly improbable.[366]

3. The Functional Structure of Corporate Groups

The purpose of this section is to examine the functional organization of corporate groups. Tax policy should not assume that the functional structures of corporate groups follow their legal structures. The analysis will suggest that the design of a group's functional structure follows a different rationale from the one that underlies the design of its legal structure (*e.g.,* insulation of liability from specific parts of the group's business; legal or practical requirements imposed by operations in a foreign country, etc.). Although both structures may eventually coincide in certain groups, they increasingly diverge.[367]

As will be discussed, this divergence is of extreme importance for CIT due its emphasis on legal form. Further, the analysis will suggest that the flexibility to create functional structures that deviate from legal structures is important to allow for the constant adaptability of corporate groups to their economic reality. Specifically, the analysis will suggest that corporate groups continually re-arrange their functional structures, usually in a

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364 *See supra* discussion at pg. 80ff.
365 *See* TEUBNER, *Unitas Multiplex: Corporate Governance in Group Enterprises, supra* note 317, at 77.
366 As will be further discussed, the CIT system choice of taxpayer is usually interrelated with the corporate law's concept of legal personality due to the potential liability for unpaid taxes, court proceedings, etc. *See* BERTIL WILMAN, *Equalizing the Income Tax Burden in a Group of Companies*, 28 Intertax 352 (2000) at 353.
367 In this sense *see* TOM HADDEN, *supra* note 318, at 279 ("[T]here is an increasing divergence between legal and managerial structures in ... large corporate groups").

movement towards operational and administrative decentralization, in order to cope with growing administrative and operational complexity. Thus, tax policy must take into consideration that tax regulations that rigidify functional structures reduce corporate groups' capacity of adapt to outside disturbances and, thus, penalize their economic performance.

a. <u>The Evolution of Functional Structures</u>

The growth in the productive and distributive capabilities of the modern enterprise has always been accompanied, and indeed made possible, by the parallel development of its governance structures.[368] The historical evolution of the firm indicates that once a firm reaches a certain level of operational complexity (as a result of the increase of the enterprise's scale and scope), the centralized single-unit governance structure cannot ensure its continued development. Further, the requirements imposed by growth do not exhaust themselves in the simple evolution from a single-unit and single-corporate enterprise to a multi-unit and polycorporate enterprise. Once the firm adopts a multi-unit form, evolution continues through the progression from centralized governance structures to decentralized governance structures.

i. From the Single-Unit and Single-Corporate Enterprise to the Multi-Unit and Polycorporate Enterprise

Economic history explains the rise of the modern industrial enterprise as a result of the introduction of technological developments that, demanding high-volume production for their use, forced entrepreneurs to develop large scale production capabilities to fully benefit from their innovative potential.[369] This growth of the firm's production capabilities required an improvement in its production management techniques (since it now possessed more personnel, more products, higher demand of raw materials, in sum, more requisite coordination and planning) and its capacity to sell (since the firm now required better and larger distribution and marketing services to sell its larger production output).[370]

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[368] *See* ALFRED D. CHANDLER, *supra* note 341.
[369] *See* ALFRED D. CHANDLER & TAKASHI HIKINO, Scale and Scope: the Dynamics of Industrial Capitalism (Belknap Press of Harvard University Press. 1990) at 8ff.
[370] Id.

As a result of these developments, large manufacturing firms started to enjoy "substantial economies of scale and scope"[371] and, thus, were able to start to "produce at lower unit costs than could the smaller works."[372] Initially, growth occurred through internal expansion, that is, by a simple increase in the size of the traditional single-unit and single-corporate enterprise. Subsequently, however, it occurred through the addition of new units to the original single-unit form, *i.e.,* it occurred through the creation of a multi-unit structure.[373] This change in growth policy, which led to the rise of the polycorporate enterprise,[374] occurred as a result of the exhaustion of the single-corporation as a solution to the requirements of modern enterprise.

In particular, the economic exhaustion of the single-corporate form resulted from the interaction of four different set of factors, namely financial (*i.e.,* exhaustion of the corporation's self-financing capabilities),[375] organizational (*i.e.,* impossibility to manage the complexity of large operations in the centralized single-unit form),[376] economic (*i.e.,* need to add new units if the firm were to maintain its profitability)[377] and legal (*i.e.,* anti-trust laws).[378]

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[371] Economies of scale are economies where the increased size of a single operating unit producing or distributing a single product reduces the unit cost of production or distribution. Economies of scope are those resulting from the use of processes within a single operating unit to produce or distribute more than one product. Id. at 96.

[372] Id. at 8.

[373] The external expansion of the business enterprise by adding new units to its single corporate and single-unit form occurred basically in four ways. One was by acquiring or merging with enterprises "using much the same processes to make much the same product for much the same markets"; that is, growth by horizontal combination. Another was by taking on units involved in the earlier or later stages of making a product, "from the mining or processing of raw materials to the final assembling or packaging"; that is, growth by vertical integration. The third way of growth was to expand geographically to distant areas. The fourth was to make new products that were related to the firm's existing technologies or markets. Id. at 37. *See also* ALFRED D. CHANDLER, *supra* note 341.

[374] The multi-unit enterprise has generally adopted the polycorporate form. This is due to the specific comparative advantages of the polycorporate form (such as the benefit of limited liability at the level of each operating unit or the administrative efficiency of its governance structure) and because a significant number of corporate expansions occurred through acquisition of shares in other companies. *See* JOSÉ ENGRÁCIA ANTUNES, supra note 326, at 20-38. For this reason, both terms are used interchangeably in this thesis.

[375] Id. at 22-26.

[376] *See* E.T. PENROSE, The Theory of the Growth of the Firm (Basil Blackwell. 1959) at 162.

[377] As Chandler notes "the modern industrial enterprise has rarely continued to grow or maintain its competitive position over an extended period of time unless the addition of new units has actually permitted its managerial hierarchy to reduce costs, to improve functional efficiency in marketing and purchasing as well as production, to improve existing products and processes and to develop new ones, and to allocate resources to meet the challenges and opportunities of ever-changing technologies and markets." *See* ALFRED D. CHANDLER, *supra* note 369, at 15.

[378] See L. HANNAH, *Mergers, Cartels and Concentration: Legal Factors in the US and European Experience, in* Law and the Formation of the Big Enterprises in the 19th and 20th Centuries (N. Horn & J. Kocka eds., 1979) at 306ff.

ii. Centralized and Decentralized Governance Structures

Interestingly, the requirements imposed by growth do not exhaust themselves in the simple evolution from a single-unit and single-corporate enterprise to a multi-unit and polycorporate enterprise. Once the multi-unit form is adopted, evolution generally continues through the progression from centralized to decentralized governance structures.

In particular, as operational complexity increases, the governance structure of the corporate group tends to evolve from a centralized holding form (H-form) to a functionally departmentalized form (U-form) to a decentralized and multifunctional form (M-form).[379] This evolution arises out of the failure of centralized governance structures to manage complexity. Specifically, the increased operational complexity in centralized structures creates a loss of control over the lower-tier affiliates' operations, and higher associated costs to implement transactions.[380] Also, the associated managerial overload of the headquarters in these cases engenders deficient strategic approaches (*i.e.,* "short-run issues" tend to dominate "long-run strategies").[381] As a result of such problems, centralized governance structures, such as the H-form and the U-form, are generally abandoned as corporate groups expand and diversify.[382]

Once the corporate group's operations reach a significantly complex level, the corporate group tends to adopt the M-form, a decentralized and multifunctional governance structure.[383] The crucial feature of this governance structure (which is the predominant functional model of western corporate groups)[384] is its mix of administrative and operational decentralization (to handle operational complexity) with centralized strategy (to ensure the existence of a unitary economic direction, crucial for the group's viability). The

379 For a detailed description of the characteristics of each model and respective internal managerial structure *see* ALFRED D. CHANDLER, *supra* notes 341 and 369.

380 In general, this is because in centralized structures information has to pass through multiple managerial levels. Id.

381 *See* WILLIAMSON, *The Modern Corporation: Origins, Evolution, Attributes, supra* note 315.

382 Id.

383 Id.

384 Although its acceptance has been slower among European than among US firms, M-Forms are arguably the dominant form of governance structures among large diversified companies in the US and Europe. *See* R. WHITTINGTON & M. MAYER, The European Corporation: Strategy, Structure and Social Science (Oxford University Press. 2000). It must be emphasized that the M-form structures are not a homogeneous set of organizational arrangements. Considerable variation has been detected concerning the size of the corporate office, the use of internal governance mechanisms and the vertical delegation of strategic tasks. *See* P. GOODERHAM & S. ULSET, *"Beyond the M-Form": Towards a Critical Test of the New Form*, 9 International Journal of the Economics of Business 117 (2002).

administrative and operational decentralization is generally achieved through the coordination of functional units (which commonly correspond to individual operating subsidiaries) by divisions (which normally aggregate operating subsidiaries under product lines or geographic regions). In turn, the centralized strategy is achieved by allocating the decision-making authority to the divisions.[385] This blend of administrative and operational decentralization with strategic centralization reduces the higher costs and control-and-strategy-formulating problems of centralized governance structures.[386]

b. <u>The Functional Structures of Multinational Corporate Groups</u>

Corporate groups handle operational complexity by decentralizing governance structures. The purpose of this section is to reinforce this claim by demonstrating that the highly complex modern multinational corporate group ("MNG") is an extremely decentralized form of enterprise. The results of this analysis emphasize the significance of the functional flexibility of corporate groups for their continued economic development.

The Modern Multinational Corporate Groups: Beyond the M-Form

The M-form is the predominant functional structure of western corporate groups. However, several economists suggest that an increasing number of multinational corporate groups are structured under "a new organizational model...significantly different from the M-form organization."[387] The next section will be dedicated to the examination of this claim. The investigation will be centred on two interrelated theories, namely the

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385 The divisions in the M-form generally have to defend their expansion plans with regards to the the headquarters in terms of profitability. These "divisional profit centers" are the foundation of the "organized internal market" that characterizes most modern corporate groups. *See* ALFRED D. CHANDLER, *supra* note 341 at 37 and 383.

386 *See* OLIVER E. WILLIAMSON, supra *note* 312.

387 *See* C. A. BARTLETT & S. GHOSHAL, *Beyond the M-Form: Towards a Managerial Theory of the Firm*, 14 Strategic Management Journal 23 (1993) at 24. Additional theorists that support a new conceptualization of the modern MNG include, among others, B. KOGUT & U. ZANDER, *Knowledge of the Firm and the Evolutionary Theory of the Multinational Corporation*, 34 Journal of International Business Studies 516 (2003) and J. BIRKINSHAW & A. MORRISON, *Configurations of Strategy and Structure in Subsidiaries of Multinational Corporations*, 26 Journal of International Business Studies 729 (1995). Note, however, that some theorists question the validity of this claim. *See* GOODERHAM & ULSET, *"Beyond the M-Form": Towards a Critical Test of the New Form*, *supra* note 384. *See also* M. GOOLD & A. CAMPBELL, Strategies and Styles: The Role of the Centre in Managing Diversified Corporations (Basic Blackwell. 1987) and WHITTINGTON & MAYER, The European Corporation: Strategy, Structure and Social Science, *supra* note 384 (authors suggest that although several European corporate groups have been developing network organizations, their governance does not deviate substantially from the M-form principle of decentralized operations and centralized strategy).

"Transnationality" theory suggested by Bartlett and Ghoshal and the notion of "Heterarchy" advanced by Hedlund.

i. Transnationality

Under Bartlett and Ghoshal's theoretical framework, the new critical source of competitive advantage for MNGs resides in the capacity of their operating subsidiaries to innovate. This innovation capacity is anchored on the efficient use of the resources and competencies located in the subsidiaries' residence jurisdictions and results in the dissemination of key assets and responsibilities throughout the corporate group.[388] Significantly, this new functional strategy reinforces intra-firm dependencies and, thus, strengthens the character of the corporate group as a network. The end result of this decentralization phenomenon is the transfer of the *locus* of entrepreneurship from the group's parent to the operating subsidiaries.[389]

In particular, the managers of the group's subsidiaries (legal entities with their own balance sheet, profit and loss statement, and substantial financial independence),[390] are given a "mandate to build their businesses as if they owned them."[391] Also, the managerial organization of the group is streamlined, with more competencies attributed to local management.[392] Under this new organizational model, the operational and business-level strategic decisions, and accountability for profits and losses are delegated directly to the operating subsidiaries, while the strategic decisions on inter-business and inter-division issues remain the responsibility of division and corporate level management.

As a direct result of this decentralized network structure, several of the group's operating companies are highly dependent on each other's resources to achieve their own objectives. However, rather than simply place them into divisions, as in the traditional M-form, or let them stand entirely on their own feet, as in the holding company model, in the modern

[388] *See* C. A. BARTLETT & S. GHOSHAL *supra* note 387.
[389] *See* C. A. BARTLETT & S. GHOSHAL, The Individualized Corporation (Harper Business. 1997). Bartlett and Ghoshal argue that the genesis of this phenomenon can best be understood in the context of a gradual evolution of multinational enterprises: from the international, multi-domestic and global enterprise to the transnational enterprise. For a description of this evolutionary process *see* C. A. BARTLETT & S. GHOSHAL, Transnational Management (Irwin 2nd ed. 1995).
[390] It is suggested that subsidiaries are generally permitted to retain a substantial portion (*i.e.,* in general, approximately one third) of their net profits. Id.
[391] Id.
[392] Id.

MNG these subsidiaries are linked both to their national management and to their global business area organization. Thus, in Bartlett and Ghoshal's model of the corporate group as a "differentiated network," the group's organizational structure is fundamentally transformed from a hierarchy in which knowledge, resources and expertise are centralized at the parent group's level or localized at the level of a specific subsidiary, into a network where they might be located anywhere, but are able, by the use of various communications systems, to be transferred to any other subsidiary when the circumstances require.

As a consequence of the decentralization of the group's resources and entrepreneurial responsibility, indirect control mechanisms play a more significant role under this new group form than under the classical M-form. In particular, the headquarters focuses mostly on driving the entrepreneurial process "by developing a broad set of objectives and by establishing stretched performance standards," with which the operating subsidiaries must comply.[393] Thus, "normative social control," that is, the implementation of managerial control by emphasizing elements such as "institutional purpose, organizational process and the moulding of people,"[394] assumes a prominent role, substituting the M-form hierarchical governance mechanism and associated functional structure.

ii. Heterarchy

Hedlund proposes a similar theoretical framework to that advanced by Bartlett and Ghoshal. Hedlund suggests that networks composed of several singular subsidiary nodes form the modern MNG.[395] Like Bartlett and Ghoshal, Hedlund emphasizes the modern MNG's significant flexibility (both in the relationship between subsidiaries among themselves and in the relationship between subsidiaries and outside agents) and its use of normative mechanisms of control to ensure its unitary economic direction.[396] In addition, Hedlund emphasizes the strengthened role of the individual subsidiary in the definition of the overall MNG's strategy[397] and the loose organizational principles of the MNG.[398]

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393 *See* C. A. BARTLETT & S. GHOSHAL, *supra* note 387 at 29.
394 Id.
395 *See* G. HEDLUND, *The Hypermodern MNC: A Heterarchy?*, Human Resource Management (1986); G. HEDLUND, *A Model of Knowledge Management and the N-Form Corporation*, 15 Strategic Management Journal 73 (1994).
396 These normative mechanisms are based on the development of a shared awareness of overall culture, values, goals and critical interdependencies. Id.
397 Specifically, Hedlund claims that the subsidiary management is given a strategic role, impacting both the subsidiary and the MNG as a whole. Id.

In sum, the organizational structures of MNGs have been gradually decentralizing in response to the complexity of managing innovation processes in the cross-border arena. The analysis suggests that multinationality accentuates two fundamental characteristics of the modern corporate group emphasized by Teubner in his "polycorporative network" theory. First, multinationality reinforces the nature of the corporate group as a network of interdependent corporations. Second, multinationality emphasizes the role of "normative" or, in Teubner's taxonomy, "contextual" mechanisms of control.

All told, the functional structures of corporate groups do not necessarily follow their legal structures. The design of a group's functional structure follows a different rationale from the one that generally underlies the design of its legal structure and, although both structures may eventually coincide in certain groups, they increasingly diverge. Also, this flexibility to create functional structures that deviate from legal structures allows for the constant adaptability of corporate groups to their economic reality. Corporate groups continually re-arrange their functional structures, usually in a movement towards operational and administrative decentralization, in order to cope with growing administrative and operational complexity.

4. *The Nature of Corporate Groups*

As member of a corporate group, a corporation is part of a larger entity, an atom of a molecular structure.[399] Through its submission to a group level unitary economic direction, the corporate atomistic entity integrates into the molecular group structure. The tension between this unitary economic direction and the individual corporation's legal and economic substratum generates the internal dynamic or *chemical bond* that gives rise to the corporate group's molecular structure.[400]

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[398] In particular, Hedlund suggests that although there are multiple organizing principles (based upon function, product, geography and customer type) no single overriding dimension is super ordinate to the rest. Id.

[399] For the classification of corporate groups as molecular structures *see* JOSÉ ENGRÁCIA ANTUNES, supra note 326.

[400] The definition of *chemical bond* is the following: "There is a *chemical bond* between two atoms or groups of atoms when the forces acting between them are strong enough to lead to the formation of an aggregate with sufficient stability to be regarded as an independent species. All bonds arise from the attraction of unlike charges." In The Columbia Encyclopedia, available at http://www.answers.com/library/Columbia+Encyclopedia-cid-14697 (Columbia University Press 6th ed. 2001-04).

This internal dynamic constitutes the critical element for the characterization of the corporate group as a particular form of enterprise. Specifically, a corporate group forms whenever certain opposing forces that are "strong enough to lead to the formation of an aggregate with sufficient stability to be regarded as an independent species" act between atomistic corporations.[401] These opposing forces are the coordinating principles of the firm vs. the market and the autonomy of the group's affiliates vs. the control imposed by the group's headquarters. The internal dynamic generated by the tension between these opposing principles fundamentally distinguishes the molecular corporate group from the atomistic single-corporate entity.

This internal dynamic or *chemical bond* materializes in the group's organized internal market. In this organized internal market, assets and income are constantly transferred between group members. Thus, in the same way that molecules only exist if atoms exchange electrons to create a *chemical bond*, the corporate group may only exist if group members exchange assets and income to create the internal dynamic of an organized internal market. The corporate group requires flexibility to transfer assets and income internally in order to be economically viable.

In order to ensure the constant maximization of overall profits in its organized internal market, the corporate group possesses a mechanism of self-regulation and control, based on a double orientation of the actions of its members. That is, in the context of a group, individual actions are simultaneously and cumulatively oriented to the common goal and to the individual goals of the members, with no normative primacy of one orientation versus the other. Subject to this internal decision-making system, the corporate group's governance structure assumes an indeterminate variety of forms and characteristics, depending upon the blend of market and hierarchy, contract and organization, strategically implemented at each moment.

This internal dynamic of the corporate group substantially distorts the individual corporation's structure. When controlled by another corporate entity and submitted to the external (and potentially differing) interest of the headquarters, the corporation's sovereign nature is distorted. In this situation, the controlled corporation may lose its status as a self-determined entity and become an entity subject to an alien hierarchical structure that

[401] Id.

privileges a higher collective interest over its own single interest. This distorts the corporation's legal personality and gives rise to a different type of property rights within the groups, *i.e.,* "organizationally-bound" property rights.

In response to the distortions introduced to the legal characteristics of a corporation, certain commentators claim that the molecular corporate group structure should be deemed the actual legal person. However, giving legal personality to corporate groups would extinguish them. That is, the tension between the opposing forces of autonomy and control, and firm and market that generate its *chemical bond* would disappear and, thus, the group as a particular form of business enterprise would cease to exist. Also, the potential conflicts that would arise from the required international coordination of legal regimes in the case of multinational corporate groups should make such approach impracticable. Therefore, the corporate group should be conceptualized not as a legal person or individual corporate actor, but as a polycorporative network with specific property rights and operational characteristics.

Finally, the functional structures of corporate groups do not necessarily follow their legal structures. The design of a group's functional structure follows a different rationale from the one that generally underlies the design of its legal structure and, although both structures may eventually coincide in certain groups, they increasingly diverge. Also, this flexibility to create functional structures that deviate from legal structures allows corporate groups to continually adapt to their economic reality. That is, corporate groups need to re-arrange their functional structures in order to cope with administrative and operational complexity. Those changes generally occur in a movement towards operational and administrative decentralization.

5. Tax Policy and the Nature of Corporate Groups

Corporate groups require flexibility to transfer assets and income internally in order to remain economically viable. However, this flexibility may produce significant negative consequences. As will be further discussed, an "unbounded" organized internal market may open the doors to transfers of assets and income between group members with the sole purpose of obtaining more favourable tax treatment for the corporate group. Thus, the design of tax rules for corporate groups faces a dilemma in that, while it must recognize that the internal transfer of assets and income is a fundamental requirement for their economic efficiency, it also needs to consider that granting unbounded flexibility to these entities may produce negative consequences capable of compromising the regulatory purposes. Indeed, when granted unbounded flexibility, corporate groups may (and commonly do) transfer assets and income between group members merely to take advantage of more beneficial tax treatment.

Further, the "chameleon-like" nature of the corporate group, despite its beneficial consequences to the group's economic efficiency, poses a serious challenge to tax policy since it may be (and often is) used to avoid tax regulations. That is, due to its extremely flexible decision-making structure, the corporate group may easily change its governance structure and make a discriminate use of the corporate veil of its affiliates to evade tax regulations.

In addition, tax policy should depart from the assumption that, in light of corporate law's limitations, the corporate group will not be considered a legal person in its own right under normal circumstances. Thus, for the purposes of this thesis, it will be assumed that the legal personification of the corporate group and, thus, its selection as a taxpayer in its own right, remains highly improbable. For purposes of this research, the corporate group will be conceptualized not as a legal person or individual corporate actor, but as polycorporative network with a specific type of property rights (*i.e.,* organizationally-bound property rights) and operational characteristics.

Lastly, tax policy should not assume that the functional structures of corporate groups follow their legal structures. Also, tax policy must take into consideration that the flexibility to create functional structures that deviate from legal structures allows for the adaptability of corporate groups to their economic reality. Thus, tax regulations that rigidify functional structures may reduce the corporate groups' capacity to adapt to outside disturbances and penalize their economic performance.

In sum, in order to minimize the deadweight loss of the CIT system, the design of tax rules for corporate groups should take into consideration the following. First, that tax regulations should be structured so as to preserve the economic efficiency advantages that corporate groups have developed during their evolution as business enterprises.[402] Second, that tax regulations should implement models that, *ab initio*, take into consideration the "chameleon-like" nature of corporate groups and its potential use to obtain (unlawful) tax advantages.[403]

Based on this analysis, this thesis will now identify the sources of deadweight loss that may arise when corporate groups are taxed under the Standard CIT System. The thesis will first analyze the mechanics of the Standard CIT System. Subsequently, it will determine how corporate groups may be expected to react to such body of rules. The section will conclude by investigating the potential consequences of taxing corporate groups under the Standard CIT system.

B. The Mechanics of the Standard CIT System

This section will examine the mechanic structure of the Standard CIT System. Then, it will analyze the problems that may arise when the Standard CIT System faces the economic, legal and functional specificities of corporate groups.[404]

1. *The Basic Operational Structure of the Standard CIT System*

Under a CIT system (*i.e.,* a realization-based, corporate-level, income tax system), the receipt of income and variations in the market value of assets and stock are subject to tax only when their legal titles are transferred between a corporation and another taxpayer.[405] For administrative reasons, the actual payment of tax on such transfers generally occurs on

402 In a similar sense in the corporate law field *see* TEUBNER, *Unitas Multiplex: Corporate Governance in Group Enterprises*, supra note 317 ("[T]he maintenance, indeed the legal encouragement, of the extremely flexible nature of the network organization can be achieved only by systematically taking into account the...characteristics of the group"); *see also* TEUBNER, *The Many-Headed Hydra: Networks as Higher-Order Collective Actors, supra* note 317.

403 Teubner, for instance, suggests that the regulatory approach itself needs to be "chameleon-like," that is "it needs to adapt itself to the flexible practice of corporate groups that chooses ad hoc and opportunistically the suitable blend between market and organization as well as the necessary degree of centralization." Id.

404 As previously noted, for purposes of this thesis, "Standard CIT System" refers to the current US CIT system rules with the exclusion of tax integration regimes (*i.e.,* US Consolidated Return regime; *de facto* consolidation under the Check-the-Box rules; Subchapter S rules; etc). Where considered relevant, certain aspects of the UK corporate tax system will be brought into the analysis.

405 In particular, tax is only due when a transfer in the sense of sale or exchange or the receipt of proceeds, which constitute earnings rather than a return of capital, has occurred. *See* discussion *supra* at pg. 19.

a yearly basis.[406] To give operational content to these structural pillars, several subsidiary rules are required.[407]

First, a distinction between capital and ordinary income is requisite.[408] Specifically, since the realization principle gives selectivity to the taxpayer of when to include income in its taxable income,[409] the divide ensures that capital losses, which can be selectively triggered, do not reduce ordinary income.[410]

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406 *See*, in the US, IRC Section 441 (a corporation, like any other taxpayer, must report its income on a taxable-year basis). The yearly tax assessment rule is imposed by practicality. Defining a moment on which all expenses and profits of a certain period are determined and offset against each other is administratively much simpler. Further, it allows the government to receive income on a periodic basis to face its expenses.

407 In a similar sense *see* DAVID A. WEISBACH, *The (Non) Taxation of Risk*, 58 Tax L. Rev. 1 (2004) at 33 ("[R]ealization creates a need for a host of other tax rules [.]"); CLARK, *The Morphogenesis of Subchapter C: An Essay in Statutory Evolution and Reform*, *supra* note 7, at 96 ("Contemporary corporate tax law may be traced to ... basic decisions or principles [.]"). *See also* discussion *infra* at pg. 111.

408 *See* id. at 33 ("[T]he concept of a capital gain is a creature of realization."); STEPEK, *The Tax Reform Act of 1986: Simplification and the Future Viability of Accrual Taxation, supra* note 251, at 784-785 ("[T]he distinction between capital gain and ordinary income, with all its complexity, must be retained unless an alternative tax system can eliminate the need for the realization requirement."). The distinction between capital and ordinary income is arguably based on an economic and practical distinction between types of income. From an economic perspective, it is argued that while certain income derives from the realized proceeds generated by an asset during the taxable period it is held (*i.e.*, the income is a result of events that have already occurred and, thus, it is certain), other income derives from the sale of the asset itself, which is actually a realization of the increase in the anticipated income the asset is expected to yield in future years (*i.e.*, this gain has an uncertain nature, since it is based on *ex ante* anticipations and thus, it is a capital gain). Therefore, from a theoretical point of view, capital gains should be taxed only to the extent that there has been a change, during the holding period, of the anticipated flow of income that the asset may generate in future years. If no such change has occurred, such gain should not be subject to tax. This clear cut distinction has, however, not been implemented in US tax law. *See* YOSEPH M. EDREY, *What are Capital Gains and Losses Anyway?* , 24 Va. Tax Rev. 141 (2004) at 146. *See also* STANLEY S. SURREY, *Definitional Problems in Capital Gains Taxation* 69 Harvard Law Rev. 985 (1956) at 990 (defending the capital/ordinary income divide based on the division between "business" and "investment" income). *But see* CUNNINGHAM & SCHENK, *The Case for a Capital Gains Preference,* supra note 55, at 326, defending that there is no relevant economic distinction between capital and ordinary income. ("[N]othing inheres in the nature of a capital gain that warrants treating it differently from other sources of income."). In addition, there is also a practical distinction between both types of income under a realization-based tax system. In particular, while certain assets require the offset of realized gain against tax basis, other income is taxed in its entirety without the need for any offset against tax basis (*i.e.*, this type of income does not require the operation of the mechanism of basis because there is no need to record pre-taxed amounts). *See* WEISBACH, *The (Non) Taxation of Risk*, supra note 407, at 33 ("[D]istinctions remain between capital gains and ordinary income because capital gains generally are offset against basis while ordinary income is not."). Certain countries, although not formally implementing this divide, have several limitations on the use of losses accrued on the transfer of capital assets, which end up by having a similar end result.

409 *See* discussion *supra* at pg. 43.

410 *See*, in the US, IRC Section 1211. Interestingly, in the UK, "trading" losses may be set-off against capital gains of the relevant accounting period. The inverse, however, is not allowed. *See* JON FURSDON, British Tax Guide: Corporation Tax (CCH. 2009) at 79-80. For a defence of the "cherrypicking" rationale to justify the capital/ordinary income divide *see* ROBERT H. SCARBOROUGH, *Risk, Diversification and the Design of the Loss Limitations Under a Realization-Based Income Tax*, 48 Tax L. Rev. 677 (1993) at 681 ("It is widely agreed that the principal justification for limiting capital losses is to prevent selective realization, or "cherrypicking," of losses by taxpayers who have unrealized gains."). *See* id. at ft 12 for extensive bibliography on the subject. *See also* ZELINSKY, *supra* note 31, at 908 ("[T]he limitation on capital loss deductions is a reasonable response to the possible manipulation of the realization regime, precluding taxpayers from accelerating the realization of loss while they postpone the realization of gain."). Note, however, that some commentators critize this "cherrypicking" rationale to justify the capital/ordinary income divide. First, it is claimed that "cherrypicking"

Limitations on the use of losses constitute a second category of rules required by this type of tax system.[411] To begin with, character loss limitations enforce the capital/ordinary income divide. That is, loss limitations avoid capital losses from being selectively characterized by the taxpayer as ordinary losses and, thereby, reduce ordinary income.[412] Further, in order to enforce the separate tax personality of individual corporations, entity loss limitations are required so that taxpayers may not transfer losses to entities other than those that originated the loss.[413] Lastly, year loss limitations are required. That is, in order to

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is based on the faulty assumption that all taxpayers have both unrealized gains and losses, what may often not be true. Further, it is claimed that it is farfetched to assume that taxpayers, absent such divide, would rush to sell loss assets, what in many cases implies taking the tax element too far when compared with business motives. Finally, this assumes that taxpayers would be able to constantly generate new loss assets, what may not always be true. *See* MICHELLE ARNOPOL CECIL, *Toward Adding Further Complexity to the Internal Revenue Code: A New Paradigm for the Deductibility of Capital Losses* 1999 U. Ill. L. Rev. 1083 (1999) at 1118. *See also* ZELINSKY, *supra* note 31, at 908; STRNAD, *Periodicity and Accretion Taxation: Norms and Implementation*, *supra* note 74, at 1888, fn.10. A different type of argument against the existence of this divide is that disallowing deductibility of capital losses (*i.e.*, true economic losses) to taxpayers with no capital gains may discourage investment. *See* SCARBOROUGH, *Risk, Diversification and the Design of the Loss Limitations Under a Realization-Based Income Tax*, *supra* note 410, at 681 ("[T]he problem of unusable losses is a problem of behavior distortion; the limitation may discourage certain investments and risk management techniques."); WEISBACH, *The (Non) Taxation of Risk*, supra note 407, at 33 ("[L]oss limitations often mean that losses cannot be fully deducted, which in turn means that losses effectively are taxed at a different rate than are gains."); ZELINSKY, *supra* note 31, at 908 ("[T]he limitation may...distort the economic behavior of such taxpayers as they seek capital gains to release otherwise nondeductible capital losses."). For this reason, several commentators have defended a special capital gains rate (and it has indeed been implemented in certain time periods in the US) or a more effective taxation of undistributed corporate earnings. The problem with the special capital gains rate is that, although it may arguably reduce lock-in, it provides a very strong incentive to tax planning in order to change the character of income. Alternatively, other commentators defend that in order to reduce the problem of cherrypicking tax rules should strongly penalize retained earnings. The argument is based on the fact that a very high proportion of all capital gains and losses derive from the sale of stock or other securities. That is, without accumulated earnings, there would be no significant capital gains to be taxed, and thus, the lock-in effect would be substantially reduced. *See* CECIL, *supra* note 410, at 1118. However, apart from the fact that these types of measures are not easy to implement (*see e.g.,* the current anti-abuse rules to combat retained earnings in the US, *i.e.,* IRC Section 531 (Accumulated Earnings Tax) and IRC Section 541 (Personal Holding Company regime)), as well as of its potential corporate governance side-effects, there could be an increase in lock-out behavior, since this measure could increase the amount of capital losses on stock dispositions. On the potential corporate governance implications *see* discussion *supra* at pgs. 50-51.

411 In the same sense *see* WEISBACH, *The (Non) Taxation of Risk*, supra note 407, at 33 ("[B]ecause of realization, the actual tax system has a number of limitations on the use of losses.").

412 *See e.g.,* in the US, rules applicable to limit bootstrap acquisitions. *See infra* note 531.

413 For instance, in the US, in the context of business combinations and reorganizations the availability of loss carryovers to other entities is restricted by several, fairly complex, provisions including IRC Section 269 (prohibits a carryover if the principal purpose of the acquisition was to avoid federal income taxes); IRC Section 381 (restricts carryovers to only certain forms of tax-free corporate reorganizations and liquidations); IRC Section 382 (limits use of carryover in certain stock acquisitions); IRC Section 383 (similar restrictions to those imposed by IRC Section 382, but applicable, among other attributes, to carryovers of capital losses) and IRC Section 384 (limits the use of carryovers on certain asset acquisitions). *See also* IRC Section 311 (a) (denies a loss deduction upon a corporation's distribution of depreciated property to shareholders). Similar entity limitations exist in the UK. For instance, where a "trading" loss has been incurred in relation to one trade and that trade is subsequently merged with another trade, the income of the merged trade must be streamed and the carried forward losses can only be set off against that part of the income of the merged trade which relates to the trade where the loss was incurred. Further, a body of anti-avoidance provisions applies to prevent the purchase of shares in a company to obtain the benefit of accumulated trading losses and to prevent the carryback of losses following a change of ownership. The provisions apply where, in any period of three years, there is a change in the ownership of a company and a major change in the nature of the conduct of the company's trade, or if at any time after the scale of the company's has become small or

counteract the negative effects of the yearly tax assessment rule, there is a need to average income and, thus, permit carryover of losses to tax years other than the one when the loss was incurred.[414] However, due mostly to administrative concerns, such possibility is limited either by restricting the carryover of losses to prior tax years or by limiting the time allowed for their use in future tax years.[415] In short, under a realization-based corporate-level income tax, paid on a yearly basis, character, entity and year loss limitations are necessary for the proper operation of the system, *i.e.,* to avoid the manipulation of the realization rule by taxpayers and to cope with administrative concerns.

Third, in order to ensure that the tax is levied only when an actual transfer of title occurs, formal changes in corporate-shareholder relationships that involve a substantial continuity of interest in a business enterprise should not be recognized for tax purposes. This avoids potential manipulations of the realization rule and recognizes, for tax purposes, the continuity of proprietary interest.[416] However, it creates the need for a multitude of rules to define continuity of business interest, as well as to determine how to put into practice the

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negligible and before any considerable revival there is a change in the ownership of the company. *See* FURSDON, British Tax Guide: Corporation Tax, *supra* note 410, at 87 and 91. Because of these different limitations on the use of losses, most often losses cannot be fully deducted, which in turn means that losses are taxed at a different rate than gains. *See* WEISBACH, *The (Non) Taxation of Risk*, supra note 407, at 33. Further, the accumulation of these different loss limitations may arguably, as will be discussed further below, have a detrimental effect on corporate risk-taking. *See* discussion *infra* at pg. 191ff.

[414] *See*, in the US, IRC Section 172 (business operating losses may be carried back two years before the year of the loss and forward twenty years) and IRC Section 1212 (for capital losses there is a carryback of three years and a carryforward period of five years). In the UK, for "trading" losses, carryback period of one year and unlimited carryforward period provided set-off is made against income arising from the same trade. As for capital losses, unlimited carryforward but no carryback period allowed. Note that from November 24, 2008 to November 23, 2010, as a temporary measure to counter the effects of the economic downturn, the period for which a business may carryback current trading losses against previous profits is extended to a period of three years. *See* FURSDON, British Tax Guide: Corporation Tax, *supra* note 410, at 85. *See also* on the need for year loss limitations PREBBLE, *Why is Tax Law Incomprehensible?, supra* note 11, at 385 ("[A]s soon as we draw lines to divide income into periods delimited by time we must have whole bodies of rules to allocate receipts and expenses to their correct years...Also, we must have other bodies of rules to try to minimize the unfair effects that strict year-by-year accounting otherwise has on people ... who have incomes that are lumpy, in that they fluctuate in amount."); M. CAMPISANO & R. ROMANO, *Recouping Losses: The Case for Full Loss Offsets*, 76 Northwestern University Law Review 709 (1981) at 710 ("The present statutory scheme is usually supported by a rationale based on the concept of income averaging: that is, the idea that taxpayers whose income fluctuate from year to year should receive tax treatment equivalent to those with stable incomes").

[415] While this administrative concern makes sense in the case of loss carrybacks, since it requires an alteration of prior tax returns, there is no apparent reason for capping carryforwards. For this reason, from an administrative point of view, it looks like there should be a limitation for the years allowed as a carryback, but there should be no such limitation for carryforwards. From this point of view, an optimal solution would seem to rest on a hybrid of the current US and UK year loss limitations, *i.e.,* limit carryback to a longer period than the one presently allowed in the UK (*i.e.,* from one to two years, as currently occurs in the US) but allow unlimited carryforwards of losses (as presently occurs in the UK). This solution, which should go in the direction of the policy recommendation previously advanced (*i.e.,* use of long carryover periods for behavioral efficiency reasons), is also, as will be further discussed, a solution privileged by some economists due to its beneficial impact on corporate risk-taking. *See* discussion *infra* at pg. 191ff.

[416] *See* discussion *infra* at pg. 120ff.

non-taxability of the transaction, despite the transfer of assets, income and, in certain cases, tax attributes, to a different taxpayer.[417]

Fourth, due to its nature as a separate tax levied on corporations, shareholder dispositions of stock need to be taxed independently of corporate-level events. Accordingly, the need to create a dual set of tax attributes, namely, a separate tax basis for assets and stock, so that dispositions of stock may be treated purely as dispositions of capital assets, follows.[418] Further, defining corporate distributions and determining their tax treatment ensues.[419] Finally, since in order to measure income, expenses must be recovered over time to match the realization of income from an investment, this type of tax system requires capitalization and depreciation rules.[420]

In sum, the selection of a realization-based corporate-level income tax, which must be payable on a yearly basis, as a method for taxing the corporate sector demands the existence of a subsidiary set of rules in order for the system to operate properly.

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417 For instance, in the US, the complexities associated with defining continuity-of-interest are considerable. As Bittker explains, "the continuity-of-interest doctrine has a multifaceted nature, depending on the context in which it arises. At the corporate level, the major focus is on the business enterprise and its continuation, under modified forms, following the corporate readjustment. At the investor level, the relevant factors are the nature and extent of investors' continued participation in the corporation's control, earnings, and assets as well as the relationship of their interests to those of other shareholders and security holders after the transaction has been consummated. Thus, the nature of the consideration received in the transaction (stock, debt or other property), the remoteness of the ownership interests from the underlying assets of the business, the proportion of old owners who continue their participation after the transaction, the length of time the investor interests continue (holding period aspects), and the special features and problems of debt securities all form important aspects of the continuity-of-interest concept." BORIS BITTKER & JAMES EUSTICE, Federal Income Taxation of Corporations and Shareholders (WGL. 2005), Section 12.21[1] at 12-26, 27. *See also* discussion *infra* at pg. 120ff.

418 *See* discussion *infra* at pg. 104.

419 In particular, an issue arises regarding which distributions classify as dividends and how to treat those dividends. *See, e.g.,* in the US, IRC Section 316 (defines the term "dividend" as a distribution of property by a corporation to its shareholders from its current or accumulated earnings and profits). On the complexities associated with such definition *see* BITTKER & EUSTICE, Federal Income Taxation of Corporations and Shareholders, *supra* note 417, at Chapter 8. *See also* on the mechanics of the distribution, Section 301 (providing whether property distributions by corporations to their shareholders are treated as dividends or as a return of stock basis). For an in-depth coverage of corporate/shareholder integration issues, an issue outside the scope of this thesis, *see* PETER A. HARRIS, Corporate/Shareholder Income Taxation and Allocating Taxing Rights Between Countries: A Comparison of Imputation Systems (IBFD Publications. 1996). *See also* BITTKER & EUSTICE, Federal Income Taxation of Corporations and Shareholders, *supra* note 417, at Section 1.08; for an exhaustive list of references on the topic *see* ALI, Integration of the Individual and Corporate Taxes (Alvin C. Warren. 1993) at 223. Further, in order to avoid absence of shareholder-level taxation, rules are required to tax retained earnings (see *e.g.* in US, Accumulated Earnings Tax (IRC Section 531) and Personal Holding Company regime (IRC Section 541)). It is arguable, however, whether these tax law restrictions have any sizeable impact on the distribution policy of corporations. *See* CECIL, *supra* note 410, at 1118 ("[T]hese provisions [*i.e.,* accumulated earnings tax and personal holding company regime], as currently designed, merely act as a trap for the unwary. Savvy tax planners can work around them.").

420 *See* WEISBACH, *The (Non) Taxation of Risk*, supra note 407, at 34 ("Realization…means that the tax system has to provide complex rules for the capitalization and depreciation of expenses.").

Specifically, from a mechanical point of view, the erection of the corporate tax system on these structural pillars demands the following rules:

1. Distinction between capital and ordinary income (*i.e.,* to avoid manipulation of the realization-rule);

2. Character, entity and year loss limitations (*i.e.,* to avoid manipulation of realization-rule and to cope with administrative concerns);

3. Rules to define and to implement the continuity of business interest (*i.e.,* to avoid manipulation of the realization-rule and to recognize the continuity of proprietary interest for tax purposes);

4. Dual set of tax attributes, namely, a separate tax value for assets and stock (*i.e.,* to allow for a corporate-level tax);

5. Rules to define corporate distributions and determine their tax treatment (*i.e.,* to allow for a corporate-level tax);

6. Tax basis and loss year carryover mechanisms (*i.e.,* to implement the realization-rule in the context of the yearly tax assessment rule); and

7. Capitalization and depreciation rules (*i.e.,* to implement the realization-rule in the context of the yearly tax assessment rule).

Further, each corporation must have a basic set of tax attributes in order for these rules to function. To begin with, each corporation must be attributed a tax value for its stock ("outside basis") and a tax value for its assets ("inside basis").[421] This dual tax basis follows

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421 Tax basis, like its equivalent financial accounting term "book value," represents an investor's initial "investment" in an asset. In the US, the determination of the initial amount of basis fundamentally depends on the source of the taxpayer's ownership of property. *See* IRC Section 1012. *See also* GLEN ARLEN KOHL, *The Identification Theory of Basis*, 40 Tax L. Rev. 623 (1985). In particular, separate groups of rules apply to cost basis, property acquired in an exchange, transferee basis, property acquired in a distribution, property acquired through contribution, and pass-through situations. The various basis rules reflect competing policy considerations. The determination of basis is generally a multi-step process, beginning with basis arising from the nature of the acquisition, continuing through the impact of acquisition costs and liabilities, and ending with an analysis of any applicable special rules. *See* JAMES E. MAULE, BNA Tax Management Portfolios, U.S. Income Series, Income Tax Basis: Overview and Conceptual Aspects (560-2nd) (Tax Management Inc. 2005).

from two main reasons. Firstly, outside and inside tax basis allow the system to keep track of untaxed amounts until an actual transfer of title of the corporation's stock or assets occurs.[422] Secondly, inside tax basis allows the system to determine and to keep track of capitalized amounts.[423]

Lastly, each corporation must be attributed individual accounts for current year taxable income and accumulated losses, in both cases, segregated into ordinary and capital income.[424] These accounts provide the tax system with the ability to accurately record the amount, location and character of the tax attributes of each individual corporation.[425] Overall, three types of losses recorded in the individual tax attributes of a corporation carryover, either to different tax years or to a different taxpayer. Specifically, ordinary losses (hereinafter "NOLS"),[426] capital losses (hereinafter "NCLs")[427] (both of which either incurred in the current tax year or accumulated from prior tax periods), and built-in losses (as recorded in the tax basis of its assets).[428] See diagram below for loss corporation P.[429]

Although the market value of stock and the underlying corporate assets is the same, each has an independent value for tax purposes and different elements that impact their tax value.

422 Specifically, upon an actual transfer of title, the existing tax basis in the property is subtracted from the net sales price (amount realized) to determine the taxable gain or loss on the sale. *See* IRC Section 1001. Since tax basis transcends taxable years, it is thus one of the devices, together with carryforwards and carrybacks of tax losses, for ensuring consistency from taxable year to taxable year. As Kohl notes, in many respects, the "role of basis in the tax law is to identify the portion of a taxpayer's wealth that is exempt from future income taxation." *See* KOHL, *supra* note 421. *See also* CAMPISANO & ROMANO, *supra* note 414, at 716 ("A firm's capital ...consists of property that has already been taxed."). This consistency, both on the record of taxed amounts and capitalization treatment, is especially relevant when property is transferred between different entities or when property is substituted for similar property. In particular, where the transaction is tax-free, the fundamental mechanics is based on the carryover-basis mechanism, *i.e.,* the transferee gets the asset with a substituted basis, which may be either transferred or exchanged. That is, basis is determined by reference to the basis in the hands of the transferor from whom the taxpayer acquired the property ("transferred basis") or by reference to other property held at any time by the taxpayer ("exchanged basis"). The result of this device is to defer the recognition of gain or loss until a proper recognition event takes place. As for taxable transfers, the fundamental mechanic device is to equalize basis with market value at the time of the realization event. Depending on the difference between their market value and their adjusted tax basis, a taxable exchange may result in the recognition of capital gain or loss by the seller. Note, however, that if the asset transferred is considered to be part of the taxpayer's trade or business, the taxable income will, in principle, be characterized as ordinary income. *See* IRC Section 1221. *See also* MAULE, *supra* note 421.

423 *See*, in the US, IRC Section 168 (in determining the annual depreciation deduction, taxpayers divide the initial inside tax basis by its useful life).

424 In addition, in the US, there is the so-called Earnings & Profits ("E&P) account, in order to keep record of the distributions that may be classified as dividends. Once the E&P account is exhausted, the distribution is classified as a return of capital. *See* IRC Section 316.

425 *See,* in the US, IRC Section 61 (generally interpreted as requiring that "income must be taxed to the one who earns it."). *See also* BITTKER & EUSTICE, Federal Income Taxation of Corporations and Shareholders, *supra* note 417, Section 12.01[2] at 14-6.

426 NOLs stands for Net Operating Losses.

427 NCLs stands for Net Capital Losses.

428 The carryover of built-in losses on the corporation's stock is a matter for its shareholder(s), not for the corporation itself.

429 The diagram assumes that Corporation P has an outside basis and an inside basis with built-in losses (*i.e.,* in both cases, the value of outside and inside tax basis is 4 and the market value of stock and assets is 2) as

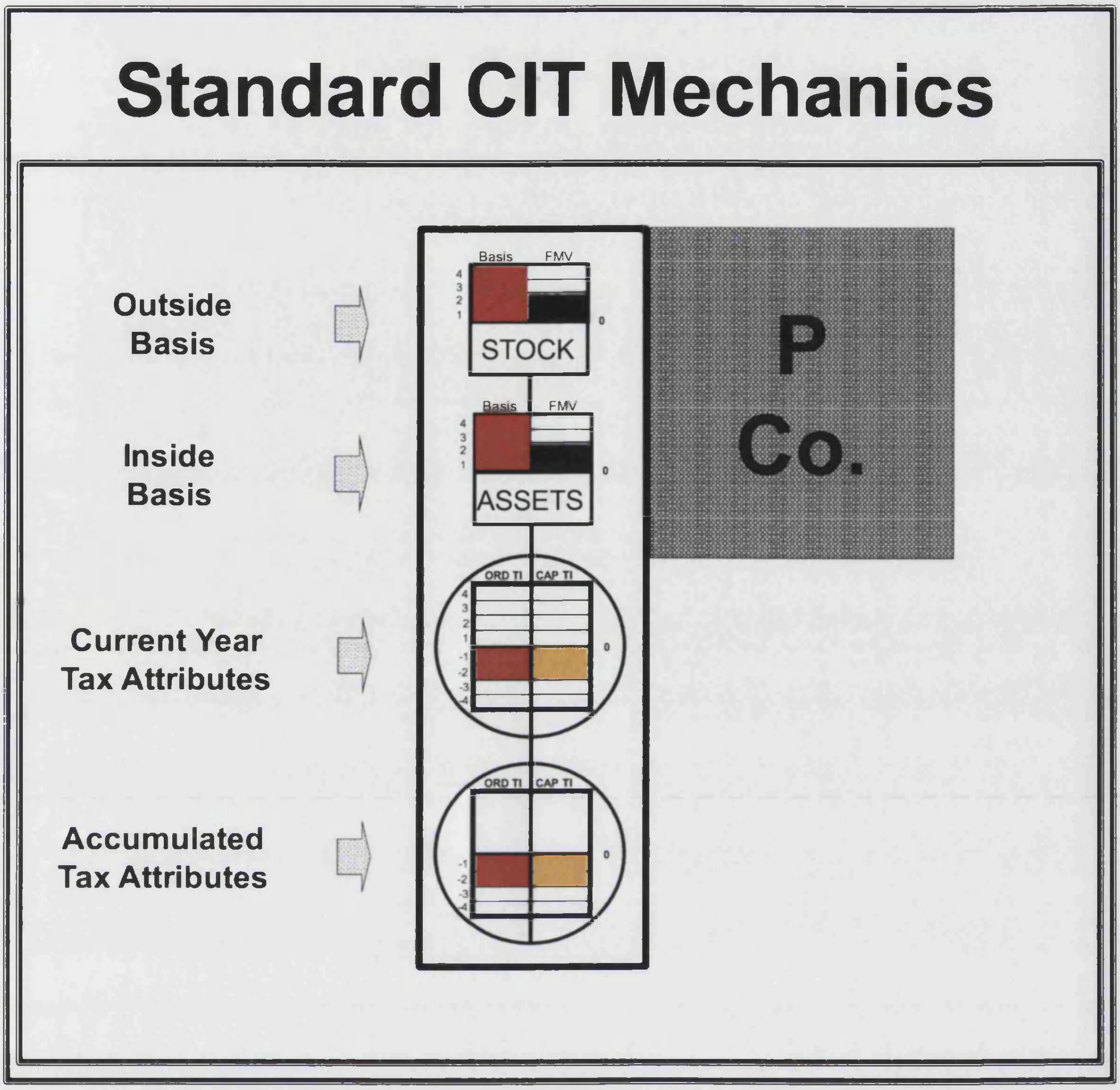

Diagram 1

2. *The Transactional Mechanics of the Standard CIT System*

Each corporation, equipped with the tax attributes just described, transacts with other corporations.[430] These transactions may transfer cash, assets, stock, and certain of the tax attributes described, between different entities. The tax treatment of such transfers depends fundamentally of four interrelated considerations:

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well as current NOLs and NCLs (both with a value of -2) and accumulated NOLs and NCLs (both also with a value of -2). In the diagram, "ORD TI" refers to ordinary taxable income and "CAP TI" refers to capital taxable income.

[430] For the purposes of this work, the analysis will focus solely on the relationships between corporations *per se*. Nevertheless, where considered relevant, relationships with partnerships and other flow-through entities may be brought into the analysis.

a) The nature of the good transferred;
b) The direction of the transactional flow;
c) The relationship of transferee and transferor corporations; and
d) The legal instrument adopted to implement the transfer.

a. Nature of Good Transferred

Depending on the nature of the good transferred (*i.e.,* cash, assets or stock), there are different formal characterizations available and, in certain cases, different tax factors to consider when structuring a transfer transaction among corporate entities. Consider the formal characterizations available to implement a transfer of assets or stock. When assets or stock are transferred, depending on the facts of the transaction, the transactions may be characterized for tax purposes, for instance, as a sale, merger, capital contribution, liquidation, spin-off or distribution in kind.[431] Certain of these formal characterizations may not be available when only cash is transferred between corporations. For example, the characterization of a transaction as a merger or a spin-off is unavailable when only cash is transferred between two corporations.[432] By the same token, when only cash is transferred, alternative formal characterizations of the transfer transaction may be available such as payment (or receipt) of interest, royalties, service fees, rents (on contracts of loan, licensing, rendering of services and lease), distribution in cash or redemptions.[433] In short, depending on the nature of the good transferred, different formal characterizations may be available to implement the transfer transaction.

Second, the tax factors associated with the transfers of assets, stock and cash differ. While the tax value of cash always equals its market value, the tax value of assets and stock may differ from their market value, *i.e.,* assets or stock may have a built-in gain or loss.[434] For that reason, they raise different tax issues. For instance, in order to avoid the manipulation of the CIT System, transfers of assets with built-in losses are usually subject to additional

[431] For the formal requirements generally associated with each of these transactions *see* in the US IRC Section 1001 (sale); IRC Section 351 (capital contribution); IRC Sections 332 and 337 (liquidation); IRC Section 368 (mergers and other corporate restructurings); IRC Section 355 (spin-offs and other corporate divisions) and IRC Section 311 (distributions in-kind).
[432] *See, e.g.,* in the US, IRC Sections 368 (mergers and other corporate restructurings) and IRC Section 355 (spin-offs and other corporate divisions) requiring the transfer of stock to be applicable.
[433] Certain of these formal characterizations may also be available for asset and stock transfers.
[434] The transfer of assets and stock, thus, demands tax basis adjustments in order for the system to keep track of already taxed amounts. *See* discussion *supra* at note 422.

restrictions to those imposed on the transfers of assets with built-in gains.[435] Further, the acquisition of stock of a business with NOLS or NCLs in its taxable income accounts are subject to different limitations to those imposed when only assets are acquired. That is, the taxable acquisition of assets of a business does not generally result in a transfer of the corporation's tax attributes.[436] In contrast, the taxable transfer of stock implies the transfer of tax attributes, namely, potential current and accumulated NOLs and NCLs. For that reason, the selection of whether to acquire a business through a stock or an asset acquisition raises different tax issues.[437] In short, depending on the nature of the good transferred, the transaction may have different tax factors to consider.

In sum, depending on the nature of the good transferred (*i.e.,* cash, assets or stock), there may be different formal characterizations available and, in certain cases, different tax factors to consider when structuring a transfer transaction.

b. Direction of Transactional Flow

The variety of available direct transactional routes between a corporation and related or unrelated corporations differs.[438] With unrelated corporations, only two possible types of transactional flows occur, depending on the side of each party to the transaction (*i.e.,* as buyer or a seller, lessor or lessee, lender or borrower), and a limited amount of available formal characterizations for the transfer exist, namely, sale (or purchase) of assets or stock, merger and payment (or receipt) of interest, royalties, service fees and rents (on contracts

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435 *See e.g.,* in the US, imposing limits on the transfer of built-in losses, IRC Section 269 (provides for the disallowance of deductions and other tax benefits when tax avoidance is the principal purpose for the acquisition of control of a corporation or for certain transfers of property from one corporation to another. Among other functions, it limits the use of losses from the sale of assets acquired with a built-in loss at the date of the acquisition) and IRC Section 382 (limits the amount of loss carryovers that can be used annually against the taxable income of a corporation acquired with, among other attributes, NOLs and "net unrealized" built in losses).

436 However, if the asset transfer is implemented through a tax free transaction (qualifying, for instance, under IRC Section 332 (liquidation) or 368(a)(1)(D) (nondivisive reorganization)), NOLs and NCLs, among other tax attributes, may potentially carryover. *See* IRC Section 381.

437 *See* discussion *infra* at pg. 127 for in-depth discussion of the different elements associated with each type of transaction. For similar asymmetries in the treatment of asset vs. stock acquisitions in the UK *see* JOHN TILEY, Revenue Law (Hart Publishing 5th ed. 2005) at 846.

438 For indirect relationships and the issues they raise *see* discussion *infra* at pg. 123ff.

of loan, licensing, rendering of services and lease).[439] All these transactions, excluding the merger, are generally taxable.[440]

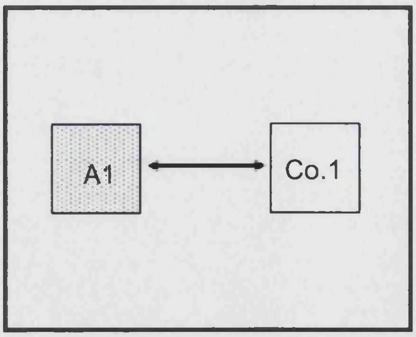


Diagram 2

When corporations are related, three direct transactional routes are conceptually possible for a corporation, *i.e.,* upward, downward and transversal. On each transactional route, two types of direction are possible, depending on which entity initiates the transaction.

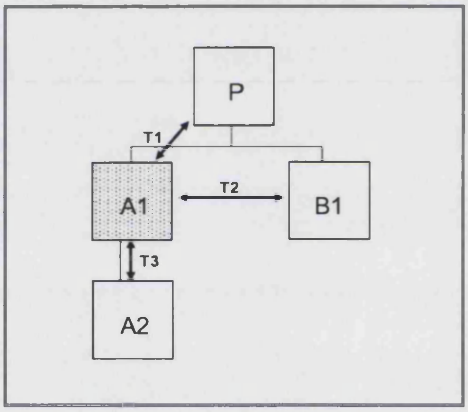


Diagram 3

In particular, due to the stock relationship, extra transactional routes come into play, *i.e.,* the upward and downward routes (See in the diagram above flows T1 and T3). On each route, each transactional flow has different formal transactions available. Thus, on the upward flow, a corporation that initiates the transaction, on top of transactions available with unrelated parties, has other potentially available transactions - the liquidation, the

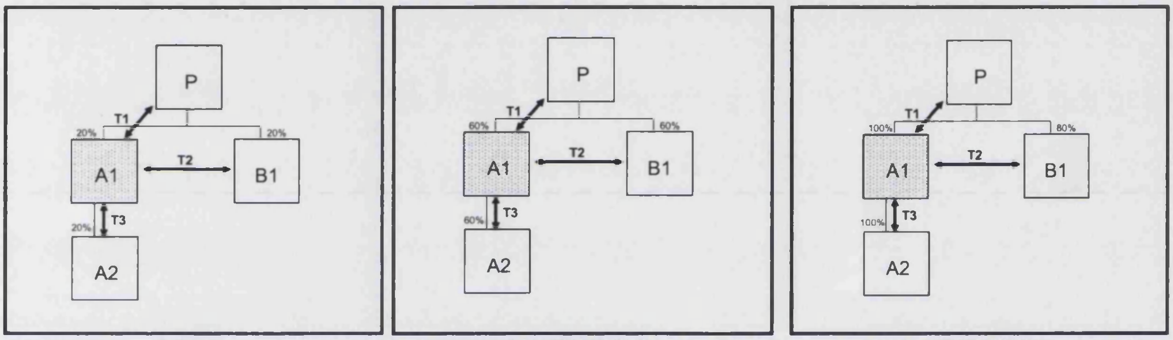
[439] Mergers may be structured in several forms. The requirements for the formal characterization of each of these transactions are outside the scope of this analysis. *See* generally BITTKER & EUSTICE, Federal Income Taxation of Corporations and Shareholders, *supra* note 417, at Chapter 8.
[440] The merger, provided certain conditions are met may be tax-free. Id.

spin-off and other divisive restructurings, distributions in cash or in kind and redemptions.[441] On the downward flow, capital contributions may be available.[442]

In sum, a mid-tier corporate group member may initiate upward, downward or transversal transfers of cash, assets and stock. The type of formal characterization available to implement a transfer should vary depending on the direction of the transactional flow.[443]

c. <u>Ownership Thresholds</u>

On each transactional flow, tax treatment tends to vary depending on the degree of ownership, that is, on whether a corporation has low, medium or high degrees of ownership over another corporation.



LOW (< 50%) | **MEDIUM** (In the US, = or >50% but <80%) | **HIGH** (In the US, = or >80%)

Diagrams 4, 5 and 6

With a low degree of integration, tax treatment tends to equate to the treatment afforded to transfers between unrelated entities. That is, income and asset transfers, with the exclusion of certain dividend distributions,[444] are generally taxable.

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[441] As discussed below, this will depend on ownership thresholds and other specific requirements for qualification for these transactions. *See e.g.,* in US, IRC Sections 332 and 337 (liquidations); IRC Section 355 (spin-offs and other divisive restructurings); IRC Section 301 and 311 (distributions in cash and in kind); IRC Section 305 (stock distributions); IRC Section 302 and 317 (redemptions).

[442] This will depend on ownership thresholds and other specific requirements for qualification. *See, e.g.,* in US, IRC Section 351.

[443] As discussed, some of these transfers may also result in a transfer of tax attributes, fundamentally, tax losses. *See, e.g.,* in the US, IRC Section 332 and IRC Section 368.

[444] *See*, in the US, IRC Section 243(a)(1) (providing for a deduction of 70 percent of dividends received from a domestic taxable corporation or 80 percent if shareholders own 20 percent or more of the stock of the distributing corporation by vote and value).

With a medium degree of integration, certain non-recognition rules apply and, thus, certain transactional flows, depending on the facts and the legal instrument adopted to implement the transaction, may be tax-free.[445] With a high degree of integration,[446] additional non-recognition provisions apply to the upward and downward flows (*e.g.,* capital contributions and liquidations).[447] In these cases, due to the application of non-recognition rules to only certain types of transactions, the tax system increases its degree of substitution.[448] Not coincidentally, therefore, several anti-abuse rules come into play only when medium to high degrees of ownership are present.[449]

Thus, the higher the integration between corporations, the stronger the benefit facilitated by tax law. This "ranking" starts with the non-taxation of dividends, and follows on to the tax-free transferability of assets, stock and tax attributes. A similar ranking applies to anti-avoidance provisions. While in a low integration context very few anti-avoidance provisions apply, many apply in the presence of medium to high degrees of integration. Tax law favours economically integrated parties but as, a counter-entry, it increases the anti-tax avoidance arsenal.

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445 *See, e.g.,* in US IRC Section 368 (a)(2)(H) (allowing for tax-free treatment under a nondivive type D reorganization when 50 control is present).

446 In general, the threshold in the US tends to be 80% (75% in the UK). The wisdom of the selection of such specific ownership thresholds is obviously debatable. *See* LEVMORE, *Recharacterizations and the Nature of Theory in Corporate Tax Law, supra* note 19, at 1063 ("[I]t is difficult to have strong feelings about the wisdom of an 80% divide."). *See also* discussion *infra* on the specificities associated with the definition of control in tax law at pg. 120ff.

447 *See,* in the US, IRC Section 351 (capital contributions) and IRC Section 332 (tax-free liquidation). *See also* IRC Section 368 (corporate restructurings) and IRC Section 355 (corporate divisions).

448 *See* discussion *infra* at pg. 116. *See also* discussion *supra* at pg. 54.

449 *See, e.g.,* in the US, the arsenal of anti-abuse rules that comes into play once medium to high ownership thresholds are present: IRC Section 267 (denies or defers deductions for payments to related parties), IRC Section 269 (provides for the disallowance of deductions and other tax benefits when tax avoidance is the principal purpose for the acquisition of control of a corporation or for certain transfers of property from one corporation to another); IRC Section 482 (transfer pricing regime); IRC Section 163 (j) (defers a corporation's deduction for so-called excess interest paid to certain related persons); IRC Sections 453 (e) and 453(g)(limits the use of the installment method in reporting gain on sales between related parties); IRC Section 1239 (converts capital gains to ordinary income on the sale of depreciable property between related parties); IRC Section 7872 (treats below-market interest loans between related parties as if made at a rate tied to the federal borrowing rate); IRC Section 336 (d) (denies a corporation's recognition of loss on its distribution of property to related persons in liquidation); Section 267(f) (defers losses from the sale or exchange of property, with the exception of certain sales of inventory in the ordinary course of business, between two members of same 'controlled group' of corporations until such losses are realized by a sale or other transfer of the property outside the 'controlled group.' In general, 'controlled group' includes a more than 50 percent ownership threshold). *See also* discussion *infra* at pg. 118.

In sum, due to the applicability of non-recognition provisions and anti-abuse rules, on each transactional flow tax treatment tends to vary depending on the degree of integration between corporations.[450]

d. Legal Instrument Adopted

The adoption of different legal instruments to implement a transaction, such as a sales contract, a lease contract or a merger deed, often results in differing tax consequences. The legal instrument adopted is closely intertwined with the elements discussed above, *i.e.,* the nature of the good transferred, the direction of the transaction flow and the relationship of transferee and transferor corporations.[451]

3. Structure, Form and Substance under the Standard CIT System

The analysis of the mechanical operation of the Standard CIT System brings a number of issues to light. First, the core principles of the CIT System fundamentally determine its asymmetric mechanical structure. Second, the formalism that naturally ensues from these principles significantly contributes to the complexity of the tax system. Third, attributing tax significance to an economic unit under a tax system with these characteristics greatly increases its complexity. This section will now discuss each of these aspects in turn.

a. The Basic CIT Principles and the Operational Structure of the CIT System

Once certain core decisions are made, such as whether to tax the corporate sector through an accretion, a consumption or a realization-based tax, or whether to impose a tax directly on corporations or tax solely its shareholders, there is a subsidiary system of rules and a set of corporate tax attributes that must come into play in order for the corporate tax system to operate properly. In the case of a CIT (*i.e.,* a realization-based, corporate-level tax), paid on a yearly basis, these elements include the distinction between capital and ordinary income, loss limitations, capitalization rules, a dual tax basis for each corporation, rules to define the tax treatment of corporate distributions and capitalization and depreciation rules. Since the remainder of the tax system is built cumulatively on these principles and the

450 As will be discussed below, in tax law, the degree of integration between entities is generally assessed based on the percentage of shareholding as well as, in certain cases, certain additional requirements. *See* discussion *infra* at pg. 120ff.
451 As discussed, depending on each of these elements, there may be different legal characterizations available. *See* discussion *supra* at pg. 106ff.

associated body of subsidiary rules,[452] their selection ends, thus, by strongly determining legislative evolution.[453] In light of the genetic incoherence of these principles,[454] the asymmetrical evolution of the CIT laws should not come as a surprise.[455] The structural asymmetries of the CIT system evidenced in the transactional analysis are, to a large extent, a logical consequence of the genetic incoherence of CIT's core principles.

b. <u>The Significance of Form on Tax Treatment</u>

The formalism that naturally ensues from these basic principles decisively contributes to the complexity of the tax system. As evidenced in the transactional analysis of the Standard CIT System, the tax treatment of intra-corporate transfers varies depending on four interrelated considerations, *i.e.,* the nature of the good transferred, the direction of the transactional flow, the relationship of transferee and transferor corporations, and the legal instrument adopted to implement the transfer.

Tax treatment changes in these situations mostly because each of these different elements induces changes in the formal characterization of the transfer transaction.[456] That is, whether the transfer involves cash, assets or stock; whether it occurs on an upward,

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452 *See* discussion *supra* at pg. 14.

453 *See* SHAVIRO, *An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax*, *supra* note 4, at 23 ("[C]orporate taxation is in many respects a closed, internally logical system, working out relentlessly the consequences of initial premises, above all the treatment of corporations as separate from their owners and corporate stock as distinct from corporate assets."); CLARK, *The Morphogenesis of Subchapter C: An Essay in Statutory Evolution and Reform*, *supra* note 7, at 92 ("The corporate tax culture is...of endogenous origin. The pressures created by its own basic postulates have controlled its development."); WEISBACH, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, *supra* note 17, at 1633 ("Many doctrines, such as the realization requirement, are fundamental building blocks of our tax system.").

454 This genetic incoherence is fundamentally imposed by practicality. That is, the separation of an entity's business life into yearly tax assessment periods, the selection of realization as a basis for taxation, or the differentiation of tax treatment depending on whether a person holds an asset directly or indirectly, although genetically incoherent from an economic point of view (*i.e.,* they create fictional lines that do not correspond to economic reality), are imposed by practicality. *See* discussion *supra* at pg. 12ff. *See also* PREBBLE, *Why is Tax Law Incomprehensible?*, *supra* note 11, at 386 ("[T]he [tax] rules suffer from the handicap that their whole reason for existence is to divide something factual, the continuing flow of income, into a pattern that is imposed by the laws of men and women.").

455 In the same sense *see* LEVMORE, *Recharacterizations and the Nature of Theory in Corporate Tax Law*, *supra* note 19, at 1061-1063 ("Corporate tax law is arbitrary because...it requires a specific recognition event before it taxes appreciation in asset values and because it regards corporations as taxable entities that are distinct from their shareholders"); EDWARDS, *Replacing the Scandal-Plagued Corporate Income Tax with a Cash-Flow Tax*, *supra* note 19, at 9 ("A key problem is that the income tax superstructure has been built ever higher on a very problematic base."). These asymmetries introduce substantial complexity and discontinuity in the tax system, which in turn, as will be discussed, may distort corporate behavior. *See* discussion *infra* at pg. 131ff. *See also* discussion *supra* at pg. 13ff.

456 By "form" this thesis means the non-tax legal attributes of the transaction. By "substance" this thesis means the non-tax economic relationships between the parties created, and commercial goals achieved, by virtue of the transaction. *See* LEWIS R. STEINBERG, *Form, Substance and Directionality in Subchapter C*, 52 Tax Law. 457 (1999) at ft. 2.

downward or transversal direction and the entity initiates or does not initiate the transaction; whether the transferee and transferor corporations are related by low, medium or high stock ownership thresholds; or whether the transfer is implemented through a sales or a rental contract, determines the formal characterization of the transaction and, thus, in most cases, its tax treatment.[457]

This link between corporate tax treatment and the formal characterization of a transaction occurs for several reasons. First, and fundamentally, the link stems from the erection of the corporate tax system on top of the realization principle. Since realization makes tax consequences occur only when a transfer of property occurs between two independent taxpayers,[458] tax comes into play only after commercial and property laws.[459] Commercial and property laws determine which entities may classify as separate taxpayers,[460] what classifies as "property,"[461] which type of legal title exists over a certain item of property, and what constitutes a "transfer" of property.[462]

Further, and interrelated, this emphasis on form results from CIT's historical evolution.[463] In origin, CIT was built upon certain basic concepts developed in corporate law, bankruptcy law and accounting.[464] Due to the essentially cumulative process of development of corporate tax law, imported concepts such as "stock," "debt," "control," or "reorganization," have significantly contributed to the formalism of the current CIT system.[465] Lastly, this emphasis on form may be related to certain practical aspects

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457 *See* discussion *infra* on the limitations imposed by anti-avoidance rules at pg. 119.

458 *See* discussion *supra* at pg. 19. *See also* discussion *infra* at pg. 116ff.

459 In general, under a realization-based tax system, rules come into play only after the application of private law rules, primarily those of property and commercial law. *See* YARIV BRAUNER, *A Good Old Habit, or Just an Old One? Preferential Tax Treatment for Reorganizations*, 2004 Brigham Young University Law Review 1 (2004) at 18.

460 The CIT System's choice of taxpayer is usually interrelated with the corporate law's concept of legal personality. *See* discussion *infra* at note 480. This occurs not only for theoretical or historical reasons, but also due to practical motives, such as the potential liability for unpaid taxes, court proceedings, etc. *See* WILMAN, *Equalizing the Income Tax Burden in a Group of Companies, supra* note 366, at 353.

461 Although the CIT System then creates different classes of property for purposes of the capital/ordinary distinction. *See* IRC Section 1222(2).

462 Although some of these concepts are then enriched with additional tax considerations, their definitions under commercial and property law tend to constitute the foundation of the tax law concepts. *See* discussion *infra* at pg. 13.

463 *See, e.g.,* CLARK, *The Morphogenesis of Subchapter C: An Essay in Statutory Evolution and Reform, supra* note 7; and STEINBERG, *Form, Substance and Directionality in Subchapter C, supra* note 456, at 496 ("While some of Subchapter C embodies the logical elucidation of fundamental tax principles, much of corporate tax reflects the quirks of history."). *See also* discussion *supra* at pg. 13.

464 STEINBERG, *Form, Substance and Directionality in Subchapter C, supra* note 456, at 496.

465 Id. *See also* id ("Initially, [the use of non-tax law concepts] made admirable sense, since it facilitated understanding by allowing taxpayers and their advisors to draw upon the rich body of meaning and interpretation already existing outside the tax law and was responsive to taxpayers' needs by clarifying how

associated with the operation of the CIT system. Specifically, an emphasis may respond to a need for expediency in the tax law;[466] to a belief that the tax law should give "fair notice" to taxpayers of how their transactions will be taxed prior to their entering into such transactions;[467] of a desire to avoid whipsaw;[468] or simply of ensuring a notion of transactional finality, such that later transactions or events do not affect the tax characterization of earlier transactions.[469]

Independently of its *raison d'être*, this formalism of the corporate tax system, when in face of the nature of the corporate taxpayer, breeds complexity.[470] Consider the central principle that taxability only occurs once a transfer of property between two independent taxpayers takes place. Although the principle appears relatively straightforward, the problem is that while the transfer of an asset's ownership through a legal sale to an unrelated party is a sale, and possession of an asset without change is not, a substantial array of possibilities between these two extremes exists.[471] The tax law must classify transactions in this blurred area as either sold or held.[472] That is, line-drawing under the Standard CIT System is mostly based

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standard transactions will be taxed. Furthermore, because amendments to the Code were often made to stop particular kinds of abusive transactions, those amendments often referenced the particular types of transactional patterns that had been commonly utilized by taxpayers, rather than the underlying tax principles or policies at issue.").

466 *See* WEISBACH, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, *supra* note 17, at 1637 ("[T]he tax code might treat a taxpayer as holding an asset only if she has the risk of loss and opportunity for gain from the asset....But implementing this rule on a general basis proved [based on past experiences in US Courts] a formidable proposition[.]")

467 STEINBERG, *Form, Substance and Directionality in Subchapter C*, *supra* note 456, at 497. *See also* id. ("Such a principle would be premised not only on notions of fairness, but also on a desire not to discourage taxpayers from consummating economically beneficial transactions because of uncertainty about how such transactions will ultimately be taxed.").

468 Id. *See also* id. ("This argument has usually been adduced to support the Service's position that the taxpayer is bound by its chosen form. But, more generally, where different transactional forms have different tax consequences to the different parties to the transaction, some more favorable and some less favorable, taxing a transaction according to its form may be necessary to ensure that the parties receive the benefits they anticipated (and paid for) in entering into the deal.").

469 Id. at ft. 187. *See also* id. at 497 ("[A] taxpayer that had previously consummated a commercially beneficial transaction would not have to fear that its after-tax position with respect to the earlier transaction would be adversely affected by entering into a subsequent transaction."). The emphasis on form may also reflect the continuing importance of common law methods of reasoning in the law, with their emphasis on precedent, consistency and reasoning by analogy. Id.

470 For discussion on the nature of the corporate taxpayer *see supra* pg. 77ff.

471 WEISBACH, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, *supra* note 17, at 1634. *See also* id. ("The scope of the realization requirement is elusive. No underlying legal or economic concept serves as a touchstone."). A significant problem arises, in particular, in those situations where there is a significant continuity of interest of the transferor on the property transferred. A primary difficulty is the how to identify and treat such situations so as to recognize for tax purposes the continuity of interest, while safeguarding the system against abuses. *See* discussion *infra* at pg. 118.

472 Id. *See also* DANIEL SHAVIRO, *Disclosure and Civil Penalty Rules in the U.S. Legal Response to Corporate Tax Shelters*, *in* Tax and Corporate Governance (Wolfgang Schon ed. 2008) at 234 ("[F]or a realization-based income tax to be feasible, one is virtually forced to make some sort of inquiry into whether or not, as a matter of economic substance, particular transactions "really" were sales (whether so classified by the taxpayer or not). This, in turn, requires inquiry into actual changes in underlying economic relationships to assets.").

on formal categories often detached from economic reality. Thus, merely by altering the legal characteristics of a transaction, the taxpayer may obtain very different tax results for economically similar transactions.[473]

Directionality provides a further example of this problem, clearly evidenced on the transactional analysis. As Steinberg notes, a transfer may have a different legal characterization depending on its transactional direction, *i.e.,* depending on whether a person is viewed as initiating an action or, instead, as being the person against whom an action is initiated.[474] By the same token, by choosing direct or indirect transactional paths the taxpayer may easily alter the type of formal characterizations available to implement the transaction.[475]

The problem is that the selection of acquired versus acquiring status, or direct versus indirect transactional routes, is ultimately just a matter of form and frequently indifferent to related parties.[476] By manipulating the transactional direction, related parties may, thus, easily control the formal characterization of the transfer transaction and, consequently, realization.[477]

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[473] *See* id. at 235 ("This basic tax law pattern – assessing the "reality" of a transaction, and thereby inducing taxpayers to massage the economics of what they are doing so as to achieve sufficient "reality" – is pervasive and fundamental."); WEISBACH, *Formalism in the Tax Law, supra* note 13, at 885 ("The tax law relies on form more than most areas of the law, and one can easily manipulate form without changing the economics of a transaction."); CANELLOS, *A Tax Practitioner's Perspective on Substance, Form and Business Purpose in Structuring Business Transactions and in Tax Shelters, supra* note 168, at 55 ("Tax practitioners involved in real transactions are called upon to cast a desired business transaction in a form that is most beneficial from a tax perspective."); id. at 50 ("To the tax adviser in true business transactions, the existence of substance is a given and form is usually a friend to the extent it permits the tax planner to control the tax results of a given substantial transaction by employing one form rather than another."); WEISBACH, *Line Drawing, Doctrine, and Efficiency in the Tax Law, supra* note 17, at 1640 ("The distinctions between the taxable and the tax-free forms of … transactions are ethereal. The order of otherwise interchangeable steps frequently determines the result."); id. at 1638 ("Given the lack of definitive rules and the economic similarity between debt and equity, designing instruments to skirt the border has become one of the most active practices in tax planning.").

[474] *See* STEINBERG, *Form, Substance and Directionality in Subchapter C, supra* note 456, at 458. *See also* id. at 472 ("Because so many of the requirements for reorganization status apply only to the acquired corporation and its shareholders, and not to the acquirer, the parties have considerable flexibility in shaping the tax consequences to the parties of the transaction.").

[475] For example, instead of a direct distribution, a corporation may implement an indirect transfer of cash using back-to-back loans with other related entities.

[476] *See* id. at 458 ("Directionality is…another manifestation of form controlling tax consequences in Subchapter C [.]"). *See also* CHARLES I. KINGSON, *The Deep Structure of Taxation: Dividend Distributions*, 85 Yale Law J. 861 (1976) at 905 ("A transfer between commonly-owned entities is not an economic event. Its significance is the tax consequences. Accordingly, economic considerations cannot distinguish between transfers which are solely of tax significance. The attempt to decide what tax significance should attach to an event which has no other significance creates disparities between taxpayers whose actions in all relevant respects are identical.").

[477] For this reason, a huge body of jurisprudence and rules were developed based on the need to verify whether form really matches the substance of the transaction. *See infra* pg. 119.

In short, tax treatment is generally interrelated with the formal characterization of transactions. This formalism of the tax system makes it more discontinuous.[478] In turn, as will be further discussed, the discontinuity of the tax system increases the potential for substitution, breeding complexity and deadweight loss.[479]

c. Economic Integration and Tax Treatment

i. Economic Integration, Substitution and Discontinuity

A pillar of the CIT System is the attribution of a separate tax personality to business entities that are, or resemble, a corporation, *i.e.*, an independent legal entity.[480] As a rule, the tax system reacts when that independence is jeopardized and a person or entity controls their management.[481] Historically, the tax system has reacted by either taxing the controlled entity on an accrual basis (*i.e.*, making all the results of the entity accrue directly to its shareholder),[482] or implementing rules that force the transactions between entity and

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478 *See* discussion *supra* at pg. 54ff.

479 *See* discussion *infra* at pg. 131ff.

480 In the US, although the definition of corporation for tax purposes includes certain entities that do not formally constitute corporations under state law, the corporate tax law definition is generally structured on the principle of attributing tax personality to entities that are or resemble a corporation in form or function. *See* IRC Section 11(a) (imposing a tax on the taxable income of "every corporation" but not defining the term "corporation.") and IRC Section 7701(a)(3) (defining "corporation" to include associations and joint stock companies). As Bittker explains "[At the moment of the inception of the corporate tax], Congress presumably had in mind the fact that a business entity may resemble a corporation in form and function even though it does not possess a state charter...Thus, classifying a domestic noncorporate entity...as a corporation is essentially a dual process: Federal law governs the corporate characteristics that must be present in order to find a 'tax law' corporation, but state....law determines whether the organization possesses these legal earmarks." *See* BITTKER & EUSTICE, Federal Income Taxation of Corporations and Shareholders, *supra* note 417, at Section 2.01[1]. These legal earmarks are generally the characteristics associated with a corporation as an independent legal entity. On the current complexities associated with defining a "corporation" for US tax purposes, especially following the check-the-box rules, *see* id. Chapter 2.

481 *See* LEVMORE, *Recharacterizations and the Nature of Theory in Corporate Tax Law*, *supra* note 19. As a rule, those who can control the timing of their taxable events are either taxed directly on such events or subject to additional anti-avoidance provisions. This occurs since parties that can control the timing of their taxable events may easily subvert the tax rules, accelerating or deferring realization events or even simulating false realization events to achieve unlawful tax benefits.

482 This is the base for the development of special tax regimes for the taxation of closely held corporations. In these cases, tax law assumes that shareholders/owners have too much power to influence the management of the entity and thus, there is not enough separation between ownership and management to ensure separate tax treatment. First, in these cases, there is usually a community of interests between the shareholders. Second, shareholders of closely held corporations are likely to participate in management. The shareholders of closely held corporations are, thus, more likely to be able to determine the timing and quantum of dividend distributions. That is, they have an increased ability to manipulate when and if they realize corporate income in their personal capacity. A similar integration between ownership and management generally occurs in the case of partnerships. For these reasons, in both cases, tax law tends to integrate the treatment of the entity with its owners. In the US, *see* IRC Subchapter S (elective flow-through regime for closely-held corporations) and Subchapter K (rules for taxation of partnerships).

shareholder (or other entities owned by the shareholder) to be structured as if they were independent parties, to avoid abuses or manipulation.[483]

These reactions of the tax system aim at to solve two different problems that arise when the system faces a controlled entity. First, when a controlled entity transacts with its owner/shareholder, the potential for substitution escalates. In principle, the higher the degree of integration, the easier it should be for parties to recast the formal characterization of the transaction and, thus, to manipulate abusively the tax system.[484] Second, due to the applicability of non-recognition provisions, the difference between the tax consequences of economically similar transactions increases when high ownership thresholds come into play. That is, the system gets more discontinuous when high ownership thresholds are involved.

Consider the degree of substitution of the tax rules when parties are related. As previously discussed, the proper operation of the realization principle presupposes a number of frictions outside the control of the taxpayer.[485] When the integration of the parties eliminates these frictions, the system does not work properly. With such integration, elements not commonly under the control of only one of the parties, and which form the basis on which the tax system determines the tax treatment of the transaction, *i.e.,* the value, timing and legal classification of the transaction, are easily manipulated because of the common economic interest that exists between both parties.[486] In principle, the higher the degree of economic integration, the worse the problem of substitution should be.

In its effort to recognize for tax purposes the continuity of business interest that generally exists between economically integrated entities,[487] the tax system increases its degree of discontinuity when dealing with entities related through high ownership thresholds and, admittedly, makes matters far worse. As a result of the applicability of non-recognition

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483 These set of rules include transfer pricing rules and substance over form principles, among many others. *See* discussion *infra* at pg. 119.
484 *See* examples *infra* at pg. 127ff.
485 *See* discussion *supra* at pg. 20.
486 Substitution is not automatic in that there are several non-tax factors that may reduce the degree of substitution, namely, the direct costs of the substitution, the existence of frictions in other regulatory areas and the taxpayer's business preferences. *See* discussion *supra* at pg. 53ff.
487 CLARK, *The Morphogenesis of Subchapter C: An Essay in Statutory Evolution and Reform, supra* note 7, at 117 ("Though certain nonrecognition rules arise from particular policy decisions, they principally reflect a desire to acknowledge for tax purposes a substantial continuity of ownership interest.").

provisions, the difference between the tax consequences of economically similar transactions increases when high ownership thresholds come into play.[488]

ii. Economic Integration and Anti-Abuse

In the face of increased potential for substitution when high ownership thresholds exist, the tax system reacts by either totally integrating the tax treatment of the controlled entity with its owner/shareholder, thereby minimizing the potential for abuse, or through the introduction of anti-abuse rules and principles to ensure that the transactions entered into between the related parties do not abusively manipulate the tax regime.

The accrual mechanism provides a particularly efficient method to solve such problems.[489] However, it is not feasible in all situations.[490] In such cases, once separate tax personality is attributed to a controlled entity, the anti-abuse arsenal required to avoid manipulation is truly daunting. This is primarily because, under a CIT system, once separate tax personality is attributed to an entity, the system needs to constantly ensure the correct location, character and amount of such entity's tax attributes. As discussed, with related parties, this task is particularly hard. Absent specific tax or non-tax restrictions, related parties may easily manipulate value, timing, and legal characterization of transactions. In light of the characteristics of the CIT system, related parties have, thus, an increased ability to generate, to randomly allocate, and to characterize tax attributes, that is, to fundamentally alter their tax treatment.

The reaction of the CIT system to this problem is materialized in a complex arsenal of anti-abuse rules. This arsenal consists, firstly, of a set of rules aimed at ensuring that related entities trade among themselves as independent parties. In essence, this set of rules is aimed at ensuring that related parties do not manipulate either the value or the legal characterization of transactions.[491] Secondly, the imposition of strict requirements to access the benefits granted where a continuity of interest exists, as well as a set of rules to ensure

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488 As previously discussed, the increase in the tax system's discontinuity generally results in an increase of the potential for substitution. *See* discussion *supra* at pg. 54ff.
489 It raises some issues though. *See, e.g.,* rules for allocation of tax attributes among shareholders and anti-abuse rules on Subchapter S (BITTKER & EUSTICE, Federal Income Taxation of Corporations and Shareholders, *supra* note 417, at Chapter 6).
490 As previously discussed, to completely integrate the tax treatment of an entity and its owners/shareholders may not be possible in certain cases due to practical issues. A paradigmatic case is the one of widely-held corporations. *See* discussion *supra* at pg. 39.
491 To a large extent, timing is left to the free will of the parties. *But see* discussion *infra* at note 570.

that the entities that qualify for such benefits do not abusively generate, eliminate or change the location or character of their tax attributes.[492]

The control of the value of transactions entered into between related parties is essentially made through transfer pricing rules. These rules aim at ensuring that related parties pay arm's length prices, *i.e.,* that the traded goods are correctly valued.[493] In turn, the control of the legal characterization of the transaction is mostly obtained through the recourse to substance-over-form rules and principles. This body of rules and principles essentially aims at determining whether the taxpayer's chosen transactional form should or should not be respected.[494] This includes a number of different doctrines, such as "substance-over-form," step transaction, agency, conduit and tax ownership.[495] Under these anti-abuse rules and principles, the government and the courts make the argument that the transaction should not generate the tax benefits associated with its form, because form does not reflect substance or because the transaction has no substance, *i.e.,* no business purpose.[496]

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[492] It is interesting to note that anti-abuse rules exist mainly in the tax law. Weisbach contends that this may be due to the problem of uncommon transactions becoming common is worse in the tax law than in other areas. In particular, "[t]he tax law relies on form more than most areas of the law, and one can easily manipulate form without changing the economics of a transaction. In addition, taxpayers often feel entitled to structure transactions to avoid taxes, an entitlement that has its origins in a long and distinguished line of case law. This type of entitlement may encourage taxpayers to push the boundaries [.]." WEISBACH, *Formalism in the Tax Law, supra* note 13, at 885.

[493] This issue is beyond the scope of this thesis. For a good background on the US transfer pricing regime *see, e.g.,* J. KUNTZ & R. PERONI, US International Taxation (Warren, Gorham & Lamont. 1992).

[494] *See* WEISBACH, *Formalism in the Tax Law, supra* note 13, at 860 ("A typical anti-abuse rule allows the government (and only the government) to override the literal words of a statute or regulation. Instead, the government may require a "reasonable" tax result if the taxpayer enters into or structures a transaction with a principal purpose of reducing tax liabilities in a manner contrary to the purposes of the statute or regulation, even if the transaction otherwise literally complies with the rules.").

[495] For a discussion of these different doctrines in the US *see e.g.,* LEVMORE, *Recharacterizations and the Nature of Theory in Corporate Tax Law, supra* note 19; CHIRELSTEIN, *Learned Hand's Contribution to the Law of Tax Avoidance,* 77 Yale L. J. (1968); BOWEN, *The End Result Test,* 72 Taxes 722 (1994); STEINBERG, *Form, Substance and Directionality in Subchapter C, supra* note 456.

[496] CANELLOS, *A Tax Practitioner's Perspective on Substance, Form and Business Purpose in Structuring Business Transactions and in Tax Shelters, supra* note 168, at 49. For instance, an excessive payment between controlled corporations is generally recasted as a constructive dividend to the common owner followed by a capital contribution from the common owner to the corporation receiving the funds. *See* Revenue Ruling 73-605 1973-2 C.B. 109. *See also* CANELLOS at 53 ("To achieve the predictable result, carefully scripted scenarios are usually followed. Indeed, it is the choreographed series of steps – typically foreign to the corporations' usual business, involving extraneous parties and often employed by other users of the same shelter type – that courts often seize upon in branding a transaction as a shelter."); STEINBERG, *Form, Substance and Directionality in Subchapter C, supra* note 456, at 488 ("[T]ransactional form will be respected so long as the substance of the transaction is consistent with the form and does not contain steps that are unnecessary to achieve the parties' economic goals."); id. at 459 ("[S]ubstance does *not* always control in Subchapter C, both because proper form is sometimes a necessary condition for the desired tax treatment and because, where the substance of a transaction is ambiguous or capable of being achieved through more than one transactional approach, form frequently becomes the dispositive factor in determining the tax treatment of the parties."). For a good definition of business purpose in US *see* IRC Treas. Reg. Sections 1.1368-1(b), 1.1368-1(c) and 1.1368-2(g).

The second type of anti-abuse measures involves the imposition of strict requirements to access the benefits granted where a continuity of interest exists, as well as a set of rules to ensure that the entities that qualify for such benefits do not abusively use or transfer their tax attributes. As in the prior group of anti-abuse measures, these rules are considerably complex. Consider the problem of selecting a criterion to ensure that there is a continuity of business interest in a transaction.

Both under the US and UK tax laws, the primary criterion adopted to define continuity of interest, and thus, qualification for the applicability of most non-recognition provisions and several anti-abuse provisions, is "control."[497] Control, however, may be implemented through a multiplicity of legal and economic mechanisms.[498] It is a complex phenomenon that extends far beyond simple *de jure* definitions, difficult to define and quite prone to manipulation.[499]

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[497] *See, e.g.,* in US, definition of control required to access the tax benefits granted to certain corporate restructurings under IRC Section 368 at BITTKER & EUSTICE, Federal Income Taxation of Corporations and Shareholders, *supra* note 417, Section 3.07. *See* generally, in the UK, TILEY, Revenue Law, *supra* note 437, at 827 and 844. *See also* discussion *infra* on the control requirements used to allow access to the benefits of Group Taxation in the US and the UK at pg. 181ff.

[498] The legal mechanisms to implement control include mechanisms of a financial nature (such as intercorporate stock ownership), mechanisms of a contractual nature (such as profit pools or business transfer contracts), mechanisms of a personal nature (such as the device of interlocking board directorates), mechanisms of an organizational nature (such as special stipulations in the by-laws of companies that derogate the general principle of "one share one vote") and mechanisms of a factual nature (such as supply agreements or exclusivity contracts). *See* ANTUNES, Liability of Corporate Groups: Autonomy and Control in Parent-Subsidiary Relationships in US, German and EU Law, *supra* note 326, at 144-155; P. C. DOLEY, *The Interlocking Directorate*, 59 American Economic Review 314 (1979) at 314ff; F. STOCKMAN, et al., Networks of Corporate Power (Polity Press. 1985) at 44. The economic mechanisms of control gravitate between the two poles of direct control (with the parent corporation intervening in the everyday operational management of the affiliate) and indirect control (generally exercised via general long-term planning or via supervision of the affiliate's economic performance). *See* ALSEGG, Control Relationships Between American Corporations and Their European Subsidiaries, *supra* note 328; EGGELHOFF, *Patterns of Control in US, UK and European Multinational Corporations, supra* note 327; CRAY, *Control and Co-Ordination in Multinational Corporations, supra* note 331.

[499] Control is a "structural relation through which a particular category of owners have *de facto* capacity to mobilize the powers vested in the company itself." *See* JOHN SCOTT, *Corporate Groups and Network Structure, in* Corporate Control and Accountability (Sol Picciotto ed. 1993) at 294. A symptom of the difficulty to define control is the inconsistency in the definitions available. In particular, inconsistencies may be found at three levels within the technical definition of the control requirement, namely, jurisdiction versus jurisdiction, specific tax legislation versus non-tax legislation and specific tax legislation vs. other tax legislation. *See, e.g.,* MARGARET LAMB, *When is a Group a Group? Convergence of Concepts of Group in European Union Corporate Tax*, 4 European Accounting Review 33 (1995).

The tax legislator faces therefore a dilemma.[500] That is, while the adoption of administratively more adequate *de jure* definitions makes the tax system easily subject to manipulation, the adoption of more encompassing, or *de facto* standards, may not always be adequate to the need for expediency required in the tax world due to the high number of transactions involved. The solution of the tax legislator to this dilemma is varied, varying even between different provisions of the same corporate tax laws. While, in certain cases, a definition of control based on percentage of vote and/or value of stock suffices,[501] in other cases additional substantive requirements are imposed.[502] Once the benefits of non-recognition are accessed, an additional set of rather intricate rules comes into play. This final set of anti-abuse measures ensures that the entities that qualify for the benefits of non-recognition do not abusively use or transfer their tax attributes.[503]

500 In the same sense *see* CLARK, *The Morphogenesis of Subchapter C: An Essay in Statutory Evolution and Reform*, *supra* note 7, at 118 ("Exactly which test will give specific content in specific contexts to the underlying concept of continuity of interest which is at the heart of all nonrecognition transactions? The task is truly enormous, given the multiplicity of ways in which businesses can operate and the manifold objectives they may serve.").

501 In the US, certain provisions define "control" by reference to objective circumstances, such as percentages of stock ownership (*see, e.g.,* IRC Sections 1563 and 267), while others use more unclear concepts. A paradigmatic case is IRC Section 482, which refers to organizations that are 'owned or controlled directly or indirectly by the same interests." This US tax provision, through its regulations, adopts a broad interpretation of what amounts to a relationship between related parties. It states that the term 'controlled' includes any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised' and adding that 'it is the reality of the control which is decisive, not its form or the mode of its exercise'." *See* IRC Treas. Reg. 1.482-1(i)(4). Further, certain rules prescribe attribution rules for determining stock ownership (*see e.g.,* IRC Sections 1563 and 267), while others do not (*see e.g.,* IRC Sections 482 and 269). As a rule, in the absence of a statutory attribution rule, stock ownership generally will not be attributed from one shareholder to another. *See* BITTKER & EUSTICE, Federal Income Taxation of Corporations and Shareholders, *supra* note 417, Section 13.01[3][a], at 13-10. For similar difficulties to define control for tax purposes in the UK *see* generally UK, TILEY, Revenue Law, *supra* note 437, at 827 and 844.

502 For instance, in the US, besides continuity of interest, the passing of intricate continuity of business and business purpose tests is often required. In general, in the context of business restructurings, the continuity of business test requires that the acquiring corporation either continue the target corporation's historic business or use in its own business a significant portion of the target corporation's assets. Alternatively, where the acquiring corporation fails to carry on the target corporation historic business, the continuity of business test can be met if a significant portion of the target corporation's assets is used by the acquiring corporation. Even where these statutory requirements have been followed, the tax-free designation of the reorganization will not be allowed unless it has a *bona fide* business purpose. The business purpose test applies the substance-over-form principle, *i.e.,* as previously discussed, looking through the transaction to determine what actually took place. These rules are generally applicable to corporate restructurings (IRC Section 368) and corporate divisions (IRC Section 355). *See, e.g.,* IRC Section 355(b)(1)(A) (immediately after the distribution, both the distributing corporation and the controlled corporation (or corporations) must be engaged in the active conduct of a trade or business).

503 *See,* in the US, IRC Section 269 (disallowing certain tax benefits if control of a corporation is acquired for the principal purpose of tax avoidance) and IRC Sections 382, 383 and 384 (limiting or disallowing the carryover of net operating losses and certain other tax allowances when stock ownership shifts in specified ways). On the relative permeability of these complex anti-abuse provisions *see* Bittker "Although the Service's position in litigated cases may suggest implacable opposition to any and all transfers of tax attributes, many, if not most, corporate reorganizations and other adjustments pass smoothly through the audit or tax-ruling process with their carryovers virtually intact." BITTKER & EUSTICE, Federal Income Taxation of Corporations and Shareholders, *supra* note 417, Section 14.47[7] at 14-127.

Overall, in the presence of high degrees of ownership, the Standard CIT System develops a high degree of complexity, which is attributable, firstly, to increased rule complexity. That is, with high degrees of ownership, non-recognition provisions and an arsenal of anti-abuse rules comes into play. Secondly, and interrelated, to increased transactional complexity, since with such degrees of ownership, the CIT system develops high degrees of discontinuity and, thus, provides an additional encouragement to substitution. Finally, to increased compliance complexity, since due to the application of several anti-abuse provisions, the *bona fide* of the transactions must be extensively documented.[504]

C. The Nature of Corporate Groups and the Standard CIT System

As previously discussed, as a member of a corporate group, the corporation is part of a larger entity, an atom of a molecular structure. The integration of the atomistic corporate entity into the molecular group structure is achieved through its submission to a group level unitary economic direction. The tension between the individual corporation's legal and economic substratum and the group's unitary economic direction generates the dynamic of an organized internal market.

In the organized internal market, assets and income are continually transferred among group members. Specifically, in the same manner molecules may only exist if exchange of electrons among atoms occurs, the corporate group requires constant transfers of assets and income among its nodes in order for its organized internal market to function.[505] These internal transfers of resources occur among different nodes of the group, such as sister to sister, subsidiary to parent or members located in different tiers.[506]

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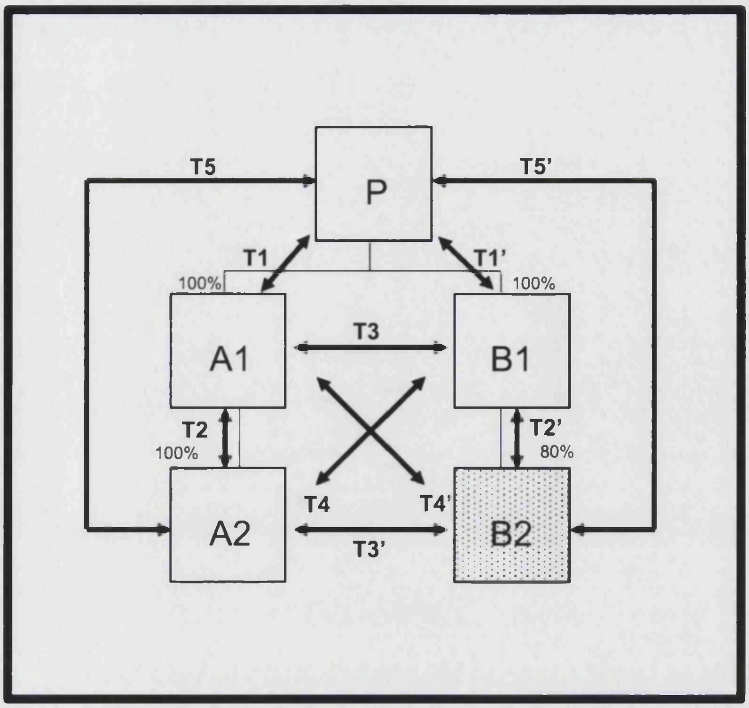
504 In the US this includes, for instance, extensive transfer pricing compliance requirements (*see* IRC Section 482), compliance with complex anti-shelter regulations (*see* IRC Sections 6111 and 6112) and compliance with information requirements for qualification for certain tax benefits (*see, e.g.,* IRC Treas. Reg. Section 1.368-3, requiring the participants in a tax-free reorganization to keep detailed records of the reorganization proceedings and to file with their returns for the year of the reorganization a complete statement, setting out the information prescribed by the regulations). On the intricate and burdensome anti-corporate tax shelter provisions and their legislative background *see* BITTKER & EUSTICE, Federal Income Taxation of Corporations and Shareholders, *supra* note 417, at Section 5.10.

505 Personnel may also be transferred inside the group. This issue is outside the scope of the present analysis. *See* generally ANTUNES, Liability of Corporate Groups: Autonomy and Control in Parent-Subsidiary Relationships in US, German and EU Law, *supra* note 326, at 97-98.

506 Id.; RICHARD CAVES, Multinational Enterprise and Economic Analysis, *supra* note 318; CHANNON & JALLAND, Multinational Strategic Planning, *supra* note 318.



TRANSACTIONAL FLOWCHART

Diagram 7

These transfers may occur directly (*e.g.,* corporation A2 to corporation P using transactional route T5) or indirectly (*e.g.,* corporation A2 to corporation P using transactional routes T2 and T1 or T2, T3 and T1´) and may assume different formal characteristics (*e.g.,* a transfer of assets from corporation A1 to corporation P using transactional route T1 may be structured as a distribution in-kind, a merger, a liquidation or a sale).[507] In most cases, a corporate group, as a direct result of its unitary economic direction and chameleon-like structure, should be able to manipulate these elements with relative ease.[508] Specifically, a group may easily select different transactional routes and legal forms to implement an intra-group transfer of assets or cash.[509] In addition, in certain cases, the group may also alter its legal or functional structures in order to obtain a more advantageous tax treatment.[510]

This flexibility of the corporate group to manipulate transactional routes, legal forms and functional and legal structures occurs for several reasons. As previously discussed, the

[507] The different formal characterization of the transaction should generally entail different tax consequences. *See* discussion *supra* at pg. 105ff.
[508] Notable exceptions are transactions that have to necessarily be implemented in a certain way due to other business aspects.
[509] The flexibility of corporate groups to manipulate the value of transactions is outside the scope of this thesis.
[510] *See* discussion *infra* at pg. 128.

sovereign nature of the corporation distorts when controlled by another corporate entity and, thus, submitted to an external interest.[511] Significantly, due to the dilution of the individual corporation's ownership of property within corporate groups,[512] assets and income must be regarded as belonging to the collective group entity, an entity without legal existence *per se*, that simply allocates assets and income to their most economically efficient uses across its nodes.[513]

Once the legal fiction of the corporate veil of corporate group members is abandoned and formalism is set aside, the corporate group appears as a subject characterized by "organizationally-bound" property rights, *i.e.,* an entity where assets and income may be transferred horizontally, vertically or transversally between its different nodes without actual change of economic ownership. Hence, unless specific risk-management considerations, creditor demands or financial reporting issues are present, the identity of the formal owner of the group's property should be largely irrelevant for the corporate group.

The internal allocation of resources among the different group nodes under a unitary business policy often demands the relegation of the particular economic interest of a subsidiary in favour of the common objective of overall profit maximization. Significantly, this unitary business policy often involves obedience to a group tax strategy of tax minimization.[514] Thus, many groups look at the tax results of their entities on a joint basis, having an added interest (and instruments) to engage in overall group tax planning.[515]

Finally, the group has a volatile nature. That is, the corporate group is able to change its governance structure and make a discriminate use of the corporate veil of its affiliates to

[511] *See* discussion *supra* at pg 83ff.

[512] The corporation that is a member of a corporate group possesses, in practice, only limited ownership rights over its assets. Id.

[513] *See* discussion *supra* at pg. 80ff.

[514] *See e.g.,* concept of "global tax planning," very fashionable among consulting companies, at http://www.kpmg.com/global/en/whatwedo/tax/international-Corporate-Tax/Pages/default.aspx or www.deloitte.com/.../us_tax_OptimizingGlobalTaxStructuresforPrivateEquity_061710.pdf. Under the global tax planning concept, the tax attributes of a multinational corporate group are managed under a globally coordinated group strategy.

[515] In particular, there is a cooperation element that makes entities work together in order to reduce the overall group tax charge. However, elements of competition remain in that it must be expected that entities will struggle for financing from the parent also claiming tax advantages on their treatment. *See* ANTUNES, Liability of Corporate Groups: Autonomy and Control in Parent-Subsidiary Relationships in US, German and EU Law, *supra* note 326, at 158-206. On an open setting scenario, this element gains renewed interest since the tax treatment of each entity may vary significantly (including taxable base, tax rates, etc.).

evade tax regulations. In particular, although often subject to business and operational restraints, a corporate group may, as a matter of principle, manipulate the webs of ownership inside the group and the functions performed by each legal entity. This should depend on a cost-benefit analysis. The higher the tax benefit, the more inclined the group may be to change its legal or functional structures to allow for a more efficient tax structure.[516]

Due to the nature of corporate groups, the degree of substitution of the Standard CIT System when facing corporate groups is, thus, especially high. Further, as previously discussed, the Standard CIT System is structurally discontinuous when high levels of ownership are present. As a direct result of these factors, the incentive for tax planning in intra-group transactions should, in many situations, be very significant. Consider the following transactional map for the transfer of built-in gain assets under the Standard CIT System when high levels of ownership (*i.e.,* 80% ownership or more) are present:[517]

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[516] This cost-benefit analysis is generally required because the selection of an efficient tax structure (*i.e.,* the structure with less associated tax costs for the group) may have collateral negative consequences for the group's operation. *See, e.g.* SCHOLES, et al., Taxes and Business Strategy: A Planning Approach, *supra* note 14, at 157 ("Income shifting and organizational forms that minimize taxes often give rise to costs along other dimensions, leading to a trade-off between taxes and nontax costs. For example, income shifting within an organization might require more centralized organizational structures, but information asymmetries might require more decentralized organizational structures."). In general, based on traditional neo-classical models, the group may generally be expected to engage in tax planning until the marginal value of the planning is equal to its cost. *See* CHORVAT, *Perception and Income: The Behavioral Economics of the Realization, supra* note 31, at 88-91. *See also* THORNTON., *Managerial Tax Planning Principles and Applications*, supra note 182, at 147 ("A corollary to the Coase Theorem is that people will engage in tax arbitrage up to the point where the marginal costs of performing the arbitrage are equal to the marginal gains.").

[517] This transactional map would be substantially different, with a different range of available formal possibilities, if different goods (*i.e.,* "built-in loss" assets, cash or stock) were being transferred or if there were lower levels of ownership (*e.g.,* 50% ownership) in the corporate group members. The situation should be similar in the UK. For the legislative background to the diagram *see* IRC Section 351 (capital contribution), IRC Section 311 (distribution in-kind), IRC Section 332 (liquidation), IRC Section 368 (mergers) and IRC Section 1001 (sales). The analysis assumes that the different qualification requirements for these provisions are met.

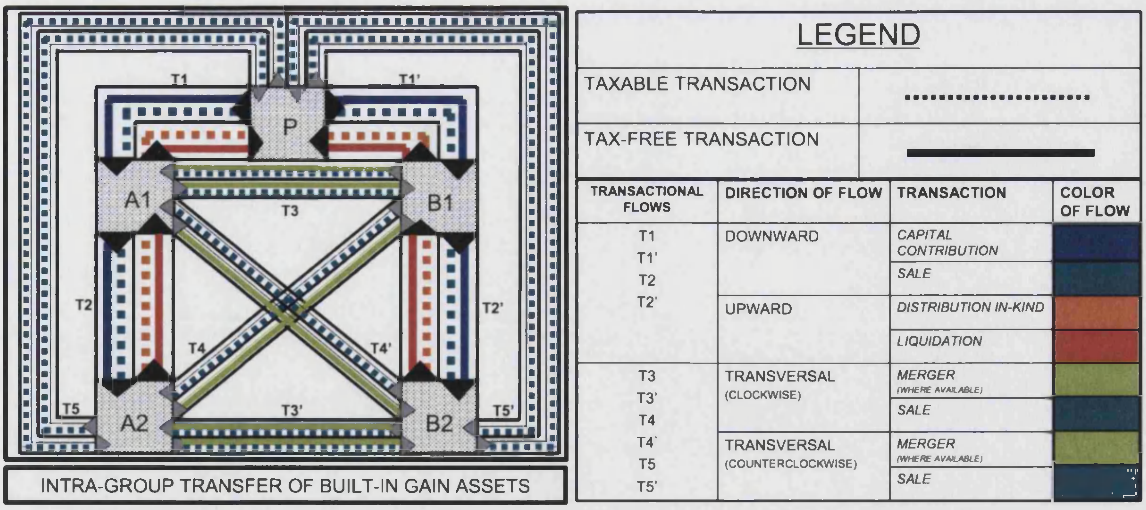

Diagram 8

In essence, a corporate group navigates through complex transactional maps defined by tax law, which vary depending on the ownership threshold in the corporate group member, and on the good transferred and its tax attributes. On each transactional map, tax consequences depend on the direction and legal form adopted to implement the intra-group transfer.[518] The corporate group's expected behaviour will be to choose the correct mix of these elements (especially direction and legal form)[519] that better serves its interests, namely, to transfer assets and/or cash from one subsidiary to the other, minimizing the transfer costs (including taxes) and general operating costs in order to maximize profits.[520] In addition, the group may be interested in generating and using tax losses, which reduce taxable income, and, therefore, the tax amount payable. Since in the Standard CIT System the use of tax losses is subject to asymmetries in the form of several basket restrictions,[521] groups may also often be interested in changing the character, source or timing of the loss so that it can be better availed of.

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518 *See* discussion *supra* at pg. 106ff.

519 For practical motives, the good transferred and its attributes are not easily subject to manipulation. Due to non-tax frictions, the manipulation of ownership thresholds may also be more difficult.

520 As previously discussed, this flexibility occurs essentially because CIT is built around realization. Under a realization-based tax system, taxpayers are relatively free to determine the occurrence, value and timing of a transfer as well as its legal characterization.

521 *See* discussion *supra* at pg. 99ff.

In order to achieve such objectives, the group may thus, be interested in manipulating the amount, location and character of tax attributes. In light of the nature of the Standard CIT System, this may be achieved by changing the value, timing and legal characterization of intra-group transfers. The primary decision will generally consist of choosing between taxability and non-taxability of the transaction.[522] This should depend on the tax attributes of the entities involved, fundamentally their inside and outside tax bases amounts; their taxable income for the year; the available carryovers of tax losses; and, in certain cases, the possibility offered by a transaction to carryover tax attributes. Consider the following examples.

As previously discussed, the attribution of a separate tax existence to corporations under the Standard CIT System requires the creation of a dual tax basis.[523] Due to their mechanical independence, the value of outside and inside bases may differ.[524] As a result, by characterizing a transfer as an asset or a stock sale, the corporate group may manipulate the amount of taxable gain or loss recognized on the transfer. Thus, when interested in transferring the business of one of its nodes (A2) to a different node (B2) under a taxable transaction, the group may, depending on the value of B2's outside and inside tax bases, opt to transfer the subsidiary's stock (B2) or its underlying assets. The higher the tax basis, less taxable gain or more taxable loss may be derived from the transaction. Further, the selection of a taxable asset versus stock disposition may allow the group to control the location of the taxable gain or loss in that the transfer of the underlying assets will give rise to recognition at the level of the transferee corporation (A2), while the transfer of stock will give rise to recognition at its parent level (A1). Depending on the parent's (A1) or transferee's (A2) tax attributes, the group may be interested in structuring the transaction differently.

Last but certainly not least, the selection of an asset versus a stock taxable disposition may significantly alter the treatment of the tax losses of the node transferred. As previously discussed, the transfers of stock of a business with NOLS or NCLs in its taxable income accounts are subject to different limitations to those imposed when only assets are

522 This option, when we are in the presence of a corporate group, due to its unitary economic direction, will be fundamentally different from the one of an economically independent corporation. Specifically, the group may be expected to maximize its overall tax attributes in a transaction. This attitude is fostered by the judicial culture in the US and UK that tends to defend the taxpayer's ability to legitimately reduce its tax costs.
523 *See* discussion *supra* at pg. 103ff.
524 Id.

transferred.[525] Specifically, while the taxable transfer of assets does not result in a transfer of tax attributes, the transfer of stock also implies the transfer of the target corporation's tax attributes, namely, potential current and accumulated NOLS and NCLs.[526] The selection of an asset versus a stock acquisition may, thus, also depend on the tax attributes of the target corporation (A2).[527]

Also, in certain cases, the changes in the location of tax attributes may involve changes to the group's functional structure. Consider, for instance, the group's potential interest in locating additional tax deductions in a profit making node (A1) and tax inclusions on a loss making node (A2). To change the group's functional structure and have A2 providing administrative services for A1, as well as for the rest of the group, provides one potential approach. As a result, while the remaining group entities, including A1, have deductions for the payments made for services, the entity rendering such services (A2) may effectively offset the group's taxable income using its unused losses from other lines of business. By the same token, group financing may be channelled through a sole entity, compounding the loan related deductions in such profit making entity (A1).[528]

An alternative approach to obtaining a more beneficial tax treatment is the implementation of the transfer through an indirect route, either to obtain higher tax benefits or to avoid specific anti-avoidance rules. For instance, in order to avoid taxability of the transaction, an intra-group transfer may be structured as a tax-free merger instead of a straight asset sale or through the implementation of several transactions instead of only one, such as capital contributions in cascade (from P to A1, and from A1 to A2) instead of a straight asset sale to a lower tier subsidiary (from P directly to A2).[529]

The manipulation of the qualification requirements for application of the non-recognition provisions, namely the concept of control, is also a viable strategy available to alter tax treatment. As previously discussed, the mechanics of the Standard CIT System vary

525 *See* discussion *supra* at pg. 106.
526 Id.
527 In the US, *see* IRC Section 338 allowing the taxpayer to elect to treat certain stock purchases as asset purchases. If the election is made, the corporation takes a cost basis in its assets and is purged of all of its prior tax attributes. *See also* IRC Section 338(h)(10) (acquisition of stock of a subsidiary). For the differences associated with an asset vs. a stock acquisition in the UK, *see* TILEY, Revenue Law, *supra* note 437, at 846.
528 Similar strategies exist for managing the group's intellectual property. These strategies are especially common once an open setting scenario is considered, due to the increased benefits provided by lower or inexistent corporate income tax rates in certain countries where to locate these types of services.
529 The indirect transactional route may also involve an unrelated party. For instance, a back-to-back loan between two corporate group members using a bank as an intermediary.

considerably depending on the degree of ownership of a parent over its affiliates, as generally assessed through ownership thresholds. By manipulating such ownership thresholds and associated substantive requirements, the group may thus have access to a different tax treatment for its intra-group transactions. Since the concept of control is a rather elusive concept in face of financial innovation and of the legal and operational flexibility of corporate groups, such manipulation may often be rather difficult to control.

Also, the group may want to manipulate the character of the taxable income or loss in order to avoid the capital/ordinary income divide and its associated loss limitations. For instance, assume a situation where the group's parent (P) has a considerable amount of accumulated NOLs to use but no accumulated NCLs, and wants to sell the stock with built-in gain that it holds in one of its subsidiaries (A1). In this situation, instead of directly selling the stock and being fully taxed on capital gains, the group may prefer to have such gains characterized as ordinary gains. Thus, the group may opt to implement, first, a distribution of profits from the subsidiary (A1), so that such income may be treated as ordinary income, and, only then, the disposition of its stock. Absent specific anti-abuse rules,[530] the disposition of stock would be treated as a capital gain. However, due to the pre-disposition distribution, the capital gain amount would be lower (or even, result in a capital loss if the actual market value of the company was now inferior to its outside basis).[531] A similar example of manipulation of character is where the group opts to structure an internal asset transfer as the rental of property, so that the rental payment may be characterized as ordinary income, instead of as a sale where the income would be characterized as capital gain.[532]

Finally, in certain situations, a corporate group may be interested in changing the timing of a taxable event.[533] For example, in order to use up expiring accumulated losses, the group may sell a built-in gain asset before its optimal business timing. In particular, a transfer that might otherwise not be done, or that under a regular scenario would only be implemented

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530 In the US, these transactions, commonly known as "bootstrap acquisitions," are subject to close scrutiny. *See* BITTKER & EUSTICE, Federal Income Taxation of Corporations and Shareholders, *supra* note 417, Sections 8.07[2] and 9.06.

531 Similar distributions made in close proximity to the corporation's liquidation also receive close scrutiny as to their character, *i.e.,* as ordinary dividends or liquidating distributions. *See* id., at Section 5.05[6], at pg. 5-52.

532 This assumes that the asset is not used in the trade or business of the transferee corporation. As previously discussed, unless specific non-tax frictions are present, in the context of organizationally-bound property rights it may be indifferent to the group to have the title on the property transferred or not to a different affiliate.

533 As previously discussed, this thesis is not concerned with the manipulation of the value of transactions.

at a later point in time, may be implemented, that is, a "lock-out" effect occurs. A similar interest may be founded on the desire to step up the tax basis of assets to their fair market value for depreciation purposes, or the desire to sell assets to permit a change in the depreciation schedule to one that is more highly accelerated.[534]

The same type of timing distortions may occur with built-in loss assets.[535] Unless a group has no capital gains for the year or has sufficient carryover capital losses to offset its tax liability for the year at the level of all of its members, the group may also be interested in triggering loss recognition, in order to minimize capital gain recognition. By the same token, in order to cash in more quickly and more fully tax-attributes such as carryforwards of NOLs or NCLs,[536] the group may implement a transaction that allows for the transfer of expiring capital losses to a member with built-in gain assets to sell.[537] A reverse timing effect, *i.e.,* "lock-in," may also occur in certain situations.[538]

As a reaction to these, and many available other avoidance opportunities generated by the structural asymmetries of the Standard CIT System,[539] a complex arsenal of specific anti-abuse rules was developed and substantial developments in judicial anti-abuse doctrines took place.[540] Corporate groups have reacted to these primarily piecemeal reforms by fostering organizational and transactional complexity in the exploration of innovative substitute transactions.

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[534] SCHOLES & WOLFSON, *The Effects of Changes in Tax Laws in Corporate Reorganization Activity*, *supra* note 182, at 141-142.
[535] That is, assets whose market value declined to a level below their tax basis.
[536] As well as other tax attributes, such as investment tax credits or foreign tax credits. *See* SCHOLES & WOLFSON, *The Effects of Changes in Tax Laws in Corporate Reorganization Activity*, *supra* note 182, at 141-142.
[537] For instance, a tax-free merger.
[538] For instance, in the case of provisions that require a minimum holding period following the transfer for substance purposes (common where a tax-free transaction occurs), the corporate group may refrain from selling an asset in order to avoid triggering taxability under the anti-abuse provisions.
[539] *See, e.g.* the array of planning opportunities available under the current US CIT System for corporate acquisitions and restructurings described at MARTIN D. GINSBURG & JACK S. LEVIN, Mergers, Acquisitions, and Buyouts (Aspen. 1999).
[540] *See* discussion *supra* at pg. 118ff.

D. The Dynamic Effects of Taxing Corporate Groups under the Standard CIT System

Due to their nature, corporate groups are generally able to manipulate the value, legal characterization and timing of transactions. In the previous section, this thesis analyzed how this ability could be used to manipulate the mechanics of the tax system. In particular, it demonstrated how such ability could allow corporate groups to manipulate location, character and amount of tax attributes, and, thus, absent the application of specific anti-abuse rules, to fundamentally alter their tax treatment. In the present section, this thesis will examine the dynamic effects (*i.e.,* the behavioural and economic effects) of such manipulation, for corporate groups and for the state.[541]

1. *The Manipulation of Legal Characterization*

a. Discontinuity, Substitution and Transaction Costs

Due to its realization-based nature, tax is only levied upon an actual transfer of title on property. This corner stone of the CIT system results in a discontinuous body of tax rules.[542] When there is discontinuity in the tax rules, the potential for substitution increases.[543] As discussed, this problem of substitution is particularly acute when corporate groups are taxed under the Standard CIT System. The reason is two-fold. First, the Standard CIT System significantly increases its discontinuity when high-ownership thresholds are present due to the applicability of non-recognition rules. Second, corporate groups enjoy particular flexibility to alter their tax treatment.

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541 The thesis will focus on the dynamic consequences of the group's ability to manipulate the legal characterization and the timing of transactions. As previously discussed, the capacity of corporate groups to manipulate the value of transactions is outside the scope of our analysis.

542 The corporate-level nature of the CIT System and its yearly tax assessment rule are two additional primary contributors to such discontinuity.

543 That is, corporations sufficiently close to the discontinuity should have a higher propensity of moving to the lower taxed regime. In principle, this should occur whenever transaction costs are inferior to the tax savings and associated risk. *See* WEISBACH, *Formalism in the Tax Law, supra* note 13, at 874. ("Where there is discontinuity, taxpayers sufficiently near the discontinuity will shift to the lower taxed regime, if transaction costs are less than the tax savings[.]").

For corporate groups, the root of the dynamic problems associated with such substitution is that, in a world of costly contracting and information asymmetries, the search and adoption of substitute transactions has associated costs and potential operational inefficiencies.[544]

b. Perfect and Imperfect Substitution

The implementation of a substitute transaction has associated structuring and implementation transaction costs. These costs include, first, the fees paid to professionals to locate these alternatives and to evaluate how cost effective it is to bear the potential frictions associated with the new tax position.[545] Second, the costs associated with implementing the substitute transaction.[546]

Apart from these costs, substitution may also result in additional inefficiencies.[547] This will depend on whether the substitute transaction is a perfect, or imperfect, substitute for the substituted transaction.[548] In the case of perfect substitutes, the corporate group should substitute without any associated inefficiencies.[549] In the case of imperfect substitutes, however, the implementation of the substitute transaction may have associated inefficiencies. In particular, these inefficiencies may include:

a. Transfer of resources to a corporate member that does not provide the best economic return for their use;

b. The adoption of a sub-optimal functional structure;

[544] Also, there are certain equity issues involved, but they are outside the concern of this thesis. Broadly, due to the reduction in taxes levied, some other taxpayers will have to share an increased tax burden in order to support the expenses of the state. *See* WEISBACH, *Formalism in the Tax Law, supra* note 13, at 886 ("Tax motivated transactions are inefficient and, by lowering tax receipts, they impose an externality on everyone else in the form of higher tax rates.").
[545] Both on monetary and reputational terms. *See* SCHENK, *An Efficiency Approach to Reforming a Realization-Based Tax, supra* note 55, at 516.
[546] Restructuring costs, etc. *See* id. at 516
[547] *See* SCHOLES, et al., Taxes and Business Strategy: A Planning Approach, *supra* note 114, at 3 ("In a world of costly contracting, implementation of tax minimization strategies may introduce significant costs along nontax dimensions.").
[548] This terminology is based on Weisbach. *See* WEISBACH, *Formalism in the Tax Law,* supra note 13, at 875 ("Tax arbitrage is inefficient. If the forms used in the arbitrage are perfect substitutes, there is no economic cost to the arbitrage; the social costs are the transaction costs, which can be large – as large as the tax avoided. If the forms are not perfect substitutes, taxpayers can change their economic position to obtain a tax advantage, creating inefficiencies [.]").
[549] The state, however, suffers a revenue loss.

c. The adoption of a sub-optimal legal structure; and

d. The adoption of a more complex transaction.

First, as a result of substitution, the transfer of group resources may be made to a corporate member that does not provide the best economic return for their use. As discussed, in order to locate deductions, inclusions, and capital gains or losses on the entity whose tax attributes are most beneficial, the location of assets and income within a corporate group may not be the most efficient from an economic perspective. Second, the implementation of substitute transactions may require the adoption of a sub-optimal functional structure. For instance, in certain cases, tax planning may be conducive to the adoption of a functional structure with a greater degree of centralization of management than would otherwise be optimal.[550]

Further, the substitute transaction may involve the adoption of a legal structure that is not the best from a business perspective. As previously discussed, certain tax planning strategies may require manipulation of the corporate veil, including the amalgamation of several group businesses in a sole corporate member or the wind up of certain corporate members. That is prejudicial to the corporate group, in that from an efficient management perspective, in certain cases it may be preferable to maintain the corporate veil of a certain line of business.[551] Finally, the substitute transaction may be more complex than otherwise

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550 That is, information asymmetries may require more decentralized organizational structures. *See* SCHOLES, et al., Taxes and Business Strategy: A Planning Approach, *supra* note 114, at 168 ("When a complex organization is composed of distinct legal entities...shifting income from one pocket to the next may require considerable coordination, and tax rules often induce a greater degree of centralization of management than would otherwise be optimal."); id. at 156 ("[T]ax considerations and information-related transaction cost considerations often have conflicting implications for efficient organizational design. Sometimes tax considerations dominate in importance and sometimes information considerations dominate. But frequently, both factors are important and trade-offs must be made."); SCHOLES & WOLFSON, *The Effects of Changes in Tax Laws in Corporate Reorganization Activity*, *supra* note 182, at 144 ("[I]n designing an organization, tax considerations and information-related transaction cost considerations are often in conflict with one another.").

551 For instance, research conducted by the Canadian government identified the following non-tax costs with respect to the use of amalgamations or windups: corporations operating in regulated industries are either directly limited in how they must conduct their activities or indirectly encouraged by the existence of regulations to operate non-regulated business in separate corporations; profit centre management controls may not operate as well if the separate corporate status is eliminated; debt covenants may have evolved that restrict different members of the group to different degrees; minority shareholders may block or delay the reorganization; groups with high-risk projects or startup situations may conduct activities through separate corporations in order to limit liability to the equity directly related to individual projects; and the cost of the reorganization in money and management time may be considerable. *See* DEPARTMENT OF FINANCE CANADA, A Corporate Loss Transfer System for Canada (Budget Papers. 1985). Further, it may be desirable to maintain the separate operational independence, track records and corporate marketing identities achieved by the segregation of businesses in distinct but related companies. There may also be labour and management

required, leading to less transparency in internal group flows and the group's organizational structure.[552]

In short, when corporate groups are taxed under the Standard CIT System, the problem of substitution is particularly acute. Such substitution, in a world of costly contracting and information asymmetries, has associated structuring and implementation costs for corporate groups as well as, in certain cases, additional operational inefficiencies. As will be discussed, these costs and inefficiencies are the root of the dynamic problem of substitution for corporate groups.

2. The Manipulation of Timing

Corporate groups are also able to manipulate the timing of transactions in order to control their tax treatment. As previously discussed, since a potential built-in gain or loss on an asset is only includable in taxable income once a qualifying transfer occurs, the members of the group may anticipate ("lock-out" effect), postpone ("lock-in" effect) or, in more extreme cases, cancel such transfer in order to obtain a better aggregate tax result.[553] The type and magnitude of the behavioural distortion will generally vary depending on the tax attributes of the corporations in question and the type of assets transferred.

3. The Consequences of Manipulating the CIT System

The manipulation of the form and timing of transactions results in several negative consequences, for the state and corporate groups, namely:

a. Increased complexity of the tax system with an associated increase of tax overhead costs, both for corporate groups and the state;

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issues arising when corporations with distinct cultures and unions merge into one conglomerate, or financial considerations when subsidiaries within a group have different costs of capital. Also, corporate investors setting up new uncertain ventures may find it desirable to co-invest with minority shareholders who may contribute their own expertise and networking to the success of innovative projects. *See* ALEXANDRE LAURIN, *Cleaning Up the Books: A Proposal for Revamping Corporate Group Taxation in Canada*, 284 C.D. Howe Institute's Fiscal Policy 1 (2009) at 5-6.

552 *See* discussion *supra* at pg. 128ff.

553 *See* SHAVIRO, *An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax*, *supra* note 4, at 48 ("The efficiency detriment of [nonrecognition rules that apply only to loss] ...is that taxpayers may alter their transactions to avoid the rules, rather than give up on selectively realizing losses.").

b. Reduction of the ability of corporate groups to shift capital to its most efficient use;

c. Agency problems; and

d. Rigid and potentially sub-optimal functional and legal structures.

a. Complexity and Transaction Costs

The manipulative behaviour of corporate groups should lead to three different types of complexity, namely, transactional, rule and compliance complexity. To begin with, the corporate groups' manipulative behaviour may result in increased transactional complexity.[554] As previously discussed, increased transactional complexity may arise due to the implementation of substitute transactions that use more complex legal instruments and/or indirect transactional routes, aiming to manipulate the formalism of the Standard CIT System.

In turn, this tax-minimizing behaviour breeds additional complexity from tax reformers and legislators who respond with measures designed to circumvent the latest tax manoeuvres.[555] The counteraction of the manipulative behaviour of corporate groups increases the quantity and complexity of the tax rules. The bigger challenge to interpret such tax rules raises the transaction costs for corporate groups through the need for professional tax preparers, lawyers and accountants.[556] As for the state, it raises the cost of designing tax rules and of supervising their operation.[557]

Further, the need to provide adequate proof of the fulfilling of the formal and substantive requirement associated with the applicable anti-abuse rules significantly increases compliance complexity.[558] That is, corporate groups experience more difficulties and incur

[554] As previously discussed, transactional complexity refers to the hardships associated with altering behaviour to benefit from the preferred routes of action defined by the legislator. *See* discussion *supra* at pg. 62.
[555] *See* BRADFORD, Untangling the Income Tax, *supra* note 180, at 266-67.
[556] *See* WEISBACH, *Formalism in the Tax Law, supra* note 13, at 860.
[557] *See* discussion *supra* at pg. 63. *See also* SHAVIRO, *An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax, supra* note 4, at 24.
[558] As previously discussed, compliance complexity includes the difficulties faced by taxpayers such as keeping records, choosing forms, and making necessary calculations. *See* discussion *supra* at pg. 63. For the arsenal of anti-abuse rules and their associated compliance requirements applicable when high-ownership thresholds are present, *see* discussion *supra* at 116ff.

higher costs to ensure their ongoing compliance with the tax system. By the same token, the supervision of the massive quantity of documentation produced to ensure compliance with these tax rules results in significant transaction costs to the state.[559]

In sum, the increased complexity of the CIT System caused by the manipulative behaviour of corporate groups results in increased tax overhead costs, both for corporate groups and the state.

b. <u>Reduction of Ability to Shift Capital to its Most Efficient Use</u>

As a direct result of the strategies implemented to manipulate the CIT System, corporate groups may reduce their ability to shift capital to its most efficient use. To begin with, due to rule and compliance complexity, it is more expensive for corporate groups to determine what rules and regulations apply to a specific transaction, to determine the ensuing tax consequences and to comply with them. At some point, the transaction costs fostered by the lack of certainty become so prohibitive that the corporate group does not undertake the planned action, because the "expected benefits of the action are less than the sum of the costs of implementing the action plus the transactions costs of determining its legal outcome."[560] That is, when these tax-related costs come into the calculus, the economic efficiency gain of an intra-group transaction may not be sufficient to offset its associated tax costs and, thus, the transaction may not be implemented or may be implemented outside its optimal timing.[561] Further, besides the additional transaction costs, rule complexity may lend to uncertainty as to tax results, which may deter corporate groups from entering into certain transactions.[562] As previously discussed, if a planned action is not

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[559] *See* discussion *supra* at pg. 64.
[560] FELLOWS, *Nonrecourse Debt and Real Estate: The Issues of Tax Basis*, *supra* note 261, at 271.
[561] *See* EDREY, *What are Capital Gains and Losses Anyway?*, *supra* note 407, at 170-174 ("[F]irms might choose not to replace an asset producing a lower rate of return if they take tax into account when calculating the cost of the new asset, which reduces its rate of return."). *See also* SHAVIRO, *An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax*, *supra* note 4, at 24 ("Taxing gain or loss upon sale...cannot help but change some taxpayers' decisions regarding the retention of particular assets."); GEORGE R. ZODROW, *Economic Analyses of Capital Gains Taxation: Realizations, Revenues, Efficiency and Equity* 48 Tax Law Rev. 419 (1993) at 467 ("[T]he taxation of capital gains on sales of business assets might discourage asset sales that otherwise would occur, thus reducing firm operating efficiency.").
[562] *See* BIRD, *Why Tax Corporations?*, *supra* note 131, at 1 ("[U]ncertainty as to the precise tax implications of various corporate decisions may act as a general deterrent to investment."). *See also* COOPER, *Themes and Issues in Tax Simplification*, *supra* note 249, at 423 ("[W]hen faced with complexity (in the sense of an uncertain outcome), all taxpayers are risk-avoiders and will try to eliminate the risk arising from uncertain tax outcomes, even if it means abandoning the transaction altogether.").

undertaken, society's wealth is lowered, as a corporate group foregoes an otherwise productive activity.[563]

Moreover, as a result of substitution, the transfer of group resources may be made to a corporate member that does not provide the best economic return for their use. In order to locate deductions, inclusions, and capital gains or losses on the entity whose tax attributes are most beneficial, the location of assets and income within a corporate group may not be the most economically efficient. Lastly, depending on the magnitude of the "lock-in" effect and the "lock-out" effect, the transaction may be implemented outside its optimal business timing or it may not be implemented at all. In these cases, a second best option in terms of economic efficiency is maintained, in that assets or income are kept in a corporate member that does not ensure the best economic return for their use.[564] Overall, in such situations, the corporate group becomes less responsive to changes in the prospects of its investments.

In sum, the manipulative behaviour of corporate groups fostered by the nature of the Standard CIT System may reduce their ability to shift capital to its most efficient use. In these situations, the flexibility of corporate groups to transfer resources between their constituent parts is penalized. This may negatively impact the corporate groups' "organized internal market" dynamic and, to that extent, may reduce the capacity of the economic system to allocate resources to their most productive use.

c. Agency Problems

As a result of the higher number of transactions and to their higher complexity, the corporate group's manipulative behaviour should produce less transparent internal group flows and more convoluted organizational structures.[565] This internal complexity makes the group more opaque from an informational perspective. Notably, it becomes more difficult for top management and other stakeholders to continue to be accurately informed about

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563 FELLOWS, *Nonrecourse Debt and Real Estate: The Issues of Tax Basis*, *supra* note 261, at 271.

564 *See* CECIL, *Toward Adding Further Complexity to the Internal Revenue Code: A New Paradigm for the Deductibility of Capital Losses*, *supra* note 410, at 1104 ("[T]he lock-in effect prevents the flow of capital to its best economical use.").

565 In the same sense *see* FRIESE, et al., *Taxation and Corporate Governance - The State of the Art*, *supra* note 169, at 380 ("[T]ax rules tend to foster complexity and reduce transparency because they promote convoluted, tax-driven corporate structures.").

the operations of the group.[566] As a result, a shift of power from the board to inside managers and an increase of the potential for managerial opportunism transpires.[567] Further, this internal complexity of corporate groups fostered by the tax system may increase the costs of the state to supervise the compliance of corporate groups with the tax rules.

d. <u>Rigid and Potentially Sub-Optimal Functional and Legal Structures</u>

Besides potentially giving rise to the implementation of sub-optimal functional and legal structures, the tax minimization strategies to explore the asymmetries of the Standard CIT System may rigidify these structures.[568] This rigidity follows from two main reasons. First, due to the transaction costs associated with the definition and implementation of corporate structures, once a certain structure is implemented to benefit from a tax advantage or to avoid a specific anti-abuse rule, it should remain in operation for a certain time.[569] Second, due to the application of anti-abuse rules, the corporate structure existing at the time of the transaction may have to be kept in place for a certain period in order for the tax treatment afforded to the transaction to be respected.[570] Although flexibility may be possible in certain cases, it usually comes at a higher cost.[571] This rigidity reduces the corporate group's

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566 This may also result in additional management inefficiencies. *See, e.g.,* id. at 379 ("[C]ompanies become less transparent with respect to an inter-temporal aspect: due to frequent and complicated tax-driven reorganizations, the development of the business performance of certain companies or their parts often cannot be easily determined because the entities involved are not comparable over time.").

567 *See* DESAI & DHARMAPALA, *Tax and Corporate Governance: An Economic Approach*, *supra* note 121, at 14 ("[T]ax avoidance demands complexity and obfuscation to prevent detection. These characteristics, in turn, can become a shield for managerial opportunism."). *See also* STEFAN MAYER, *The Link Between Taxation and Corporate Governance: Report on the Discussion*, *in* Tax and Corporate Governance (Wolfgang Schon ed. 2008) at 67 ("[T]he intuition that tax planning shifted power away from the board to inside managers was supported by the experience from past scandals. For instance, the business of Tyco has been structured in such a complex way and with so many subsidiaries that hardly anybody had a complete picture of the enterprise's activities.").

568 *See* MARTINA BAUMGARTEL, *Taxation, Accounting and Transparency: The Interaction of Financial and Tax Accounting*, *in* Tax and Corporate Governance (Wolfgang Schon ed. 2008) at 99 ("'Over-optimization' very often leads to inflexible and complicated structures and downsides in case the tax legislation changes.").

569 These costs include fees paid to external consultants (*i.e.,* lawyers' fees, accountants, management consultants, etc) as well as the internal costs required to implement new operational guidelines throughout the organization.

570 *See, e.g.,* in the US, IRC Section 368 (requiring a post-acquisition continuity of business); IRC Treas. Reg. Section 1.355-2(d) (imposing restrictions on post-distribution sales); IRC Section 382 and IRC Treas. Reg. Section 1.368-1(d)(disallowing carryover unless business-enterprise continuity exists for two years after the limitation-triggering event and subjecting built-in losses to limitation if they are recognized during the five-calendar-year post-change recognition period).

571 *See* SCHOLES, et al., Taxes and Business Strategy: A Planning Approach, *supra* note 114, at 185 ("In the presence of uncertainty regarding future pretax cash flows and the tax rules themselves, a premium is placed on contracts that offer flexibility in tax planning to respond to unexpected changes in tax status. But building flexibility, however, into contracts does not come free...flexibility typically requires greater contracting costs.").

capacity for adaptation to outside disturbances, which, as previously discussed, may penalize its economic performance.[572]

Therefore, the taxation of corporate groups under the Standard CIT System may result in the following overall effects:

a. Increase of tax overhead costs both for corporate groups and the state;

b. Reduction of corporate groups' ability to shift capital to its most efficient use;

c. Agency problems; and

d. Rigid and potentially sub-optimal functional and legal structures.

All these effects, according to the parameters defined in this thesis, constitute deadweight loss.[573] The next section will examine alternative mechanical solutions to tax corporate groups under a corporation income tax system and assess how they deal with these problems.

[572] The situation may be especially damaging where the functional or legal structure adopted to benefit from tax advantages or avoid the application of specific anti-abuse rules is sub-optimal from a transaction cost or agency perspective.
[573] *See* discussion *supra* at pg. 72ff.

A. The Mechanics of Tax Integration

1. The Tax Integration Solutions

Under the Standard CIT System, as a matter of principle, corporate group members are treated as separate taxable entities.[574] Consequently, the system requires recordation of the amount, the location and the character of income at the level of each corporate group member. In light of the nature of the Standard CIT System, corporate groups may substantially alter such individual records and, thus, their tax treatment, by changing the value, timing and legal characterization of intra-group transactions. With regard to legal characterization,[575] unless an arsenal of anti-abuse rules exists, corporate groups' flexibility enables them to easily manipulate the formalistic nature of the Standard CIT System through the accurate selection of transactional routes, legal forms of transactions and legal and functional structures. This manipulation of the Standard CIT System results in several negative consequences, both for the state and corporate groups, including the increase of tax overhead costs; a reduction of corporate groups' ability to shift capital to its most efficient uses; agency problems and the potential adoption of sub-optimal corporate structures.

The current section intends to examine alternative mechanic solutions to tax corporate groups under a CIT system and to assess how they cope with these problems. Adopting an opposite perspective to the Standard CIT System, the section will focus on the study of mechanic solutions that aim at treating the corporate group as a sole taxable entity. Thus, this section will analyze tax solutions that, to the maximum extent possible, allow for the free transfer of assets, income and tax attributes inside a corporate group, and that impose a single layer of taxation on the income derived by corporate group members. For purposes of this thesis, these different taxation models will be referred to as Tax Integration Solutions.

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574 For the exceptions to this general rule on anti-abuse situations *see* generally discussion *infra* at pg. 116ff.

575 This thesis is not concerned with the manipulation of the value of transactions. For the manipulation of timing *see supra* discussion at pg. 43.

2. *The Structure of Tax Integration Solutions*

The taxation models that allow for tax integration may be conceptualized as closed operating systems that use particular tax mechanics within the boundaries of a qualifying corporate group (hereinafter, "Tax Group") aimed at integrating its operating results as if a sole taxable entity was at stake.[576] Although these models frequently make use of mechanic concepts alien to the Standard CIT System, their mechanic structure must be designed in a way that allows for a proper interaction with it. This occurs for two reasons.

Firstly, Tax Group members generally interact with entities taxed under the Standard CIT system and, thus, their tax attributes must be compatible with those existing under the Standard CIT System. For example, if an asset is transferred outside the Tax Group, be it in a taxable transaction or a tax-free transaction, it must be attributed a tax value, *i.e.,* a tax basis, so that the acquirer may determine its amount of gain (or loss) on a subsequent sale and its amount of allowable amortization deductions. By the same token, if a Tax Group member makes an interest payment to an unrelated entity, a tax deduction at the Tax Group level and an inclusion by the same amount at the unrelated entity level must occur to ensure that no tax attributes effectively "drop out" of the tax system.

Secondly, the corporate group has a volatile nature. Thus, entities previously subject to the Standard CIT System may join the Tax Group. Similarly, at a certain point in time, some corporate group members may leave the Tax Group and start a new existence as a separate taxable entity subject to the rules of the Standard CIT System.[577] Therefore, a tax integration regime must interact with the Standard CIT System when dealing with an entity's pre-entry tax attributes and when determining what occurs to an entity once it exits the Tax Group.

Besides interacting with the Standard CIT system rules, the Tax Integration Solutions may interact with rules from other regulatory fields. For instance, to totally disregard a corporation for tax purposes may have associated corporate law consequences (*e.g.,* which entities to sue if the group does not pay its consolidated tax bill; whether the tax consolidation of the group's results collides with the legal rights of minority shareholders;

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[576] For the issues surrounding the definition of qualifying corporate group for tax integration purposes *see* discussion *infra* at pg. 181ff.
[577] This may occur for different reasons, such as sale of stock, disqualification for Tax Group eligibility requirements, etc.

etc). Finally, although an issue outside the scope of this thesis, Tax Integration Solutions may interact with the international tax system. For instance, the classification of corporate group members for purposes of application of tax treaties or their classification for foreign tax purposes may condition the implementation of certain models of tax integration.

First, this section will discuss a Tax Integration Solution that completely eliminates the separate tax existence of corporate group members. As will be discussed, although this model may be a particularly sound solution to tax corporate groups, it is advisable only when complete ownership is present. When ownership is incomplete, as often occurs in the business world, this model raises very strong problems. Accordingly, the section will then discuss alternative solutions that may be applicable in cases of partial ownership. The section will first discuss a pass-through model of integration and then the US and UK group taxation models. Throughout this discussion, the qualification of the corporate group members for the eligibility requirements for the different integration regimes analyzed will be assumed. This approach allows the discussion to focus on the complex mechanic issues of tax integration. After discussing the extent to which the different tax integration models may be combined into a more efficient mechanic design, the section will then briefly discuss the problems associated with the definition of corporate group for tax integration purposes. In conclusion, the section will assess the dynamic effects of tax integration and will suggest, following the policy guidelines previously proposed, how corporate groups should be approached under a CIT system.

3. The Full Tax Integration Model

a. <u>The Mechanics of Full Integration</u>

The full tax integration model completely eliminates the separate tax existence of corporate group members. It effectively treats all corporate group members as a single taxable entity and, thus, gets rid of the need to track the amount, location and character of income for each corporate group member. From a mechanic standpoint, it eliminates the outside basis of all Tax Group members, except for the group's parent, and their individual tax attributes. By losing stock basis, all Tax Group members are effectively treated as divisions of the group's parent for tax purposes. This means that a unified tax calculation of tax attributes for all Tax Group members exists and that all tax tracking is made exclusively at the parent corporation's level. See diagram below.

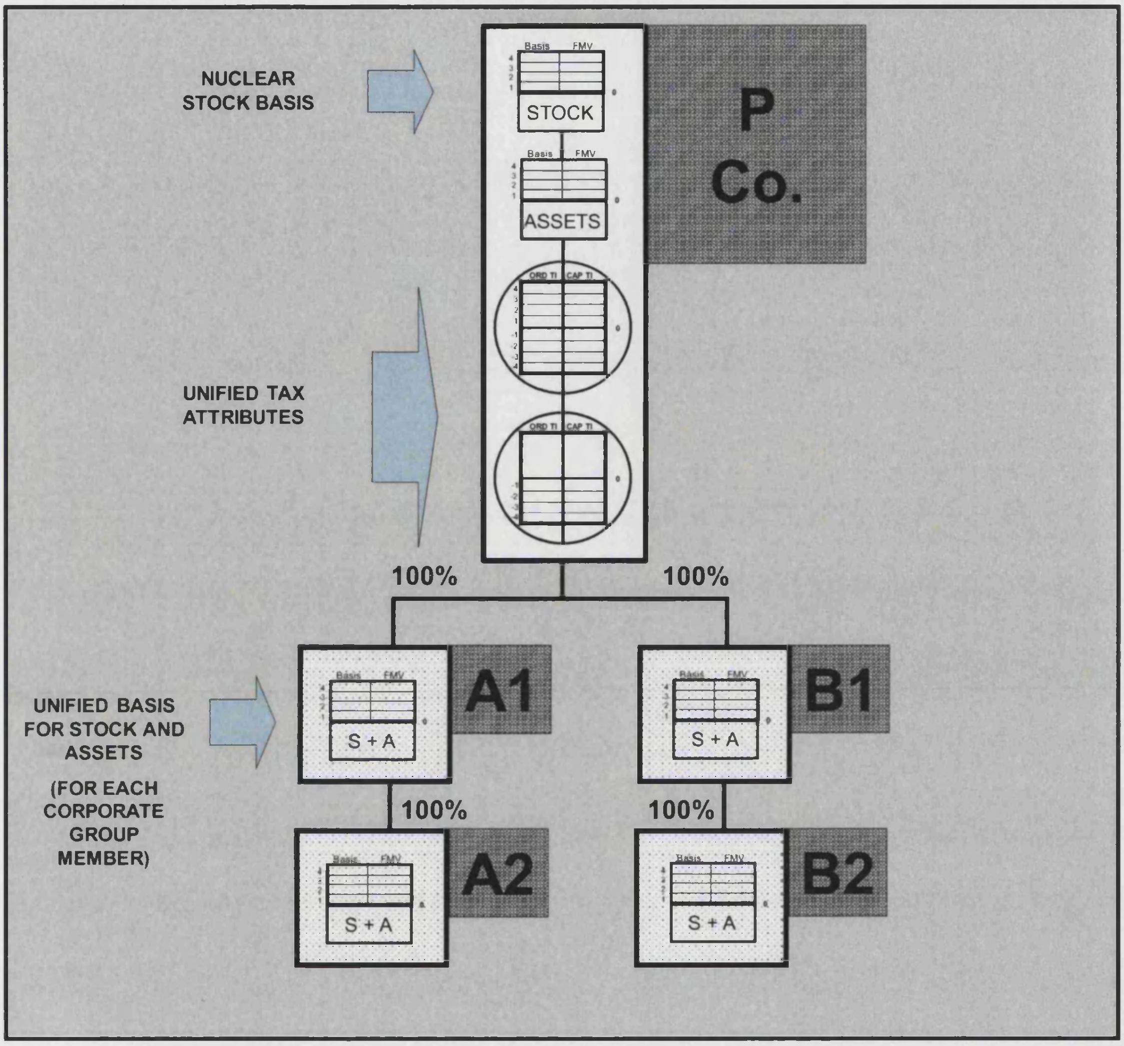
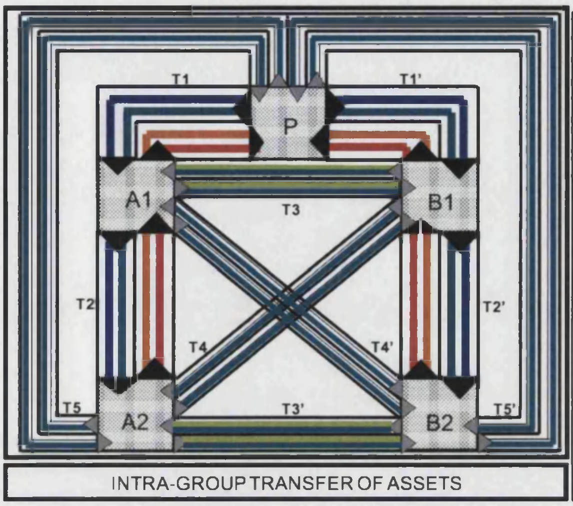


Diagram 9

This method of taxing corporate groups reduces the opportunities for manipulation of the CIT system and its associated complexity. Within the boundaries of a fully integrated corporate group, flows of cash and assets occur without any tax consequences, both in upward, downward and transversal flows, independently of their formal characterization and of the corporate group member that undertakes the transaction.[578] Intra-group transactions, in whichever form or direction, may be effectively disregarded for tax purposes. By the same token, tax attributes, including NOLs and NCLs, are freely

578 When assets are transferred, this treatment applies independently of whether an asset has a built-in gain or loss.

transferable within the boundaries of the fully integrated group. In contrast to the Standard CIT System, the significance of line-drawing in intra group transactions is completely eliminated. See diagram below.



LEGEND

TAXABLE TRANSACTION	....
TAX-FREE TRANSACTION	————————

TRANSACTIONAL FLOWS	DIRECTION OF FLOW	TRANSACTION	COLOR OF FLOW
T1 T1' T2 T2'	DOWNWARD	*CAPITAL CONTRIBUTION*	
		SALE	
	UPWARD	*DISTRIBUTION IN-KIND*	
		LIQUIDATION	
T3 T3' T4 T4' T5 T5'	TRANSVERSAL (CLOCKWISE)	*MERGER (WHERE AVAILABLE)*	
		SALE	
	TRANSVERSAL (COUNTERCLOCKWISE)	*MERGER (WHERE AVAILABLE)*	
		SALE	

Diagram 10

b. The Problems of the Full Integration Model

This model, despite the appeal of its simplicity, has certain problems. First, and fundamentally, with incomplete ownership, the attribution of an outside basis to each corporate group member is advisable in order for the tax system to operate and, thus, the tax existence of group members may not be completely eliminated for tax purposes.[579]

A further set of problems relate to the interaction of this model with the Standard CIT System. Consider the group's relationship with outside parties. Although the stock basis of Tax Group members is eliminated, their stock may still be sold to outside parties. When that occurs, the issue that arises is what should be the tax value of the stock. A potential solution may be to treat the sale of stock as a sale of the underlying assets. In such case, inside basis could dictate the amount of capital gain (or loss) on the stock sale. In principle, this capital gain (or loss) would be recognized at the level of the parent corporation, the only entity with tax attributes under this model.[580]

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579 *See* discussion *infra* at pg. 176.

580 This is the solution adopted by the US tax system for entities that classify as disregarded entities under the Check-the-Box regime. Under this type of solution, since the sale of stock is the sale of the underlying assets, an issue arises as to whether stock may classify as an asset used in the trade or business and thus, under the generally applicable rules, whether the respective sale gives rise to ordinary income (or losses) instead of

The treatment given to an entity's tax attributes once it enters or leaves a fully integrated tax group produces a further interaction problem with the Standard CIT System. A possible solution for pre-entry tax attributes may be to eliminate all the entity's tax attributes upon entry to the Tax Group. In such case, the outside basis of the corporate group member, together with all remaining tax attributes, would be eliminated without recognition of gain (or loss) by any member of the Tax Group. In principle, the inside basis for all assets would carryover. This type of solution, although more restrictive to the taxpayer in that all of its pre-entry tax attributes would be effectively lost, remains attractive because of its simplicity and difficulty to manipulate.[581]

An alternative solution, more beneficial to the taxpayer but with higher associated complexity, assumes a tax-free liquidation to the parent corporation upon entry of the new corporate group member and allows the carryover of old tax attributes of the new corporate member to the group's parent. In this case, all assets, liabilities, and items of income, deduction, and credit of the entering corporation would be treated as assets, liabilities, and items of income, deduction and credit, of the group's parent. In principle, the transfer of assets and the deemed liquidation would be disregarded for tax purposes.[582] However, this solution should require complex rules to avoid abuses (*e.g.,* limiting the use of pre-entry losses to income derived by the corporate group member), and more complex tax accounting.

As for the exit of a Tax Group member, a potential solution could be to treat the departing corporate group member as a new corporation acquiring all of its assets and assuming all of its liabilities. In such case, the departing Tax Group member would take a cost-basis in its assets, which should determine the value of its new stock basis. In addition, the carryover of any attributes generated while it was a member of the Tax Group could be simply disallowed.

Thus, although the interaction of the full integration model with the Standard CIT System raises some mechanic issues, they could, in principle, be dealt with using more or less

capital gains (or losses). This solution of attributing all the group's activities to its parent (*i.e.,* the only entity with tax attributes under this system), could also be used to deal with the treatment of inbound and outbound flows of cash. Thus, in the case of a loan entered into with an unrelated party by a Tax Group member, potential tax deductions (on payment) and tax inclusions (on receipt) should occur solely at the parent's level.

581 That is, this solution eliminates the potential for tax planning operations aimed at importing losses into the fully integrated tax group by acquiring corporations with accumulated losses.

582 *See* similar policy for QSub corporations at IRC Treas. Reg. Section 1.1361-4.

restrictive mechanic solutions. Although this issue will not be subject to further development in this thesis, we note that it must be carefully considered by the legislator to avoid potential loopholes or malfunctions of the tax system.

The relationship of the full integration model with other regulatory fields presents another area of trouble. Fundamentally, the implementation of this model is subject to a corporate law and accounting analysis of the feasibility of making the tax treatment independent of the corporate law treatment. In the US, as the recent experience with the Check-the-Box regime demonstrated, this should pose no extraordinary problems.[583] However, in jurisdictions that more closely align corporate law and corporate income tax law, to totally disregard the separate tax existence of a corporation for tax purposes may be more troublesome.[584]

Finally, the elimination of the separate tax existence of corporate groups raises certain international tax issues. Although these issues remain outside the scope of this thesis, it is worth noting that the application of tax treaties to the disregarded corporate group members, the classification of disregarded corporate group members for foreign tax purposes, and the treatment of foreign losses must be analyzed once one considers the implementation of this model. The US experience with the Check-the-Box regime should provide a rich source of analysis of potential problems and solutions in this field.[585]

In sum, the full integration model presents considerable advantages to tax corporate groups, reducing opportunities for manipulation of the CIT system and its associated complexity. However, it presents certain implementation issues. Although the interaction of this model with the Standard CIT System raises certain mechanical issues, it appears as if they can be dealt with through the use of more or less restrictive mechanic solutions. This is an issue that the legislator must carefully consider. The model's relationship with other regulatory fields and with the international tax environment incorporate more complex

583 *See, e.g.*, HUGH DOUGAN, et al., *"Check-the-Box" - Looking Under the Lid* 75 Tax Notes 1141 (1997).
584 For instance, which entities are deemed liable for the payment of the group's tax liability; what happens in terms of court proceedings, etc. In certain countries, an issue also arises regarding the legal grounds for the tax pooling of profits and losses. For example, in Germany a legal contract between corporate group members is required in order to implement tax consolidation. *See* IFA, Group Taxation (Sud Fiscale & Financiële Uitgevers. 2004) at 43.
585 In this regard, *see, e.g.*, ALICE G. ABREU, *Making Something Out of Nothing: Tax Planning With Disregard Entities in* Tax Planning for Domestic & Foreign Partnerships, LLCs, Joint Ventures & Other (Practising Law Institute ed. 2004); REUVEN S. AVI-YONAH, *To End Deferral As We Know It: Simplification Potential of Check-the-Box* 74 Tax Notes 219 (1997); DANIEL S. MILLER, *The Strange Materialization of the Tax Nothing* 87 Tax Notes 685 (2000).

issues, which, as the US experience with the Check-the-Box regime demonstrates, are solvable. Fundamentally, in order to avoid complexity and abuses, careful analysis must precede potential implementation.

4. *The Partial Integration Models*

Often, the corporate group is not the sole shareholder of a corporate group member. In these cases, as will be further discussed, the outside basis should not be eliminated as occurred under the full integration model. This maintenance of the dual basis mechanism in cases of partial ownership is a major source of mechanical complexity for integration models.

In these cases of partial ownership, two taxation solutions are mechanically feasible.[586] A first option is to tax the partially-owned corporate group member under a flow-through regime, akin to those applicable to partnerships or closed corporations. Alternatively, partially-owned corporate group members may maintain their separate taxable personality, but through different mechanic solutions, they may be treated as if a sole taxable entity is at stake. This section will investigate the mechanics of both Tax Integration Solutions.

a. <u>The Flow-Through Model</u>

i. The Mechanics of the Flow-Through Model

Under a flow-through model, corporate group members would be subject to a tax regime similar to those currently applicable to partnerships or closed corporations. Under this model, an outside basis would still be required. However, it is not the "rigid" outside basis of the Standard CIT System discussed previously.[587] Under the mechanic principles of flow-through taxation, the outside basis of Tax Group members would have, instead, a floating nature. In particular, under this model, the outside basis of each member would be regularly increased and decreased to keep track of taxed amounts, distributions and tax

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[586] In theory, a mark-to-market solution could also be devised whereby the group and the minority shareholders would be taxed on the periodic changes in value of the shares of partially-owned corporate group members. Besides raising issues regarding valuation and liquidity concerns, this type of solution would not commingle tax attributes of corporate group members and, thus, is not included in this study as a Tax Integration Solution.

[587] Under the Standard CIT System, outside basis is generally unaltered independently of corporate-level events, such as distributions or use of losses to offset taxable income.

attributes, such as losses and deductions that flow-through to the group and other shareholders. This would allow the tax system to allocate the tax attributes of Tax Group members among the group and its minority shareholders and to avoid potential situations of double or no taxation. Consider, for instance, the taxation of corporation A1 in the diagram below.

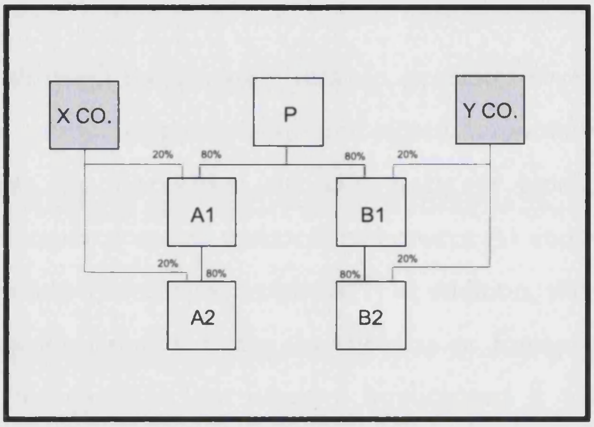

Diagram 11

Under this model of tax integration, A1's shareholders, P and the unrelated corporation XCo, would be taxed on a flow-through basis as partners in A1's business. The taxation of A1's profits would occur at P's and XCo's level independently of distribution. In order for the tax system to avoid situations of double or no taxation, whenever P and XCo were taxed on their share of A1's undistributed income, their bases in A1's stock would increase to reflect such fact.[588] As a result, P and XCo would not be taxed a twice if they sold their stock at a price reflecting the income that they reported on their returns, but that A1 retained and accumulated. Following the same mechanic logic, P and XCo would have to reduce the basis of their A1's stock by their *pro rata* shares of A1's deductions and losses. That is, since P and XCo could take advantage of these items on their returns, the reduction in basis would be necessary to prevent the same items from being used to reduce their gain (or increase their loss) upon selling the stock. For the same reason, the basis of the stock would have to be reduced if P and XCo received any distribution from A1. That is, since these distributions would consist of previously taxed corporate income, the adjustment would offset the earlier increase in the basis of the stock when the income

[588] In effect, P and the XCo would increase the basis of their shares just as if the income had been distributed and reinvested as a contribution to A1's capital.

passed through to P and XCo.[589] Finally, the character of A1's income should pass through to P and XCo. Income, losses, deductions, and credits would retain their corporate-level character, be allocated to P and XCo and treated by them as if attributable directly to the source from which they were generated.[590]

ii. The Problems of the Flow-Through Model

This type of model, although mechanically feasible, generates several problems. First, as may be seen from the taxation of partnerships and closed corporations, it should be rather complex. In particular, the disposition of A1's assets or stock, either in a taxable transaction or tax-free transaction, and transactions between A1 and its shareholders, P and XCo, generate a multitude of complex problems.[591] In addition, this system may generate complicated administrative issues if many shareholders or foreign shareholders exist. A further problem of this model is the negative implications it may have for minority shareholders. That is, the taxation of the minority shareholder XCo depends on who owns the remaining 80% of A1's stock. Consequently, the tax treatment of XCo may change not by its own actions but by who else bought shares in A1, *i.e.,* in our example, corporation P. This may give rise to two interrelated problems. First, the treatment of XCo could be different if the 80% were not owned by P but by other shareholders taxed under the generally applicable tax rules, a fact over which XCo may have no control at all. In particular, depending on whether the 80% interest is owned by P or not, XCo may see its tax treatment radically modified, from a flow-through treatment to a separate entity treatment. In the case of a later disposition of P's interest in A1 to parties taxed under the

589 Any excess would be generally treated as gain on the sale of property. These principles should generally apply for distributions of cash and property. However, a distribution of appreciated property would trigger the recognition of gain at the corporate level. This gain would pass through to the shareholders, P and XCo, and result in an increase of their basis of A1's stock. This, in turn, would ensure that the distribution itself was tax-free to them.

590 This is in line with the treatment currently afforded to close corporations in the US. Following the same principles, A1 should be able to sell its assets with only a single tier of tax (at the shareholders' level) and be able to participate in tax-free reorganizations, buy the assets or stock of another business, redeem its own stock, divide tax-free into two or more separate entities or liquidate. See treatment of S Corps in US at BITTKER & EUSTICE, Federal Income Taxation of Corporations and Shareholders, *supra* note 417, Section 6.

591 For the issues that would be associated with the disposition of A1's assets or stock, *see, e.g.,* id., Section 6.09[3] (discussing similar issues in the context of S Corporations) and WILLIAM S. MCKEE, Federal Taxation of Partnerships and Partners (Warren, Gorham & Lamont 2007) (discussing the complex issues associated with the disposition of partnership interests). For the issues that would be generally associated with the transactions entered into between A1 and its shareholders, *see, e.g.,* IRC Section 707 and respective Treasury Regulations. *See also* MCKEE at Chapter 13. Broadly, the main issues revolve around whether the transactions should be taxed and how to allocate the attributes of the pass-through entity from such transactions. For instance, in the partnership rules, a rather controversial assessment of facts is required in order to determine whether the interest holder in the pass-through entity acted or not is his capacity as a member of the entity with respect to each particular transaction.

generally applicable tax rules (whereby separate entity treatment would in principle apply to A1 and its shareholders), potentially complex mechanic rules could also be required to ensure that XCo's transition between tax regimes occurred without tax attributes effectively dropping out of the tax system or giving rise to abusive tax planning opportunities. Second, since a flow-through regime applies, P's actions as a controlling shareholder over A1's business and tax policies should directly affect XCo's yearly tax return (*e.g.,* decision to sell certain A1's capital assets with built-in losses in order to obtain a capital loss inclusion in a specific tax year advantageous to P, with immediate inclusion at XCo's and P's level of the capital loss derived by A1 on the sale). These problems may be especially acute in that under the corporate laws of many jurisdictions the restrictions that are generally applicable to the transfer of interests in partnerships and close corporations - whereby the law often puts in place mechanisms to restrict the free transferability of interests - may not be applicable. Thus, in this case minority shareholders could face a significantly low degree of protection. Although these constitute effective problems, we note that there are certain solutions available that could ameliorate these downsides of the model (*e.g.,* celebration of agreement between XCo and P whereby P commits to reimburse XCo for potential downsides associated with A1's operations on XCo's tax return and/or requirement of XCo's consent to transfer P's interest in A1 to other parties). Finally, it should be noted that this model may also result in a potential worsening of agency problems. That is, since XCo and P are taxed directly on A1's income, the firm's tax policy takes on a distinct dimension for them. In such situation, XCo and P are expected to become more interested in controlling the decisions of A1's management in order to obtain a better individual tax result, what as previously discussed may give rise to agency problems. Finally, problems similar to those identified under the full integration model transpire upon the entry of, and the exit of corporate group members from the integrated corporate group, and upon the model's interaction with other regulatory fields and the international tax environment.

In sum, although the flow-through model is a mechanically feasible solution to integrate partially owned corporate group members, it raises several complex issues.

b. The Group Taxation Model

In several jurisdictions, there are special taxation regimes that, while maintaining the separate tax existence of corporate group members, allow for their integration for tax purposes.[592] A corporate group member may generally access these regimes provided that there is a significant control of the corporate group over the corporate group member.[593] These special regimes generally allow, to various degrees and in different ways, for the offset of profits and losses among corporate group members and for the deferral of tax on intra-group transfers of assets and income. There are several group taxation models with different rules to achieve one or both objectives.[594]

All these group taxation regimes face a standard set of mechanic problems to integrate corporate groups for tax purposes, because the separate tax existence of corporate group members continues, and, thus, the location, character and amount of tax attributes must still be recorded at the level of each corporate group member. Consider the following mechanic problems that arise once we try to integrate for tax purposes corporations with a separate tax existence.[595]

Problem 1: Treatment of Intra-Group Asset Transfers

Consider the following situation. Assume that corporation A2, a member of P's corporate group, owns an asset with a tax basis of 50 and a FMV of 100. In year 1, A2 transfers the asset to B2, a member of the same corporate group. During year 2, this asset appreciates in value and its FMV is now 150. At the end of year 2, B2 sells the asset to an unrelated party.

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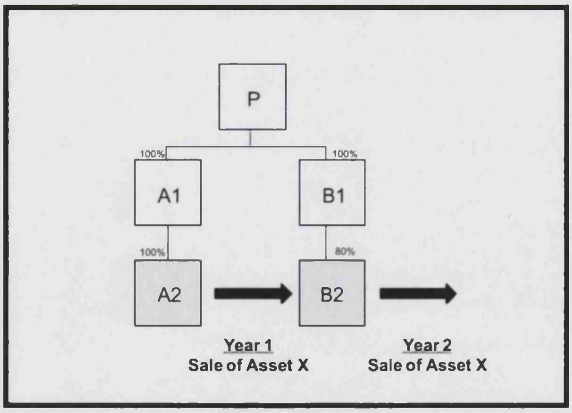
592 *See, e.g.,* DIETER ENDRES, *The Concept of Group Taxation: A Global Overview*, 31 Intertax 349 (2003).
593 *See* discussion *infra* at pg. 183ff for eligibility requirements for US and UK.
594 *See* generally on Group Taxation models, IFA, Group Taxation, supra note 584; WILMAN, *Equalizing the Income Tax Burden in a Group of Companies, supra* note 366; ENDRES, *The Concept of Group Taxation: A Global Overview, supra* note 592; ANTHONY TING, *Policy and Membership Requirements for Consolidation: A Comparison Between Australia, New Zealand and the US*, 3 British Tax Review 311 (2005); J. RICHARD, *Comparison Between UK and French Taxation of Group Companies*, 31 Intertax 20 (2003); ABADAN JASMAN & JUNAID SHAIKH, *Developments and New Ideas in the Group Relief Framework*, 8 IBFD Asia-Pacific Bulletin 334 (2002); DUBROFF, Federal Income Taxation of Corporations Filling Consolidated Returns (Matthew Bender. 2005).
595 This problematization of group taxation regimes builds on the work developed at IFA, Group Taxation, *supra* note 584, at 40-42 and 51-52.

Diagram 12



PROBLEM 1

If we decide to integrate the tax treatment of this corporate group, an issue of how to treat these asset transfers for tax purposes arises. Location of the gain recognized presents a primary issue. A possible option is to make each party recognize the amount of gain that accrued while it owned the asset. Thus, A2 would recognize a gain of 50 and B2 would recognize the remaining gain of 50. In this scenario, a further issue arises regarding the timing of recognition, that is, whether the gain should be recognized immediately on each transfer or only later upon disposition of the asset outside the group, a solution more in line with tax integration.

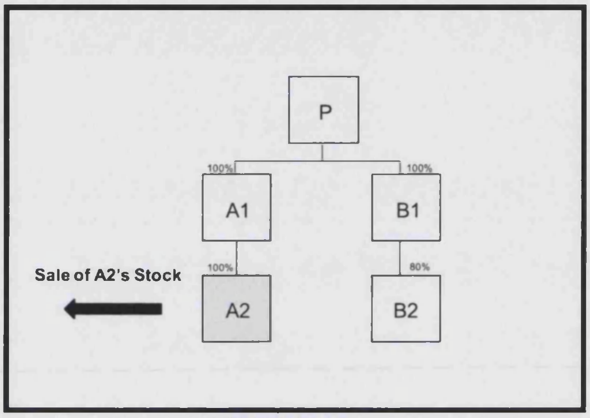
Another possible option regarding location of gain is to make the total gain accrued while the asset was within the group be recognized exclusively by either A2 (*i.e.,* through the disregard of intra-group asset transfers) or B2 (*i.e.,* through the application of a carryover basis mechanics to intra-group asset transfers). Thus, in these cases, either A2 or B2 would recognize the full 100 of gain. Under these options, recognition would only occur once the asset was transferred outside the group.

Apart from these problems regarding location and timing of gain recognition, amortization deductions provide a further issue. That is, in each of these different scenarios, which entity should benefit from the amortization deductions on the asset and which cost basis should be used to determine the amount of the amortization deductions.

Problem 2: Double Counting

A further problem that arises once we integrate the tax treatment of corporate group members is the elimination of the potential double taxation of profits or the double deduction of losses. Consider the following situation, assuming that no mechanism for integration of corporate and shareholder taxation is applicable.

Diagram 13



PROBLEM 2

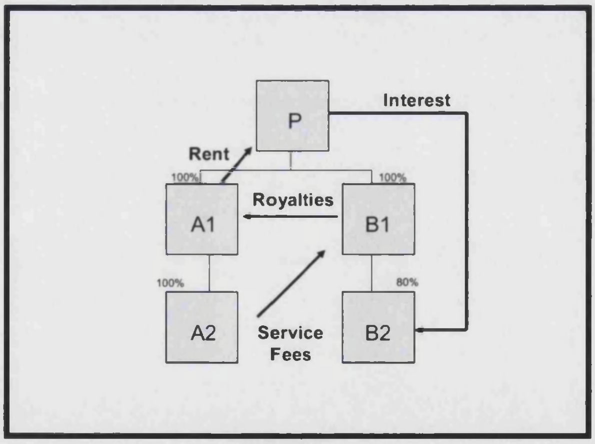
Imagine that A2's stock basis and market value is 100. Assuming we integrate P's group, when A2 earns profits of 50, this amount is consolidated with the group's profits and taxed immediately at the group level, independently of distribution. Assuming a 35% tax rate, a tax of 17,5 is imposed on such profits. If later, A1 sells A2's shares at a price of 132,5, the amount of gain is 32,5. However, A2's profits of 32,5 have already been taxed as part of the consolidated income of the group. Taxation of gains in stock would represent a second layer of taxation on the same profits within the same group. By the same token, the danger of double counting exists with regard to losses. Imagine that A2 incurs operating losses or losses from the sale of its assets of 50, which reduce the consolidated income of the group. Later, A1 sells the A2s shares at a price of 50. If the cost base of A2's shares remains 100, A1 recognizes a capital loss of 50. In this case, a double deduction within a single group transpires.

For jurisdictions that have already implemented a participation exemption mechanism covering distributions, and capital gains and losses derived on stock transfers, these situations should pose no particular problems. Any potential real or deemed distributions, and potential gains or losses on stock transfers, would simply be exempt from taxation. However, for jurisdictions, such as the US, that have not yet implemented a participation exemption, the tax integration of a corporate group requires that these double counting problems are adequately dealt with.

Problem 3: Intra-Group Payments

A further problem relates to intra-group payments. As a rule, under the Standard CIT System, no general principle requires the tax consequences of a transaction to be determined based on another taxpayer's treatment of the same transaction, *i.e.,* the so-called "Systemic Matching."[596] Thus, when one taxpayer takes a deduction, the Standard CIT System does not necessarily require another taxpayer to include the deducted amount in its income.[597] In the face of the nature of corporate groups and of the existence of highly complex hybrid instruments, allowing for consolidation, without such principle being applicable, may lead to the implementation of circular cash-flows that generate phantom deductions and reduce the taxable income of the entire group.

Diagram 14



PROBLEM 3

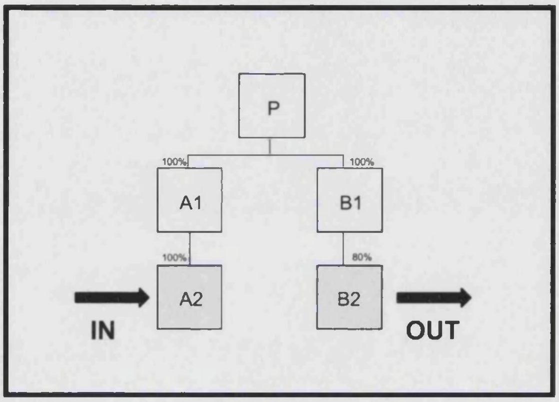
Problem 4: Entry and Exit of Corporate Group Members

The fact that corporate entities that make up a group may have had, or may have in the future, their own separate existence as business entities presents a further problem of

[596] ROIN, *Unmasking the "Matching Principle" in Tax Law, supra* note 140.
[597] Id.

integration. Tax law is forced to recognize a dual nature in each component of the group: its nature as a member of an aggregate entity and its individual nature as a business entity, which despite "dormant" while the corporation is a member of a group, may, at any moment, be brought to life due to its exit of the corporate group.

Diagram 15



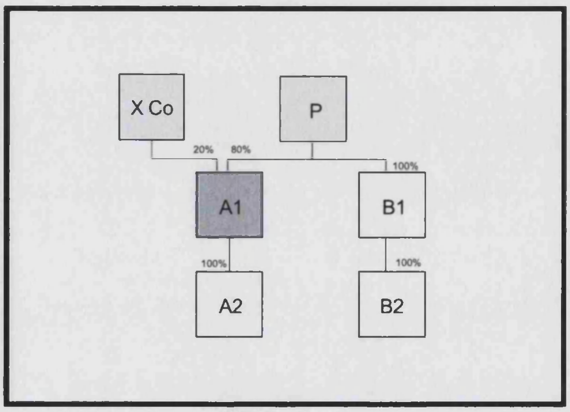
PROBLEM 4

The main mechanic problems associated with this dual nature of corporate group members relate to the treatment to be afforded to pre-entry and post-exit tax attributes, fundamentally tax losses, so as to avoid either a double use or an unreasonable purging of such attributes.

Problem 5: Treatment of Minority Shareholders

A final mechanic problem relates to the treatment of minority shareholders. Consider corporation A1 below.

Diagram 16



PROBLEM 5

If we decide to integrate A1 with P, whether we should allocate all or only a part of A1's results to the group remains in question. If we attribute all of A1's results to the corporate group, the issue then becomes when, and how, to reimburse XCo for the fact that A1 lost tax attributes that could reduce its taxable income in future tax years.

Overall, all group taxation regimes face this standard set of mechanic problems. The next section will analyze and compare the mechanic solutions that the US and UK Group Taxation regimes propose to tackle these problems and to integrate corporate groups for CIT purposes.[598]

i. The Mechanics of the US Group Taxation Regime

The US Group Taxation regime proposes a Tax Integration Solution that substantially alters the mechanics of the Standard CIT System.[599] The alterations introduced allow the regime to integrate a corporate group for tax purposes, while avoiding situations of no or double taxation. The following section will start by analyzing two core mechanic devices of the US Group Taxation regime, *i.e.,* its altered outside and inside basis. Subsequently, the section will analyze certain additional alterations introduced to the regular mechanics of the Standard CIT System and discuss how the regime determines the consolidated tax liability of the group. The section will conclude by examining the problems raised by this Tax Integration Solution.

1. <u>Outside Basis</u>

Under the US Group Taxation regime, outside basis operates as a highly interactive floating mechanism. Following a mechanic logic akin to the flow-through model, its value increases and decreases every year to keep track of changes in the value of corporate group members and of the amount of their individual losses that are used to offset the group's consolidated

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598 As previously discussed, the current thesis focuses on the analysis of the US and UK tax laws. Note, however, that further group taxation models are available, such as the "Organshaft" or the "Group Contribution" models. Both these models have, however, important short backs. The Organshaft model does not allow for the deferral of gains or losses arising from intra-group transfers of assets. In turn, tax relief under the Group Contribution model is generally conditioned upon a transfer of wealth, what generates several practical and corporate law problems. Probably for these reasons, these models have a reduced representation in the international tax arena. *See* generally on both models IFA, Group Taxation, *supra* note 584.

599 The US Group Taxation regime is commonly known as "Consolidated Return" regime. This thesis will, however, adopt the Group Taxation taxonomy.

taxable income.[600] Significantly, in order to fulfil the maximum potential of its floating nature, outside basis is even allowed to go negative, something mechanically unique in the entire US CIT system. This allows outside basis to perform its tracking functions without requiring immediate gain recognition when the recorded balance becomes negative.[601] See diagram below.

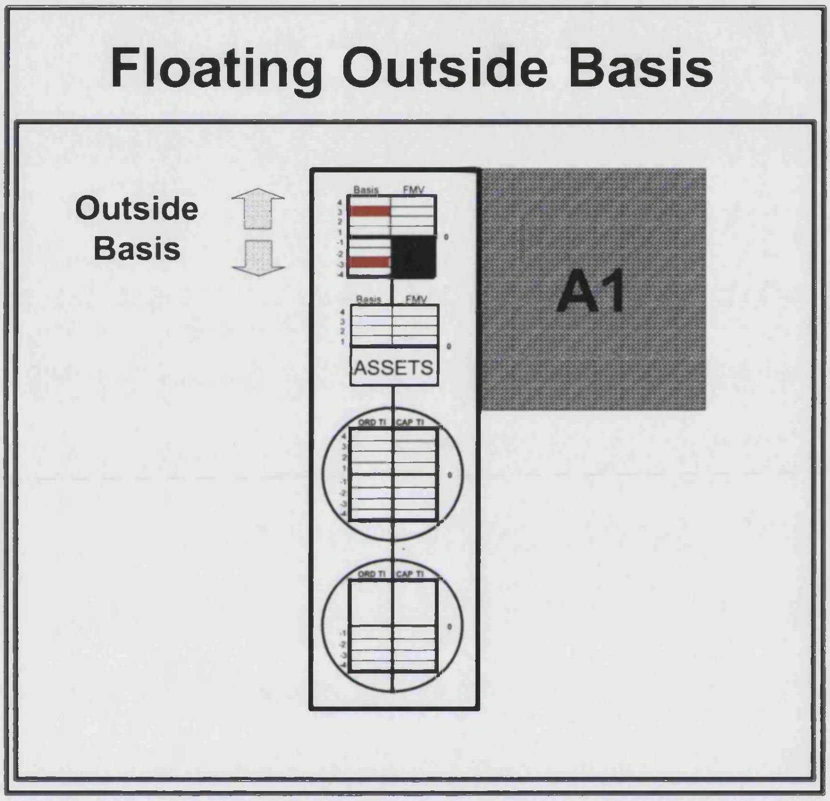

Diagram 17

This mechanism allows the US Group Taxation regime to tackle the double counting problem (See Problem 2 above). Specifically, the system increases outside basis whenever it considers that the corporation experienced an increase in value that should not be subject to tax, either because it has already been taxed or because it should be exempt from taxation. Through this upward adjustment, the system avoids double taxation or taxation of tax exempt amounts when the stock of the corporation is later transferred in a taxable

600 *See* IRC Treas. Reg. Section 1.1502-32.

601 When outside basis is negative, a so-called ELA ("Excess Loss Account") arises. ELA must be recognized on a later disposition of stock. In particular, if the stock of the subsidiary is sold before the balance turns positive, the negative amount of basis is included in the parent's income when it disposes of the stock of its subsidiary and generally treated as gain from the sale of stock. *See* IRC Treas. Reg. Section 1.1502-19.

transaction. Since the value of outside basis increases, the group will recognize a smaller gain (or a larger loss) upon a later taxable transfer of the corporate group member's stock. By the same token, outside basis is reduced whenever the system considers that the value of the corporate group member has been reduced or a certain amount which has not yet been taxed should be subject to tax. Due to this downward adjustment, the group will have to recognize a larger gain (or a smaller loss) upon a taxable transfer of the corporate group member's stock in the future.

In particular, at year end,[602] outside basis suffers an upward adjustment for undistributed income and a downward adjustment for distributions and losses utilized in consolidation, both operating and capital.[603] Income and tax attributes that have no relevance for tax purposes (*i.e.,* tax exempt income and non-deductible expenses) are neutralized following the same mechanic logic. That is, outside basis increases by the amount of tax-exempt income for the year and decreases by the amount of non-capital, non-deductible expenses.[604]

Although complex, this tracking system is particularly accurate. Consider the taxation of ordinary income. At year end, if the taxable income balance is positive, outside basis will increase by the amount of such balance. This means that such amount has already been subject to tax as part of consolidated taxable income and, therefore, should not be subject to tax again. However, if the balance is negative, the change will not occur automatically. It will only occur if the NOL is actually used to reduce the consolidated taxable income of the group. That is, if the loss does not leave the corporation, it may be used in future tax returns and, thus, the potential loss carry forward must be factored into the value of the corporate group member. Similar mechanic principles apply to capital gains and losses. A positive balance will always result in a corresponding increase in the value of outside basis.

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602 As a rule, the adjustments to outside basis are made at the close of each consolidated return year. However, adjustments may also occur whenever necessary to determine "a tax liability of any person." *See* IRC Treas. Reg. Section 1.1502-32 (b)(1).

603 *See* IRC Treas. Reg. Section 1.1502-32. For the issues associated with the allocation of these adjustments to different classes of stock *see* IRC Treas. Reg. Section 1.1502-32 (c).

604 *See* IRC Treas. Reg. Section 1.1502-32 (b)(2). The interactive nature of outside basis under the US Group Taxation regime extends also to the tax attributes of other Tax Group members. That is, the outside bases of all tax group members are linked vertically. When stock basis adjustments are made at year-end, they tier up from lower tier to higher tier members. *See* IRC Treas. Reg. Section 1.1502-32 (a)(3)(iii).

In comparison, a negative balance, a NCL, will only reduce outside basis once utilized by the group.[605] See diagram below.[606]

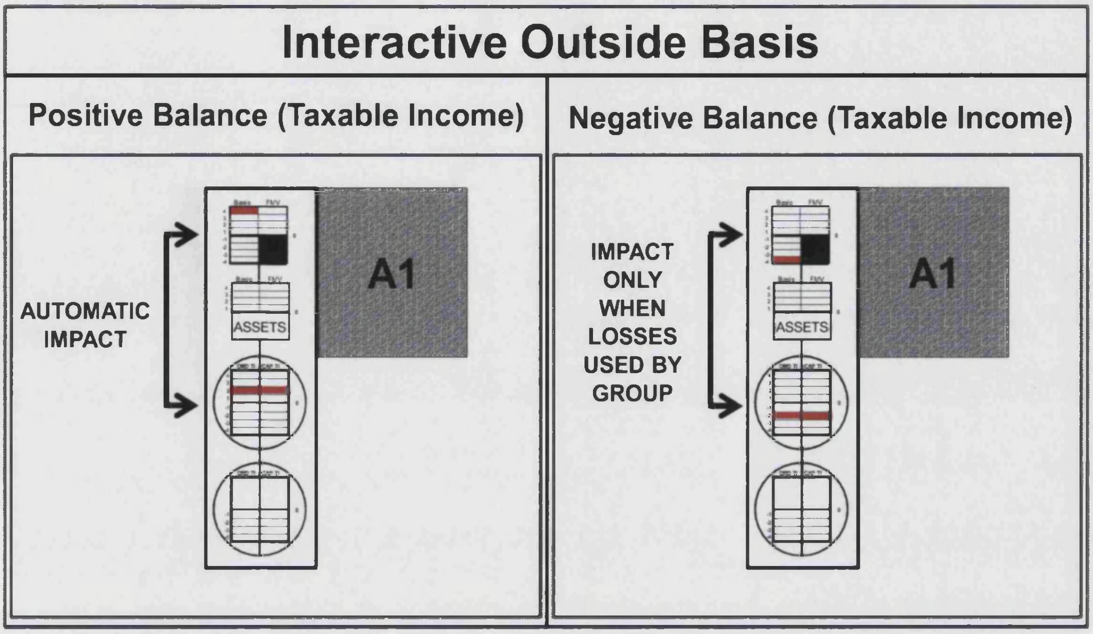

Diagram 18

Following the same mechanic logic, since the value of a corporation decreases with the exit of cash to its shareholders, outside basis is reduced by the amount of distributions.[607]

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[605] *See* BITTKER & EUSTICE, Federal Income Taxation of Corporations and Shareholders, *supra* note 417, at Section 13.44 [2][a]. Note that the adjustments to outside basis when losses are availed of by the group, occur on the year in which loss arose (if loss is used in past year tax return) or in year in which loss is used in tax return (if loss is used in the same year). *See* IRC Treas. Reg. Sections 1.1502-32(b)(3)(i)(A), (B).

[606] At the beginning of the year, Corporation A1 outside's basis has a tax value of 0. At year end, A1 recognizes +2 of ordinary taxable income and +2 of capital income. Its outside basis is increased by +4. However, if A1's ordinary and capital income are negative (-2 each) the adjustment of-4 to outside basis will only occur when losses are availed of by the group.

[607] *See* IRC Treas. Reg. Section 1.1502-32 (b)(2). This adjustment occurs independently of the characterization of the distribution as a dividend or non-dividend distribution. Because the outside basis of the distributing corporation is reduced equally independently of the characterization as dividend or non-dividend, there is no difference in consolidation regarding one or the other in this aspect as far as the distributing corporation is concerned. *See* IRC Treas. Reg. Section 1.1502-13 (f)(2)(ii). Nevertheless, in opposition to the Standard CIT System, if a dividend distribution by a member is not out of E&P and exceeds the distributee's tax basis in such member's stock, the gain which would otherwise be recognized (under IRC Section 301) will be added to the ELA of such member and only reported as income when tracking is no longer possible (*i.e.,* when its stock is considered to be disposed of). Note that this linking of adjustments to taxable income instead of to E&P arises as a result of legislative history and has to do with the fact that it made more sense to link stock basis adjustments to taxable income in that they both have a same underneath rationale, *i.e.,* prevent understatement of amounts (as opposed to E&P where the rules try to avoid overstatement). *See* GEORGE L. WHITE, BNA Tax Management Portfolios, U.S. Income Series, Consolidated Returns—Investment in Subsidiaries (755-3rd) (Tax Management Inc. 2009) at Section IV-C.

When outside basis disappears, tracking is not possible. Thus, intercompany items associated with a member's stock, that is, deferred gain or loss from previous intercompany transactions, are triggered when the Tax Group member liquidates.[608]

2. Inside Basis

Similarly to outside basis mechanics, the mechanics of inside basis under the US Group Taxation regime deviates from the traditional mechanic rules of the Standard CIT System. Instead of the conventional carryover or cost basis mechanics, an original mechanic device applies whereby the transaction is granted deferral (*i.e.,* no tax is recognized on the transaction), but the acquirer gets an updated cost basis in the asset transferred.[609] This so-called "Deferred Sale System" provides another interesting example of sophisticated tax engineering. It allows the amount and location of gain or loss on a taxable asset transfer to be determined on a separate entity basis, while timing and character are determined on a single entity basis.

Consider Problem 1 discussed above. Under the US Group Taxation regime, timing is determined on a single entity basis. Thus, the built-in gain or loss on asset X will be triggered only when B2 transfers the asset in a taxable transaction to a party outside the Tax Group. In addition, following the same single entity rationale, the holding periods of A2 and B2 are "blended," and the character of the gain or loss is determined taking into account the activities of both A2 and B2 with respect to the property.[610]

However, separate entity treatment applies for purposes of determining the amount and location of these items. Specifically, due to the treatment of the intra-group transfer on a cost basis, once asset X leaves the Tax Group, A2 and B2 are taxed on the respective shares of asset appreciation that occurred during their holding periods. Thus, A2 and B2

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608 That occurs even when the liquidation is tax-free to the shareholders under IRC Section 332. The items are taken into account immediately before it first becomes impossible to achieve tracking. Note that there is elective relief for reincorporation and certain other specified cases (*e.g.,* liquidations under IRC Treas. Reg. Section 338(h)10)). *See* id. at Section V-B. Further, note that the stock ownership of all members is aggregated to determine whether tax-free treatment applies to the distribute on the liquidation. *See* IRC Treas. Reg. Section 1.1502-34.

609 *See* IRC Treas. Reg. Section 1.1502-13.

610 *See* IRC Treas. Reg. Section 1.1502-13 (c). The holding period of property transferred in an intercompany transaction is generally the aggregate of the holding periods of seller and buyer. However, if the basis of the property is determined by reference to the basis of other property, the property's holding period is determined by reference to the holding period of the other property. For example, if A2 distributes stock to A1 in a distribution to which IRC section 355 applies, A1's holding period in the distributed stock is determined by reference to A1's holding period in the stock of A2. *See* IRC Treas. Reg. Section 1.1502-13.

are treated as effectively engaging in the transaction and owning the actual property involved.[611] These mechanic principles apply to different types of transactions such as sales, distributions in liquidation or in-kind distributions.[612]

A substantial problem that arises with this altered mechanics is the treatment of the amortization deductions associated with asset X. Since B2 obtains an updated cost basis in asset X at the time of its acquisition from A2, an issue arises as to whether B2's amortization deductions should be calculated on such updated basis. If that occurs without any adjustments, there could be a stepped up tax basis with increased deductions that could be used to offset the income of the whole Tax Group. This could be used *ad infinitum* to constantly generate new tax deductions. For this reason, under the US Group Taxation regime, B2 maintains A2's previous asset basis with the same rate of depreciation, *i.e.,* it simply gets into the shoes of A2 for its amount of basis.[613]

As for the step up amount, a new depreciation period starts.[614] Further, in order to neutralize the tax effects of this operation, A2 recognizes gradually as income the amount of depreciation deductions recognized by B2 on the stepped up tax basis amount. In the end, B2's amortization deductions on the stepped up amount and A2's income recognition neutralize themselves in a wash by coinciding on the same date, *i.e.,* the date of the amortization deduction.[615] Despite its complex nature, this mechanism prevents the use of amortization deductions to abusively reduce taxable income and allows depreciable property to be transferred from one member to another without losing the benefit of rapid depreciation methods.[616]

Interestingly, while gain attributable to member stock is generally triggered currently when that member's stock is disposed of in a redemption or liquidation transaction, property distributed in the redemption or liquidation transaction remains subject to the deferral regime. The logic provides that since matching can continue in the distributee member, the

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611 *See* IRC Treas. Reg. Section 1.1502-13.

612 In general, under the US Group Taxation Regime, intercompany distributions of property are equated with intercompany sales. *See* IRC Treas. Reg. Section 1.1502-13 (f)(2)(iii). For a detailed discussion of intercompany sale transactions *see* GEORGE L. WHITE, BNA Tax Management Portfolios, U.S. Income Series, Computation of Consolidated Tax Liability (756-3rd) (Tax Management Inc. 2007).

613 *See* IRC Treas. Reg. Section 1.1502-13.

614 Id.

615 Id.

616 *See* IRC Treas. Reg. Section 1.1502-12 (g).

regimes allows for continued deferral for the deferred intercompany items of the liquidating member (including gain or loss generated in liquidation).[617]

3. Other Relevant Mechanic Alterations

Apart from these alterations to outside and inside bases mechanics, the US Group Taxation regime introduces certain other deviations of relevance to the regular mechanic rules of the Standard CIT System. Elements of especial relevance for our analysis include the application of a matching principle to intra-group payments and the treatment of boot in intra-group reorganizations.[618]

As previously discussed, under the Standard CIT System, a taxpayer's treatment of one transaction may determine the tax consequences of a later, related transaction. For example, the amount of gain a taxpayer recognizes upon the disposition of an asset depends on the circumstances under which the taxpayer acquired the asset, namely, the tax basis created as a result of the acquisition.[619] Such a tracking mechanism ensures that a taxpayer neither omits nor counts twice income items affected by transactions taking place in two different taxable years.[620]

However, a similar principle does not exist to ensure that the tax treatment of one taxpayer in a transaction will determine the tax treatment of another taxpayer in the same transaction. For instance, a principle requiring that when one taxpayer takes a deduction, another taxpayer must include the deducted amount in its income. Administrative reasons primarily explain the absence of such a principle under the Standard CIT System. The massive quantity of information involved (*i.e.,* large number of taxpayers, transactions, tax years, etc) should make the system extremely difficult to administer.[621]

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617 *See* BITTKER & EUSTICE, Federal Income Taxation of Corporations and Shareholders, *supra* note 417, at Section 13.43[3].

618 Other noteworthy alterations to the regular Standard CIT System mechanics include the treatment of in-kind distributions of loss property (deferred and not eliminated) and redemptions (amount distributed is treated as a tax-free distribution). Since they are not central to our analysis they will not, however, be developed here. *See generally* WHITE, BNA Tax Management Portfolios, U.S. Income Series, Computation of Consolidated Tax Liability (756-3rd), *supra* note 612.

619 *See* ROIN, *Unmasking the "Matching Principle" in Tax Law, supra* note 140, at 813.

620 Id. at ft. 4.

621 *See* JOSEPH M. DODGE, The Logic of Tax: Federal Income Tax Theory and Policy (West Publishing Company 1989) at 102 (Dodge asserts that mandatory joinder is unworkable because there are "too many parties to too many transactions involving too many taxable years for such a system to work"). Similarly Roin points out that under normal circumstances "it is often difficult to join all parties to a transaction for purposes of determining each one's tax liability." In addition, Roin underlines that "requiring an absolute

While it is understandable that to enact this type of general principle under the Standard CIT System is farfetched, the same should not occur within the limited boundaries of a corporate group. In this case, a limited number of parties and transactions would be matched. Indeed, this thesis believes that Systemic Matching, *i.e.,* relating the tax treatment of various parties in a given transaction to each other's tax treatment, should be a basic tax policy tool with regard to corporate groups. As previously mentioned, in face of the nature of corporate groups and of the existence of highly complex hybrid instruments, the absence of a Systemic Matching principle within the closed boundaries of a corporate group may lead to abuses. Based on the current existing knowledge on the behavioural nature of corporate groups,[622] corporate groups may well structure internal circular cash-flows with the sole aim of creating phantom tax deductions, without offsetting income inclusions, to reduce the group's taxable income. By allowing this focus on transactional results as an instrument of assessment of tax coherence, the reliability of the tax system improves, in that deductions will always have corresponding inclusions, or even simpler, both may be simply eliminated.

This is precisely the approach that the US Group Taxation regime proposes for intra-group payments. Under the US regime, intra-group payments offset each other in a wash, the timing of which is controlled by the paying member's timing rule.[623] Going back to Problem 3, the timing of B2's inclusion and P's interest deduction are synchronized, with the timing of B2's inclusion determined based on the accounting methods of P. That is, the matching is obtained by making the deduction and the inclusion occur on the same specific date, and, thus, effectively obtaining a wash for intra-group transactions. Different types of intra-group payments and transactions remain subject to this matching principle,[624] including intra-group payments of interest, royalties, rents and fees.[625]

The treatment of boot in intra-group reorganizations presents another noteworthy alteration to the Standard CIT System. An intercompany reorganization is one that is

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matching of tax consequences in all circumstances would conflict with basic features of our current income tax system, such as the co-existence of different accounting systems and the maintenance of multiple, progressive rate schedules." *See* ROIN, *Unmasking the "Matching Principle" in Tax Law, supra* note 140, at 814.

622 *See* discussion *supra* at pg. 124ff.

623 *See* WHITE, BNA Tax Management Portfolios, U.S. Income Series, Computation of Consolidated Tax Liability (756-3rd), *supra* note 612.

624 The matching rule under the US Group Taxation regime applies uniformly to period transactions (*e.g.,* payment of currently deducted interest), sales of property, performance of capitalized services, and transactions involving stock or obligations of members. *See* IRC Treas. Reg. Section 1.1502-13 (b)(1)(i)(c).

625 Note that each payment of interest or accrual or premium on a loan qualifies as a separate intercompany transaction. *See* IRC Treas. Reg. Section 1.1502-13 (b)(1)(i).

wholly internal to the Tax Group (*i.e.,* all parties to the reorganization are members of the group before and after reorganization). Property received as part of a reorganization exchange is boot.[626] The US Group Taxation regime bifurcates the boot and the reorganization.[627] In this adopted fiction, the boot is received in a transaction separate from the reorganization exchange. Accordingly, the boot is treated as a distribution.[628] Non-taxability with correspondent adjustment to outside basis ensues.[629] This rule provides a very good example of regulatory simplification based on pragmatic assumptions associated with the reality of a Tax Group.

4. The Determination of the Tax Liability of the Corporate Group

Making use of these altered mechanics, at year end, the system determines the tax liability of the group. The separate calculation by each corporate member of its taxable income presents the starting point. The entity must calculate its separate taxable income as if all the transactions that occurred with other group members did not exist for tax purposes.[630] Thus, all intra-group transactions must be neutralized. The neutralization of intra-group transactions occurs through the use of the mechanisms discussed above, *i.e.,* altered outside and inside basis mechanics, application of the matching rule to intra-group payments, tax free treatment of boot in internal reorganizations, etc. This operation results in the elimination of intra-group distributions, and profits and losses from intercompany transactions. In addition, certain tax attributes, which must be calculated on a joint basis, are not taken into consideration on this calculation. Thus, capital gains and losses and NOLs are disregarded in computing each member's separate taxable income.[631]

Once the separate taxable incomes are calculated in this manner, they are combined in a global account, made up of adjusted separate taxable incomes. Then, the items calculated on a joint basis are added to such global account. Thus, the last step of the calculation is to

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626 *See* IRC Treas. Reg. Section 1.1502-13 (f)(3)(i).
627 *See* IRC Treas. Reg. Section 1.1502-13 (f)(3(ii).
628 That is, boot is treated as received under IRC Section 302 and as distributed under IRC Section 311. *See* Rev. Rul. 93-61, 1993-2 C.B. 118.
629 The term "boot" is used to describe nonqualifying property, such as money, that is received in a reorganization exchange along with qualifying property (stock).
630 *See* IRC Treas. Reg. Section 1.1502-12.
631 Also, certain attributes such as Foreign Tax Credits and the Dividends Received Deductions (*see* IRC Section 243) are calculated in an aggregated fashion. That is, the limitation percentage is applied to the appropriate consolidated, rather than the separate income item. Thus, a deduction or credit which would otherwise be unavailable to a member of the group in a separate return (because of insufficient income or tax) might become available to the group in a consolidated return. *See* WHITE, BNA Tax Management Portfolios, U.S. Income Series, Computation of Consolidated Tax Liability (756-3rd), *supra* note 612.

combine the separate taxable incomes and compute NOLs, and the capital gains and losses on a consolidated basis.[632] As a rule, the current loss must be absorbed first. Thus, current income and losses of all members must offset each other in the consolidated computations before any carryovers or carrybacks can be absorbed on a consolidated basis.[633] The foregoing formulates the taxable income of the consolidated group. This hybrid figure constitutes the consolidated taxable income over which tax will be levied.[634]

5. Entry and Exit of Corporate Group Members

As previously discussed in Problem 4, the treatment of pre-entry losses is a transversal problem to all integration regimes. There are three types of pre-acquisition losses that may generally carryover, NOLs, NCLs and built-in losses.[635] The US Group Taxation regime classifies these three types of pre-entry losses into a separate category, the so-called Separate Return Limitation Year ("SRLY"), and restricts their use, either totally or partially.[636] As a rule, losses subject to the SRLY limitation may only be used to offset the group's income to the extent of the member's contribution to consolidated taxable income.[637]

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632 *See* IRC Treas. Reg. Section 1.1502-21.

633 Once such losses are used to offset consolidated taxable income, the outside basis of the group member that contributed such losses suffers a downward adjustment. As previously discussed, net losses are a negative adjustment only to the extent they are used in the current year consolidated return or are carried back to another year. *See* WHITE, BNA Tax Management Portfolios, U.S. Income Series, Computation of Consolidated Tax Liability (756-3rd), *supra* note 612.

634 In an effort to keep the separate tax existence of each member alive the tax liability is allocated to each member. Although each member is responsible for such tax liability and for the tax liabilities of all remaining group members, this allocation is important because it is used to calculate E&P. That is, such tax liability will reduce E&P. Id.

635 *See* discussion *supra* at pg. 104.

636 *See* IRC Treas. Reg. Sections 1.1502-1 (e),(f) (definition of SRLY); IRC Treas. Reg. Section 1.1502-15 (limitation on built-in losses); IRC Treas. Reg. Sections 1.1502-21 (a),(b),(c) (computation and operational rules for NOLs) and IRC Treas. Reg. Sections 1.1502-22 (a),(b),(c) (computation and operational rules for NCLs). The restriction on the use of pre-entry losses may also occur under IRC Section 382, which continues to be applicable under the US Group Taxation regime. The consequences arising from admission to a Tax Group under both SRLY and section 382 events depend upon the timing of these events. Where the SRLY event (*i.e.,* the time at which the corporation becomes a member of the Tax Group) occurs within six months of the IRC Section 382 triggering event, an "overlap rule" applies, and the Section 382 event supersedes the SRLY event; that is, the section 382 limitation alone applies to the utilization of the NOLs by the Tax Group. Where the SRLY event occurs more than six months after the section 382 triggering event, both the SRLY and section 382 limitations apply to the NOLs transferred to the Tax Group. Where the admission of the corporation to the Tax Group is neither a SRLY nor a section 382 event, the NOLs carried over become consolidated net operating losses (CNOLs) and can be utilized unencumbered by the consolidated group. *See* IRC Treas. Reg. Sections 1.1502-21(g)(1) and 1.1502-21(g)(2)(ii)(A).

637 Interestingly, the member's contribution to consolidated taxable income is not measured on a year-by-year basis but cumulatively over the entire period during which the corporation is a member of the group. Thus, NOL carryovers and carrybacks subject to the SRLY restriction may be included in the group's consolidated NOL deduction only to the extent that they do not exceed the aggregate consolidated taxable income for all consolidated return years of that specific group member, computed by taking into account only the loss

As for the exit of a Tax Group member, in principle, all deferred intra-group items trigger upon exit. Further, when this occurs during the taxable year, the departing corporation takes its allocable share of NOLs.[638] Once the member exits the Tax Group, it can be readmitted only after five years.[639]

6. The Treatment of Minority Shareholders

From a mechanic perspective, minority shareholders are effectively isolated from the consolidation process. Their stock basis is not affected by the different adjustments introduced to a Tax Group member's stock basis by the US Group Taxation rules.[640] Further, although not valid against the Internal Revenue Service, Tax Group members can contractually agree to allocate the burden for the consolidated group tax liability through a "tax-sharing agreement."[641] These agreements provide a certain level of protection to minority shareholders in that they allocate the tax burden on the basis of each separate corporation's taxable profits, as if such entity were to file a separate federal income tax return.[642]

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member's items of income, gain, deduction and loss. Further, the US Group Taxation regime does not permit the separate NOL carryover or carryback of a member to be applied directly against its own taxable income included in the consolidated return. It does not matter whether the NOL arose in a consolidated return year or in a SRLY. That is, even NOLS subject to the SRLY restriction that are carried over or back by the loss member are deducted as part of the consolidated NOL deduction that offsets the income of the group as a whole. *See* IRC Treas. Reg. Section 1.1502-21 and IRC Treas. Reg. Section 1.1502-22. *See also* WHITE, BNA Tax Management Portfolios, U.S. Income Series, Computation of Consolidated Tax Liability (756-3rd), *supra* note 612.

638 In particular, the portion of the consolidated NOLs allocable to that corporation becomes its own NOL for carryforward. The NOL available for carryforward by the departing corporation is determined after the CNOLs have been applied to the consolidated taxable income for the year, *i.e.,* only the CNOL attributable to the departing corporation which is not absorbed by the group in that year is carried over to the departing corporation's first separate return year. IRC Treas. Reg. Section 1.1502-21(b)(2)(ii)(A). A corporation that joins or leaves a consolidated group during the taxable year has a deemed taxable year-end on the date its group status changes. IRC Treas. Reg. Section 1.1502-76(b)(1)(ii).

639 IRC Section 1504(a)(3).

640 *See* IRC Treas. Reg. Section 1.1502-32 (c)(1). In general, adjustments are allocated to all shares of the Tax Group member on a share-for-share basis. As a result of this rule, adjustments are allocated even to shares owned by non-members (minority interests). However, the adjustments allocated to minority stock have no effect on the basis of such stock because non-members are not subject to the investment basis adjustment system. *See* WHITE, BNA Tax Management Portfolios, U.S. Income Series, Consolidated Returns—Investment in Subsidiaries (755-3rd), *supra* note 607.

641 Tax Group members are jointly and severally liable for the entire tax of the group. *See* WHITE, BNA Tax Management Portfolios, U.S. Income Series, Computation of Consolidated Tax Liability (756-3rd), *supra* note 612.

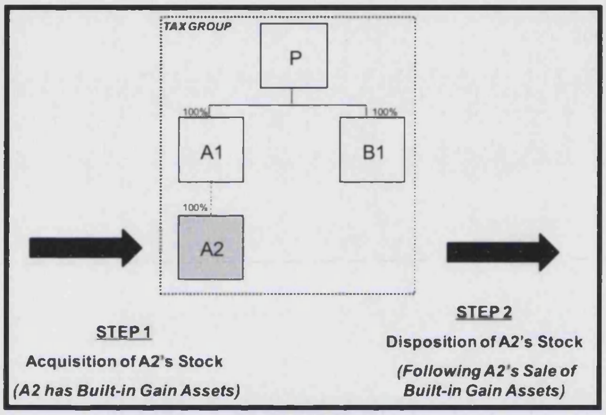
642 *See* GEORGE L. WHITE, BNA Tax Management Portfolios, U.S. Income Series, Consolidated Returns - Elections and Filing (754-3rd) (Tax Management Inc. 2005).

7. <u>The Problem of Transfers of Tax Group Members' Stock</u>

The use of a floating outside basis to neutralize intra-group transactions while maintaining the separate tax existence of a corporate group member signifies a significant setback of the US solution for partial integration. This mechanism gives rise to substantial complexity once stock of a Tax Group member is transferred. Consider the following situations.

<u>Situation 1</u>

Diagram 19

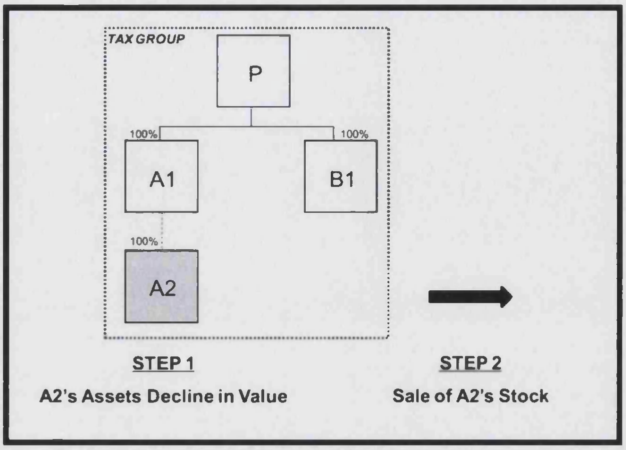


SITUATION 1

In this situation, A1 acquires A2's stock from an unrelated party. A2 owns an asset with a built-in gain. Later, while a member of the Tax Group, A2 sells its built-in gain asset and recognizes a taxable gain. Under the basis adjustment rules discussed above, A1's outside basis would be stepped up by the amount of gain recognized in A2's asset sale. The problem is that if A1 then sells A2's stock, it will recognize a loss (or a reduction on taxable gain) on an amount equal to the prior step up in A2's stock basis. In this situation, the basis adjustment to A2's stock does not reflect an increase in A2's underlying assets. Thus, the loss realized by A1 on the sale of A2's stock does not represent an economic loss to either A1 or A2.

Situation 2

Diagram 20

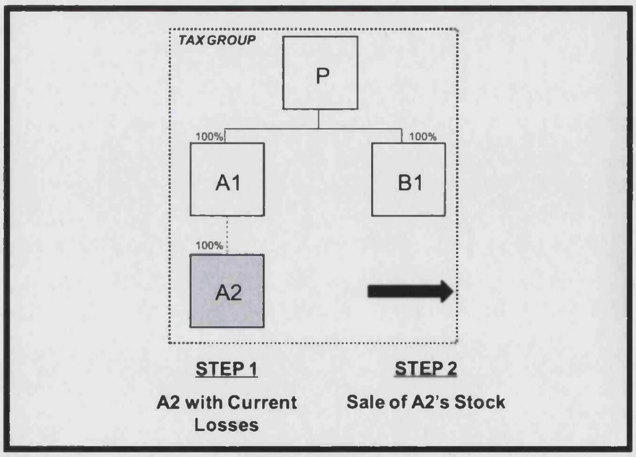


SITUATION 2

In this situation, A2 owns an asset that declines in value while A2 is a member of the Tax Group. Under the basis adjustment rules, since the loss is not realized, it does not produce an adjustment to A2's stock basis. If A1 then sells A2's stock to an unrelated party, it will recognize a loss (or a reduction on taxable gain) of an amount equal to the decline in value of A2's assets. In addition, later when A2 sells its built-in loss asset, it will recognize such built-in loss. Thus, in this situation, the value of A2's built-in loss may be effectively duplicated.

Situation 3

Diagram 21



SITUATION 3

In this situation A2 has current losses. A1 then decides to sell A2's stock. Despite the adjustment rules discussed above, due to the offset of A1's gains with A2's losses in consolidation, the sale would not have any net effect upon consolidated taxable income.

In order to address situations such as those described in Situations 1 and 2, the US Group Taxation regime has an additional body of very complex provisions, the so-called Loss Disallowance Rule ("LDR") and Deconsolidation Rule.[643] Broadly, the LDR provides that no loss is recognized by a member upon the disposition of the stock of a subsidiary. This rule is backstopped by an additional anti-avoidance rule, *i.e.,* the Deconsolidation Rule.[644] Under this rule, subsidiary stock is generally reduced to its value upon the deconsolidation of a subsidiary.[645] Lastly, in order to address situations such as Situation 3, the US Group taxation regime does not allow A2's losses to be used to offset A1's stock gain. A2's losses can only be used to offset other income of the group.[646]

In sum, the neutralization of transactions through the use of a floating outside basis poses several problems once the stock of a Tax Group member is transferred, either at a gain or a loss. If no limitations are imposed, the floating outside basis mechanics may be easily manipulated to obtain unlawful tax benefits. To deal with such problems, very complex anti-abuse rules are required.

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643 That is, eliminate the possibility that gain recognized on the disposition or consumption of an acquired subsidiary's built in gain assets may be offset by a loss at the parent level created by an investment adjustment attributable to the subsidiary's recognized built-in gains (see Situation 1); and prevent losses of a subsidiary from being duplicated in the form of a parent's investment losses (see Situation 2). *See* IRC Treas. Reg. Section 1.1502-20 (a) (Loss Disallowance Rule) and IRC Treas. Reg. Section 1.1502-20 (b) (Deconsolidation Rule).

644 Without it, consolidated return filers could easily avoid the brunt of the LDR. For instance, assume P has an unrealized loss in A1 stock. P sells sufficient A1 stock to cause A1 to drop out of the P consolidated return into a separate return environment where the LDRs would be inapplicable to a subsequent sale of the A1 stock retained by P. The deconsolidation rule thwarts this scheme by marking to market the basis of the A1 stock retained by P, thus precluding the recognition of loss by P on a subsequent sale of A1 stock. *See* WHITE, BNA Tax Management Portfolios, U.S. Income Series, Computation of Consolidated Tax Liability (756-3rd), *supra* note 612, at Section III-G.

645 A "deconsolidation" is any event that causes a share of stock of a subsidiary that remains outstanding to be no longer owned by a member of any consolidated group of which the subsidiary is also a member. Where there is an overlap between a disposition (which triggers the LDR) and a deconsolidation (which triggers a basis reduction), the former controls. Id.

646 For purposes of determining the amount of gain or loss on a disposition of A2's stock, the consolidated taxable income or loss of the group is tentatively determined without regard to any gain or loss on the disposition of the stock. Investment adjustments are then made to the basis of this stock based on this tentative computation. Gain or loss on the disposition is then determined based on this adjustment to the basis of the stock. This problem is usually referred to as the "circular basis problem". Id.

8. Conclusion on the Mechanics of the US Group Taxation Regime

The US Group Taxation regime is overly complex. Although it has developed very interesting mechanic solutions for tax integration, the overall complexity of the regime does not make it very appealing as a comprehensive solution to integrate corporate groups for tax purposes. A core problem of the regime is the use of a floating outside basis to avoid the double counting problem. Although this mechanism allows for a rather accurate tracking of relevant intra-group events, it gives rise to very complex situations once a sale of stock of a Tax Group member occurs. Also, the operation of the mechanism itself is particularly intricate. Further, although the determination of the tax liability of the Tax Group comes very close to achieving a true single-entity result, the complexities associated with such calculations (*e.g.,* intricate ordering rules for use of losses, intricate calculations of separate and consolidated taxable items, etc.) raise the issue of whether an outright consolidation of results of separate taxable entities is desirable from an overall efficiency perspective. Lastly, this type of system raises complex interaction problems. In particular, due to the complexity of its altered mechanics, the interaction of the US Group Taxation regime with the tax rules for taxation of partnerships and disregarded entities proves particularly troublesome.[647]

Nevertheless, the US Group Taxation regime is illustrative for the sophistication of certain solutions it uses to integrate corporate groups for tax purposes. In particular, the Deferred Sale System and its associated rules for the amortization of transferred assets; the Matching Rule on intra-group payments; the treatment of boot in Tax Group reorganizations; and the comprehensive restrictions to the use of pre-entry losses provide commendable approaches to tax corporate groups.

ii. The Mechanics of the UK Group Taxation Regime

The UK tax system proposes an entirely different solution to the tax integration of corporate groups. While maintaining the separate tax existence of corporate group members, the UK solution uses a simpler mechanic apparatus to integrate corporate groups for tax purposes. The secret of the comparative simplicity of the UK regime lies in the fact

[647] *See, e.g.,* COLLINS, et al., *Consolidated Return Planning and Issues Involving Disregarded Entities*, supra note 301; HYDE, et al., *The Use of Partnerships and LLCs in Structuring Consolidated Groups,* supra note 301. These authors describe how disregarded entities and partnerships can be used to manipulate the US Group Taxation regime (*e.g.,* not to recognize an ELA, etc.).

that, by and large, it uses the regular mechanics of its Standard CIT System. Although the degree of tax integration achieved is not as high as under the US Group Taxation regime, the UK solution is mechanically simpler.

1. <u>The Structure of the UK Tax Integration Regime</u>

In the UK the integration process is simplified due to the fact that a participation exemption is applicable under its Standard CIT System. Dividends and gains or losses on the sale of a Tax Group member's stock are effectively neutralized using this mechanism and, thus, the problem of double counting upon integration (see Problem 2 above) is avoided. Further, the UK does not consolidate the tax results of the Tax Group members, as occurs under the US Group Taxation regime. Instead, each corporate group member calculates its taxable income separately and losses are set-off individually. Due to the participation exemption and to the simpler loss offset mechanism, the complexities associated with the use of an altered outside basis are avoided.

In contrast to the US, the UK regime has followed a segregated approach to the tax integration of corporate groups, individualizing tax attributes and types of income in different regimes. Specifically, the tax integration of corporate groups is achieved using the following mechanisms:[648]

1. Participation exemption (allows for tax free distributions inside the group and for the avoidance of double taxation or double use of losses upon the sale of a corporate group member's stock);[649]

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[648] *See* YASH RUPAL, *Report on Group Taxation in the UK, in* IFA, Group Taxation, Cahier de Droit Fiscal International Vol. 89b (Yoshihiro Masui, et al. eds., 2004) at 697; FURSDON, British Tax Guide: Corporation Tax, *supra* note 410, at 141-142.Note that the UK corporation tax legislation has been rewritten over the last two years as part of the Tax Law Rewrite programme. It is now largely contained in the Corporation Tax Acts 2009 and 2010 (CTA 2009 and CTA 2010 – the latter includes Group Relief) and the Taxation (International and Other Provisions) Act 2010 (TIOPA 2010). The exception is the material on the chargeable gains of companies, which remains unrewritten in the Taxation of Chargeable Gains Act 1992, which it is not planned to rewrite.

[649] Note that owing to changes flowing from EU issues, distributions are not automatically free from corporation tax (*see* CTA 2009, Part 9A – applicable since July 2009); however, distributions from controlled companies are generally exempt (CTA 2009, Section 931E), subject to the anti-avoidance rules, especially Section 931. As the participation exemption for the sale of stock of a group member, this thesis refers referring to the substantial shareholding exemption in TCGA 1992, Schedule 7AC. This exemption has only applied since 2002. Note that this exemption has a one-year minimum holding period and that it applies essentially only to trading groups (thus, excluding in particular investment activities).

2. Group relief (allows for transfers of NOLs inside the group);

3. Capital gains group (allows for tax free transfers of assets and transfers of NCLs inside the group);

4. Loan relationships and derivative contracts transfers (allows for the transfer of loan relationships and derivative contracts between group companies on a tax neutral basis);[650]

5. Roll-over relief (allows for the rollover of tax provided the proceeds from certain sales are reinvested in group operations);

6. Intangible fixed assets transfers (allows for the transfer of intangible fixed assets between group companies on a tax free basis); and

7. Pooling of foreign tax credits (allows excess foreign tax credits to be surrendered by one company to another company in the group).[651]

The following discussion will focus on the group relief and capital gains group regimes due to their relevance to our analysis.

2. Intra-Group Transfers of Assets and NCLs

The transfer of assets between members of the same Tax Group does not give rise to gains or losses.[652] The transfers are not ignored. However, the consideration received by the transferor for the transfer is deemed to be of such an amount that secures that neither a

650 Note that if the loan relationship or derivative contract is accounted for on the amortising cost basis, the transfer is tax free, but if it is accounted for on the fair value basis, the transfer is on normal terms; however, the latter is consistent with the fair value basis as it is not a realization basis, so the basis does not accelerate tax liability on an intra-group transfer, it merely allocates any gain or loss for the year between the group members on the basis of the value at the transfer date.

651 This regime is relatively new, dating back only to 2001. It only applies to tax credits in respect of foreign dividends and the profits of foreign branches. For additional mechanisms of integration in the UK, for instance, for stamp duty purposes, *see* FURSDON, British Tax Guide: Corporation Tax, *supra* note 410, at 141-142.

652 See TCGA 1992, Section 171. The applicable legislation refers to a Tax Group as a "Chargeable Gains Group." Note that relief applies to all capital assets but special rules apply if the asset forms part of the "trading stock" of either the transferor or the transferee. In other words, if it changes its character to or from capital. *See* YASH RUPAL, *Report on Group Taxation in the UK*, *in* IFA, Group Taxation, *supra* note 648, at 696.

gain nor a loss arises to the transferor.[653] The transfer is implemented on a carryover basis, *i.e.,* the transferee corporation inherits the tax basis of the transferor on the asset.[654] This postpones any tax liability until the asset is disposed of outside the group.

Besides facilitating the free transfer of assets between Tax Group members, the UK regime allows for the transfer of NCLs between them. Thus, an asset may be transferred directly out of a Tax Group member and benefit of the NCLs of another member to reduce the gain on the transfer.[655]

3. Intra-Group Transfers of Losses

Under the UK solution for intra-group transfers of losses (*i.e.,* so-called "Group Relief" regime), each member of the Tax Group computes its tax liability on a single entity basis.[656] A company may then make a claim on its tax return to use the losses of another Tax Group member incurred in the same fiscal year to offset its profits for the year.[657] This process of loss offset involves therefore a so-called "claimant" company (*i.e.,* the company that claims the use of another company's tax losses in its tax return) and a "surrendering" company (*i.e.,* the company that surrenders the losses to the claimant company).

The claim for group relief has to be made in the claimant company's tax return with the consent of the surrendering company.[658] However, note that both the claimant and the surrendering company remain responsible for preparing their separate tax computations

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653 Id.

654 Id. In the UK, this value is generally adjusted for indexation relief. Id. Note that the UK tax legislation does not use a concept analogous to "basis," although practitioners refer to "base cost." Having no concept of "basis," the UK legislation cannot make adjustments to basis or carryover basis, but has to use other mechanisms to achieve similar results.

655 For gains and losses accruing before July 21, 2009 this result could only be achieved by election for the notional transfer of the asset before its disposal to a third party. *See* TGCA Section 171A, as inserted by FA 2009, Section 31, Sch. 12. *See also* FURSDON, British Tax Guide: Corporation Tax, *supra* note 410, at 141-142 and 164-165 (describing in detail the operation of this mechanism). Under the new regime, where a group company realises a chargeable gain or allowable loss (*i.e.* on a disposal outside of the group), there is now an election enabling it to transfer the gain or loss to another group member. As before, allowable losses can only be offset against chargeable gains, even when transferred.

656 Note, as will be further discussed below, that the qualification requirements for the Chargeable Gains Group and Group Relief differ. *See* discussion *infra* at pg. 184ff.

657 The group relief regime applies to the transfer of trading losses, excess interest expenses on borrowings and certain other amounts (excess capital allowances, management expenses of investment companies, charges on income and certain losses relating to intangibles. Capital losses cannot be surrendered as group relief. However, losses surrendered under group relief can be set off against all types of profit, including capital gains.

658 It is possible to enter into simplified arrangements which enable a group to appoint one of its members to act on behalf of the group in making the necessary claims.

and discharging their tax liability. In general, group relief is set-off against total profits (including capital gains once realized) of the claimant company for the current accounting period. These total profits are arrived at after deducting all reliefs available to the claimant company that relate to previous accounting periods.

The same year restriction for group relief is a primary feature of this regime. This means that losses carried forward from an earlier accounting period or carried back from a later accounting period of the surrendering company cannot be claimed. By the same token, group relief surrendered to a claimant company cannot be carried back or forward to other accounting periods of the claimant company.

Note that there is no compulsion to surrender losses by way of group relief and the loss-making company is free to choose to carry losses forward to reduce its tax liability on future profits or, in case of certain losses, to carry losses back against the profits of previous periods.

Another point of relevance is that the losses of a corporation may be divided among several Tax Group members. Different claims may be made in respect of different portions of the losses of the surrendering company and by different members of the Tax Group. The group chooses what proportion of losses available for surrender is to be surrendered, and which corporations are to be the claimant companies.[659] Claims are made on an accounting period by accounting period basis.[660]

4. Entry and Exit

Similarly to the US, the UK has several restrictions to the use of pre-entry losses. As a general rule, ordinary losses incurred by the surrendering company prior to its joining cannot be surrendered. Only losses which are incurred whilst the surrendering company is

[659] A claim can be withdrawn at the group's discretion within appropriate time limits.
[660] Note that UK corporate tax law further provides for a so-called "consortium relief." Broadly, whereas group relief requires 75% ownership but gives the right to surrender 100% of a loss, consortium relief applies where a number of companies (a consortium) each owns at least 5% but less than 75% of a subsidiary. A loss of the subsidiary can only be surrendered to a consortium member in proportion to its ownership, *i.e.* 45% of a loss could be surrendered to a 45% owner. Conversely if a consortium member surrenders a loss to the subsidiary, it can surrender the loss only up to the ownership proportion of the subsidiary's profits, so the 45% owner could only surrender enough of the loss to offset 45% of the subsidiary's profits. There are also rules about what happens when a consortium member is part of a group or the subsidiary has a group under it. Consortium relief is generally restricted to trading companies. *See* generally TILEY, Revenue Law, supra note 437, at 929-932.

in the group can be surrendered and they can only be set off against those profits of the claimant company that are earned whilst it is in the group.[661] Similarly, the use of pre-entry capital losses (including built-in losses) is subject to several restrictions.[662] Also, the set-off of capital losses by a group against gains realized by a corporation before it joins the group is subject to limitations.[663]

With respect to the exit of a corporate group member of a Tax Group, there is a trigger of deferred gains on intra-group asset transfers undertaken within the prior six years to the date of the exit.[664] However, note that there is no recapture of group relief if the claimant company leaves the group.

5. <u>The Treatment of Minority Shareholders</u>

Where a Tax Group member has minority shareholders, such member may still surrender all of its eligible losses to the Tax Group and it may set off group relief from the Tax Group against all of its relevant profits.[665] Although no such requirement exists, the claimant company may compensate the surrendering company for group relief by making a payment to it. A surrender of group relief has no impact on the tax basis of any corporation. As a rule, a payment for group relief will not be taxable (or deductible) provided that it does not exceed the amount of the loss surrendered.

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661 *See* YASH RUPAL, *Report on Group Taxation in the UK*, *in* IFA, Group Taxation, *supra* note 648, at 693.

662 Specifically, the use of pre-entry losses is restricted where a corporation joining a group brings with it capital losses realized prior to it becoming a member of the Tax Group and where losses are realized by a corporation after its membership of the Tax Group has commenced but in respect of assets held by it prior to it joining the group. These losses can only be set-off against gains on the assets that the joining corporation (or its associated corporations) brings into the new group or against gains on new assets acquired from a third party and used in an existing trade of the new member. Further, where the loss in relation to a pre-entry asset is realized after membership of the new group has commenced, a proportion of that loss is treated as a pre-entry loss and is subject to these limitations.

663 Note that the limitation on the use of pre-entry gains is currently limited to cases of tax avoidance under TCGA 1992, Section 184B. *See* the Guidance Notes at Appendix 8 to the HMRC Capital Gains Manual (available at http://www.hmrc.gov.uk/manuals/CG1manual/index.htm).

664 In particular, to prevent abuses through the transfer of an asset which is to be sold outside the group to a new group member followed by the sale of the shares in the new member (*i.e.,* to benefit from the exemption on capital gains on sale of shareholdings), an "exit charge" applies. Specifically, if the transferee company (or an "associated" company) leaves the group whilst holding the asset within 6 years of the intra-group transfer, the transferee company is deemed to have disposed of the asset at its market value immediately after it acquired the asset from the other group member. This exit charge may not be imposed if both the transferor and transferee company leave the group together (and are associated immediately thereafter). *See* YASH RUPAL, *Report on Group Taxation in the UK*, *in* IFA, Group Taxation, *supra* note 648, at 696.

665 Note that this does not occur in the case of consortium relief

6. Conclusion on the Mechanics of the UK Group Taxation Regime

Although the degree of tax integration achieved under the UK Group Taxation regime is not as high as under the US Group Taxation regime, the UK solution remains mechanically simpler. One interesting feature is the avoidance of a floating outside basis mechanics due to the use of a participation exemption and to the individual set-off of losses. However, the regime has certain drawbacks. First, although the regime is fairly flexible from an entity carryover perspective, it is extremely restrictive from a year carryover standpoint.[666] Further, the segregation of the tax integration regime into different regimes generates unneeded complexity. In particular, it gives rise to the proliferation of qualification requirements, which do not always match up.[667]

5. The Molecular Group Taxation System Proposal

Based on the analysis undertaken, the realization-based model that achieves all the objectives of tax integration in the simplest possible form is the full integration model. Assets, income and tax attributes are freely transferable inside the corporate group and income derived by corporate group members is subject to a single taxation layer at the shareholder level. However, this model retains an important drawback. For mechanic reasons, it would most likely require complete ownership over the corporate group member. This is due to two reasons. First, since we may be considering a corporation with listed shares, once a corporate group member has more than one shareholder, the tax system must attribute an outside basis to each shareholder for it to be able to trade freely on its stock. Second, where a flow-through regime is applicable to a corporation that is owned by more than one shareholder, the tax system might well attribute an outside basis to each shareholder in order to keep track of taxed amounts, distributions and tax attributes (*e.g.,* losses and deductions) that flow-through to the shareholders. In these cases, outside basis should allow the tax system to allocate the tax attributes of the flow-through entity among its shareholders and to avoid potential situations of double or no taxation. Due to these limitations, where ownership is partial, alternative realization-based models

666 Apparently, the explanation for such restrictive use of losses has to do with the fact that the rules for offsetting losses from one source against income from another and the rules for carryback and carryforward are overly technical. See *See* YASH RUPAL, *Report on Group Taxation in the UK*, *in* IFA, Group Taxation, *supra* note 648, at 706.
667 *See* discussion *infra* at pg. 184ff regarding differences of qualification requirements for Group Relief and Chargeable Gains Group purposes.

that attribute an outside basis to each shareholder of the corporate group member would better be applied. The problem with these alternative models is that they either fall short of achieving the objectives of full tax integration or achieve them with added complexity.

Therefore, from a pure mechanic perspective, the most sensible solution would be to use the full integration model wherever possible and, for the remaining cases, adopt an alternative integration model. Thus, while in the case of wholly-owned entities the full integration model would apply, the partially-owned entities would be subject to a partial integration solution. This co-existence of full and partial integration solutions in a sole tax integration regime is not entirely new. In practice, this already occurs in the US with the interaction of the US Group Taxation regime with the US CTB provisions.

Based on the lessons from the US experience, the use of a floating outside basis must be ruled out for this type of proposed hybrid model to work properly. Specifically, in order to ensure a safe interaction with the full integration model, the floating outside basis of the flow-through model and of the US Group Taxation regime should better be ruled out as partial integration possibilities.[668] Therefore, the use of a Group Taxation solution that does not require a floating outside basis should qualify as a preferable approach to the tax integration of partially owned entities within such a hybrid model.[669]

In particular, based on the analysis undertaken, the partial integration solution that would better interact with the full integration solution, while ensuring the highest possible degree of tax integration, should have the following mechanic characteristics:

a. Use of the regular outside basis mechanics of the Standard CIT System. As witnessed in the US experience, although the use of a floating outside basis for tax integration purposes allows for an accurate tracking of relevant intra-group events, it gives rise to very complex situations once there is a sale of stock of a Tax Group member. Also, the operation of the mechanism itself is particularly intricate. Finally,

[668] *See supra* note 301.

[669] Further advantages of a Group Taxation model over a pure flow-through model include the fact that the proportionality of allocation is eliminated and, thus, the regime is simplified. In addition, under the Group Taxation model, the partially owned entity is kept, as a matter of principle, as a separate tax entity. This simplifies the interaction with the Standard CIT System rules, with other regulatory fields and with the international tax system.

based on the current US experience, it gives rise to complex interaction problems with the remainder of the CIT system.

b. Use of a participation exemption mechanism, even if only within the limited boundaries of the Tax Group. As previously noted, the Tax Integration Solutions work as closed operating systems. Thus, the solutions for tax integration do not necessarily need to replicate the mechanisms of the Standard CIT System. Therefore, even in a tax system such as the US, which has not yet implemented a participation exemption under its Standard CIT System, a participation exemption may be implemented for the limited purposes of tax integration of corporate groups. One of the problems of the participation exemption is its potential for sheltering of unrealised gains. For instance, due to the exemption for capital gains on stock sales, corporate taxpayers may be encouraged to disguise the sale of assets, which should be taxable, as the sale of stock, which is not. By the same token, a parent corporation may acquire the shares in a subsidiary as part of a tax-free reorganization from persons that would not be able to utilize the capital gains exemption, namely, individuals and partnerships. These incentives for tax planning could add a new layer of difficulty to the government's ability to administer the tax law. For this reason, a participation exemption should generally be cumulated with additional rules to prevent abuses. For instance, restrictions preventing a non-eligible entity from avoiding capital gains taxation by transferring shares tax-free to a corporation or a step transaction doctrine enabling the tax authorities to recast a purported stock sale as an asset sale whenever deemed required.

c. Apply a regime for individual set-off of losses similar to the UK Group Relief instead of an outright consolidation of the group's results as proposed by the US Group Taxation regime. The complexities associated with the outright consolidation of results of separate taxable entities (*e.g.,* use of a tracking mechanism based on adjustments to outside basis, intricate ordering rules for use of losses, intricate calculations of separate and consolidated taxable items, etc.) make this option less appealing.

d. As for the adoption of the UK solution for individual transfers of NOLs, maintain the same approach regarding entity carryover but enlarge its year carryover scope, allowing for unlimited NOLs carryforwards. As will be further discussed, this option is also advisable from a dynamic perspective.[670] For similar motives, adopt an equivalent approach to intra-group transfers of NCLs (*i.e.,* flexible entity and year carryover limitations).

e. Use Deferred Sale System for accounting for intra-group transfers of assets. This mechanism allows for a very accurate determination and location of tax attributes and for transfers of property without losing the benefits of rapid depreciation methods.

f. Apply a Systemic Matching principle to intra-group transactions, adopting the "wash" solution of the US Group Taxation regime (*i.e.,* make payment deduction and income inclusion coincide in the same specific date).

g. Treat boot in intra-group reorganizations as tax free distributions.

h. Maintain limitation for pre-entry NOLs, NCLs, and built-in losses. On exit, trigger of deferred items, but no recapture of loss amounts used.

i. Unified regime with respect to qualification requirements for tax integration. The segregation of the tax integration regime into different regimes generates unneeded complexity, namely as far as the proliferation of qualification requirements is concerned.

j. Lastly, provided corporate group members are appropriately reimbursed for the use of their tax attributes at the group level, there is no reason why the Tax Group should be limited to entities that meet a 75% or 80% ownership threshold. Although its advantages and disadvantages must be carefully considered prior to implementation, this thesis suggests that the legislator should be aware that the regime may also be made applicable, for instance, to >50% owned entities.[671]

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[670] *See* discussion *infra* at pg. 191ff.

[671] This is, for instance, the position adopted by Germany, with a 50 percent test. *See* IFA, Group Taxation, *supra* note 584, at 38. The protection of the interests of minority shareholders may be accomplished in different ways, such as the existence of a right for the minority shareholders to force the majority owner to acquire the minority shares; an agreement from the minority shareholders consenting to consolidation; guaranteed dividends to minority shareholders; or the existence of compensating payment made to minority shareholders. *See* IFA, Group Taxation, *supra* note 584, and WILMAN, *Equalizing the Income Tax Burden in a Group of Companies*, *supra* note 366.

Thus, under this proposed hybrid solution, hereinafter referred to as "Molecular Group Taxation System," there would be two different levels of tax integration, the intra-atomic level and the inter-atomic level. Each tax atom would correspond to a corporate group node fully-integrated for tax purposes. While at the intra-atomic level full integration would apply, the inter-atomic relationship would be subject to the partial integration solution described above.

Inside the tax atom the tax consequences of the transactions entered into by corporate group members would be totally independent of legal formalism and the corporate veil fiction. Inside these tax atoms, assets, stock, income and tax attributes, including losses, would be freely transferable. The stock basis and tax attributes of the parent corporation of each corporate group node (*i.e.,* the filled-in square in the diagrams below) would be the record keepers for tax purposes of all that occurs inside that specific node, as well as of the transactions that occur between corporate group members of that node and other parties, including transactions entered into with corporate group members from different nodes. The tax atom may be conceptualized as follows:

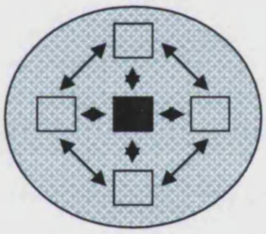

Diagram 22

In turn, the inter-atomic relationship would be subject to the partial integration solution described above. The tax molecule may be conceptualized as follows:

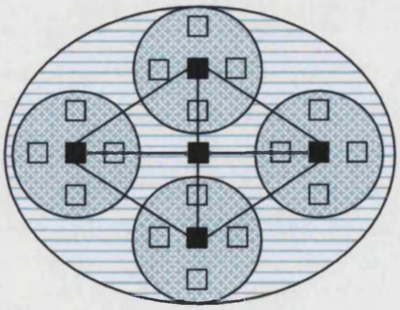

Diagram 23

As an exemplification of the operation of the proposed tax integration system, assume the following corporate group:

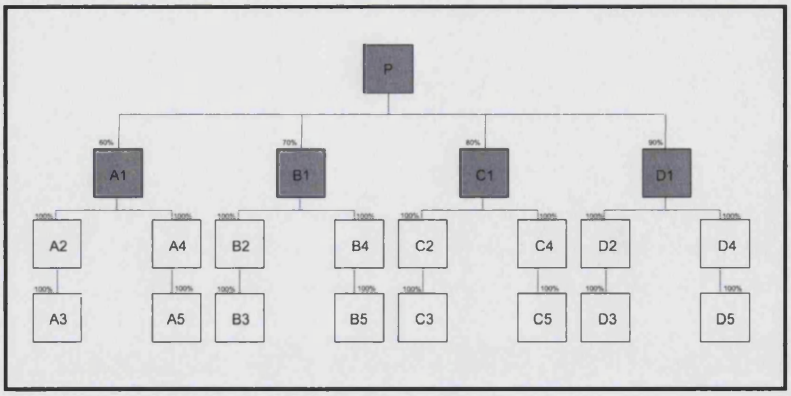

Diagram 24

Under the Molecular Group Taxation System, the A1, B1, C1 and D1 group nodes would be fully integrated. Within each of these nodes, or *tax atoms*, all the considerations discussed above regarding the operation of the full integration model would apply.[672] At the inter-atomic level, if corporation A5 made a payment of interest, royalties, rents or service fees to corporation B3, the Systemic Matching rule would apply. Therefore, the payment deduction by A5 and its respective inclusion by B3 would offset each other in a wash controlled by A5's accounting of the payment deduction. Further, the transfer of assets between A5 and B3 would be subject to the Deferred Sale System rules, while the transfer of NOLs and NCLs between them would occur under an individual set-off mechanism, as described above. In turn, the distributions from A1, B1, C1 and D1 to P would be exempt under a participation exemption. The sale of shares in each of these corporations, either at a gain or loss, would be exempt from taxation under the same mechanism. The allocation of the relevant tax attributes of each tax atom to the group would be made on a full basis. The minority shareholders of each tax atom, in turn, would receive adequate compensation for the use of the tax attributes of the tax atom by the corporate group.

As previously noted, the implementation of this model in jurisdictions that closely align corporate tax law and corporate law treatment is subject to a feasibility analysis of making the tax treatment independent of the corporate law treatment. Further, the considerations made above regarding the international tax aspects of full integration should be paid due attention.

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[672] *See* discussion *supra* at pg. 144ff.

6. *The Definition of Qualifying Corporate Group for Tax Integration Purposes*

Throughout the above discussion on the mechanics of tax integration, corporate group members were assumed to qualify as Tax Group members for purposes of the different integration solutions analyzed provided they met simple ownership thresholds. As previously noted, this approach allowed the discussion to focus on the complex mechanic issues of tax integration. Now that the mechanic issues of tax integration have been dealt with, the current section aims to look into the particularities associated with the definition of a qualifying corporate group for tax integration purposes. The section will start by contextualizing the problem through a brief review of the issues commonly associated with the definition of corporate groups for general regulatory purposes. Once this general framework is laid out, the section will discuss the specificities associated with the definition of corporate groups for tax integration purposes.

a. The Definition of Corporate Group for General Regulatory Purposes

As previously discussed, corporate groups have no formal existence or organs of their own. For that reason, the definition of their boundaries for application of external regulations is normally operated based on the concept of "control."[673] The prevalent agreement on the adoption of "control" to define the boundaries of corporate groups has not resulted, however, in a uniform approach to its definition. Extremely diverse definitions of control have been proposed in different jurisdictions and in different regulatory contexts.[674] This diversity is a symptom of the complexity of the intercorporate control phenomenon.

Control is a complex phenomenon that extends far beyond simple *de jure* definitions. It is a "structural relation through which a particular category of owners have *de facto* capacity to mobilize the powers vested in the company itself"[675] and that may be implemented through a multiplicity of legal and economic mechanisms.[676] Recognizing the complexity of this phenomenon, legislators, courts and commentators have often gone beyond simple *de jure*

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673 Legislators in most countries, and for most regulatory purposes, have realized that "without the existence of control, the corporations do not constitute a corporate group. *See* BLUMBERG, The Multinational Challenge to Corporation Law: The Search for a New Corporate Personality, at 14.

674 Id. *See also* LAMB, *When is a Group a Group? Convergence of Concepts of Group in European Union Corporate Tax*, *supra* note 409.

675 *See* SCOTT, *Corporate Groups and Network Structure, supra* note 499, at 294.

676 *See supra* discussion at note 498 on the legal and economic instruments that may be used to implement control.

definitions of control and proposed more encompassing definitions based on the effective control of the parent corporation over the behaviour and economic existence of its subsidiaries. The implementation of these more encompassing *de facto* or hybrid standards has generally been aimed at counteracting the potential for manipulation of simple *de jure* definitions.[677]

For instance, in the US, the legislator and the courts have proposed definitions such as "unitary business," "integrated enterprise" or "economic integration."[678] These more encompassing standards generally combine control with elements such as economic integration and managerial structure. For example, the "unitary business" standard requires that the affiliates are "functionally integrated" into the parent's business. That is, it requires a "substantial mutual interdependence" of the group components and of the "contributions to income resulting from functional integration, centralization of management and economies of scale."[679] These *de facto* standards generally allow for a more realistic definition of the boundaries of a corporate group, providing less opportunity for corporate groups to affirmatively elect out of regulatory provisions. However, their adoption is problematic. Fundamentally, their practical verification may involve such an administrative hurdle that, in practice, their implementation as regulatory standards is often impracticable.[680]

b. The Definition of Corporate Group for Tax Integration Purposes

The definition of the boundaries of a corporate group for tax integration purposes faces similar hurdles to those outlined above.[681] While the adoption of administratively simple *de*

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677 This potential for manipulation is based on the diversity of legal and economic mechanisms available to implement effective intercorporate control. In certain regulatory contexts (*e.g.,* regulation of economically diversified corporate groups such as conglomerates) the implementation of such standards has also been operated because simple *de iure* definitions have not been considered sufficient to identify those circumstances under which the rights and duties of one corporation of a corporate group should be attributed to its parent corporation or other affiliated constituent companies of the group. *See* BLUMBERG, *supra* note 436 and 350.
678 *See* BLUMBERG, *The American Law of Corporate Groups*, *supra* note 346, at 324.
679 *See* BLUMBERG, *supra* note 350, at 351ff. Certain commentators have also focused on "non-contractual" or power elements of control, introducing concepts of control such as "control through a constellation of interests." *See* SCOTT, *Corporate Groups and Network Structure, supra* note 499, at 303ff (Scott suggests that large enterprises with dispersed capital are controlled by a small but diverse constellation of institutional shareholders. The overlapping constellations create a complex network of constraining shareholdings, which underlies the specific contractual relations which enterprises establish with one another).
680 *See* BLUMBERG, *supra* notes 346 and 350. *See also* PHILLIP BLUMBERG, The Law of Corporate Groups - Procedural Problems in the Law of Parent and Subsidiary Corporations (Little. 1983).
681 This discussion assumes that all corporate members are includible corporations for purposes of the US and UK Group Taxation regimes. Broadly, in the US, an includible corporation is any entity taxable as a

jure definitions makes the tax provisions subject to easy manipulation, the adoption of more encompassing, or *de facto* standards, may not always be adequate to satisfy the need for expediency required in the tax laws. The positions adopted in the US and UK Group Taxation regimes differ in this matter. While the US has adopted a *de jure* definition of control backed up by comprehensive attribution rules, the UK has adopted a hybrid standard, requiring certain *de facto* elements to recognize the existence of control.

Specifically, in the US, the definition of control is based on a threshold of stock ownership test, which requires ownership of at least 80 percent of the total voting power and 80 percent of the total value of all outstanding stock.[682] In order to avoid abuses, complex attribution rules complement this test.[683] A different, and more complex, position is adopted in the UK tax laws. To start with, as previously noted, the UK tax laws have adopted different eligibility requirements for the Group Relief and Chargeable Gains regimes. Although the conditions for eligibility for these benefits overlap in certain aspects, they remain distinct. Further, in addition to a *de jure* definition of control, each of these regimes requires an economic nexus between corporate group members to effectively recognize the existence of control.

In particular, the Group Relief regime requires two cumulative tests to recognize a corporation as an eligible member to integrate a Tax Group, namely, the "75 percent

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corporation except those corporations specifically excluded by the statute. In general, all domestic corporations will qualify as includible corporations except certain domestic corporations that are either tax exempt or subject to special taxing regimes. As a general rule, all foreign corporations are excluded from the definition of an includible corporation including those with a US permanent establishment. Similarly, in the UK only companies can be members of a Tax Group for group relief purposes. Although non-UK resident companies can be members of a group, both the surrendering company and the claimant company must either be UK tax resident or be carrying on a trade in the UK through a permanent establishment. Similar rules apply for the chargeable gains regime purpose. A non-UK resident company can be a member of the group, although an asset can only be transferred to it without tax consequences if the asset will be connected with a permanent establishment through which that non-resident company carries on a trade in the UK. *See* YASH RUPAL, *Report on Group Taxation in the UK, in* IFA, Group Taxation, *supra* note 648, at 688 and 694.

682 IRC Section 1504(a)(2). The 80 percent test must be met *every day* of the taxation year (IRC section 1501). Note that for a Tax Group to exist there must be at least two or more companies in the group with a common parent that is also an includible corporation. Thus, brother–sister chains of includible corporations do not meet this affiliation test if they are connected through a non-includible entity such as an individual, a partnership, or a foreign parent. In addition, the includible common parent must own directly the stock meeting the 80 per cent vote and value threshold in at least one other includible corporation. By the same token, the stock meeting the 80 per cent vote and value threshold in each of the other includible corporations (excluding the common parent) must be owned directly by one or more of the other includible corporations. Thus, stock ownership in an includible corporation (other than the entity controlled directly by the common parent) meeting the 80 per cent vote and value threshold may be disbursed among members of the affiliated group. However, stock held by a non-includible corporation cannot be considered as held by the Tax Group. Lastly, note that once the affiliated group has been identified, the consent of all includible corporations is required for the formation of the consolidated group. IRC Treas. Reg. Section 1.1502-75(b).

683 See IRC Section 318 and related IRC Treas. Regulations.

subsidiary" test and the "75 percent profits and assets tests." Broadly, the "75 percent subsidiary test" will be satisfied in relation to a subsidiary if the parent company owns directly or indirectly at least 75 percent of the nominal value of the issued ordinary share capital of the subsidiary.[684] As for the "75 percent profits and assets" tests, they will be met if, in the relevant accounting period, the parent company is entitled to at least 75 percent of (1) the accounting profits of the subsidiary that are available for distribution to its "equity holders," and (2) the assets available for distribution to "equity holders" in the subsidiary on a notional winding up of the subsidiary (as shown in the subsidiary's balance sheet at the end of the relevant accounting period).

The application of these "profits and assets" tests is particularly complex. From the definition of "equity holders" and the associated definitions of preference shares and commercial loans, to the anti-avoidance rules associated with these tests (for instance, regarding the use of options), complexity is the touchstone of these provisions.[685]

The definition of control for purposes of the Chargeable Gains regime follows a similar logic. Broadly, a chargeable gains group consists of a company (the "principal company") and its "75 percent subsidiaries."[686] For a company to be a "75 percent subsidiary," the parent company must hold at least 75 percent of the ordinary share capital of the subsidiary.[687] In addition to this *de jure* test, a *de facto* requirement is imposed. Specifically, a company that is not an "effective 51 percent subsidiary" of the principal company cannot be a member of the group. A company will be an "effective 51 percent subsidiary" of the principal company if the principal company is beneficially entitled directly or indirectly to more than (1) 50 percent of the profit available for distribution to "equity holders" of the subsidiary and (2) more than 50 percent of the assets of the subsidiary that are available for distribution to its "equity holders" on a winding up.[688] The definition of "equity holder" is

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684 Ownership for these purposes means beneficial ownership. Broadly, "ordinary share capital" means all the shares of a company apart from capital, the holders of which have a right to a dividend at a fixed rate and no other right to share in profits. *See* YASH RUPAL, *Report on Group Taxation in the UK*, *in* IFA, Group Taxation, *supra* note 648, at 689. For the rules for determining indirect ownership *see* CTA 2010, Sections 1154-1157.
685 *See* YASH RUPAL, *Report on Group Taxation in the UK*, *in* IFA, Group Taxation, *supra* note 648, at 689-692. It should be underlined, however, that although these provisions are rather complex, the new rewriting under CTA 2010, Chapter 6 introduced a significant improvement to the previous ICTA 1988, Sch. 18.
686 *See* TGCA 1992, Section 170. *See also* NATALIE LEE, Revenue Law - Principles and Practice (Tottel Publishing 25th ed. 2007) at 1072.
687 The definition of "ordinary share capital" that applies is the same as for group relief.
688 *See* FURSDON, British Tax Guide: Corporation Tax, *supra* note 410, at 149-150.

the same as for group relief and these profit and assets tests, with some exceptions, are applied in a similar manner.[689]

The UK solution, especially for a group that intends to qualify for both the Group Relief and Chargeable Gains regimes, involves a considerable administrative hurdle. Further, in face of the chameleon-like nature of corporate groups, these rules may be an invitation for complex tax planning,[690] with associated deadweight loss both for the state and corporate groups.

In light of the nature of corporate groups previously discussed in this thesis and to the need for expediency in the tax laws, the solution proposed by Hellerstein and Mclure of defining corporate groups for tax integration purposes based on a simple *de jure* definition (similar to the current US definition) complemented with comprehensive attribution rules and certain objective and easily administrable *indicia* of economic integration (*e.g.,* a percentage of revenues derived from related-party transactions) should merit further consideration from researchers and policymakers).[691]

B. <u>The Dynamic Effects of Tax Integration</u>

On the previous section this thesis analyzed the mechanics of tax integration. The section showed that several mechanic possibilities exist to integrate corporate groups and that all available models remain subject to practical and mechanic limitations. It then suggested that once these different limitations are taken into consideration, the solution that more fully achieved the mechanic objectives of tax integration (*i.e.,* allow for the free transfer of

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689 The main exceptions are that the option arrangements provisions that apply for group relief do not apply and the group relief rules dealing with shares and securities carrying varying rights have limited application. Note that there is no requirement that the principal company of the group exercise voting control over any member of the chargeable gains group. *See* YASH RUPAL, *Report on Group Taxation in the UK, in* IFA, Group Taxation, *supra* note 648, at 695.

690 *See* planning intricacies associated with the manipulation of the definition of control in UK at YASH RUPAL, *Report on Group Taxation in the UK, in* IFA, Group Taxation, *supra* note 648, at 697-700.

691 *See* WALTER HELLERSTEIN & CHARLES E. MCLURE, *The European Commission's Report on Company Income Taxation: What the EU Can Learn from the Experience of the US States*, 11 International Tax and Public Finance 199 (2004) at 206 ("[W]e give our nod to a legal, rather than an economic, definition of the consolidated group."); id. at 205 ("One could...introduce anti-tax abuse safeguards into a group definition based on legal ownership that might mitigate this issue. (For example, the constructive stock ownership rules embodied in the Internal Revenue Code for purposes of denying losses among related parties (IRC Section 267) and in connection with various corporate transactions (IRC Section 318) would restrain the ability of economically related parties to manipulate their ownership interests to achieve tax benefits.)...In addition, one might impose certain objective and easily admininistrable indicia of economic integration as a condition of consolidated filing (*e.g.,* a percentage of revenues derived from related-party transactions).

assets, income and tax attributes inside a corporate group and impose a single layer of taxation on the income derived by corporate group members) blended full and partial integration solutions. Further, the section suggested that the partial integration model that better interacted with the full integration model, while ensuring the highest possible degree of integration, was based on a blending of mechanic solutions of the US and the UK Group Taxation regimes. The section concluded by suggesting that, in light of the different limitations imposed to tax integration, the Molecular Group Taxation System should be the model that would achieve the mechanic objectives of tax integration in the fullest and simplest available way.

The issue that arises at this stage is whether tax integration is an appropriate approach to tax corporate groups once both the perspectives of the state and the corporate groups are taken into consideration. In order to answer this question, this section will evaluate the potential effects of tax integration on the operation of corporate groups and on the functioning of the tax system. The analysis will use the Molecular Group Taxation System as the reference model of tax integration. This option is taken because this model was considered the solution that better implemented the mechanic objectives of tax integration, and, thus, it should provide a more accurate indication of the dynamic effects of integration. Further, since this model blends full and partial integration models, it provides a richer analytical perspective for the proposed evaluation.

1. *The Dynamics of Tax Integration*

a. The Continuity of the Tax Rules in Intra-Group Transactions

Under tax integration, the CIT system has a high degree of continuity within the boundaries of a Tax Group. That is, intra-group transactions and their closest substitutes tend to be taxed equally. This means that a mere change in transactional form in an intra-group transaction will not yield a substantially different tax result. Consider the transfer of income inside the Tax Group. Both at the intra-atomic and inter-atomic levels, it is indifferent whether the transfer of income is characterized as a payment of interest, royalties, management fees or dividend distribution. While at the intra-atomic level all these transactions would be simply disregarded, at the inter-atomic level the Systemic Matching rule (for payments of interest, royalties and management fees) and the Participation

Exemption (for dividend distributions) would render the transactions irrelevant for tax purposes. By the same token, in light of the mechanic treatment of intra-group asset transfers, the characterization of an asset transfer as a merger or a sale should be largely irrelevant for tax purposes both at the intra and inter-atomic levels.

A fundamental effect of the continuity in the tax rules is that there is no tax benefit associated with substitution. As a result, taxpayers are generally not interested in substituting transactions.[692] Thus, no need to adopt more complex legal instruments or implement more expensive and complex transactions than those strictly required to achieve the desired economic end result exists. Since transactional form is largely irrelevant for tax purposes, the group will be inclined to structure the transaction in the simplest and cheapest possible way.[693] Thus, within the boundaries of the Tax Group, the transfer of assets and income should, in principle, be implemented using simpler transactions and corporate law instruments than under the Standard CIT System (e.g., transfer of income using a direct loan instead of complex hybrid instruments or indirect transactional routes; straight sale instead of complex merger; etc.).

Thus, beyond avoiding taxpayers to base economic decision-making at least in part on tax considerations as opposed to the underlying economic factors, tax integration should result in a reduction in the costs incurred by taxpayers to implement transactions. As previously discussed, in a world of costly contracting and information asymmetries, the search and adoption of substitute transactions has associated costs. Besides the fees paid to professionals to locate and to evaluate substitute transactions and the costs associated with their implementation, substitution may result in additional inefficiencies in case the substitute transaction is an imperfect substitute for the substituted transaction (*e.g.,* adoption of sub-optimal functional or legal structures). Tax integration should result in a substantial reduction of these costs and inefficiencies.

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692 Several commentators have already underlined the efficiency advantages of a continuous tax law. *See* SHAVIRO, *An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax, supra* note 4, at 4 ("A tax system minimizes substitution effects by being neutral at key decisional boundaries, thereby giving taxpayers no reason to change their decisions or behavior."). *See also* WEISBACH, *An Efficiency Analysis of Line Drawing in the Tax Law, supra* note 17, at 71 ("[L]ines should be drawn so that a transaction or item is taxed like its closest substitutes."); WEISBACH, *Formalism in the Tax Law, supra* note 13, at 873 ("A discontinuous law...may have very different behavioural effects than a continuous law [.]"); id. at 874. ("Where there is discontinuity, taxpayers sufficiently near the discontinuity will shift to the lower taxed regime, if transaction costs are less than the tax savings [.]").

693 This should generally occur unless specific risk-management considerations, creditor demands or financial reporting issues may dictate otherwise.

Further, the decrease in the complexity of internal group flows that follows from the reduction of substitution should make the corporate group more transparent from an informational perspective.[694] This increased internal transactional transparency should make it easier for top management and other stakeholders to be accurately informed about the operations of the group. As a result, the potential for managerial opportunism should be minimized.[695] Also, this internal transparency of corporate groups should decrease the costs of the state to supervise the compliance of corporate groups with the tax rules.

It must be noted that the transactions that tax integration would in principle eliminate (*i.e.,* mostly pure tax planning transactions) are not informational in nature. Accordingly, their reduction or elimination should not result in negative consequences to the CIT's regulatory functions previously identified.[696] Indeed, a relative improvement of such functions should occur due to the more transparent group structures and intra-group transfers.

All in all, the secret of the integration approach lies on its success to deal with the "chameleon-like" nature of corporate groups. As previously discussed, the group's flexible governance structure poses a serious challenge to tax policy since it is often used to avoid tax regulations. Tax integration eliminates this problem since within the boundaries of the Tax Group the corporate veil and the formal characterization of transactions lose most practical relevance for tax purposes. The result, as suggested above, is a reduction of deadweight loss, both for corporate groups and the state, and corporate governance improvements.

b. Optimization of Group Resources

Since under tax integration the tax factor is largely irrelevant in intra-group transfers, assets or income may be transferred at the optimal business timing to the corporate member that ensures the best economic return for their use. That is, tax integration eliminates the interest in structuring transactions with the aim of locating deductions, inclusions, and capital gains or losses on the corporate group member whose tax attributes are more

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694 *See* LAURIN, *Cleaning Up the Books: A Proposal for Revamping Corporate Group Taxation in Canada*, *supra* note 551, at 1 ("[T]he web of intragroup transactions and structural changes needed to achieve some degree of tax consolidation adds complexity and artificiality to the tax system and the business environment since the sole purpose for these business activities is to gain a tax advantage.").
695 *See* discussion *supra* at pg. 137.
696 This includes the deterrent and the reliability functions. *See* discussion *supra* at pg. 138.

beneficial. Thus, absent constraints from other regulatory fields, in principle, assets and income will be transferred to the corporate member that ensures the best economic return for their use.[697] Further, since the "lock-in" and "lock-out" effects are eliminated in intra-group transactions, these transfers may occur on their optimal business timing. Hence, under tax integration, the CIT system should not interfere with the flexibility of corporate groups to transfer resources between their constituent parts and, thus, should not negatively affect their "organized internal market" dynamics. Overall, the corporate group should become more responsive to changes in the prospects of its investments.

c. Flexibility for Restructurings of Corporate Structures

Further, at the intra-atomic level, group restructurings would be made easier since all restructurings would be regarded as a mere internal transfer of assets without any tax consequences. With certain limitations, a similar result would be obtained at the inter-atomic level. This approach is in line with the "organizationally-bound" property rights of corporate groups. Further, as previously discussed, this flexibility to restructure corporate structures allows for the constant adaptability of corporate groups to their economic reality, and, thus, ensures their best economic performance.[698]

d. Simplified Combination of Tax Attributes

Lastly, tax integration should allow for the mix up of the corporate group's attributes, most importantly losses, in a cost efficient way. When available, alternative ways of obtaining the same benefits under the Standard CIT System, such as mergers,[699] are generally more expensive and complex and may often have negative collateral consequences for corporate groups.[700]

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697 *See* discussion on the group's organized internal market dynamics above at pg. 32ff.

698 Nonetheless, functional and legal structures may be somewhat influenced by the desire to include or exclude corporate group members from tax integration.

699 Other examples include transfer of loan receivable to loss making entity, "sale and leaseback" transactions, write-off of the shares of loss making entity, financing triangulations, "stuffing" of loss making entity, "round robin" transactions, etc.

700 *See* LAURIN, *Cleaning Up the Books: A Proposal for Revamping Corporate Group Taxation in Canada*, *supra* note 551, at 5 ("Current loss-utilization techniques involve complex transactions that may be costly to implement, not to mention difficult for authorities to trace. Other than management time and planning costs, tax planning strategies often involve substantial accounting and administrative costs...In addition, the complexity of some of these tax-planning measures raises the issue of higher auditing costs for tax collectors... Large corporate groups may go to great lengths to set up the web of intragroup transactions necessary to shift profits and losses among related corporations ... These transactions add complexity and artificiality to the tax

All things considered, tax integration should result in a significant reduction of the deadweight loss associated with the operation of the CIT System for corporate groups. In addition, it could also benefit the state due to the reduction in the administration and supervision costs that follow from the reduction in transactional and compliance complexity.

The CIT system's impact on the firm's organizational arrangements and on the Structural Distortions of timing and transaction costs under tax integration should be considerably different from those under the Standard CIT system. The CIT system's impact on risk taking presents another Structural Distortion that may be substantially altered with tax integration. The next section explores this issue.

2. *Tax Integration and Corporate Risk-Taking*

This section will investigate the impact of tax integration on corporate risk-taking. First, the section will investigate the relationship between corporate taxation and corporate risk-taking. Once this general analytical framework is established, the section will examine the impact of tax integration on corporate risk-taking.

a. The CIT System and Corporate Risk-Taking

As previously discussed, the CIT system may impact the level of corporate risk-taking.[701] In principle, since investment decisions are based on after-tax returns, a CIT system should discourage the undertaking of risk by taxing the rewards from an investment, and encourage the undertaking of risk by bearing a portion of the losses.[702] In principle, pure

system. Their artificial appearance may create difficulties for auditors – and corporate managers – in trying to establish the intent and determine the valid business purpose of such transactions.").

[701] *See* discussion *supra* at pg. 43. For a definition of risk *see* DOMAR & MUSGRAVE, *Proportional Income Taxation and Risk-Taking*, *supra* note 156, at 396 ("Of all possible questions which the investor may ask, the most important one, it appears to us, is concerned with the probability of the actual yield being less than zero, that is, with the probability of a loss. This is the essence of risk."). In general, the risk literature distinguishes between systematic risk - the risk of the market - and unsystematic risk - the risk of a particular asset. Unsystematic risks can be managed by diversifying into different types of investments, while systematic risk is unavoidable and inherent in the nature of the system. For an extensive definition of risk *see* REBECCA S. RUDNICK, *Enforcing the Fundamental Premises of Partnership Taxation* 22 Hofstra L. Rev. 229 (1993) at 267-270.

[702] *See* RUDNICK, *Enforcing the Fundamental Premises of Partnership Taxation,* supra note 702, at 273-278. *See also* MARTIN H. DAVID, Alternative Approaches to Capital Gains Taxation (Brookings Institution. 1968) at 140 ("The deductibility of losses has a profound effect on the willingness of private investors to undertake risky investments."); CECIL, *Toward Adding Further Complexity to the Internal Revenue Code: A New Paradigm for the Deductibility of Capital Losses, supra* note 410, at 1107.

neutrality towards risk should not be possible under a realization-based CIT system.[703] The characteristics of the loss offset system should dictate whether the CIT system enhances or reduces the risk-taking capabilities of corporations.[704] Specifically, the following spectrum of loss relief is theoretically possible under a CIT system:

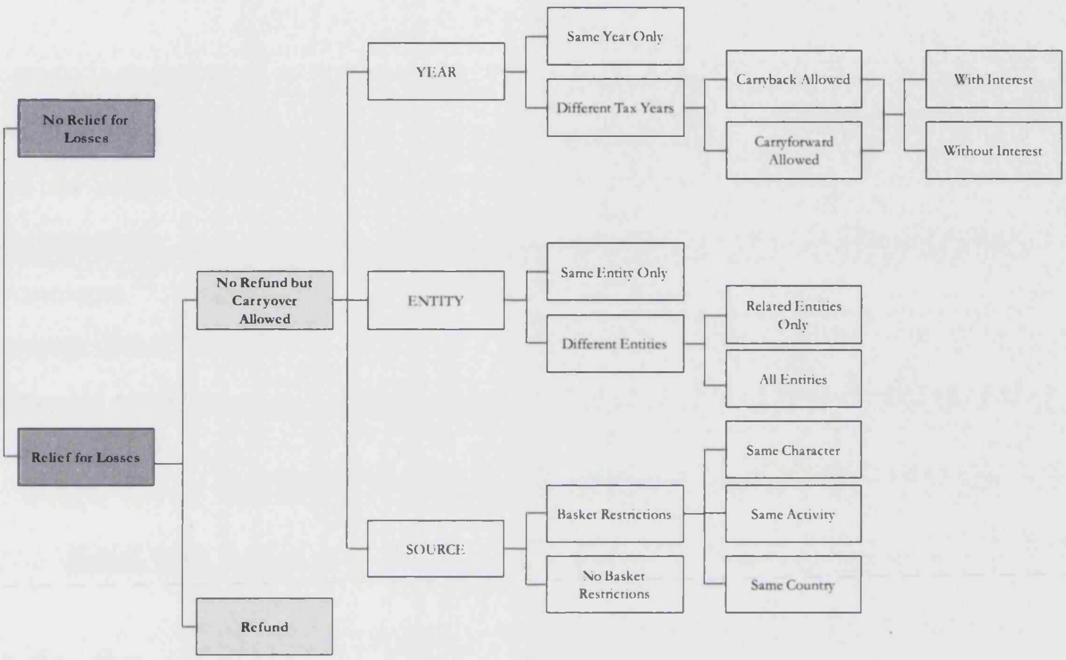

Diagram 25

The spectrum of loss relief under a CIT system ranges from the possibility of providing no relief for the losses incurred by a business to providing a full refund for such losses. Within these two extremes, several intermediate positions exist. In these intermediate positions, although refund is denied, the CIT system may allow for the carryover of losses to different tax years, different sources of income and/or different entities. Specifically, the possible spectrum ranges from relief being granted only to losses from the same tax year, incurred by the same entity, and respecting to the same source of income, to carryover being allowed both to prior and subsequent tax years, to all types of related and unrelated entities, and to offset income from whatever source (*i.e.,* independently of the character of the

[703] *See, e.g.* SCARBOROUGH, *Risk, Diversification and the Design of the Loss Limitations Under a Realization-Based Income Tax*, *supra* note 410, at 685 ("[N]eutrality towards risk is not possible under a realization-based income tax."); id. at 717 ("If losses were allowable without limit, taxpayers would be encouraged to make risky investments so that they could selectively realize losses. If losses were limited, however, risky investments could give rise to unusable losses and thus would be discouraged. No treatment of losses eliminates both of these biases.").

[704] *See* DOMAR & MUSGRAVE, *Proportional Income Taxation and Risk-Taking*, *supra* note 156, at 391ff (In general, whether an income tax system with a realization requirement encourages or discourages risk depends on how the system treats losses).

income, or the activity or country where it was generated). In principle, the risk-taking consequences of these different alternatives should vary. The following section will review each of these alternatives in turn.

b. No Relief For Losses

A first possibility is to provide no relief for losses. Under this possibility, a corporation would be taxed whenever it generated profits. However, in the years where it suffered a loss, no relief would be granted for such loss. This policy has certain advantages. Fundamentally, it is simple and should deter the continued operation of unsuccessful investments.[705] Further, in the short-term, it would likely result in an increase in tax revenues. Based on available research, this type of policy should, however, penalize risk-taking and result in a double taxation of capital.[706] In addition, in the medium to long-term, the unfavourable conditions for investment could potentially decrease tax revenues.

c. Relief With Full Refund

On the other extreme of the relief spectrum, the possibility of granting a refund for the losses incurred by a business exists. Under this alternative, the government would reimburse the taxpayers in the tax year when the loss was incurred. In principle, this type of policy should encourage risk-taking.[707] Further, this type of alternative could contribute to cyclical stability by providing a source of funds to firms during recessions.[708] In addition, it could also increase the supply of external finance. Specifically, since the potential tax

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[705] *See* M. DONNELLY & A. YOUNG, *Policy Options for Tax Loss Treatment: How Does Canada Compare?*, 50 Canadian Tax Journal 429 (2002) at 439.

[706] On the risk-taking consequences *see* DOMAR & MUSGRAVE, *Proportional Income Taxation and Risk-Taking*, *supra* note 156, at 390 ("Since, without loss offset, the yield is cut, while risk is unchanged, the competition for risk-taking is reduced...practical evidence would indicate that the investor is likely to shift in the direction of less risk."). On the double taxation of capital that results from this policy option *see* CAMPISANO & ROMANO, *Recouping Losses: The Case for Full Loss Offsets*, *supra* note 414, at 717 ("When a firm generates losses its costs of producing income will not be fully accounted for by the tax system unless the loss can be deducted, and the nonavailability of a deduction against zero income effectively constitutes a tax on the loss firm's capital...But since that capital has been taxed once before, prior to its investment in the firm, the business's inability to recover the loss for tax purposes results in a double taxation of the capital.").

[707] *See* SCARBOROUGH, *Risk, Diversification and the Design of the Loss Limitations Under a Realization-Based Income Tax*, *supra* note 410, at 717; ("If...the Treasury were to pay refunds to investors with losses, risk taking would be encouraged."); in the same sense *see* DOMAR & MUSGRAVE, *Proportional Income Taxation and Risk-Taking*, *supra* note 156, at 392 and CAMPISANO & ROMANO, *Recouping Losses: The Case for Full Loss Offsets*, *supra* note 414.

[708] *See* DOMAR & MUSGRAVE, *Proportional Income Taxation and Risk-Taking*, *supra* note 156, at 392. ANDREW WEISS, *The Fair Tax: A Tax Reform To Alleviate Recessions and Reduce Biases in the Tax Code*, Boston University Working Paper, available at SSRN: http://ssrn.com/abstract=258853 (1999) at 3.

subsidy could be pledged to repay debts in the case of defaults on loans, it should reduce the risk to lenders and, thus, increase their willingness to lend.[709] Finally, this type of policy should eliminate the potential for a double tax on capital and the potential for discrimination associated with alternative loss relief systems.[710]

For these different reasons, several commentators have defended the implementation of this type of loss relief system.[711] Despite its theoretical appeal, this system has not enjoyed practical success. The main reason for the dismissal of this policy option lies on its alleged high cost to the public coffers.[712] However, certain commentators have disputed this argument and argued that the full refund option should not be more costly than the system of partial refundability that currently exists in the US or the UK.[713] The argument is that full refundability would only speed up the use of the loss and, thus, the difference would be only one of timing.

This argument, although attractive, assumes full utilization of losses during the available carryover periods, which does not seem to be generally the case.[714] Further, this argument loses sight of the fact that, based on the behavioural nature of the taxpayer, the benefit of the refund could well induce additional tax planning. Specifically, the possibility of selective

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[709] *See* WEISS, *The Fair Tax: A Tax Reform To Alleviate Recessions and Reduce Biases in the Tax Code*, *supra* note 709, at 3.

[710] *See* CAMPISANO & ROMANO, *Recouping Losses: The Case for Full Loss Offsets*, *supra* note 414, at 718 ("Recoupment eliminates ... double tax on corporate capital. The firm immediately cashes in its losses and its capital therefore remains unimpaired with respect to collections by the Treasury."); id. at 711 ("[R]ecoupment would not discriminate in favor of some firms and against others – as does the current averaging system through its varying restrictions on loss deductibility [.]").

[711] *See* id. at 711 ("[The] policy underlying the compensation of taxpayers should ... be based on the concept of recoupment: that is, the full recovery of the tax value of the NOL."); *See also* DONNELLY & YOUNG, *supra* note 706, at 444 ("[T]he full refundability system is believed by many to be the most conceptually and philosophically "pure" [.]"); MICHAEL L. SCHULTZ, *Section 382 and the Pursuit of Neutrality in the Treatment of Net Operating Loss Carryovers*, 39 U. Kan. L. Rev. 59 (1990) at 84 (author argues that neutrality concerns raised by loss carryovers could be eliminated by current reimbursement of losses); WEISS, *The Fair Tax: A Tax Reform To Alleviate Recessions and Reduce Biases in the Tax Code*, *supra* note 709.

[712] *See* CANADA DEPARTMENT OF FINANCE, Report of the Technical Committee on Business Taxation (Department of Finance. 1998) at 4:15 ("The full and immediate refundability of losses would substantially reduce or virtually eliminate corporate income tax revenues for several years. With reduced taxes on business, governments would need to increase business taxes by other means [.]"). The report cites several subsidiary reasons for the rejection of this policy, namely (1) to reduce the availability of tax incentives to inefficient businesses that are more likely to earn a low economic rate of return on their investments compared to efficient businesses; (2) to reduce the scope for tax evasion that arises when businesses report claims for refunds without actually suffering losses for which claims are made; (3) to preserve the business tax base and to preserve a substantial revenue loss to governments; and (4) to reduce the volatility of corporate income tax revenues and resulting spill-over effects into other parts of the tax system. Id.

[713] *See* DONNELLY & YOUNG, *supra* note 706, at 445.

[714] For instance, research undertaken in Canada showed that only a small fraction of the losses was utilized at the earliest possible time and not all loss carryforwards were able to be claimed. As Donnelly notes, "in the Canadian experience, only about 10 percent of the available loss balance is utilized at the earliest possible time, and not all loss carryforwards are able to be claimed in the 10-year carryover period." Id. at 445.

triggering, generation and recharacterization of losses should not be discarded. As previously discussed, when faced with the realization-based nature of the current CIT system, the corporate taxpayer may engage in lock-in and lock-out behaviour, as well as in tax planning operations to abusively generate tax losses. In face of the refund benefit, these tax planning operations would likely increase. Thus, despite its theoretical appeal, the implementation of this type of system should, in principle, have a strong negative impact on government revenues and increase the potential for abusive tax planning.[715]

d. Relief Without Refund But With Carryover Allowed

Under a realization-based CIT system, not allowing for loss relief should discourage corporate risk-taking and result in a double taxation of capital. The other extreme position, *i.e.,* providing for a full refund for losses incurred, should solve such problems and result in additional collateral benefits. However, in all likelihood, it should produce a substantial revenue loss for governments and increase the potential for abusive tax planning. The definition of the treatment of losses under a CIT system faces therefore a dilemma. While not allowing for relief unduly penalizes businesses, providing for a full refund may impoverish the state´s treasury and may generate a potentially significant deadweight loss. Most probably for these reasons, the US and the UK, as many other countries around the world, have adopted intermediate positions to loss relief whereby, although a refund is denied, the carryover of losses to different entities, tax years and/or sources of income is generally allowed.[716]

i. Inter-Entity Loss Carryovers and Tax Integration

A first possibility of loss carryover is to allow losses incurred by an entity to reduce the taxable income of a different entity. The possible spectrum of inter-entity loss carryover

[715] Other commentators have also discarded this option as a viable policy alternative for tax loss treatment. *See* id. at 445-446 ("In the end, we must conclude that the conceptual advantage of a policy of recoupment is not enough to overcome the more pragmatic need to preserve the business tax base and survive the political realities of corporate tax policy formulation.").

[716] *See* ALAN J. AUERBACH, *The Dynamic Effects of Tax Law Asymmetries*, 53 The Review of Economic Studies 205 (1986) at 206 ("[The] current tax treatment [of partial refundability] represents a compromise between discouraging undesirable activity and not discouraging risk-taking."). *But see* JACK M. MINTZ, *An Empirical Estimate of Corporate Tax Refundability and Effective Tax Rates*, 103 Quarterly Journal of Economics 225 (1988); JACK M. MINTZ, *Corporation Tax: A Survey*, 16 Fiscal Studies 23 (1996) (author argues that the current asymmetric treatment of tax losses discriminates against risk-taking and entrepreneurship since expected taxes disproportionately reduce the rate of return expected on risky investments when compared to riskless investments). On the different regimes for loss-offset around the world *see* generally HUGH J. AULT, et al., Comparative Income Taxation: A Structural Analysis (Kluwer Law International 3rd ed. 2010).

ranges from one extreme where entities may freely trade in losses as regular saleable assets,[717] to another where only the entity that incurred the loss may use it in its tax return.[718] The US and UK tax laws have adopted intermediate positions to inter-entity loss carryover whereby losses, in specified circumstances, may be transferred to related parties. One of those circumstances is under the tax integration regimes previously described.[719]

While the risk-taking consequences associated with the no relief and full refund positions were relatively clear,[720] the determination of the risk-taking consequences associated with an intermediate position such as tax integration is more ambiguous. This stems from mainly two reasons. First, the restrictions imposed to inter-entity loss carryovers interact with the restrictions imposed to year and source loss carryovers making this assessment particularly difficult. A very restrictive inter-entity loss carryover regime will have a different impact on risk-taking if coupled with very restrictive year and source loss carryover rules (*e.g.,* losses may only be used in the same year they are incurred and must respect to income of the same activity, character and country) or with a very flexible one (*e.g.,* losses may be carried back and forward for several years and may be offset against

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717 In theory, a CIT system may allow for the actual legal transfer of a loss consistent with the view of losses as saleable assets. Under this position, no economic interdependence between the transferor and transferee corporations is required. This solution represents, however, only partial refundability due to transaction costs associated with the market mechanisms required to make this system operational. That is, to encourage the transferee to acquire the loss on the open market, the tax value of the loss would have to be discounted. The transferor corporation will not realize the full value of the loss, and the transferee will have a windfall gain to the extent that the tax savings are less than the cost of purchasing the loss. In addition, the inefficiency inherent in free market trading in losses is compounded by the transaction costs incurred to implement the transfer. *See* SATYA PODDAR, *Refunding the Tax Value of Unutilized Losses, in* Policy Options for the Treatment of Tax Losses (Clarkson Gordon Foundation ed. 1991) at 5:11. *See also* CANADA DEPARTMENT OF FINANCE, Report of the Technical Committee on Business Taxation, *supra* note 713.

718 There is a considerable theoretical debate regarding who is the actual owner of the loss in order to support these different inter-entity loss carryover positions, *i.e.,* whether the business as a legal entity or its corporate or individual shareholders. The debate is centred on the fact that if the loss is considered to belong to the corporation, it should not be transferable to other corporations or individuals. If, instead, the loss is considered to belong to the shareholders or to the corporate group of which the company is a part, there should be some provision for the loss to be transferred from the loss corporation to another taxpayer within the group, to its shareholders or even, at the limit, to other unrelated corporations provided adequate compensation was received in return. In practical terms, this debate has, however, been relatively sterile in that no sound guidance for tax policy has resulted from it. *See* CANADA DEPARTMENT OF FINANCE, Report of the Technical Committee on Business Taxation, *supra* note 551, at 4:14; See also LAURIN, *Cleaning Up the Books: A Proposal for Revamping Corporate Group Taxation in Canada*, *supra* note 713, at 2.

719 *See* discussion *supra* at pg. 150ff. For other situations where the transfer of losses among related entities is allowed, such as mergers and windups, and for the restrictions generally associated with such transfers *see* discussion *supra* at pg. 106ff.

720 Although most authors agree on the risk-taking consequences of these two extreme positions, the impact of taxation on risk-taking is not without controversy. *See, e.g.,* MARTIN S. FELDSTEIN, *The Effects of Taxation on Risk Taking*, 77 The Journal of Political Economy 755 (1969) at 763 ("The widely accepted proposition that proportional taxation with full loss offsets causes increased risk taking has been shown to rest on weak theoretical foundations."). *See also* JEREMY I. BULOW & LAWRENCE H. SUMMERS, *The Taxation of Risky Assets*, 92 The Journal of Political Economy 20 (1984) at 22 ("The paradoxical conclusions obtained in much of the literature suggesting that taxes on risky assets may actually encourage investment in them are shown to depend on implausible assumptions.").

income from any source). For most taxpayers, the potential for unusable losses, and, thus, the discouragement to risk-taking, should be very different under each of these scenarios.

Further, the task is particularly complex because, under intermediate positions, the determination of the impact of tax on risk-taking behaviour is more dependent on the specific profile of each taxpayer. While when analyzing the no relief and full refund positions, the main variable associated with the taxpayer's profile that could impact the analysis was whether the taxpayer had incurred or expected to incur losses, the elements associated with the taxpayer's profile that may impact the assessment of an intermediate loss relief position are far and away more complex. Specifically, under intermediate positions such as the ones currently adopted by the US or the UK, the impact of the loss relief system on corporate risk-taking should vary significantly depending on a firm's size, degree of diversification and degree of establishment, and on its potential for selective recharacterization and triggering of tax losses. Also, the determination of the impact of a taxpayer's present and expected future tax attributes on the analysis is more complex.

Consider the characteristics of a business. Under an intermediate loss relief system such as the ones presently in existence in the US and the UK, elements such as the size, degree of diversification or degree of establishment of a firm may substantially alter the impact of the loss relief system on risk-taking.[721] For instance, in face of the availability of inter-entity loss carryovers, a large and diversified firm should be more likely to rapidly use up losses than a small and non-diversified firm.[722] By the same token, whether the firm has been established or not for a long time and, thus, whether or not it possesses past taxable income, should alter its ability to benefit from the loss carryback provisions. Similarly, in light of the propensity of new businesses to incur losses in their first operating years, the use of a loss as a carryforward by a new business may only occur much later in time than would be the

[721] Although not developed in this work, a firm's use of hedging may also alter its reaction to the loss relief rules. *See* SCARBOROUGH, *Risk, Diversification and the Design of the Loss Limitations Under a Realization-Based Income Tax*, *supra* note 410, at 685 ("[H]edging... can be used by taxpayers to eliminate the bias against risk that results from the potential for unusable losses).

[722] *See, e.g.,* DOMAR & MUSGRAVE, *Proportional Income Taxation and Risk-Taking*, *supra* note 156, at 391 ("A large corporation or a large-scale financial investor may undertake a risk investment as a sideline and know that possible losses are covered by other income which is reasonably certain to be derived from the main line of business."); ROSANNE ALTSHULER & ALAN J. AUERBACH, *The Significance of Tax Law Asymmetries: An Empirical Investigation*, 105 The Quarterly Journal of Economics (1990) at 81 ("The incidence of tax constraints varies by firm size."); CAMPISANO & ROMANO, *Recouping Losses: The Case for Full Loss Offsets*, *supra* note 414, at 709 ("Provisions for consolidated corporate tax returns favor conglomerate corporations over non-diversified ones.").

case if the firm had been long established for a long time.[723] Overall, the characteristics of businesses may result in a different propensity to accumulate unusable tax losses and, thus, result in different risk-taking consequences for each of them.

Another element that may significantly impact the reaction of a taxpayer to an intermediate loss offset regime is its ability for selective re-characterization and triggering of losses. Notably, under systems with basket limitations such as the US and the UK, the impact of the CIT system on risk-taking should change depending on whether the taxpayer can easily re-characterize capital losses as ordinary losses, or foreign losses as domestic losses, and can easily trigger tax losses. A taxpayer more able to manipulate the loss relief rules should have an inferior propensity to accumulate unusable tax losses and, thus, be less discouraged by loss limitations to incur risks. As discussed, the ability of the corporate taxpayer to manipulate the loss relief rules should depend on their degree of substitution. In turn, the degree of substitution of the loss relief rules should vary depending on a multitude of variables, many specific to each taxpayer, such as the relative importance of the taxpayer's competing non-tax goals, risk-taking profile or organizational design.[724]

Lastly, on these intermediate positions, the determination of the impact of a taxpayer's present and expected future tax attributes on the analysis is more complex. For instance, under an intermediate loss relief position such as the ones of the US or the UK, if the taxpayer has no use for its losses in its past and future tax returns for several years and has no related entities to which it may transfer such losses, it should be in a position equivalent to the no relief position described above. However, if despite its inability to use losses in its past and future tax returns, the taxpayer is able to transfer its losses to a related entity in the year the loss is incurred and obtains a reimbursement for the transfer of such loss, in effect, the taxpayer is in a position equivalent to a full refund. By the same token, while a taxpayer with continuous losses and no related entities to which it may carryover losses should suffer more from the absence of a loss offset, it may be more likely to accelerate investment to use up loss carryforwards.[725] Thus, on these intermediate positions, the

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[723] *See, e.g.,* DOMAR & MUSGRAVE, *Proportional Income Taxation and Risk-Taking*, *supra* note 156, at 392 ("[L]oss carryback...gives an "old" corporation (that is, a corporation with past net income) the certainty of possible loss offset, thus placing it in a very advantageous position as compared with a new company.").
[724] *See* discussion *supra* at pg. 53ff.
[725] *See* AUERBACH, *The Dynamic Effects of Tax Law Asymmetries*, *supra* note 717, at 206.

determination of the impact of a taxpayer's present and expected future tax attributes on the analysis is far more complex than under the no relief and full refund options.[726]

In sum, due to these different variables, it remains very difficult to assess the impact of intermediate loss relief positions, such as tax integration, across the board for all taxpayers. At the most, certain broad principles may be advanced. In particular, based on existing research, the following principles may be advanced with relative legitimacy:

- The higher the rate of loss offset enjoyed by a taxpayer once all the elements discussed above are taken into consideration, the higher should be the degree of risk taken after the tax;[727]

- Where tax integration allows a specific corporate group to benefit from a loss in the same year it is incurred, tax integration should be closer to a full refund than partial relief;[728] and

- For this specific corporate group, the full loss offset allowed by tax integration should, in principle, provide an encouragement to risk-taking.[729]

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[726] *See* RUDNICK, *Enforcing the Fundamental Premises of Partnership Taxation,* supra note 702, at 274 ("An investor's utility for gain and disutility for loss determines her risk aversion."). *See also* DOMAR & MUSGRAVE, *Proportional Income Taxation and Risk-Taking, supra* note 156, at 391 ("The extent to which investors may utilize these provisions [i.e., carryforward and carryback of losses] depends upon the availability of other income. Here the position of various taxpayers differs greatly.").

[727] *See* DOMAR & MUSGRAVE, *Proportional Income Taxation and Risk-Taking, supra* note 156, at 391 ("[T]here appears little doubt that the higher is the rate of loss offset, the higher will be the degree of risk taken after the tax."). Note that although for purposes of this thesis risk-taking is generally assumed as a positive good, there is a substantial controversy on whether risk-taking is or not beneficial. Even assuming risk-taking is beneficial, as defended by several authors, there is a substantial controversy on whether tax is the ideal mean to foster it. This issue is beyond the scope of this work. For a good introduction *see* RUDNICK, *Enforcing the Fundamental Premises of Partnership Taxation, supra* note 702. *See also* Avi Fiegenbaum & Howard Thomas, Attitudes Toward Risk and the Risk-Return Paradox: Prospect Theory Explanations, 31 Acad. Mgmt. J. 85 (1988) (surveying the risk-return literature).

[728] *See* CAMPISANO & ROMANO, *Recouping Losses: The Case for Full Loss Offsets, supra* note 414, at 711("[B]ecause some firms can file consolidated returns, or simply diversify, a patchwork system of recoupment already exists sub rosa."); MICHAEL LIVINGSTON, *Risky Business: Economics, Culture and the Taxation of High Risk Activities*, 48 Tax L. Rev. 163 (1993) (author argues that the current system approaches complete loss offsets in the case of established firms that can offset losses from one venture with the income from another); LAURIN, *Cleaning Up the Books: A Proposal for Revamping Corporate Group Taxation in Canada*, *supra* note 551, at 13 ("[B]y improving the after-tax return on risky investments for corporate taxpayers, the ... group reporting regime would likely lead to greater risk taking [.]").

[729] The loss relief under tax integration should also result in a control of cyclical downturns, in that the ability to use tax losses more effectively may enable corporate groups to maintain loss-making operations in certain subsidiaries during cyclical downturns for a longer period of time than would otherwise have been possible. Further, it may help firms stabilize their operations by reducing the incidence of temporary disruptions in production or hiring plans due to cyclical slowdowns. *See* LAURIN, *Cleaning Up the Books: A Proposal for Revamping Corporate Group Taxation in Canada*, *supra* note 551, at 13. *See also* MICHAEL COOPER & MATTHEW

ii. Year Carryovers

As noted above, besides allowing for inter-entity loss carryovers, a CIT system may allow losses to be carried back to prior tax years, carried forward to future tax years, or both. The carryover periods may be the same for NOLs and NCLs or, as occurs under the US and UK tax laws, may be distinct.[730] In general, when losses are carried back, the taxpayer obtains a benefit for the losses in the same year they are incurred. For this reason, a carryback should, in effect, result in a full refundability of losses.[731] Conversely, where losses can only be carried forward, refundability should only be partial. This is because losses that must be carried forward may be subject to two penalties, a loss of interest and expiration.[732] That is, in light of the time value of money, a loss applied in a future taxation year is worth less than in the year in which it arose. In addition, where there is a definite carryover period, the probability of completely utilizing the loss is limited.[733]

Allowing for an unlimited carryforward with interest provides one possibility to counteract these two problems of loss carryforwards. As noted by certain commentators, this presents an interesting policy alternative to loss relief insofar as the benefits of a full refund may be obtained without the associated drawbacks.[734] Specifically, since future income is still required to benefit from the loss, the impoverishment of the state coffers and fraud should be limited.[735] The current approach under the US and the UK Standard CIT systems is, however, more restrict. In both jurisdictions, the solution chosen was to allow for limited carrybacks supplemented by carryforwards, which may be either limited, as in the US, or unlimited, as in the UK.[736] This thesis generally agrees with this approach.[737] However, while the limitation of carrybacks is understandable for administrative reasons, no reason exists to cap carryforwards. The taxpayer is already penalized by the loss of interest.

KNITTEL, *Partial Loss Refundability: How Are Corporate Tax Losses Used?*, 59 National Tax Journal 651 (2006) at 651-663.

730 *See* discussion *supra* at note 410. It is not clear what type of policy rationale may reasonably underlie a differentiation of carryover periods between the two types of losses. For simplicity and clarity, it would be more reasonable to unify both carryover periods.

731 DONNELLY & YOUNG, *supra* note 706, at 441. A problem of the carryback is that it may discriminate against corporations with different economic histories. Id.

732 AUERBACH, *The Dynamic Effects of Tax Law Asymmetries*, *supra* note 717, at 205.

733 DONNELLY & YOUNG, *supra* note 706, at 441.

734 *See, e.g.,* AUERBACH, *The Dynamic Effects of Tax Law Asymmetries*, *supra* note 717, at 220.

735 Id. ("[A] system of unlimited loss carryforward with interest would appear to protect against [fraudulent abuse]...It is unclear what other problems, if any, such an approach would present, or why it has not been adopted.").

736 *See supra* note 410 for the year carryover periods of tax losses in the US and the UK.

737 In principle, this solution is biased in favour of the state coffers.

Therefore, a sensible approach rests on an unlimited carryforward of losses supplemented by a limited carryback.[738] This solution would avoid impoverishment of the state, while not creating an unnecessary bias against risk-taking.[739]

Whether tax integration regimes should be subject to the same year carryover rules of the Standard CIT system or to distinct year carryover rules raises further fruit for discussion. Provided the Standard CIT system retains reasonable year carryover rules, as occurs in the US and the UK, this thesis believes that the same treatment of year loss carryovers should be applicable to tax integration regimes and to the Standard CIT System. No reasonable argument establishes a distinction. Adjustments to the rate structure address potential equity concerns better than inefficient drafting of the tax rules.[740]

iii. Source Carryovers

Finally, the CIT system may allow losses to offset only income from the same source or income from any source (*i.e.,* independently of the character of the income, or the activity or country where it was generated). As with the year loss limitation, the less restrictive the treatment, the more reduced the possibility of the existence of unusable losses, and, thus, the lesser the possibility of discouraging risk-taking. In face of the nature of corporate groups, this thesis defends a relaxed approach to source limitations in a tax integration scenario, especially with regard to character and activity.

In sum, the CIT system may impact the level of corporate risk-taking. In principle, since investment decisions are based on after-tax returns, a CIT system should discourage the undertaking of risk by taxing the rewards from an investment, and encourage the undertaking of risk by bearing a portion of the losses. The characteristics of the loss offset system should dictate whether the CIT enhances or reduces the risk-taking capabilities of corporations. Specifically, the spectrum of loss relief under a CIT system ranges from the possibility of providing no relief for the losses incurred by a business to providing a full

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738 In the same sense see DOMAR & MUSGRAVE, *Proportional Income Taxation and Risk-Taking, supra* note 156, at 392 ("[I]f necessary and feasible, unlimited carry-forward of losses should be permitted, supplemented by a limited carry-back.").

739 Tax policy should aim at eliminating unnecessary bias for or against risk. *See* SCARBOROUGH, *Risk, Diversification and the Design of the Loss Limitations Under a Realization-Based Income Tax, supra* note 410, at 717 ("Although there is no way to treat losses under a realization-based income tax that is neutral, several reforms of the current law capital loss limitation are possible that would eliminate unnecessary bias for or against risk.").

740 *See* discussion *supra* at pg. 74.

refund for such losses. Within these two extremes, several intermediate positions are possible. In these intermediate positions, although refund is denied, the CIT system may allow for the carryover of losses to different tax years, different sources of income and/or different entities. Due to the different variables at stake, assessing the impact of these intermediate positions, such as tax integration, on risk-taking across the board for all taxpayers is especially difficult. Nevertheless, a broad rule may be advanced. Specifically, the higher the rate of loss offset enjoyed by a taxpayer, the higher should be the degree of risk taken after the tax. Thus, for the specific corporate group that, due to tax integration mechanics, is able to benefit from a full loss offset in the same year the loss is incurred, tax integration should provide an encouragement to risk-taking when compared with the Standard CIT system.

C. The Taxation of Corporate Groups under Tax Integration Regimes

This section examined the taxation of corporate groups under tax integration regimes. The section showed that there are several mechanic possibilities to integrate corporate groups for tax purposes and that all available models are subject to practical and mechanic limitations. Then, in light of these different limitations, the section argued that the achievement of the mechanic objectives of tax integration in the fullest and simplest available way should involve a blend of full and partial integration solutions.

After determining the most appropriate mechanic approach to tax integration, the section then analyzed whether, once both the perspectives of the state and corporate groups are taken into consideration, tax integration is a commendable approach to tax corporate groups. In order to answer this question, the section evaluated the potential effects of tax integration on the operation of corporate groups and on the functioning of the tax system using a hybrid integration model as the reference model (of tax integration). Following the policy approach previously defined in this thesis, the analysis of the effects of tax integration was made by identifying and by evaluating the potential distortions, and their interactions, introduced by the tax rules to corporate behaviour, and by factoring them into the analysis. The results of the analysis undertaken allow this thesis to draw the following conclusions:

➢ *Taxing corporate groups under the proposed tax integration model is more efficient than taxing them under the Standard CIT system.*

Tax integration should result in a minimization of substitution effects (*i.e.,* changes in the taxpayer's decisions or behaviour due to the tax system) and in a reduction of the amount of resources consumed in applying the tax system, when compared with the Standard CIT system.[741] First, under tax integration, intra-group transactions and their closest substitutes tend to be taxed equally. This means that a mere change in transactional form in an intra-group transaction will not generally result in a substantially different tax result. A fundamental effect of this continuity in the tax rules is that there is no tax benefit associated with substitution. As a result, taxpayers are not generally interested in substituting transactions. Thus, there is no need to adopt more complex legal instruments or implement more expensive and complex transactions than those strictly required to achieve the desired economic end result. Since transactional form is largely irrelevant for tax purposes, the group will likely, absent non-tax law constraints, structure the transaction in the simplest and cheapest way possible. Thus, within the boundaries of the Tax Group, the transfer of assets and income should, in principle, be implemented using simpler transactions and corporate law instruments than under the Standard CIT System

Second, since under tax integration the tax factor is largely irrelevant in intra-group transfers, assets or income may be transferred at the optimal business timing to the corporate member that ensures the best economic return for their use. That is, the interest of structuring transactions with the aim of locating the deductions, inclusions, and capital gains or losses on the corporate group member whose tax attributes are most beneficial is eliminated. Thus, absent constraints from other regulatory fields, assets and income will, in principle, be transferred to the corporate member that ensures the best economic return for their use. Further, since the "lock-in" and "lock-out" effects are eliminated in intra-group transactions, these transfers may occur at the optimal business timing. Hence, under tax integration, the CIT system should not interfere with the flexibility of corporate groups to transfer resources between their constituent parts and, thus, should not negatively affect their "organized internal market" dynamics. Overall, corporate groups should become more responsive to changes in the prospects of their investments.

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[741] *See supra* pg. 72 for definition of efficiency for purposes of this thesis.

Third, tax integration should allow for the mix up of a corporate group's attributes, fundamentally tax losses, in a cost efficient way. When available, alternative ways of obtaining the same benefits under the Standard CIT System, such as mergers, are usually more expensive, more complex and may have negative collateral consequences for the group.

Thus, beyond discouraging taxpayers from basing economic decision-making on tax considerations, as opposed to the underlying economic factors, tax integration should reduce the costs incurred by taxpayers to implement transactions. This includes the fees paid to professionals to locate and to evaluate substitute transactions, and the costs associated with their implementation. Further, the decrease in the complexity of internal group flows, as a result of the reduction of substitution, should make the corporate group more transparent from an informational perspective. This internal transparency of corporate groups should decrease the costs of the state to supervise compliance of corporate groups with the tax rules.

In sum, it should be more efficient to tax corporate groups under tax integration than under the Standard CIT system. In particular, tax integration should minimize the substitution effects and reduce the amount of resources required to apply the tax system when compared with the Standard CIT system, both for corporate groups and the state. Based on the policy approach previously defined in this thesis, the issue that arises is whether the potential collateral drawbacks of tax integration outweigh these efficiency advantages. In this regard, the results of the analysis undertaken allow this thesis to draw the following conclusions concerning the collateral effects of tax integration:

➢ *Tax integration minimizes the impact of the corporate tax system on the firm's organizational arrangements, being better adapted to the objectives and the needs of corporate groups.*

The taxation of corporate groups under the Standard CIT system should generally reduce their ability to shift capital to its most efficient uses and result in a potential implementation of sub-optimal functional and legal structures. Tax integration should minimize these negative impacts of tax on the firm's organizational arrangements, being better adapted to the objectives and needs of corporate groups. As discussed above, tax integration is better able to deal with the corporate group's chameleon-like nature, organizationally-bound property rights and organized internal market dynamics. In particular, it minimizes the relevance of the corporate veil and the formal characterization of transactions for tax purposes; allows for an optimization of group resources and a simplified combination of tax attributes; and allows for a higher flexibility for internal corporate restructurings, and, thus, for a higher adaptability of corporate groups to their environment.

> *The taxation of corporate groups under tax integration should not result in negative corporate governance consequences. Indeed, when compared with the Standard CIT system, a relative improvement should occur due to the more transparent group structures and intra-group transfers.*

Based on the policy principles defined in this thesis, research should be mindful of potential indirect corporate governance implications of proposed tax reforms. As a rule, research should ensure that the proposed tax intervention does not result in indirect negative corporate governance implications and profit from the corporate governance advantages that naturally ensue from CIT's existence. As discussed, the elimination of transaction costs and other sources of deadweight loss should be pursued only when it does not adversely affect CIT's regulatory functions. Otherwise, when regulatory functions are at stake, research should go through a cost-benefit analysis before eliminating transaction costs and other sources of deadweight loss.

In this regard, it should be noted that the transactions that tax integration would eliminate (*i.e.,* mostly pure tax planning transactions) are not, in principle, informational in nature. Accordingly, their reduction or elimination should not result in negative consequences to CIT's regulatory functions.[742] Indeed, a relative improvement of such functions should occur due to the more transparent group structures and intra-group transfers. Further, from the specific perspective of the corporate group, this increased internal transactional transparency should make it easier for top management and other stakeholders to be accurately informed about the operations of the group. As a result, based on the analysis undertaken, the potential for managerial opportunism should be minimized.

Overall, tax integration should not result in negative corporate governance consequences. Indeed, when compared with the taxation under the Standard CIT system, a relative

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[742] This includes the deterrent and the reliability functions. *See* discussion *supra* at pg. 32ff.

improvement should occur as a result of the more transparent group structures and intra-group transfers.

➢ *For the specific corporate group that, due to tax integration mechanics, is able to benefit from a full loss offset in the same year the loss is incurred, tax integration should provide an encouragement to risk-taking when compared with the Standard CIT system.*

A further element that research must take into consideration when evaluating CIT reform proposals is their interaction with general market dynamics and with the Structural Distortions. In this regard, this thesis argued that, apart from the impact on timing and transaction costs, tax integration could impact corporate risk-taking. However, the thesis concluded that due to the different variables at stake, it was very difficult to assess the impact of tax integration on risk-taking across the board for all taxpayers. Nevertheless, a broad rule was advanced. In particular, for the specific corporate group that, due to tax integration mechanics, was able to benefit from a full loss offset in the same year the loss was incurred, tax integration should provide an encouragement to risk-taking when compared with the Standard CIT system.

➢ *Tax Integration may raise certain equity issues. These issues should be dealt with by the use of non-tax law frictions and/or adjustments to the CIT system's rate structure.*

As previously discussed, it is important to analyze the interaction of the constraints and benefits imposed by the tax system with the frictions imposed by other regulatory fields and, when required, consider the possibility of making an affirmative use of such frictions. This is especially relevant when analyzing tax integration because, since all intra-group transactions are tax-free, tax integration may provide an incentive for the group to prefer to transact more within itself than with unrelated parties and, thus, to internalize certain operations within the boundaries of the Tax Group. Further, the coupling of the benefits of inter-entity loss offset, with the limited liability of corporate group members, may make this model especially attractive to undertake business when compared with other business forms. Overall, tax integration may potentially provide an incentive for economic concentration. This thesis believes that this issue should be dealt with by non-tax law frictions, namely, anti-trust laws. Corporate tax law should focus on efficiency. To tackle the issue of economic concentration using the CIT system would create a paradoxical opposing objective. It is better for the CIT system to pursue solidly the objective of efficiency and leave other opposing objectives to be pursued by existing non-tax law frictions.[743]

If this is not considered sufficient by the legislator, a solution that could be considered, although subject to further analysis, is to impose a slightly higher statutory corporate tax rate on corporate groups. In order to explore the feasibility of this solution, it would be important to consider, taking into consideration the corporate taxpayer's potential for arbitrage, whether the general conditions for investment should be more favourable under a somewhat higher tax rate, together with more complete loss offset or, instead, under a lower tax rate accompanied by more imperfect offset conditions.[744]

In sum, tax integration should significantly reduce the deadweight loss associated with the operation of the CIT System for corporate groups. In addition, it should be beneficial to the state due to the resultant reduction in administration and supervision costs that ensue from the reduction in transactional and compliance complexity. Further, besides being more efficient, it minimizes the negative collateral impact of the Standard CIT system. Thus, under the criteria defined in this thesis, taxing corporate groups under tax integration regimes rather than under the Standard CIT system constitutes an incremental improvement to the taxation of corporate groups.

Since tax integration is the best way to tax corporate groups under a CIT system, this thesis recommends that its scope of application be enlarged. First, although its advantages and disadvantages must be carefully considered prior to implementation, this thesis suggests that the legislator should be aware that tax integration may also be made applicable to >50% owned entities. In this regard, in line with other commentators, this thesis suggests that in light of the nature of corporate groups and the need for expediency in the tax laws, the definition of corporate groups for tax integration purposes may be operated based on a simple *de jure* definition (similar to the current US definition), complemented with comprehensive attribution rules and certain objective and easily administrable *indicia* of

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[743] *See* SCHIZER, *Frictions as a Constraint on Tax Planning*, *supra* note 16 (defending the affirmative use of non-tax law frictions to pursue tax policy objectives). *See also* discussion *supra* at pg. 76 regarding the care that must be taken when using non-tax law frictions.

[744] *See* DOMAR & MUSGRAVE, *Proportional Income Taxation and Risk-Taking*, *supra* note 156, at 392 ("Even if some loss in revenue results, the condition for investment will be more favorable under a somewhat higher tax rate, together with more complete loss offset than under a lower tax rate accompanied by more imperfect offset conditions."); id. at 420 ("[T]he optimum tax rate will be the higher, the higher is the rate of offset").

economic integration (*e.g.,* a percentage of revenues derived from related-party transactions). Second, it would be worth analysing whether tax integration could be enacted as a mandatory regime for corporate groups, and not elective, as is currently the case in the US, the UK and all other jurisdictions that have enacted similar regimes.[745] In principle, the proposed definition of control should effectively avoid corporate groups electing whether or not to be taxed under tax integration.

CONCLUSION | *The Taxation of Corporate Groups Under a CIT*

Corporate groups are notoriously difficult to tax. At the moment it is not clear whether corporate groups should be approached as single taxable entities or whether a separate tax existence should be attributed to corporate group members. The current ambiguity creates problems not only for the government and society, but also for corporate groups, generating a substantial deadweight loss for the entire economic system. In the light of the current state of affairs, the thesis sought to determine what may be the best approach to tax corporate groups once both the perspectives of the government and corporate groups are taken into account. In order to answer this central question, the thesis first tackled three preliminary questions.

First, it determined how research should approach corporate taxation. The thesis argued that CIT law is influenced and constrained by a wide range of elements. Thus, the proper apprehension of the problems under study demanded that these different influences and constraints were factored into the analysis. In turn, this demanded the adoption of an interdisciplinary approach whereby elements such as market imperfections, the behavioural nature of the corporate taxpayer, or the rules of related regulatory fields, were brought into the investigation. Further, in light of the nature of CIT law, the thesis argued that it could be more productive for this research project to adopt an analytical perspective that started from the analysis of the existing CIT system, taking into consideration its different influences and constraints, than to assume a clean plate perspective. Therefore, the thesis adopted a perspective of incremental change rather than a fundamental tax reform perspective.

745 *See* YOSHIHIRO MASUI, *General Report, in* IFA, Group Taxation, Cahier de Droit Fiscal International Vol. 89b (Yoshihiro Masui, et al. eds., 2004) at 39.

Once the thesis defined its methodological approach to the study of corporate taxation, it determined whether it made sense for research to focus on potential improvements to the current CIT system or, in light of other potentially available alternatives, whether it would be better to simply discard it as a valid option to tax the corporate sector. Despite the merits of alternative proposals to tax the corporate sector, the thesis concluded that research focusing on the optimization of the current CIT system should be rather useful and, therefore, decided to focus its efforts on the study of the current CIT system.

Based on the analysis undertaken to the core structural elements of the CIT system, the thesis argued that most of the current CIT system's deficiencies resided on its theoretical pillars and suggested that research should take into consideration the following problems:

- The deficiencies of the system when related parties are involved;
- The asymmetries that result in transactional discontinuities;
- The encouragement provided for taxpayers to engage in tax planning;
- The distortions introduced to the regular *modus operandi* of economic agents that penalize their economic efficiency; and
- The formalism and the complexity of the CIT law.

In addition, the thesis argued it would be important to factor into the analysis the CIT system's specific strengths, namely its regulatory potential. In light of the substantial amount of research being undertaken on the Reliability Effect and Deterrent Effect, the thesis decided to focus its efforts on the Control Effect.

Once it determined whether it is valuable or not to pursue further work on the current CIT system and identified its core strengths and problems, the thesis then examined the determinants associated with the CIT system's impact on corporate behaviour in order to refine its approach to the central research question.

The thesis argued that the use of CIT law for corporate behavioural control should only occur when direct subsidies are not a better option. In particular, the thesis claimed that the use of the CIT system for corporate behavioural control could produce significant non-intended negative consequences and be subject to a considerable degree of uncertainty regarding its intended behavioural effects. The thesis concluded that in many cases direct subsidies should have higher targeting potential and lower associated transaction costs.

In addition, the thesis suggested that if considered that in a specific situation tax intervention could be more adequate than direct subsidies, the intervention should achieve the desired behavioural effects with as few as possible associated distortions and costs. The thesis then suggested several guidelines to achieve this purpose.

Once the thesis understood the determinants associated with the CIT system's impact on corporate behaviour, it suggested how the central research question should be approached. The thesis argued that as a result of the different distortions, and their interactions, associated with the design and operation of the CIT system, to simply look at how far a certain policy was from optimality could be insufficient to determine whether an incremental improvement was occurring. Accordingly, the path this thesis proposed to determine whether incremental improvements were indeed improvements consisted in *looking for more efficient tax solutions and, then, go further by identifying the distortions and their interactions associated with the operation of the CIT system, and factor them into tax policy analysis.*

For this purpose, the thesis defined efficiency as the minimization of transaction costs and other sources of deadweight loss. This included the minimization of substitution effects (*i.e.,* changes in taxpayer decisions or behaviour due to the tax system) and tax overhead costs (*i.e.,* the amount of resources, including the value of time or labour, consumed in applying the tax system, through taxpayer or government activities such as tax planning, compliance, litigation, administration, and law-making). Based on the analysis undertaken, the thesis further proposed that this efficiency objective could be pursued by looking for the tax treatment that was better aligned with the particularities associated with the nature of each category of business entities. The thesis noted that it was concerned with a classification criteria based on corporate structure.

In addition, the thesis proposed that, in order to adequately factor into the analysis the different distortions and their interactions associated with the operation of the CIT system, the following guidelines should be observed:

- As a general rule, the use of the CIT system to implement policy objectives other than raising cash should be minimized;

- Take into consideration the pre-existing distortions of the playing field, including the Structural Distortions, market imperfections, and the regulatory effects of the CIT system;

- Focus on corporate-level intervention and avoid shareholder-level intervention;

- Ensure that the tax intervention does not result in indirect negative corporate governance implications and profit from the corporate governance advantages that naturally follow from CIT's existence. In this regard, the elimination of transaction costs and other sources of deadweight loss should be pursued only when it does not adversely affect CIT's regulatory functions. Otherwise, when regulatory functions are at stake, go through a cost-benefit analysis before eliminating transaction costs and other sources of deadweight loss;

- To the extent consistent with the tax policy objectives, minimize the negative impact of tax rules on the operation of business entities. This requires that the objectives and needs of business entities are adequately taken into consideration in the process of policy design;

- Favour long carryover periods for tax attributes; and

- Analyze the interaction of the CIT system with the frictions imposed by other regulatory fields and consider the possibility of making an affirmative use of such frictions.

The thesis then underscored that it was not concerned with equity issues in the CIT law. Following other commentators, the thesis argued that equity issues could be better dealt with at the shareholder's level or with adjustments to the CIT's rate structure.

Finally, the thesis argued that it would follow a non-uniform approach to CIT policy design. The design of a CIT system with differing structural rules for different business entities, despite raising certain problems, especially higher interaction costs, should allow for better adaptability of tax law to the underlying economic and business reality of the real world of transaction costs, information asymmetries and agency costs.

Following this policy approach, the thesis then analyzed the economic, legal and functional nature of corporate groups in order to identify the potential sources of deadweight loss and other collateral effects that could arise when corporate groups were taxed under the Standard CIT system.

The thesis argued that the corporation that is a member of a corporate group is a part of a larger entity, an atom of a molecular structure, and that the integration of the corporate atomistic entity into the molecular group structure is achieved through its submission to a group level unitary economic direction. The tension between this unitary economic direction and the individual corporation's legal and economic substratum generate the internal dynamic or *chemical bond* that gives rise to the corporate group's molecular structure.

The analysis showed that this internal dynamic constitutes the critical element for the characterization of the corporate group as a particular form of enterprise. The thesis claimed that in the same way that molecules may only exist if there is an exchange of electrons between atoms to create a *chemical bond*, the corporate group may only exist if there is an exchange of assets and income between group members to create the internal dynamic of an organized internal market. Overall, the thesis concluded that corporate groups require flexibility to transfer assets and income internally in order to be economically viable.

The thesis further claimed that in the group context, individual actions simultaneously and cumulatively orient to the common goal and to the individual goals of the members, with no normative primacy of one orientation or the other. As a result of this internal decision-making system, the thesis concluded that the corporate group's governance structure could assume an indeterminate variety of forms and characteristics, depending on the blending of market and hierarchy, contract and organization, strategically implemented at each moment.

Further, the thesis argued that the internal dynamic of the corporate group created substantial distortions to the individual corporation's structure. When controlled by another corporate entity and submitted to the external interest of the headquarters, the corporation's sovereign nature was distorted. In this situation, the controlled corporation could lose its self-determined entity status and become an entity subject to an alien hierarchical structure that favoured a higher collective interest over its own single interest. This could distort the corporation's legal personality and promote the creation of a different type of property rights within the groups, *i.e.,* the so-called "organizationally-bound" property rights.

Finally, the thesis claimed that the functional structures of corporate groups do not necessarily follow their legal structures. The design of a group's functional structure follows a different rationale from the one that generally underlies the design of its legal structure, and, although both structures could eventually coincide in certain groups, they are increasingly diverging. Also, the thesis argued that the flexibility to create functional structures that deviate from legal structures allows for the constant adaptability of corporate groups to their economic reality.

The thesis concluded that the nature of corporate groups poses very specific challenges to tax policy. Specifically, the thesis argued that, in order to minimize the deadweight loss of the CIT system, tax rules should be structured so as to preserve the economic efficiency advantages that corporate groups developed during their evolution as business enterprises. Further, tax rules should implement models that, *ab initio*, take into consideration the "chameleon-like" nature of corporate groups and its potential use to obtain (unlawful) tax advantages.

After analyzing the economic, legal and functional nature of corporate groups, the thesis then moved on to identifying the sources of deadweight loss that could arise when corporate groups were taxed under the Standard CIT System. The thesis argued that the degree of substitution of the Standard CIT System when facing corporate groups was especially high. In addition, the thesis claimed that the Standard CIT System was structurally discontinuous when high levels of ownership were present. As a result of these two factors, the thesis concluded that the incentive for tax planning in intra-group transactions should, in many situations, be quite significant. Specifically, the thesis argued that the ability of corporate groups to manipulate the value, legal characterization and timing of transactions could be used to manipulate the mechanics of the tax system since it allowed corporate groups to manipulate the location, character and amount of tax attributes, and, thus, absent the application of specific anti-abuse rules, to fundamentally alter their tax treatment.

The thesis then examined the dynamic effects of such ability for manipulation, for corporate groups and for the state. For corporate groups, the thesis argued that the root of the dynamic problems associated with such manipulation was that, in a world of costly contracting and information asymmetries, the search and adoption of substitute transactions had associated costs and could result in certain operational inefficiencies. In the case of imperfect substitutes these inefficiencies could include transfer of resources to a corporate member that did not provide the best economic return for their use; the adoption of a sub-optimal functional structure; the adoption of a sub-optimal legal structure; and the adoption of a more complex transaction.

Further, the manipulative behaviour of corporate groups under the Standard CIT system should lead to transactional, rule and compliance complexity. Transactional complexity should arise due to the implementation of substitute transactions that use more complex legal instruments and/or indirect transactional routes, with the aim of manipulating the formalism of the Standard CIT System. The counteraction of this manipulative behaviour should increase the quantity and complexity of the tax rules. In turn, the greater challenge to interpret such tax rules should raise the costs of transactions for corporate groups through the need for professional tax preparers, lawyers and accountants. As for the state, it should raise the cost of designing tax rules and of supervising their operation.

Further, the need to provide sufficient proof of the fulfilment of the formal and substantive requirement associated with the applicable anti-abuse rules should significantly increase compliance complexity. Specifically, corporate groups should experience more difficulties and should incur higher costs to ensure their ongoing compliance with the tax system. By the same token, the supervision of the massive quantity of documentation produced to ensure compliance with these tax rules should result in significant transaction costs to the state. Overall, the thesis concluded that the increased transactional, rule and compliance complexity of the Standard CIT System caused by the manipulative behaviour of corporate groups should result in increased tax overhead costs, both for corporate groups and the state.

In addition, as a direct result of the strategies implemented to manipulate the Standard CIT System, corporate groups should reduce their ability to shift capital to its most efficient use. Due to rule and compliance complexity, it should be more expensive for corporate groups to determine what rules and regulations are applicable to a specific transaction, to determine the ensuing tax consequences and to comply with them. When these tax-related costs were taken into consideration, the economic efficiency gain of an intra-group transaction could be insufficient to offset its associated tax costs and, thus, the transaction could be implemented outside its optimal timing or not be implemented.

Further, besides the additional transaction costs, rule complexity could result in uncertainty as to tax results, which could deter corporate groups from entering into certain favourable transactions. Moreover, as a result of substitution, the transfer of group resources could be made to a corporate member that did not provide the best economic return for their use. Overall, in these situations the flexibility of corporate groups to transfer resources between their constituent parts should be hampered and they should become less responsive to changes in the prospects of their investments. This could negatively impact the corporate groups' "organized internal market" dynamic and could reduce the capacity of the economic system to allocate resources to their most productive use.

Further, the thesis argued that because of the higher number of complex transactions, the corporate group's manipulative behaviour should result in less transparent internal group flows and more convoluted organizational structures. This internal complexity should make the group more opaque from an informational perspective, and should make it harder for top management and other stakeholders to remain accurately informed about the operations of the group. As a result, a shift of power from the board to inside managers and increased potential for managerial opportunism could occur. Also, this internal complexity of corporate groups fostered by the tax system could increase the costs of the state to supervise the compliance of corporate groups with the tax rules.

Finally, the thesis claimed that, besides potentially giving rise to the implementation of sub-optimal functional and legal structures, the tax minimization strategies to explore the asymmetries of the Standard CIT System could rigidify these structures. This could occur for two main reasons. First, due to the transaction costs associated with the definition and implementation of corporate structures, once a certain structure was implemented to benefit from a tax advantage or to avoid a specific anti-abuse rule, it should tend to remain in operation for a certain time. Second, due to the application of anti-abuse rules, the corporate structure existing at the time of the transaction could have to be kept in place for a certain period in order for the tax treatment afforded to the transaction to be respected. The thesis argued that this rigidity reduces the corporate group's capacity for adaptation to outside disturbances, which could penalize its economic performance.

Overall, the thesis concluded that the taxation of corporate groups under the Standard CIT system should yield significant tax overhead costs both for corporate groups and the state; a reduction of corporate groups' ability to shift capital to its most efficient use; agency problems, and rigid and potentially sub-optimal functional and legal structures.

Subsequently, the thesis examined alternative mechanic solutions to tax corporate groups under a corporation income tax system and assessed how they dealt with these problems. In particular, the thesis investigated how corporate groups could be taxed using Tax Integration Solutions. The thesis showed that there are several mechanic possibilities to integrate corporate groups and that all available models are subject to practical and mechanic limitations. Further, in light of these different limitations, the thesis argued that the achievement of the mechanic objectives of tax integration in the fullest and simplest available manner should involve a blend of full and partial integration solutions.

After determining the most appropriate mechanic approach to tax integration, the thesis analyzed whether tax integration was a commendable approach to tax corporate groups once both the perspectives of the state and corporate groups were taken into consideration. In order to answer this question, the thesis evaluated the potential effects of tax integration on the operation of corporate groups and on the functioning of the tax system using a hybrid integration model as the reference model (of tax integration). Following the policy approach previously defined, the results of the analysis undertaken allowed this thesis to draw the following conclusions:

- *Taxing corporate groups under the proposed tax integration model is more efficient than taxing them under the Standard CIT System.*

Tax integration should result in a minimization of substitution effects and in a reduction of the amount of resources consumed in applying the tax system, when compared with the

Standard CIT System. First, under tax integration, intra-group transactions and their closest substitutes tend to be taxed equally. This means that a mere change in transactional form in an intra-group transaction will not generally result in a substantially different tax result. A fundamental effect of this continuity in the tax rules is that there is no tax benefit associated with substitution. As a result, taxpayers are not generally interested in substituting transactions. Thus, there is no need to adopt more complex legal instruments or implement more expensive and complex transactions than those strictly required to achieve the desired economic end result. Within the boundaries of the Tax Group, the transfer of assets and income should, in principle, be implemented using simpler transactions and corporate law instruments than under the Standard CIT System

Second, since under tax integration the tax factor is largely irrelevant in intra-group transfers, assets or income could be transferred at the optimal business time to the corporate member that ensures the best economic return for their use. Specifically, the interest in structuring transactions to locate deductions, inclusions, and capital gains or losses on the corporate group member whose tax attributes are more beneficial, should be eliminated. Thus, absent constraints from other regulatory fields, in principle, assets and income should be transferred to the corporate member that ensures the best economic return for their use. Further, since the "lock-in" and "lock-out" effects are eliminated in intra-group transactions, these transfers should occur at their optimal business time. Hence, under tax integration, the CIT system should not interfere with the flexibility of corporate groups to transfer resources between their constituent parts and, thus, should not negatively affect their "organized internal market" dynamics. Overall, corporate groups should become more responsive to changes in the prospects of their investments.

Third, tax integration should allow for the mix up of a corporate group's attributes, fundamentally, tax losses, in a cost efficient way. When available, alternative ways of obtaining the same benefits under the Standard CIT System, such as mergers, are generally more expensive, complex and may have negative collateral consequences for the group.

Thus, beyond avoiding taxpayers to base economic decision-making on tax considerations, as opposed to the underlying economic factors, tax integration should reduce the costs incurred by taxpayers to implement transactions. This includes the fees paid to professionals to locate and to evaluate substitute transactions, and the costs associated with their implementation. Further, the decrease in the complexity of internal group flows due to the reduction of substitution should make the corporate group more transparent from an informational perspective. This internal transparency of corporate groups should decrease the costs of the state to supervise the compliance of corporate groups with the tax rules.

Overall, the thesis concluded that it should be more efficient to tax corporate groups under tax integration than under the Standard CIT system. Tax integration should minimize the substitution effects and reduce the amount of resources consumed in applying the tax system, both for corporate groups and the state, when compared with the Standard CIT system. Based on the policy approach previously defined, the issue that arose was whether the potential collateral drawbacks of tax integration could outweigh these efficiency advantages. In this regard, the results of the analysis undertaken allowed this thesis to draw the following conclusions:

- *Tax integration minimizes the impact of the corporate tax system on the firm's organizational arrangements, being better adapted to the objectives and the needs of corporate groups.*

The taxation of corporate groups under the Standard CIT system should generally reduce their ability to shift capital to its most efficient uses and to implement optimal functional and legal structures. Tax integration should minimize these negative impacts on the firm's organizational arrangements, as it is more adaptive to the objectives and the needs of corporate groups. Also, tax integration is better able to appreciate the corporate group's chameleon-like nature, organizationally-bound property rights and organized internal market dynamics. In particular, it minimizes the relevance of the corporate veil and the formal characterization of transactions for tax purposes; allows for an optimization of group resources and a simplified combination of tax attributes; and allows for a higher flexibility for internal corporate restructurings, and, thus, for a higher adaptability of corporate groups to their environment.

- *The taxation of corporate groups under tax integration should not result in negative corporate governance consequences. Indeed, when compared with the Standard CIT system, a relative improvement should occur due to the more transparent group structures and intra-group transfers.*

The thesis noted that the transactions that tax integration would in principle eliminate (*i.e.,* mostly pure tax planning transactions) were not informational in nature. Accordingly, their reduction or elimination should not yield negative consequences to CIT's regulatory functions. Indeed, a relative improvement of such functions should occur due to the more transparent group structures and intra-group transfers. Further, from the specific perspective of the corporate group, this increased internal transactional transparency should make it easier for top management and other stakeholders to remain accurately informed about the operations of the group. As a result, the potential for managerial opportunism should be minimized.

Overall, the thesis concluded that tax integration should not result in negative corporate governance consequences. Indeed, when compared with the taxation under the Standard CIT system, a relative improvement should transpire due to the more transparent group structures and intra-group transfers.

➢ *For the specific corporate group that, due to tax integration mechanics, is able to benefit from a full loss offset in the same year the loss is incurred, tax integration should provide an encouragement to risk-taking when compared with the Standard CIT system.*

The thesis suggested that, apart from the impact on timing and transaction costs, tax integration could potentially impact corporate risk-taking. However, the thesis concluded that due to the different variables at stake, it was very difficult to assess the impact of tax integration on risk-taking across the board for all taxpayers. Nevertheless, a broad rule was advanced. In particular, for the specific corporate group that was able to benefit from a full loss offset in the same year the loss was incurred, tax integration could potentially provide an encouragement to risk-taking when compared with the Standard CIT system.

➢ *Tax Integration may raise certain equity issues. These issues should be dealt with the use of non-tax law frictions and/or adjustments to the CIT system's rate structure.*

The thesis argued that tax integration could potentially provide an incentive for economic concentration and claimed that this issue should be dealt with by non-tax law frictions, namely, anti-trust laws. In particular, the thesis argued it was better for the CIT system to solidly pursue efficiency and to leave other opposing objectives to existing non-tax law frictions.

The thesis further argued that if this measure was not considered sufficient by the legislator, it would be worth considering whether a slightly higher statutory corporate tax rate could be imposed on corporate groups. In order to explore the feasibility of this solution, it would be important to consider, taking into consideration the corporate taxpayer's potential for arbitrage, whether the general conditions for investment should be more favourable under a somewhat higher tax rate, together with more complete loss offset or, instead, under a lower tax rate accompanied by more imperfect offset conditions

All in all, the thesis concluded that tax integration should result in a significant reduction of the deadweight loss associated with the operation of the CIT System for corporate groups. In addition, it should be beneficial to the state due to the reduction in administration and supervision costs that follow from the reduction in transactional and compliance complexity. Also, besides being more efficient, tax integration should minimize the negative collateral impact of the Standard CIT system. Thus, under the policy criteria adopted, taxing corporate groups under tax integration regimes, rather than under the Standard CIT system, should constitute an incremental improvement to the taxation of corporate groups.

Since tax integration should be the best way to tax corporate groups under a CIT system, this thesis recommended that its current scope of application should be enlarged. First, the thesis suggested that partial Tax Integration Solutions could also apply, for instance, to more than 50% owned corporate group members. In this regard, the thesis claimed that in light of the nature of corporate groups and the need for expediency in the tax laws, the definition of corporate groups for tax integration purposes could potentially be operated based on a simple *de jure* definition, complemented with comprehensive attribution rules and certain objective and easily administrable *indicia* of economic integration. Second, the thesis argued that it would be worth considering whether tax integration could be enacted as a mandatory regime for corporate groups, and not an elective regime. The thesis suggested that the proposed definition of control could, in principle, avoid corporate groups effectively electing whether or not to be taxed under tax integration, although this issue should be the subject of further research.

In light of the discussion undertaken, this thesis believes that it could be beneficial to review the current US and UK legislation for taxation of corporate groups. As discussed, potential areas that should be subject to consideration include reformulating the current US Group Taxation Regime in order to eliminate the floating outside basis mechanism and substitute it with a participation exemption; introduce longer carryover periods for loss offsets in the UK Group Taxation regime; consider implementing a full integration model in the UK in conjunction with the UK Group Taxation regime; consider making the US and the UK Group Taxation regimes applicable to more than fifty percent-owned entities using the control criteria defined above; and consider making tax integration regimes mandatory in both countries. Further, it would be important if subsequent research could expand the analysis undertaken herein, bringing into the research foreign entities and foreign transactions. Finally, it would be interesting to analyze the current discussion on the creation of a consolidated tax base in the European Union using the conclusions from this research project.[746]

Corporate groups are notoriously difficult to tax. Based on the research undertaken, this thesis concludes that approaching corporate groups as single taxable entities is the best approach to tax corporate groups once both the perspectives of the government and corporate groups are taken into consideration.

[746] *See, e.g.,* MALCOLM GAMMIE, et al., Achieving a Common Consolidated Corporate Tax Base in the EU: CEPS Task Force Report (Centre for European Policy Studies 2005).

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