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The Cashless Corporate Tax

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I. INTRODUCTION

Proposals for reforming the federal corporate income tax are never-ending and ever-multiplying. They range from those that merely tinker around the edges, such as most recent proposals attacking the various perceived abuses that masquerade under the moniker “corporate tax shelter,” to various integration approaches that arguably would gut the enterprise of a corporate income tax altogether. Since everything and the kitchen sink is at least theoretically in play, it seems appropriate to add this modest proposal, which I call the “cashless corporate tax” (CCT).

As described below, the CCT is a “tax” that would replace the current corporate income tax—defined as the income tax the government currently collects directly from corporations—with government share ownership. The basic idea is that the government’s current rights to corporate cash flows, as set forth in the Code, are functionally a form of equity ownership. Accordingly, it should be possible to replace such rights with direct equity ownership interests in corporations. The primary challenge is to determine the quantity and quality of the equity ownership interests, which, if held by the fisc, would most closely resemble—in whatever ways the legislature or the author deems relevant—the current corporate income tax. It is my hope that the process of meeting that challenge will lead to some insights into the nature of the current corporate income tax. In any event, replacing the current tax with direct government ownership interests would serve to make more transparent certain effects of the current regime. That may or may not be a good thing, of course, depending on one’s point of view.

In addition to providing an alternative view as to the nature of the current corporate tax, the CCT would offer at least one significant

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practical benefit viz. the current tax regime. By giving the government direct equity interests in corporations, the CCT would cause corporate managers to treat the government in the same manner as other equity holders. In particular, to the extent that the mantra of corporate management is “maximize shareholder value,” corporate managers would be induced to maximize the value of the government’s tax collections simply by performing their usual function of maximizing shareholder value generally.¹ This is, of course, a stark contrast to the incentive of corporations under current law to earn as much economic income as possible in ways that are not subject to income tax (or equivalently to engage in transactions that do not produce economic income but yet reduce income tax).

As presented in this Article, the CCT—by being a replacement merely for the corporate portion of the current corporate income tax regime—would need to be accompanied by a shareholder tax, presumably structured in the same way as is the shareholder tax under current law. This fact is merely an observation and is not intended, by any means, to be an endorsement of the current regime. I do not dwell on the shareholder tax. One can argue, however, that the focus on only the corporate portion of any corporate tax regime is hopelessly myopic, since what is relevant is the total tax levied on corporate income, whether collected from the corporation, the shareholders, or both. Nonetheless, I adopt this approach for several reasons. The simplest is that since a two-level organizational scheme happens to exist under current law, any study of such law—and this *is* intended to be such a study—is entitled to acknowledge and follow this scheme. Indeed, if one wants to understand better the effects solely of the corporate portion of the current corporate income tax regime, it is actually necessary to follow such scheme.

A second reason for focusing on the corporate portion of the current regime, however, is that this approach suffers from no particular loss of generality. For example, it is trivially easy to turn the CCT into part of an “integrated” tax regime: One possibility is to set incremental shareholder taxes uniformly to zero. To be sure, tax rates under an integrated CCT would need to be adjusted if one wanted to perfectly replicate the revenues currently collected from both corporations and shareholders. But that is not an incremental problem of the integrated CCT, since determining the suitable “tax” rates to ensure revenue neutrality under the unintegrated CCT is a nontrivial empirical question that would need to be addressed in any event.

The third and most important reason for accepting the CCT’s initial focus on only the corporate portion of the current corporate income

¹ I ignore the effects that agency costs could have on this story.

tax regime is that it turns out to be easy to broaden this focus. Thus, the CCT readily generalizes into a tax that replicates both the corporate and the shareholder components of current law.

A final point to note at the outset is that the CCT, as presented below, would take current law regarding capital structure as given. That is, the current corporate income tax regime imposes tax on a base that is reduced by allocations of corporate income to various nonequity owners of corporations: debt holders, employees with deferred compensation arrangements (including nonqualified stock options), counterparties to derivatives contracts, and the like. Whether and when such allocations are appropriate as a theoretical matter is a difficult question, but one that I can ignore. That is, since the CCT is designed to replace the tax currently imposed on the already reduced (by taking capital structure into account) corporate income tax base, it must take at least some elements of that base as given, for otherwise it would cease to be even a passable replication. Again, this is not intended as an endorsement of the current tax rules related to capital structure. Instead it is intended as an endorsement of the simple proposition that to everything there is a season and this Article is not “the season” for examining capital structure.

II. THE LAY OF THE LAND

A. *What Needs Fixin’?*

It is not at all difficult to argue that imposing the current corporate income tax is a bankrupt enterprise. For example, if the incidence of such tax were its nominal incidence on equity capital, it imposes a relatively nonsensical incremental cost on such capital.² Why such capital should be disfavored relative to other types of capital, or to labor, is unclear. Whether the Congress that first imposed such tax even considered the possibility of such disfavor is equally unclear.³ Moreover, the manner in which such disfavor is imposed—at a uniform rate that takes no account of the tax characteristics of the beneficial owners—is inconsistent with much of the rest of the Code.⁴ Gladly, there is no real point in trying to disentangle these threads,

² Of course, one can make very imperfect arguments that such incremental cost merely offsets benefits otherwise provided either by limited liability or (which is arguably the same thing) equity capital market liquidity. See generally William A. Klein & Eric M. Zolt, *Business Form, Limited Liability, and Tax Regimes: Lurching Toward a Coherent Outcome?*, 66 U. Colo. L. Rev. 1001 (1995).

³ See Steven A. Bank, *The “Corporation” in the Corporate Income Tax: Separate Entity or Shareholder Proxy?* (Fla. St. U. College of Law Public Law and Legal Theory Working Paper No. 23, 2001), available at <http://papers.ssrn.com>.

⁴ See Klein & Zolt, note 2, at 1017-18.

since the actual incidence of the corporate income tax is uncertain.⁵ Accordingly, I feel justified in throwing “ultimate” rationality to the winds and taking as a given that it is (or in any event has been deemed to be) desirable to have a corporate tax regime extracting a double tax more or less in exactly the amounts such tax is extracted at present.

So my focus is not with the general propriety of the current regime, but merely with certain problems related to its implementation.⁶ This necessarily means that, even within my limited scope, I am not interested in having the CCT replicate *all* of the effects of the current regime. Rather, as a fictional lawgiver, I have the freedom to replicate only those effects that I believe are both intended and (giving due license to Congress’ power to regulate economic activity) at least arguably salutary. That not all effects of the current regime meet these criteria is best exemplified by the phenomenon of corporate tax shelters.

Very broadly defined, a corporate tax shelter is anything that creates or increases a disparity between a corporation’s economic income and its taxable income, and thus reduces the corporation’s federal income tax payments to something less than they would have been in the absence of the shelter. Linguistically, such things “shelter” (economic) income from tax, hence the propriety of the definition. Of course, a shelter only reduces corporate income tax payments if it is respected, either in toto or in part, but this generally will be the case even for the most “abusive” shelter by virtue either of the “audit lottery” or the horse trading that characterizes the audit settlement process. Whether and when a shelter *should be* respected is a more complicated question, for most shelters are sanctioned by literal applications of the Code, the regulations, or other precedents, and indeed, many are affirmatively intended as incentives for engaging in certain activities. It is only that in the eye of certain beholders, a literal application of the tax law occasionally leads to consequences that are unintended or, more bluntly, “smell.”⁷ Making matters more complicated, there is some temporal element to the notion of what smells: It evolves with the passage of time.⁸

⁵ See, e.g., Alan J. Auerbach, Taxation and Corporate Financial Policy (NBER Working Paper No. 8203, 2001) (discussing effect of tax on corporate financing and investing activities).

⁶ As already noted, other implementation problems, like the debt-equity distinction, are beyond the scope of this Article.

⁷ E.g., Calvin H. Johnson, The Anti-Skunk Works Corporate Tax Shelter Act of 1999, 84 Tax Notes 443 (July 19, 1999).

⁸ To see why this phenomenon is not at all surprising, see Herwig J. Schlunk, Little Boxes: Can Optimal Commodity Tax Methodology Save the Debt-Equity Distinction?, 80 Texas L. Rev (forthcoming 2002). A practical example of the phenomenon can be found in

There is a veritable host of things that fit into my admittedly exceedingly broad definition of tax shelters—owing largely to the Code’s penchant for defining taxable income in ways that poorly reflect economic income—but they all fall into one of three categories. The first category contains (benign) shelters that Congress affirmatively desires. Such tax-subsidized investments as municipal bonds or low income housing fall into this category; accelerated depreciation may or may not. The second category contains (somewhat less benign) shelters that Congress does not necessarily desire, but accepts as a matter of pragmatism. The realization requirement is such a shelter, as is the 15-year amortization period for purchased intangibles like goodwill. The third category contains (malignant) shelters that are simply unintended. Entering into a transaction that generates an artificial capital loss falls into this category.⁹ Note that the first and second categories of tax shelter are not “tax shelters” in the colloquial pejorative sense.¹⁰

Of course, when confronted with a shelter, broadly defined, it is frequently less than clear whether it is benign or malignant. But there are some questions that tax professionals ask, the most important of which is whether or not the underlying activity that produces the shelter has sufficient “substance.” While that question may sound as if it has real content, it generally does not. Rather the professional is apt to rely on analogy (shelters are benign if they have direct analogies to other shelters with historic pedigrees; utterly novel shelters are more likely suspect). And the professional is apt to be swayed by the shelter’s clothing (burying a shelter in the complex midst of genuine business activity tends to render it benign; dressing it in the emperor’s new clothes renders it less so). But neither the availability of analogy, nor the intricacy of the clothing, is even remotely robust: New shelters can be the result of innovations in areas including but not limited to finance, having nothing overtly to do with tax, and clothing, by its very nature, can be changed. So tax planners, the Service, and the courts are left to wrestle mightily with sterile questions.

the tortured history of the use of spin-offs in connection with corporate mergers and acquisitions, culminating in the enactment of § 355(e).

⁹ See, e.g., *Compaq Computer Corp. v. Commissioner*, 113 T.C. 214 (1999); *ACM Partnership v. Commissioner*, 157 F.3d 231 (3d Cir. 1998). But see *IES Indus. v. United States*, 253 F.3d 350 (8th Cir. 2001).

¹⁰ This is all the more the case since there is no proclamation in the Code that economic income is indeed the desired metric for the corporate income tax. Cf. IRC § 446(b), which allows the Secretary to put taxpayers on tax accounting methods that “clearly reflect income.” What is meant by the “income” to be clearly reflected is, however, far from clear. What is clear, however, is that what is meant *cannot* be pure economic income. For if it were, tax preferences of all sorts (now writ large to include such aberrations as the realization principle) would be undone by “clear reflection.”

Consider, for example, a corporation that wishes to invest some excess funds pending commencement of a project. Absent tax considerations, the corporation can make a variety of passive investments, all of which should yield the same risk-adjusted rate of return, namely the risk-free rate. Thus, the corporation could invest in Treasury bills or in more volatile corporate stock. If it invests in the latter, it can hedge away the risk associated with some or all of the acquired stock's volatility. But of course the corporation can make various sorts of tax-favored investments as well. For example, it can purchase municipal bonds. Assuming, as is generally the case for high tax-rate taxpayers including corporations, that less than all of tax benefit of § 103 is capitalized into the price of the bonds, the corporation can earn a higher after-tax return from such bonds than from more conventional investments. Alternatively, the corporation can invest in relatively nonvolatile stock of corporations paying very high dividends. Assuming, as is generally the case, that not all of the tax benefit of § 243 or § 901, whichever is relevant, is capitalized into the price of the stock, the corporation again can earn a higher after-tax rate of return than from conventional investments.

None of the foregoing investments is, without more, a category three "malignant" tax shelter. Indeed, in the case of the tax-favored investments, all clearly are intended by Congress and have perfectly good tax policy underpinnings. Yet, it is possible for each of the tax-favored investments to be made in a way that meets with disapproval. Thus, if the municipal bonds are debt-financed, the tax benefits disappear. Or if the high-dividend-paying stock is not held in a sufficiently unhedged way for a sufficiently long time, the tax benefits disappear. But why either of those extraneous circumstances robs the underlying investment of "substance" is unclear. Is it merely that tax benefits obtained somewhat passively are acceptable, while those aggressively sought are not? Or is there something deeper at work?¹¹

¹¹ A good discussion of "substance" can be found in Daniel N. Shaviro, *Economic Substance, Corporate Tax Shelters, and the Compaq Case*, 88 Tax Notes 221 (July 10, 2000). Shaviro defines substance in part as the assumption of sufficient real economic risk. Thus, for example, if a corporation holds stock for a more or less substantial period of time (preferably a period long enough that normal price volatility threatens to more than undo the desired tax benefit), there is no reason to balk at allowing such corporation a dividends received deduction or a foreign tax credit. But this view begs a series of questions.

Why should taking this kind of risk matter? If it does, what should be the requisite quantum of risk? Should the Code encourage such risk taking? And how should the Code react when the "friction" disappears, as it inevitably will? For with a little education, rational shareholders holding diversified portfolios should want *all* corporations to engage in *Compaq*-like transactions, irrespective of a holding period requirement. The fact that some such transactions will be "losers" is irrelevant; corporations on average will win. Thus, the friction that makes such transactions currently unpalatable—compensation schemes for corporate managers based on actual rather than expected results—ultimately

However one feels about the merits of “economic substance,” the issue fortunately can be swept away if a fictional lawgiver (that is, me) proposes to base a new corporate tax regime on an income measure that removes the incentive to earn economic income in tax-favored ways. For the real heart of the tax shelter problem is not so much that the Code frequently mismeasures income, but that human nature causes people to behave in ways that exploit the mismeasurement. Simply put, it is the human nature of shareholders to care only about the after-tax economic income they earn with respect to the corporations in which they invest, and which generally will be maximized to the extent that the corporation maximizes its after-tax economic income. Thus, it is only to be expected that any incongruities that allow a corporation to depress taxable income without depressing economic income will be fully exploited.¹²

Given this, the solution to the tax shelter problem is simple: The corporate income tax regime must equate corporate taxable income and corporate economic income. No lesser solution, be it increasing reporting requirements, increasing penalties, codifying and/or putting more teeth into various nebulous anti-abuse rules, legislating a sufficient “substance” requirement for transactions, or shifting the boundaries of various of the Code’s arbitrary categories, can work.¹³ What

will disappear. Accordingly, one should expect that in the future corporate managers will be rewarded for entering into such transactions, even if *ex post* the given transaction fails to yield a profit. Once this happens, the holding period requirement will have no further effect. But none of this, it seems to me, will make future acquisitions of corporate stock any more or less “substantive” than are current ones.

See David M. Schizer, *Frictions as a Constraint on Tax Planning*, 101 *Colum. L. Rev.* 1312 (2001). Schizer similarly suggests that tax rules can be given “substance” by taking advantage of nontax frictions.

¹² Learned Hand observed that it is a given that people *are allowed to* arrange their transactions in ways that minimize their tax payments. *Helvering v. Gregory*, 69 F.2d 809, 810 (2d Cir. 1934), *aff’d*, 293 U.S. 465 (1935). That misses the truth by half. The more relevant half is that so long as the Code provides opportunities for them to minimize their tax payments, people *will* arrange their transactions to exploit the opportunities. For taxpayers are economic actors, economic actors maximize utility, and more often than not, maximizing utility in the context of an income tax means minimizing tax payments.

While Hand was talking primarily (though, given the transaction involved, not exclusively) about human taxpayers, not juridical ones, that makes no difference. The objectives of a corporation are, if anything, more focused than those of a human. A corporation exists not to maximize something as diffuse and as difficult to measure as utility, but merely the wealth of its shareholders and other interest holders. Since any dollar of corporate tax that is saved must go to some interest holder, the imperative facing a corporate tax planner is quite clear: reduce corporate income tax payments up to the point where a dollar spent on tax reduction expenditures saves only a dollar of taxes!

¹³ For just a couple in a spate of recent discussions, see Johnson, note 7; Shaviro, note 11; George K. Yin, *Getting Serious about Corporate Tax Shelters: Taking a Lesson from History*, 54 *SMU L. Rev.* 209. For recent congressional bills addressing corporate tax shelters, see *Abusive Tax Shelter Shutdown Act of 2001*, H.R. 2520, 107th Cong., 2001 TNT 149-73, Aug. 2, 2001, available in LEXIS, TNT File; Staff of Senate Comm. on Finance, Tax

is needed is nothing less than a complete overhaul. The CCT is one such possible overhaul, but as the next Section makes clear, there are others as well.¹⁴

B. Aligning Incentives

The ultimate goal of the CCT is to align the incentives of corporate shareholders (and their management representatives) and the fisc through the simple expedient of making the fisc “just another” shareholder. As noted, if properly done, the ability of corporations to shelter income in certain ways would disappear.¹⁵ Moreover, other ancillary benefits would accrue. For example, the effective base broadening attending any elimination of shelter activity would allow for lower nominal “tax” rates.¹⁶ In addition, the resources currently employed in shelter activity—particularly high-powered human capital—could be diverted to more socially productive uses. And corporations would reap transactional efficiencies from engaging in transactions in the form that makes the most economic sense, rather than the most tax sense. Finally, there would be gains from simplified tax reporting, tax administration, and tax enforcement.¹⁷

The CCT, however, is not the only tax regime that aligns shareholder and government incentives, and that thus achieves these various savings. There are a number of other possible regimes that also align incentives and are thus the logical competitors of the CCT. They

Shelter Disclosure Act Discussion Draft, 2001 TNT 151-58, Aug. 6, 2001, available in LEXIS, TNT File. For recent congressional and Treasury papers on corporate tax shelters, see Staff of the Joint Comm. on Tax'n, 106th Cong., Comparison of Recommendations Relating to Corporate Tax Shelters Made by the Department of Treasury and the Staff of the Joint Committee on Taxation (Comm. Print 2000); Staff of the Joint Comm. on Tax'n, 106th Cong., A Description and Analysis of Present-Law Tax Rules and Recent Proposals Relating to Corporate Tax Shelters (Comm. Print 1999); Treasury Dep't, The Problem of Corporate Tax Shelters (Discussion, Analysis and Legislative Proposals) (1999).

¹⁴ To the extent that Congress affirmatively desires a tax benefit for the purpose of affecting corporate behavior, it could then reinstate such incentive through affirmative transfer payments. The benefits of such an approach are many, not the least of which is that the corporation would have the burden of demonstrating it had complied with Congress' wishes in order to get its cash; it could not simply “take a tax return position” as under current law and thus withhold cash from the fisc, subject to ultimate audit. This change in posture—which smacks of possession being 9/10ths of ownership—would likely eliminate most claims that the Service currently characterizes as abusive.

¹⁵ Other avenues for sheltering income, such as exploiting capital structure, would remain.

¹⁶ If the CCT replicates current law but for eliminating the ability to engage in “tax shelters,” enacting it would be the equivalent of base broadening. See David Weisbach, Ten Truths about Tax Shelters, 55 Tax L. Rev. (forthcoming 2001).

¹⁷ It is estimated that the cost of complying with federal income tax law will be \$140 billion in the current year, all of which is deadweight loss. Wall St. J., Nov. 7, 2001, at A1.

each have their own peculiar benefits and detriments, both relative to one another and relative to the CCT.

The simplest such regimes are lump sum tax regimes. For example, Joseph Bankman has proposed (in conversation) that corporations enter into negotiations with the fisc with the goal of determining their tax payments for some suitably long future period (for example, 10 years). The payments presumably would be loosely based on expected income, but would not subsequently be adjusted in light of actual income. Thus, once the payment schedule is set, each corporation has the incentive (during the period in question) to maximize economic income, without further distortion by the tax regime.¹⁸

Alternatively, one might impose a lump sum "wealth" tax at a given rate on any corporation's fair market value. Such a tax would be efficient, and certainly would be fair ex ante.¹⁹ Of course, it would be necessary to have an alternative tax regime for privately held corporations. But such an alternative exists under current law (the partnership vs. the corporate tax regime, and within the realm of corporations, the privately held regime in which most economic income can be denominated "compensation" and the publicly traded regime in which it cannot be²⁰). Moreover, the political reality may be that an alternative tax regime for privately held corporations would be a necessary component of any corporate income tax regime that could actually be enacted.²¹

A second type of tax regime that aligns shareholder and government incentives is any regime that measures corporate income on a mark-to-market basis. The reason is that such regimes base tax collections on net increases in shareholder wealth, and (so long as the effective tax rate is less than 100%) rational shareholders will want to

¹⁸ Query whether potential corruption under such a regime is a significantly bigger problem than in the current haphazard audit settlement process. Query further whether issues of asymmetric bargaining power would preclude applying such a regime to corporations falling below certain size thresholds. Query finally what the incentives would be during the period immediately prior to a negotiation with the fisc.

¹⁹ Assuming a wealth tax were in fact periodic, it is essentially equivalent to a mark-to-market income tax in every period except the first and the last. Deborah H. Schenk, *Saving the Income Tax With a Wealth Tax*, 53 *Tax L. Rev.* 423, 435-41 (2000); David Shakow & Reed Shuldiner, *A Comprehensive Wealth Tax*, 53 *Tax L. Rev.* 499, 512-23 (2000) (both demonstrating the equivalency). Thus, there is no good reason not to treat it as any other income-type tax.

²⁰ See *Exacto Spring v. Commissioner*, 196 F.3d 833, 838-39 (7th Cir. 1999).

²¹ I say this since small businesses, like small farms, are one of the most sacred of sacred cows. Presumably, the liquidity and other benefits of having access to public capital markets more than compensate for the incremental tax burden on public corporations under the current tax regime. There is no reason to believe that these benefits would be less significant under alternative tax regimes.

maximize such increases. In the tax literature, mark-to-market regimes have been proposed in three basic forms.

1. Mark-to-Market Tax Imposed Currently on Interest Holders

Joseph Dodge has elaborated in great detail an integrated mark-to-market tax system ("MTM") that dispenses with corporate tax collections, instead collecting the tax on "corporate" income from shareholders.²² In the case of publicly traded corporations, shareholders would pay a tax annually on changes in the market value of their shares.²³ In the case of non-publicly traded corporations, shareholders would pay tax under a subchapter K-type pass-through regime.²⁴ Thus, in its most basic form, the MTM system is integrated. But for those enamored of actually collecting green from both corporations and shareholders, Dodge includes an optional partial integration variant, which would continue to tax corporations at a low rate on accounting income.²⁵

Although it is nominally a shareholder tax regime, the MTM system can be viewed as a corporate income tax regime for the reason previously stated: What is relevant to shareholders is the aggregate tax burden imposed on the activities underlying their shares. Whether that tax is imposed primarily on the shareholders, on the corporation, or partially on each, is just a detail. Thus, in what follows, I consider the MTM system to be a corporate income tax regime. Nonetheless, the fact that no (significant) amount of tax is collected from the corporation is not entirely without moment. Among other things, it implies different corporate liquidity constraints than does a more traditional corporate tax. And it arguably raises different agency concerns than does a mark-to-market tax imposed directly on corporations, as discussed below.²⁶

²² Joseph M. Dodge, A Combined Mark-to-Market and Pass-Through Corporate-Shareholder Integration Proposal, 50 Tax L. Rev. 265 (1995).

²³ Id. at 295.

²⁴ Id. at 299-300.

²⁵ Id. at 308. It is structurally important to use accounting income rather than some alternative measure like "taxable income." First, since corporations need to compute such income for nontax purposes anyway, no incremental reporting burden is created. But more importantly, since publicly-held corporations tend to have a strong preference for reporting higher rather than lower accounting income, there is little incentive to reduce such income just to reduce tax payments (relative to the current tax regime, in which taxable income generally is not reported to the financial markets).

²⁶ See Section II.B.3. If equity is difficult to raise, a corporate manager faced with a mark-to-market tax imposed on the corporation might not want to maximize shareholder wealth, since such maximization would take more cash out of her coffers and thus reduce her operational flexibility (as well as the size of her managerial kingdom). This type of misalignment of interests should not be present in the MTM system. On the other hand, in the case of publicly traded corporations with significant inside stock ownership, there

Probably the most important practical difficulty of the MTM system is that the tax collection is not based on realization. Indeed, that is the whole point. But given the U.S. tax history and the fixation of large segments of the investing public with the significance of realization, imposing a tax burden absent a sale or other realization event is not likely to curry favor with legislators. So a difficulty it is. A second problem posed by the MTM system is that it treats publicly traded and private corporations differently. Of course, the current corporate income tax regime suffers from the same infirmity and it is likely a political necessity that any regime retains such infirmity. Nonetheless, it is an imperfection, both as a theoretical and as a practical matter.

2. *Deferred Mark-to-Market Tax Imposed on Interest Holders*

Alan Auerbach and David Bradford have shown that it is possible to achieve the functional equivalent of mark-to-market taxation on a deferred basis.²⁷ Their scheme, which they refer to as generalized cash flow taxation (“GCFT”), nominally is aimed at correcting the problems of realization accounting, and in particular, the lock-in effect, that is, the taxpayer’s ability to reduce the effective tax rate with respect to appreciated assets by continuing to hold them.²⁸ Nevertheless, since GCFT applies, among other things, to stock in corporations, it can be considered a corporate income tax regime. Note that, like the MTM system, the GCFT is an integrated tax imposed, in the first instance, solely on shareholders.²⁹

Auerbach’s original treatment imposes tax at the time of realization in an amount that makes investors *ex ante* indifferent between selling and holding assets, including shares in corporations. His tax is based solely on the proceeds from a sale, the holding period of the asset, and interest rates. Actual *ex post* gain is irrelevant.³⁰ Bradford generalizes Auerbach’s tax by adding a nonzero tax on the actual gain realized from the asset.³¹ This addition, while logically straightforward, is computationally quite difficult. Auerbach and Bradford then generalize this tax regime again by separating the two component taxes of

might be an incentive on the part of insiders to depress market value under the MTM system, at least during tax periods where no insider intends to dispose of stock.

²⁷ Alan J. Auerbach & David F. Bradford, *Generalized Cash Flow Taxation*, Draft (2000) (unpublished manuscript, on file with the Tax Law Review); see also Alan J. Auerbach, *Retrospective Capital Gains Taxation*, 81 *Am. Econ. Rev.* 167 (1991); David F. Bradford, *Fixing Realization Accounting: Symmetry, Consistency and Correctness in the Taxation of Financial Instruments*, 50 *Tax L. Rev.* 731 (1995).

²⁸ Auerbach & Bradford, note 27.

²⁹ More correctly, no corporate tax is explicitly specified.

³⁰ Auerbach, note 27, at 169-73.

³¹ Bradford, note 27, at 770-73.

Bradford's regime into a negative "tax" at the time of investment (reflecting basis recovery) and a tax at the time of sale (reflecting sales proceeds).³² Since this system, while equivalent to an income tax, in fact taxes cash flows, they call it generalized cash flow taxation.

GCFT offers two significant benefits over the MTM system. First, it imposes tax only on realization. Thus, even with respect to liquid assets, it never forces a taxpayer to sell any assets to pay a tax.³³ Second, GCFT can be imposed on shares in privately held corporations as easily as it can be imposed on shares in publicly traded corporations. Thus, there is no artificial tax divide based on the number of a corporation's shareholders.

But alongside these advantages, GCFT has some drawbacks. First, in its nascent (and most easily applicable) form,³⁴ it is not in a relevant sense an *income* tax because it does not impose tax on actual ex post gain.³⁵ Thus, exactly like certain lump sum taxes, it arguably introduces ex post inequities into the tax regime. How much one should care about this is, as always, a legitimate question.³⁶ Second, and more important, in all of its forms, the GCFT imposes a nontrivial computational burden in establishing the relevant tax rate, and then exacts tax at a different rate from each realization transaction based on a small number of variables.³⁷ Again, this is the whole point. By imposing a different nominal tax rate on different realization transactions, the GCFT imposes the same effective tax rate on all such transactions. But expecting Congress or the public to understand this bit of magic is surely asking an awful lot.

3. *Mark-to-Market Tax Imposed on Corporations*

Finally, a mark-to-market regime could impose tax on corporations directly. Thus, both Joseph Bankman and Michael Knoll have proposed an unintegrated tax regime that would replace the current corporate income tax with a corporate tax based on changes in the value of a corporation's equity from the beginning of the tax year to the

³² Auerbach & Bradford, note 27.

³³ Even for liquid assets, taxing at times other than realization may involve significant transaction costs, particularly for those with large portfolios who attempt to maintain certain features—such as the beta—of those portfolios. Of course, for individuals whose holdings are simply market-based mutual funds, the transactions costs are essentially irrelevant.

³⁴ See Auerbach, note 27.

³⁵ One can argue that due to the possibility of and relevance of portfolio adjustments, the current income tax regime also does not in any real sense tax actual ex post gain. See Schenk, note 19, at 429-31.

³⁶ Auerbach, note 27, at 176.

³⁷ Moreover, in the case of a holding period approaching eternity, the tax rate approaches 100%. Although this is the correct result, it is not particularly palatable.

end.³⁸ This tax generally would be combined with a shareholder tax that could be identical to the shareholder tax collected under the current regime (although shareholder taxes could just as easily be either modified or abolished). I refer to the direct corporate portion of such regime as the market-value tax (“MVT”).

Like the MTM system and the GCFT, the MVT generally aligns the incentives of corporate managers with the interests of the fisc, for it is unlikely that a rational corporate tax planner would purposely sabotage the corporation’s equity value simply to reduce corporate income tax payments.³⁹ But it is not impossible, for the imposition of a (considerable) tax directly on the corporation would produce an agency cost not present under the MTM system or the GCFT: It would force corporate managers to part with cash. Managers may have good (operational flexibility) or bad (empire-building) reasons for wanting to keep extra cash in their coffers. Thus, it is possible they would intermittently try to depress the corporation’s market value. Nevertheless, as a first approximation, I assume that under the MVT, the corporation’s and the fisc’s interests are aligned.

Nevertheless, the MVT has a number of implementation problems. First, like the MTM system, the MVT preserves the difference in tax treatment between publicly traded and privately held corporations. This difference could perhaps be ameliorated through an expedient such as applying different tax rates to public and private corporations.⁴⁰ Or it could be addressed by imposing an accrual regime on private corporations.⁴¹ Or it could be addressed, a la the MTM system, by imposing a pass-through regime on private corporations. But an ugly and, in some sense, arbitrary borderline nonetheless would remain.

Second, and far more important, the MVT creates interesting liquidity issues for certain corporations. For while a shareholder of a publicly traded corporation theoretically could satisfy the MTM system tax by liquidating a part of her position, it is far from clear that public corporations could raise the necessary billions they might need to raise to pay their corporate income tax arising from a year of mete-

³⁸ Joseph Bankman, A Market-Value Based Corporate Income Tax, 68 Tax Notes 1347 (Sept. 11, 1995); Michael S. Knoll, An Accretion Corporate Income Tax, 49 Stan. L. Rev. 1 (1996).

³⁹ The MVT would not affect other means of sheltering corporate income from taxes, such as making creative use of capital structure to self-integrate.

⁴⁰ See, e.g., David Weisbach, A Partial Mark-to-Market Tax System, 53 Tax L. Rev. 95 (1999).

⁴¹ See, e.g., David J. Shakow, A Proposal for Accrual Taxation, 134 U. Pa. L. Rev. 1111 (1986); Reed Shuldiner, A General Approach to the Taxation of Financial Instruments, 71 Tex. L. Rev. 243 (1992).

oric market value growth.⁴² Finally, and related to the prior point, there is the problem of how to treat losses in market value. Presumably, the negative “taxes” corresponding to such losses would be fully refundable (at least in the cases of corporations whose equity had sufficient prior gains). But in a real bear market, the magnitude of refunds could make paying them prohibitive (or at least might give Congress a misguided incentive to make mid-stream changes to the Code).⁴³

All of this is just another way of saying that perhaps—just perhaps—there is something important lurking behind realization after all: Not in the context of the publicly traded stock holdings of investors, but in the context of defining the corporation’s taxable income. For what the MVT taxes, in the first instance, is not really today’s corporate income, but the change in expectations about future corporate income. Those expectations neither are present cash, nor in many cases are likely to become future cash. Put into tax argot, the expectations may never be “realized.” A conceptually analogous issue arises in at least one other tax context: the question of whether one could or should tax the economic income represented by changes in a human’s quantity of human capital. The Code has never attempted to tax such income. Perhaps this is due to measurement problems, or perhaps it is because imposing such a tax would be the functional equivalent of imposing upon the taxpayer an affirmative obligation to work. Whatever the case, no tax is imposed or is ever likely to be imposed, in spite of the fact that such income is indubitably “economic income.” It is simply economic income that is not sufficiently realized under even the most generous interpretation of the word “realized.”

A corporation experiencing an increase in market value is in much the same boat as a human experiencing an increase in the value of her human capital. Suppose, to make matters concrete, that *XYZ Corporation* has been issued a patent on sliced bread. *XYZ*’s stock soars in value by \$10 billion. And at that moment *XYZ* does indeed have an asset—the patent—that in some sense is worth \$10 billion. So it has enjoyed \$10 billion of economic income. But *XYZ*, in general, cannot take the \$10 billion and run. There are likely no ready buyers for the

⁴² This problem would have been particularly acute during the internet stock bubble of the late 1990’s. Bankman recognized the problem (without the benefit of perfect foresight), but the solutions he suggests—deferring a part of the tax or setting aside and selling additional stock, Bankman, note 38, at 1352,—are unaesthetic and create additional issues. What is an extraordinary rise in market value? Should the government bear the risk that the price of the set-aside stock might decline precipitously? And so on.

⁴³ Of course, actually paying such refunds might work as a powerful counter-cyclical economic stimulant. See Bankman, note 38 at 1352.

asset. XYZ can realize its unrealized economic income only if a number of things—some within and some without its control—come to pass. It must formulate and execute a sound business plan—easier said than done. And it must hope that its patent is not suddenly made obsolete by the patent on the best thing since sliced bread. Is it realistic to expect a lender to lend XYZ multiple billions of dollars to pay the tax resulting from its \$10 billion increase in market value? Would the equity markets come to the rescue? As in the case of an increase in the value of human capital, XYZ's income in a relevant sense has not been sufficiently realized. Maybe it never will be.⁴⁴

4. *Synopsis of Mark-to-Market Regimes*

The MTM system, the GCFT, and the MVT all solve the basic problem of the current corporate tax regime—the misalignment of interests between corporate managers and shareholders on the one hand and the fisc on the other—in at least a large subset of cases (that is, publicly traded corporations), but not without introducing some new difficulties. The CCT would endeavor to solve the same basic problem, but without the difficulties.

Thus, the CCT would (like the GCFT, but unlike the MTM system or the MVT) apply equally to all corporations, both publicly traded and privately held. It would not be based on realization (sharing this feature with the MTM system and the MVT), but would be imposed in a way that would make neither shareholders nor the corporation fret about the lack of realization. And while it would impose some computational burden (like the GCFT), that burden would be imposed solely on corporations (that is, it would be invisible to shareholders) and importantly would be uniform across corporations.

III. THE SIMPLE CCT

As already noted, my goal in this Article is to create an alternative corporate income tax regime—the CCT—that mimics the current corporate tax regime but is based on government ownership of shares in

⁴⁴ The result may be different to the extent that the patent produces liquidity or otherwise allows XYZ to exercise dominion over incremental cash. Thus, suppose XYZ successfully borrows \$2 billion on the strength of the patent and distributes that \$2 billion to its shareholders. Notwithstanding *Woodsam Associates, Inc. v. Commissioner*, 198 F.2d 357 (2d Cir. 1952), the combination of the borrowing and the distribution in every sense guarantees that a minimum of \$2 billion of income will be (has been) earned by XYZ with respect to the patent. Since the equity holders never will be required to return this \$2 billion, it clearly has been realized by XYZ, even if XYZ ultimately earns nothing from the patent. Of course, in the latter case, certain lenders are likely to have a separate \$2 billion loss.

corporations. The adjective “cashless” is and needs to be a misnomer, of course, because at the end of the day, the government would be hard pressed to finance expenditures without having some means of converting its shares into cash. Nonetheless, the name will surely appeal to the legions of CFOs who resent paying cash—in the form of taxes—to the fisc. But the name is not a complete misnomer, for what the CCT envisions is that each domestic corporation would treat the fisc as simply another equity owner, entitled to receive cash as and when cash was received by other equity owners. In particular, this means that domestic corporations would not readily be able to engage in transactions for the purpose of selectively disadvantaging the fisc.

A. *Iteration #1*

My first iteration of the CCT endeavors to “get the tax right” under the assumption that each corporation annually pays out in cash 100% of its after-tax economic income. This is not, to say the least, a realistic assumption—not under current law, and not under the incentives that would be created by the CCT. Nonetheless, it is useful as a starting point for the sole reason that it is simple.

Thus, suppose that amounts invested in the equity of any corporation earn *at the corporate level* a uniform risk-adjusted pre-corporate-tax rate of return of s , and suppose the effective corporate tax rate is t . Then, under current law, the aggregate cash flow received by shareholders from \$1 of equity in corporate solution is equivalent to $(1 - t)s$ per year in perpetuity. The fisc, meanwhile, garners cash flow of ts per year in perpetuity. Thus, under current law, the fisc receives exactly $t\%$ of all amounts ever distributed by the corporation. This is exactly what the fisc would receive if it directly owned $t\%$ of the equity of the corporation. The first iteration of the CCT makes use of this fact. The remainder of this Subsection describes the rules of this iteration.

Rule 1.1: Issuance of Phantom Equity. When a domestic corporation issues new equity of any class to someone other than a domestic corporation,⁴⁵ it must simultaneously issue new “phantom” equity of such class to the fisc.⁴⁶ Assuming $t\%$ is the desired effective tax rate,

⁴⁵ This qualification is made for initial ease of exposition. Consolidation provisions, discussed in Section V.C, address issuances to other domestic corporations.

⁴⁶ This rule cannot be applied without a definition of corporate *equity*. As I have already noted, what constitutes equity can be a contentious question under current law, and is in any event a question that has no robust answer. See, e.g., Schlunk, note 8. Fortunately, my approach to the CCT—which is to mimic the tax effects of current law to the greatest extent possible—does not require addressing this question. This is simply one of many problems that the CCT would not solve. Hence, the current arbitrary “definition” of equity suffices.

the amount of phantom equity issued to the fisc would be $t\%$ of the new issue. Such phantom equity would possess no voting rights.⁴⁷

Example 1: Let $t = 20\%$. Newly-formed domestic *XYZ Corporation* issues 100 shares of class A voting common stock and 200 shares of class B nonvoting common stock to noncorporate investors. *XYZ* would be required to issue 25 phantom shares of class A common stock and 50 phantom shares of class B common stock to the fisc. All of the fisc's phantom stock would lack voting rights.

The receipt of phantom equity is not, of course, a receipt that the fisc could spend. Rather, the phantom equity would provide the fisc with cash only as and when corporate distributions were made. The following rule clarifies what is meant by distributions, and ensures that the fisc is never disadvantaged when such distributions are made.

Rule 2.1: Payments in Respect of Phantom Equity. Subject to the return of capital provision in Rule 3.1 (discussed below),⁴⁸ the phantom equity of any class owned by the fisc participates ratably with other outstanding equity of such class in any cash payments made by the issuing corporation *or any other domestic corporation* with respect to such class.⁴⁹

Example 2: *XYZ* has 100 shares of common stock outstanding as well as 25 phantom shares of common stock owned by the fisc. If *XYZ* pays a dividend of \$1 per share on the common stock, the fisc would receive \$1 for each phantom share.

⁴⁷ The lack of a vote is a critical condition since I see little merit in enmeshing politicians more than absolutely necessary in issues of corporate governance. But the lack of vote should be relatively uncontroversial, since the fisc's equity-like interest under current law also comes without voting rights. Note, however, that it may become necessary to relax this restriction to some extent if allowance is made for government transfer of corporate shares (see Rule 5.1). In such case, it might be useful to allow the phantom shares to have a springing voting interest, that arises only as and when phantom shares are transferred.

⁴⁸ See text accompanying notes 52-53.

⁴⁹ The transactions that trigger a cash payment to the fisc—a “tax”—are the same as those that trigger the uniform corporate-level distributions tax proposed in George K. Yin, *A Different Approach to the Taxation of Corporate Distributions: Theory and Implementation of a Uniform Corporate-Level Distributions Tax*, 78 *Geo. L.J.* 1837 (1990). The reason for the overlap is simple. Yin is concerned with shareholder taxation, and hence focuses on transactions that are taxable to shareholders: generally transactions that put cash in shareholder hands. I focus on transactions that take cash out of corporate solution. These are, of course, the same transactions.

Note that this definition may raise collateral issues of accommodation between different governmental departments. Thus, for example, if a cash acquisition of one corporation by another yields revenues for the fisc, will there be incremental pressure on antitrust regulators to approve the acquisition?

Thus, private shareholders would receive an aggregate of \$100 and the fisc would receive \$25.

Similarly, if *XYZ* redeemed 20 shares of common stock from private shareholders for \$5 per share, it must redeem five phantom shares from the fisc. Again, \$100 would flow into private hands and \$25 would go to the fisc.

If instead, *ABC*, a domestic corporation, purchased 20 shares of *XYZ*'s common stock for \$5 per share, *ABC* also must purchase five phantom shares from the fisc, resulting again in \$100 flowing into private hands and \$25 going to the fisc. If, however, *J*, an individual, had acquired the 20 shares of *XYZ*'s common stock, *J* would not be required to make any payment to the fisc, since in this case, no cash flowed out of corporate solution and into private hands.

Rule 2.1 makes no distinction between distributions that are what might be termed a "return of capital" and those that are not. No distinction is necessary in the case of a corporation that annually distributes exactly the entirety of its after-tax earnings: By definition, such corporation never parts with capital. Nonetheless, since most corporations do not behave in this manner, it is necessary to address the question.

There are a number of reasons why one might want the CCT *not* to have a return-of-capital provision. First, it would be far simpler without it. Much of the complexity of current subchapter C flows from attempts to make this very distinction.⁵⁰ Second, dollars flowing out of any corporation are all equally green, with no difference in shading depending on the artificial constructs of earnings and return of capital. Such artificial constructs tend to induce tax-motivated behavior, and it is such behavior that the CCT is designed to eliminate. Third, common stock is, at least in theory (a theory contradicted by redemptions or acquisitions), a perpetual instrument. As such, it produces various cash flows through time—cash flows that one can credibly view as being paid solely out of earnings on the originally invested capital—and only returns its capital in the infinite future. The net present value of the expected return of capital is therefore zero. Thus, there is no need

⁵⁰ In subchapter C, the distinction is generally relevant to questions of shareholder taxation, usually arising in the guise of basis recovery. A sort of exception is the dividend definition of § 316 and its interplay with § 312. Those rules (as well as rules imbedded in them, such as depreciation rules) are the best analogue to the concept "return of capital" as used in the CCT. In any event, one could argue that the wholesale preservation of the shareholder tax regime by the CCT—at least in its simple form—means that there is little incremental complexity from adding a return-of-capital provision. This is incorrect. The question here is one of complexity at the corporate level, not at the shareholder level.

to have a special provision reducing the corporate “tax” in the case of a return of capital.

There are, of course, some good counter arguments. First, without a return-of-capital provision, it is hard to characterize the CCT as an “income” tax. For whatever the infirmities surrounding the appellation “income,” the notion clearly contemplates that no tax is due if there has been no net activity. But without a return-of-capital provision, an incorporation followed by an immediate liquidation would produce positive “tax.” Second, while it is possible to argue for the propriety of not having a return-of-capital provision with respect to common stock, it is problematic to make such argument for preferred stock of fixed maturity.⁵¹

Balancing these considerations, I opt for a sort of compromise return-of-capital provision that treats capital invested in a class of stock as being permanently invested, subject only to the caveat that when the class of stock is entirely redeemed or retired, such capital would be returned.

Rule 3.1: Return of Capital. Payments made by a domestic corporation to its equity holders with respect to its equity generally are deemed to be returns *on* rather than returns *of* capital, and therefore are governed by Rule 2.1. If, however, all shares of a given class of equity are either redeemed by the issuing corporation or acquired by another domestic corporation, an allowance⁵² for a return of capital is made that is equal to the amount of paid-in capital for all shares of the class.⁵³

Example 3: On incorporation, XYZ received \$1,000—or \$10 per share—for its 100 shares of common stock (it also issued 25 phantom shares to the fisc). If XYZ redeems 20 shares of common stock from private shareholders for \$5 per share, it would be required to redeem five phantom shares from the

⁵¹ It would be equally problematic if the CCT were applied to returns from debt instruments as it might be, for example, if one wanted to obliterate the debt-equity distinction.

⁵² The fact that this is a class-based definition, at the margins, will create an incentive to multiply classes of equity to take advantage of this provision. I do not consider this to be a significant problem, since I believe that the potential loss of liquidity from multiplying classes of equity would place a sharp limit on such practice. Of course, in cases where liquidity is irrelevant—privately held corporations—the problem would likely persist.

⁵³ In the case of an issuance of shares in exchange for property, rather than cash, the return-of-capital provision theoretically could credit the contributor’s basis or the fair value of the property at the time of contribution. An analogy to § 351 and § 362 would provide credit only in the amount of the contributor’s basis. This would lead to the same sort of double taxation of built-in gain or loss as under current law. Since there is no compelling justification for such double taxation—particularly when § 351 protects the fisc *viz.* the contributor’s gain or loss—the better rule would seem to be to provide credit on the basis of fair market value.

fisc for \$5 per share. That is, since less than all of the common stock was redeemed, the redemption would be governed by Rule 2.1. If *ABC* subsequently purchased the remaining 80 shares of common stock from private shareholders for \$20 per share, it would be entitled to treat \$12.50 per share of such amount as a return of capital ($\$1,000/80 = \12.50). Accordingly, *ABC* would be required to redeem the 20 phantom shares owned by the fisc for \$7.50 per share ($\$20 - \12.50).

Of course, not every distribution by a corporation involves cash. Thus, a rule is required that protects the fisc in the event of in kind distributions.

Rule 4.1: Distributions of Property Other Than Stock. A distribution of property (other than stock of another domestic corporation) by a domestic corporation is treated identically to a distribution of cash (that is, under Rules 2.1 and 3.1). The fisc, however, is entitled to have its share paid in cash.

Example 4: Assume all of the stock of *XYZ* is held by individual *A*; the fisc has a 20% phantom interest. If *XYZ* distributes an asset worth \$100, the fisc is entitled to take a 20% undivided interest in the asset, with *A* receiving an 80% undivided interest. Alternatively, the fisc could insist on a cash payment in lieu of the undivided interest. In that case, *XYZ* presumably would distribute \$20 of cash to the fisc and would distribute the asset, encumbered by a \$20 liability, to *A*.

In *Example 4*, one would expect *XYZ* to attempt to play a valuation game with the asset, claiming a fair market value of something less than \$100. While this is clearly a problem, it is conceptually identical to the problem that arises under current law whenever a corporation distributes an illiquid asset with built-in gain. Thus, it is not a problem unique to the CCT.⁵⁴ But it is also not a problem cured by the CCT.

While a regular and reliable cash flow would not be a problem for the fisc under iteration #1 if corporations did indeed annually distribute the entirety of their after-tax economic earnings, the sad truth is that they do not and that they cannot be expected to. Indeed, if tax payments were in some sense voluntary (as they are under the CCT), one might fear concerted action on the part of U.S. corporations, pur-

⁵⁴ Generally, constructive dividend issues would continue unabated under the CCT. Thus, the CCT similarly would have no superior answer if, in the example, *XYZ* "sold" *A* the asset for less than \$100.

suant to which no corporation would ever again distribute any cash to any shareholder.⁵⁵ This means, among other things, that it might be prudent to provide the fisc with the right to sell its phantom shares. But the sale question is complicated, since the fisc's phantom shares in two significant respects would not be interchangeable with those of other shareholders: The phantom shares would have no vote and the phantom shares would not be entitled to any payments in respect of returns of capital. Here are some possibilities.

Rule 5.1: Sale of Government Shares (a Menu). *Option 1:* The fisc's phantom shares would not be transferable. This option avoids all the technical difficulties, and is arguably the most congruent with the fisc's rights under current law.⁵⁶ *Option 2:* The fisc's shares would be freely transferable, and the transferee would succeed only to the rights granted to the fisc under the CCT. This option also avoids a host of technical issues, but grants the fisc a right to cash at times other than those chosen by the corporation. As a practical matter, the phantom shares would constitute a different class of stock than the underlying shares, but the sophistication of modern capital markets is such that one would expect little difficulty in the pricing of such shares. *Option 3:* The fisc's shares are freely transferable, but convert into shares of the underlying class on transfer. This option avoids the problem of creating a second class of stock, but does so at the cost of giving the fisc superior rights on sale to those that it theoretically should be entitled to.

One important thing to consider, in choosing among the foregoing options, is that a transfer of shares by the fisc precludes the fisc—in iteration #1—from ever again receiving revenue with respect to the transferred fraction of the corporation's activity. Thus, for example, a government intent on covering short-term spending needs might sell its entire portfolio of phantom shares, and thus would be permanently left without any future revenue from the corporate sector (ignoring for this purpose subsequent share issuances). Such government behavior strikes me as almost inevitable. Moreover, after the wholesale disposition of phantom shares, it is not unlikely that the government would attempt to reintroduce some sort of corporate tax. Sort of having one's cake and eating it too. My fear of the likelihood of this pattern of behavior leads me to choose Option 1. But this choice will

⁵⁵ For reasons having to do with the tax advantages of not making current distributions, advantages that are exacerbated under the CCT, see Section III.C, this possibility is more than merely a manifestation of paranoia.

⁵⁶ Under current law, the fisc cannot sell its right to future tax receipts of an individual corporation (although government debt issuance is arguably a partial sale of future tax receipts from all taxpayers). On the other hand, the lack of this right does not affect the ability of the fisc to obtain a cash flow from such corporation.

be of short duration, since both the second and third iterations of the CCT will naturally accommodate a government right to sell shares.⁵⁷

To round out the basic rules of iteration #1, it is necessary to have a rule regarding equity outstanding at the time the CCT becomes effective. Since the goal of the CCT is to replace (but largely replicate) the current corporate income tax regime, it should be unproblematic to apply the CCT from the moment the current regime ceases to apply.

Rule 6.1: Transition Rule. Upon implementation of the CCT, no further corporate income tax would accrue under the current tax regime. Instead, the fisc would be issued phantom equity pursuant to Rule 1.1 with respect to all existing corporate equity as if all such equity were newly-issued on the date the CCT goes into effect. For purposes of the return of capital provision, paid-in capital would include the earnings and profits of existing corporations at the time of the conversion from the current tax regime to the CCT (for otherwise the same corporate income would be twice subjected to the same corporate tax).⁵⁸

Example 5: XYZ Corporation has 400 shares of common stock outstanding on January 1, 2002, the date on which the CCT goes into effect. If the initial Rule 1.1 tax rate were 20%, XYZ would be required to issue 100 phantom shares of common stock to the fisc on that date.

In the case of a corporation that annually distributed all of its after-tax economic earnings, this “transition rule” would create no windfall gains or losses, nor any other pre-implementation dislocations. Such corporation would continue to earn and then part with cash in the same pattern after implementation of the CCT as before. But market equilibrium is not based solely on such corporations. Thus, one can imagine a variety of corporations that might be affected by enactment of the CCT.

In general, conversion to iteration #1 of the CCT would yield a transition gain to existing shareholders since cash in corporate solution

⁵⁷ See Sections III.D and III.E.

⁵⁸ As in footnote 53, regarding contributions of property in exchange for shares of stock, one could alternatively argue for giving credit in an amount equal to the fair market value of the corporation on the date of transition. This would put existing stock on a par with newly-issued stock, and would preserve the ability of the CCT to tax what it is designed to tax: economic income accruing to all stock (from the date of enactment). Giving credit only for earnings and profits as of the transition date, however, is all that is technically required in order to nominally prevent double taxation of corporate income that already was taxed under the prior regime. Since I think the better answer is not to have a return-of-capital provision in the CCT regime at all, I do not expend much thought on which alternative is better.

can be reinvested free of corporate tax after implementation of the CCT, making such cash more valuable.⁵⁹ Offsetting this may be a transition loss resulting from the fact that a fraction of *all* future distributions would be siphoned off by the fisc. Likely winners of the trade-off would be corporations currently paying a high effective rate of tax but generally retaining their earnings. Such corporations would be able to shift a fraction of their cash outflows from the fisc to their private shareholders. Likely losers would be corporations currently paying a low effective rate of tax but making frequent distributions to their shareholders (for example in the form of periodic stock repurchases). Such corporations would be forced to shift a fraction of their cash outflows from their private shareholders to the fisc.

B. Rates and Revenues

There are at least two straightforward ways to take a cut at the question of what the Rule 1.1 tax rate should be (that is, the share of phantom equity the fisc receives with respect to any new issue). The first is a bottom-up approach, which I already have suggested. It observes that an *effective* corporate tax rate of t implies that the fisc already effectively “owns” $t\%$ of certain corporations (that is, those making full annual distributions).⁶⁰ It therefore follows that, under the CCT, the fisc should own $t\%$ of each corporation’s equity. Thus, if the stated corporate tax rate of 35% is the intended effective tax rate, the fisc would be issued approximately .54 phantom shares for each real share of stock issued to noncorporate shareholders.

Of course, the stated 35% corporate tax rate is too high a figure for the effective tax rate. Indeed, 1996 figures show total corporate tax payments of \$171 billion on total corporate net taxable income of \$806 billion, for an effective 21% tax rate based on *taxable income*.⁶¹ Using this alternative effective tax rate would result in a far more modest phantom stock issuance of .27 phantom shares per real share. And even this effective tax rate probably dramatically overstates the true

⁵⁹ See Section III.C.

⁶⁰ The fisc generally would own a greater share of other corporations. To see this, compare the stream of cash flows received by the fisc and that received by shareholders, and discount them each at their appropriate rates. Since t is the effective tax rate, it represents a real steady stream of cash earned by the fisc. The remaining income earned by the corporation may be distributed or reinvested. But assuming no returns of capital, at most $(1 - t)\%$ of earnings would be distributed to private shareholders. Thus, in every year, the fisc would receive at least $t\%$ of all amounts distributed, and so effectively would own at least $t\%$ of the corporation. (Note, further, that the stream of cash to be received by the fisc is surely less risky than the stream of cash to be received by other shareholders. Thus, the discount rate to be applied to such flow is surely lower. This, too, makes such flow more valuable).

⁶¹ IRS, Statistics of Income 1996, Corporation Tax Returns 51 tbl. 5 (1999).

effective tax rate, due to a number of factors, including accelerated depreciation, the realization principle, and other deferral opportunities such as good old malignant tax shelters, all of which work to depress taxable income relative to economic income. For example, in 1996, the increase in market value of the Wilshire 5000 (which somewhat understates the increase in market value of all U.S. corporations for such year) was \$1.141 billion.⁶² Again using aggregate tax collections of \$171 billion, this implies an effective tax rate of 13%. Accordingly, with such rate, the fisc would receive approximately .15 phantom shares for each newly issued share.⁶³

The second approach to tax rates is a top-down approach. It does not focus on the value of what is “owned” by the fisc, but rather on the fisc’s current cash receipts, attempting to keep such receipts constant on conversion to the CCT. Since the mechanics of payment to the fisc under the CCT would differ radically from those under the current tax regime, any estimate of receipts is apt to be somewhat speculative. One could begin, however, with an estimate of corporate distributions—dividends, stock buy-backs, and cash mergers—under current tax law, add current corporate tax payments, and conclude that corporations in the aggregate were able *and generally willing* to carry on without that amount of cash under current law. If they made the same decisions under the CCT—a question to be taken up in a moment—it is a trivial matter to calculate the fisc’s required share.

Proceeding somewhat unscientifically, it appears that in 1996, corporations made roughly \$307 billion of distributions (dividends, redemptions in excess of paid-in capital, cash acquisitions in excess of paid-in capital) to equity holders.⁶⁴ In addition, they paid \$171 billion in taxes.⁶⁵ Thus, corporations, partly voluntarily and partly involuntarily, parted with \$478 billion of cash. If this amount continued to be distributed under the CCT, the fisc would need to receive approximately 36% of the total. This would mean that the fisc should be issued approximately .56 shares of phantom stock for every share of stock issued to others.

⁶² See 5 CDA Wiesenberger Mutual Funds Update 1 (Dec. 31, 1996); 4 CDA Wiesenberger Mutual Funds Update 1 (Dec. 31, 1995).

⁶³ This estimate, based on a single year, is necessarily quite bad, since changes in aggregate market value vary wildly from year to year. Nonetheless, the key point is that, when averaged over a number of years, this measure likely produces a lower effective tax rate than the other measures. And it is this effective tax rate that is most relevant.

⁶⁴ Retained earnings during 1996 rose by \$328 billion. Statistics of Income, note 61, at 37 tbl. 2. This amount should equal the excess of net income (\$806 billion) over taxes paid (\$171 billion) and distributions made (broadly defined). Thus, the latter amount should be \$307 billion.

⁶⁵ See note 61.

The plausible range of tax rates set forth above is, of course, disconcerting. But better data would surely improve the estimate. And, in any event, if the CCT were implemented, and if the initial phantom stock issuance rate was too high or too low—relative to revenue needs—it could be adjusted, exactly as the current corporate income tax rate can be adjusted (and occasionally is). Such adjustment, which would be the functional equivalent of a change in tax rates under current law, would involve nothing more than multiplying the fisc's phantom shares by a factor that would produce, after the multiplication, the newly-desired ownership interest.

A final related point is that iteration #1 of the CCT almost surely would result in a different pattern of tax payments than the current corporate tax, for tax payments under the CCT are correlated with corporate distributions (broadly defined), rather than with "corporate taxable income." Since making corporate distributions is in some sense a more voluntary activity than is earning corporate taxable income, one generally would expect tax collections based on the former to be more lumpy than those based on the latter.⁶⁶ On the other hand, the pattern of tax payments under the CCT surely would be less lumpy than that under the various mark-to-market regimes discussed in Section II.B, since corporate distribution patterns are surely more stable than are changes in market price.⁶⁷

⁶⁶ This need not be so. For example, on a corporation-by-corporation basis, it may be true that a cash flow based on distributions is smoother than the tax cash flow based on income. This is particularly true for so-called cyclical businesses that may have extended periods of negative taxable income, but still find it in their interest to maintain dividend payments during such periods.

⁶⁷ One could attempt to make the comparison rigorous using historical data. Thus, for example, during the three years 1993, 1994, and 1995, the corporate income tax raised approximately \$120 billion, \$135.5 billion, and \$156.5 billion, respectively. IRS, *Statistics of Income 1993: Corporate Income Tax Returns* 2 fig. A (1996); IRS, *Statistics of Income 1994: Corporate Income Tax Returns* 37 tbl. 2 (1997); IRS, *Statistics of Income 1995: Corporate Income Tax Returns* 37 tbl. 2 (1998). During such years, the total distributions made by corporations appears to have been \$292 billion, \$442.5 billion, and \$83.5 billion, respectively, based on net retained earnings numbers reported on corporate tax returns. *Id.* Obviously, these numbers are suspect. Finally, the total changes in market value of publicly traded equities, as measured by the Wilshire 5000, was \$383 billion, -\$132 billion, and \$1.516 billion, respectively. See CDA Wiesenberger Mutual Funds Update 1 (Dec. 31, 1992); CDA Wiesenberger Mutual Funds Update 1 (Dec. 31, 1993); CDA Wiesenberger Mutual Funds Update 1 (Dec. 31, 1994); CDA Wiesenberger Mutual Funds Update 1 (Dec. 31, 1995). These numbers, if accurate, would seem to indicate that revenues under the current regime are the most predictable (least lumpy), those under the CCT are likely to be less predictable, and those under a mark-to-market-based regime are likely to be the least predictable.

*C. The Gaping Hole in Iteration #1: Corporate
Reinvestment Incentives*

One beauty of the CCT (both in iteration #1 and those presented below) is that no corporation would be forced, on an ongoing basis, to part with cash unless it “wanted” to. But that begs the question of whether any corporation would ever want to. The glib answer is that corporations currently part with cash for dividends, stock repurchases, and cash acquisitions, even though every such parting may inefficiently accelerate a tax burden (not, in general, a corporate tax burden, but a shareholder tax burden). If corporations behave in this arguably “irrational” way under current law, why not expect the same under the CCT?⁶⁸

Perhaps what transpires under current law is not so irrational as it at first appears. After all, the value of any financial instrument—including corporate equity—is the discounted value of the cash flows such instrument is expected to produce in perpetuity. If Microsoft announced tomorrow that it would never return a penny to shareholders—not only retaining its vaunted (and arguably rational) no-dividend policy, but also ending its spate of stock repurchases—its shares likely would drop in value to zero, at least if the market thought the announcement credible.

But the fact that returns of cash to equity holders would likely continue under the CCT does not address the more difficult question of how such returns might change. This requires an examination of why corporations distribute cash. There are two distinct sets of reasons. First, a corporation may distribute cash—irrespective of its expected returns from investing such cash—if the distribution serves some larger purpose. Perhaps the most important such purpose is to send a signal to equity holders: either a signal about the prospects for the corporation’s future earnings, or [alert: sarcasm ahead] a signal that the management is disciplined and fiscally responsible and really truly cares about the masses holding the corporation’s shares! There is no simple way to assess a management’s incentives for making such distributions. But there is no a priori reason to believe that a management’s incentives for making such distributions would be different (or less) under the CCT than under current law. Thus, such distributions presumably would be unaffected by a conversion to the CCT.

⁶⁸ A second glib answer is that the fisc should not care about the rate of distribution. Unlike under current law, where the fisc’s claims are inchoate, the government would affirmatively hold assets, easily capable of valuation, and (even if transfer of such assets were prohibited) presumably could borrow more efficiently against these than against more general future revenues. It would be a sort of “going on margin.”

Second, a corporation may distribute cash when it simply has nothing better to do with the cash. Consider, under current law, a corporate CFO who has \$1 sitting in her corporation's coffers at time zero. She can distribute the dollar, resulting in value of \$1 to the equity holders (prior to any equity holder taxes). Or she can reinvest the dollar at the risk-adjusted pre-corporate-tax rate of return s' peculiar to her corporation. The reinvestment would yield a certainty equivalent of $[1 + (1 - t)s']$ to distribute next year. If the risk-adjusted market discount rate applicable to equity holders is r , the net present value to an equity holder of next year's distribution would be $[1 + (1 - t)s']/(1 + r)$. This will be less than 1—implying that current distribution is the rational decision—if and only if $s' < r/(1 - t)$.⁶⁹

Now consider the same CFO with the same dollar under iteration #1 of the CCT. Assuming a “tax” rate of t , the CFO, through a current distribution, could place $(1 - t)$ of value in the hands of her private equity holders (prior to any equity holder taxes). The remaining t would be paid to the fisc.⁷⁰ If, however, the CFO reinvested the dollar at the same risk-adjusted pre-“tax” rate of return of s' peculiar to her corporation, there would be $(1 + s')$ available for distribution in the following year. Again taking r as the market discount rate for holding corporate equity, the net present value of next year's distribution to private equity holders would be $[(1 - t)(1 + s')]/(1 + r)$. This is less than $(1 - t)$ —implying that current distribution is the rational decision—if and only if $s' < r$.⁷¹ Thus, relative to the current corporate tax regime, iteration #1 of the CCT discourages the distribution of earnings, or equivalently, encourages their retention.⁷² Accordingly, itera-

⁶⁹ If s is the risk-adjusted pre-corporate-tax rate of return available to corporations generally, then s must equal $r/(1 - t)$. This, in turn, means that distribution is rational so long as $s' < s$, that is, so long as the corporation has only inferior (to the corporate market as a whole) investment opportunities. This is hardly a surprising result.

⁷⁰ This assumes that the return-of-capital provision played no significant role (which generally should be a safe assumption after a sufficient period of corporate existence when the amount of capital represented by any share is likely to be *de minimis*).

⁷¹ If s is the risk-adjusted pre-corporate-tax rate of return generally available to corporations, this distribution criterion can alternatively be written as $s' < (1 - t)s$. Thus, the corporation would make investments that generally should not be financed with corporate equity. Note that it is not entirely clear whether this is a good or a bad thing, or even to what extent it is a different thing. That is, the lower investment hurdle r is applicable under current law to investments made by noncorporate persons. Moreover, it is even the hurdle applicable to corporations under certain circumstances (for example, the corporation has sufficient NOLs so as not to pay taxes, or the corporation finances its incremental investments solely with debt).

⁷² Technically, this is only necessarily true if the rate of return r demanded by investors was the same in the CCT world as under the current tax regime. And it would not be, at least under the CCT as so far described, since interest rates would adjust to take into account the higher returns generally available to corporate investment. My goal for the CCT, however, is to replicate the current tax regime (albeit without the current incentives

tion #1 of the CCT *would* raise less revenue than one otherwise would expect based on current corporate distribution policy.

Example 6: Assume the current tax regime is in place. XYZ has \$100 of invested capital and earns a pretax return of 10% on such capital, thus earning \$10 in Year 1. If the effective tax rate is 20%, XYZ must pay \$2 in taxes and additionally can distribute some or all of its \$8 remaining.

Suppose XYZ reinvests the \$8, again at 10%, earning an incremental \$.80 in Year 2. Of this amount, 20% or \$.16, is paid in taxes, and the remaining \$.64 is available to distribute to shareholders at the end of Year 2. Thus, the decision to reinvest \$8 at the end of Year 1 produces the ability to distribute an incremental \$.64 at the end of Year 2 and every year thereafter. Provided $r = 8%$, a shareholder of XYZ would be indifferent to a receipt of \$8 in Year 1 and a receipt of \$.64 in Year 2 and every year thereafter.

Example 7: Assume iteration #1 of the CCT was in effect, and that the fisc had a phantom equity stake of 20% in XYZ. As in *Example 6*, XYZ has \$100 of invested capital and earns a pre-“tax” return of 10% on such capital, thus earning \$10 in Year 1. XYZ could, but would not be required to, distribute some or all of the \$10 to its equity holders. If XYZ distributed the entire \$10, its private shareholders would receive \$8 and the fisc would receive \$2. If instead XYZ reinvested the entire \$10, again at 10%, it would earn an incremental \$1 in Year 2. Thus, the reinvestment would permit XYZ to distribute an incremental \$.80 to private shareholders at the end of Year 2 and in every year thereafter. Assuming $r = 8%$, that is, that the CCT has been properly constructed so that shareholders demand the same returns as in the current world, a shareholder would prefer a receipt of \$.80 in Year 2 and every year thereafter to a Year 1 receipt of \$8.

D. Iteration #2

Iteration #1 of the CCT functions admirably under the very unrealistic assumption that corporations annually disgorge the entirety of their after-tax economic income to their equity holders. As if that

to distort corporate taxable income). Thus, if I do my job well, r would be the same under the ultimate CCT as in the current world. Thus, there is no loss from already assuming equality.

assumption were not bad enough in and of itself, however, the structure of iteration #1 incrementally discourages corporations from doing that very thing. Thus, it is necessary to devise an alternative, which in an excess of creative zeal, I call iteration #2. This alternative is motivated by the desire to “get the tax right” under the only slightly less unrealistic assumption that corporations *never* disgorge any cash to their equity holders. But, as becomes apparent, it in fact “gets the tax right” more generally.

How can one construct a government equity stake that protects the fisc (necessarily in a valuation sense, rather than a cash flow sense) if corporations reinvest all their cash? My approach is to equate the returns of private equity holders under iteration #2 to their returns under the current tax regime. Then, so long as the conversion from the current regime to iteration #2 neither creates nor destroys wealth,⁷³ the fisc’s interest under both regimes—which is everything other than the private equity holders’ interests—also must be identical. So the trick is to construct and adjust the fisc’s equity interest in each corporation in such a way that private equity holders get exactly the same return under iteration #2 as they would under the current tax regime. Or, equivalently, the trick is to construct and adjust the fisc’s equity interest in each corporation in such a way that the expected risk-adjusted rate of return earned by a corporation and available for distribution to its equity holders is reduced from s to $(1 - t)s$. The following rule, which I call the reinvestment provision, due to its effect on corporate reinvestment decisions, accomplishes this.

Rule 1.2: Issuance of Equity (aka Reinvestment Provision). Let s be the risk-adjusted pre-corporate-tax rate of return available with respect to corporate investments, and let t be the desired effective tax rate. Then if $y(n)$ is the share of a domestic corporation’s equity owned by the fisc at the beginning of Year n , $y(n + 1)$, the share of such corporation’s equity owned by the fisc at the beginning of Year $(n + 1)$, must equal $1 - (1 - y(n))[(1 + (1 - t)s)/(1 + s)]$. In particular, if $y(n) = 0$, then $y(n + 1) = 1 - [(1 + (1 - t)s)/(1 + s)]$. Mechanically, the fisc would be issued equity each year, in whatever quantity is necessary to raise the fisc’s ownership share to the level specified in this rule. As in iteration #1, and for the same reasons, such equity would be nonvoting. For reasons stated below, however, such equity can in all other respects be “real,” and so I do not call it “phantom” equity.

⁷³ If behavior under the CCT replicated current behavior, and if an appropriate transition rule were implemented, this generally should be the case, except to the extent that the new tax system, by being more efficient, increased economy-wide income. It is convenient to ignore this increase. In any event, such increase should not hurt the fisc.

To see that this rule indeed accomplishes its goal, consider \$1 invested in corporate solution and beneficially owned by a private investor. In one year, this \$1 grows to $(1 + s)$. But the investor's claim is no longer to the entire amount. Rather, she is entitled only to the fraction $[(1 + (1 - t)s)/(1 + s)]$ of such amount, or an aggregate of $(1 + s)[(1 + (1 - t)s)/(1 + s)] = (1 + (1 - t)s)$. Accordingly, as advertised, she earns an after-corporate-tax rate of return of $(1 - t)s$, precisely as under the current tax regime.

Example 8: As in *Example 7*, XYZ has \$100 of invested capital and earns a pre-“tax” return of 10% on such capital, thus, earning \$10 in Year 1. Suppose XYZ reinvests this amount. If the fisc initially has no ownership interest in XYZ's equity, and if $t = 20\%$, then, at the end of Year 1, the fisc would receive $1 - [(1 + (0.8)(0.1))/1.1]\%$ or 1.82% of XYZ's equity. Since the entirety of XYZ's equity is worth \$110, the value of the fisc's piece is \$2 (assuming no return-of-capital provision). Hence, the private shareholders of XYZ have indeed seen their Year 1 return from their investment in XYZ fall from \$10 to \$8, and the rate of such return fall from 10% to 8%.

While this is the desired result, it is important to note that the same result holds if the corporation has a more liberal distribution policy.

Example 9: As in *Example 8*, except that XYZ annually distributes the \$10 it earns. Thus, in Year 1, it would distribute \$9.82 to its private shareholders and \$.18 to the fisc. In Year 2, following a second application of Rule 1.2, it would distribute \$9.64 to its private shareholders and \$.36 to the fisc. In Year n , following n applications of Rule 1.2, it would distribute $\$(1.08/1.1)^n \times 10$ to its private shareholders and the remainder of its \$10 of earnings to the fisc. Under these facts, the cash stream received by private shareholders would be worth exactly \$100 at an 8% discount rate. This is just another way of saying that such shareholders indeed would receive exactly a return of 8% on their corporate investment.

All of this illustrates that Rule 1.2 restores the corporation's reinvestment incentives to those existing under current law. For suppose that during Year n , a corporation has \$1 in its coffers. It must decide whether to distribute the dollar or not. If the dollar were distributed, the corporation's equity holders other than the fisc would receive $(1 - y(n))$ and the fisc would receive $y(n)$. If, instead, the corporation rein-

vested the dollar at its peculiar risk-adjusted pre-“tax” rate of return s' , the dollar would grow to $(1 + s')$ by the beginning of Year $(n + 1)$. Thus, in Year $(n + 1)$, the corporation could distribute $(1 - y(n + 1))(1 + s')$ to its private equity holders and $y(n + 1)(1 + s')$ to the fisc. Comparing the two strategies, private equity holders would favor current distribution only if $(1 - y(n + 1))(1 + s')/(1 + r) < (1 - y(n))$, or $s' < [(1 - y(n))/(1 - y(n + 1))](1 + r) - 1$. But under Rule 1.2, $[(1 - y(n))]/[(1 - y(n + 1))] = (1 + s)/[(1 + (1 - t)s)]$ where s is the risk-adjusted pre-“tax” rate of return generally required to justify making an investment in corporate form, so that $s = r(1 - t)$. Substituting into the prior inequality yields the result that private equity holders will favor current distribution only if $s' < s$. This is the same distribution criterion as under current law.

Of course, iteration #2 of the CCT is in need of additional rules, and these largely parallel those of iteration #1.

Rule 2.2: Payments in Respect of Equity. The equity of any class owned by the fisc entitles the fisc to participate ratably with other outstanding equity of such class in any cash payments made by the issuing corporation *or any other domestic corporation* with respect to such class.

Rule 3.2: Return of Capital. Since the equity the fisc receives under Rule 1.2 is based solely on deemed *income* of the corporation, it would be wrong to reduce that right in any way by giving privately owned shares a return-of-capital allowance. Accordingly, there is no return-of-capital allowance.

Rule 4.2: Distributions of Property other than Stock. Same as Rule 4.1.

Rule 5.2: Sale of Government Shares. In this iteration, the fisc *must* be given the right to sell its shares, since the paradigm assumes that there will *never* be corporate cash distributions. But giving the fisc this right should be largely unproblematic, since there is no difference in economic rights between the fisc’s shares and anyone else’s. Nonetheless, the sale right introduces at least two issues. First, should the fisc’s shares become voting (to the same extent as other shares of like class) once they have been sold? While this question sounds partly in fungibility, the larger issue is whether the tax system should be allowed to slowly dilute the voting interests of controlling shareholders—something the current tax regime does not do. I do not think there is a right or wrong answer to this question, but there must be an answer. Since, however, it plays no role in subsequent analysis, I take no position.

The second question is the extent to which one should allow the fisc to engage in market timing. This is a paternalism question, although

one in the somewhat unusual posture of having the legislature implementing iteration #2 of the CCT deciding the extent to which future government action should be constrained. Again, I take no position on this. The reason is that the annual receipt of shares by the fisc would be essentially a substitute for *current* cash tax revenues and therefore is ripe for immediate disposition. Assuming the government acts as I would expect it to, and immediately disposes of all shares received, there is no question of market timing.

Example 10: As in *Example 8* above, except that the fisc annually sold the shares it received. Thus, in Year 1, the fisc received and sold 1.82% of XYZ's equity. In Year 2, the fisc again received and sold 1.82% of XYZ's equity (now reflecting a slightly larger share base, however). By Year n , an original shareholder would have seen her share of XYZ drop from $w\%$ to $(1.08/1.1)^n \times w\%$. Given that the value of all of XYZ would have grown at an annual rate of 10%, however, this stake would be exactly what such investor should own assuming an 8% rate of return. The fisc, in turn, would garner cash flow from share sales of \$2 in Year 1, \$2.20 in Year 2, and so on. This would be exactly the cash flow it would receive from a 20% corporate tax under the assumption of full reinvestment of all earnings (including sufficient new investment to pay all taxes). This is also the same cash flow the fisc would receive under iteration #1 under the assumption that all amounts distributed were reinvested in new shares (funded by borrowing to the extent necessitated by the portion of the distribution going to the fisc).⁷⁴

Rule 6.2: Transition Rule. In a steady state world, where each corporation retains and reinvests all earnings, there would be no obvious transition difficulties, hence no need for a special transition rule. Rather, in the year of implementation, the current tax would fall away, and the new annual share extraction would take its place. Since the reinvestment provision of Rule 1.2 has the effect of making the expected effective tax rate of each corporation $t\%$,⁷⁵ windfall winners would generally be corporations currently paying higher effective tax

⁷⁴ Importantly, the regimes are not identical if there is a different tax imposed at the shareholder level, as there would be due to the current inclusion of dividends in the individual income tax base in iteration #1. This difference, however, is not one with respect to how much *corporate* income tax is collected. Thus, it has no more relevance than the difference in aggregate taxation under current law between income earned by a dividend-paying corporation and income earned by a non-dividend-paying corporation.

⁷⁵ The actual (ex post) effective tax rate may vary. See Section III.F.

rates than $t\%$, and windfall losers would generally be corporations currently paying lower effective tax rates than $t\%$.

E. Iteration #3: A Hybrid

Iteration #1 properly mimics the current corporate tax regime only if corporations behave in an unrealistic way. Iteration #2 functions properly in general, but dispenses with any semblance of permanent government share ownership (which, of course, may be a good thing). One might ask if there is a way to combine the approaches of the two iterations in a way that “works.” The answer is yes, but it is more complicated and hence less aesthetic.

Rule 1.3A: Issuance of Phantom Equity. Let $t\%$ be the desired effective tax rate. Then, as and when a domestic corporation issues new equity of any class to someone other than another domestic corporation, such corporation must simultaneously issue new “phantom” equity of such class to the fisc. The amount of phantom equity to be issued to the fisc will constitute $t\%$ of the new issue. As in prior iterations, such phantom equity is nonvoting.

Rule 1.3A is identical to Rule 1.1. Accordingly, Rule 1.3A functions adequately only if corporations annually distribute the entirety of their economic income. Suppose a corporation did not behave in this way. From Rule 1.2, it should be pretty clear that some sort of dilutive “excess accumulation penalty” can be added to Rule 1.3A to “get the tax right.” Sadly, such penalty is not pretty.

Rule 1.3B: Excess Accumulation Penalty. In Year n , let $y(n)$ be the share of a given class of corporate equity owned by the fisc. For example, $y(0) = t$. Let c be the economic capital underlying such class of equity. For example, if a corporation has only a single class of stock outstanding, and such stock is publicly traded, c theoretically would be the fair market value of the corporation’s outstanding equity.⁷⁶ Let s

⁷⁶ Determining the proper amount of capital is generally not trivial. In the case of public companies, fair market value of outstanding equity, including such real equity received by the fisc under Rule 1.3B but not phantom equity received under Rule 1.3A would be proper, since this is the amount that private individuals would be willing to pay to “replicate” the corporation. In the real world, however, market values are so volatile that one can make a strong argument that capital should be adjusted to dampen volatility, for example by taking the average market value over a suitably long period of time (such as two years). In the private corporation context, capital of necessity would need to be even more crudely approximated. The starting point would be actual paid in capital. Such amount would be adjusted annually at the assumed $s\%$ growth rate, and then reduced to reflect actual distributions. Such regime could then be supplemented by adding a periodic right (exercisable by either the corporation or the fisc) to establish a better valuation. Note, however, that either in the public or the private context, the incremental complexity posed by the need to ascertain the proper level of capital is such that it militates heavily against preferring iteration #3 of the CCT to iteration #2.

be the risk-adjusted pre-corporate-tax rate of return available on corporate investments. Thus, the corporation can predictably earn sc on its capital, meaning that a full distribution policy would result in annual year-end distributions of $y(n)sc$ to the fisc and of $(1 - y(n))sc$ to the corporation's other shareholders. If the corporation distributes at least this amount, there is no reason to issue additional equity to the fisc. Suppose, however, that the corporation distributes only a fraction d of this amount, so that the total amount distributed is dsc . Then, $y(n+1)$, the share of the corporation's equity owned by the fisc at the beginning of Year $(n+1)$ must equal $1 - (1 - y(n)) [(1 + (1 - t)(1 - d)s)/(1 + (1 - d)s)]$. Note that this formula is a generalization of the formula in Rule 1.2; in particular, if $d = 0$, this formula simplifies to that in Rule 1.2. As before, the fisc would be issued sufficient shares to raise its ownership interest to the level specified in the rule.

To see that Rule 1.3B indeed accomplishes the goal, consider \$1 invested in corporate solution at the beginning of Year n . Private shareholders beneficially own $(1 - y(n))$ of this \$1. The value of this privately-owned equity is $(1 - y(n))/(1 - t)$.⁷⁷ Absent the application of the excess accumulation penalty, and absent any distributions, the \$1 predictably grows to $(1 + s)$ by the beginning of Year $(n+1)$. Now, suppose the corporation distributes the fraction d of its income. For each \$1 invested, private shareholders thus receive $(1 - y(n))ds$. In addition, the original \$1 invested in corporate solution yields $(1 + (1 - d)s)$ invested in corporate solution at the beginning of Year $(n+1)$. But under Rule 1.3B, private shareholders beneficially own $(1 - y(n+1))\%$ or equivalently $(1 - y(n))[(1 + (1 - t)(1 - d)s)/(1 + (1 - d)s)]\%$ of this amount. Thus, private shareholders beneficially own $(1 - y(n))[(1 + (1 - t)(1 - d)s)]$ of corporate capital at the beginning of Year $(n+1)$, which is worth $(1 - y(n)) [(1 + (1 - t)(1 - d)s)]/(1 - t)$. Adding the two pieces together, private shareholders receive for their original $(1 - y(n))/(1 - t)$ in value of corporate equity a dividend of $(1 - y(n))ds$ and future value of corporate equity of $(1 - y(n)) [(1 + (1 - t)(1 - d)s)]/(1 - t)$. Simplifying this expression, private shareholders indeed earn a return of $(1 - t)s$.

Example 11: XYZ has \$100 of invested capital and earns a pre-“tax” return of 10% on such capital. Thus, in Year 1, XYZ earns \$10. Suppose that the fisc owned a 20% phantom interest in XYZ at the beginning of Year 1, and that $t = 20\%$. If XYZ distributed 40% of its income, it would distribute \$3.20 to its private shareholders and \$.80 to the fisc. Since such distribution would be less than the amount re-

⁷⁷ This follows from Rule 1.3A.

quired by Rule 1.3B, XYZ would be subject to the excess accumulation penalty. Under such penalty, the fisc's interest in XYZ would rise to 20.9%, and the private shareholders' interest would fall to 79.1%. Thus, of the \$106 remaining in corporate solution, private shareholders would have a claim to \$83.84 (ignoring return-of-capital provisions). This amount, invested in corporate solution, would be worth \$104.80. Putting the two pieces together, the private shareholders' original \$100 stake in XYZ would produce a dividend of \$3.20 and a new stake of \$104.80. Thus, the aggregate return received indeed would be 8%.

It is possible, and even necessary, to make a distinction with respect to the fisc's shares between those that are functionally Rule 1.3A shares—the $t\%$ phantom ownership the fisc receives ab initio—and the Rule 1.3B shares—the real shares that result from “insufficient” corporate distributions. For example, while it might be desirable to prohibit the fisc from selling the former, it is surely desirable to allow the fisc to raise periodic revenue by selling the latter. The only trick with respect to allowing such sales is to be sure to properly identify which of the fisc's shares fall under which rule. The following example demonstrates the identification procedure.

Example 12: Suppose, at the beginning of Year n , that XYZ was owned 70% by private shareholders and 30% by the fisc. If $t = 20\%$, and if XYZ had 100 total shares (real and phantom), the fisc's stake would necessarily consist of 10 Rule 1.3B real shares and 20 Rule 1.3A phantom shares. Suppose XYZ had invested capital of \$1,000. Then each real share including each Rule 1.3B share would be worth \$12.50, since that is what would need to be contributed into corporate solution to replicate XYZ in light of Rule 1.3A.

Let $s = 10\%$, so that $r = 8\%$. If XYZ made no distributions during Year n , then applying Rule 1.3B, the fisc's stake in XYZ would rise from 30% to 31.27%, which mechanically requires that 1.85 additional shares be issued to the fisc. Note that while all such shares would be issued under Rule 1.3B, they are not all real shares. That is, under Rule 1.3A, the fisc's phantom share of XYZ's equity must always be 20%. If such equity consists of 100 shares, the fisc must own 20 phantom shares. If such equity consists of 101.85 shares, the fisc must own 20.37 phantom shares. Thus, at the end of Year n , the capitalization of XYZ would consist of 70 privately owned real shares, 11.48 Rule 1.3B real shares owned

by the fisc (and subject to immediate alienation), and 20.37 phantom shares held by the fisc (and not subject to alienation).

To follow through, note that a return of $s = 10\%$ would increase the amount of invested capital in *XYZ* to \$1,100. Given the real share base of 81.48 shares, this means that each share would now be worth \$13.50. If the fisc chose to sell the incremental Rule 1.3B real shares received—1.48 shares—it thus would garner revenue of \$20. This, of course, corresponds exactly to a tax of 20% on *XYZ*'s income.

The other rules necessary to round out iteration #3 would track the rules in iteration #1, except as already noted regarding the fisc's right to sell its Rule 1.3B real shares. This congruity stands to reason, since the purpose of this iteration is simply to correct the reinvestment defect of iteration #1. I do not further belabor the additional rules.

F. The Zen of Tax-Free Reinvestment

Iterations #2 and #3 of the CCT—that is, the iterations that “work”—permit an increment of tax-free reinvestment that is arguably above and beyond that available under the current corporate income tax regime. Thus, consider a corporation that in Year m has an investment opportunity in a project with an n -year life at a compounding rate of return of s' . Under current law, and assuming that t reflects the effective tax rate on economic income, \$1 invested in the project grows to $(1 + (1 - t)s')^n$ over the project's life. In contrast, under the CCT, \$1 invested in the project grows to $(1 + s')^n$. The private equity holders' original stake of $(1 - y(m))$ shrinks under the CCT, however, to $(1 - y(n + m))(1 + s')^n$, which is just $(1 - y(m))[(1 + (1 - t)s)(1 + s')/(1 + s)]^n$. Comparing shareholder entitlements yields the result that more cash would be available at the end of the project for shareholders in the CCT world than under the current tax regime if and only if $(1 + (1 - t)s)(1 + s')/(1 + s) > 1 + (1 - t)s'$. This in turn simplifies to $s' > s$. Thus, above-market returns would compound somewhat faster under the CCT than in the current world. This is equivalent to saying that there would be a possibility of incremental tax-free accumulation in the CCT world.⁷⁸

Of course, the current corporate income tax regime does not come with entirely clean hands. Indeed, my intuition is that corporations with high rates of return are, under the current tax regime, able to

⁷⁸ The problem is actually magnified under iteration #3, to the extent that the corporation is private and has sufficient cash from other sources to fund the distributions necessary to forestall the excess accumulation penalty.

earn partially tax-free compounded returns exactly as in the CCT world. The reason for this is that economic income is not identical to taxable income, but is generally less identical in the case of corporations earning high rates of return than in the case of corporations earning low rates of return. That is, the effective tax rate on corporate economic income is not uniform across corporations, and is likely to be lower for corporations earning high rates of return. Such corporations tend to earn a disproportionately large amount of their economic income in the form of unrealized and hence currently untaxed appreciation of (intangible) assets. Since a smaller fraction of their income is taxed currently, their effective tax rate is lower. The difference between their effective tax rate and the “average” effective tax rate allows them to enjoy an increment of tax-free reinvestment.

Thus, suppose again that under the CCT, a corporation is able to earn an above-market rate of return of s' on its capital for a period of n years, beginning in Year m , before regressing to the mean market rate of return of s . During this period, it would be able to convert \$1 into $(1 + s')^n$. Thus, its private equity holders would be able to convert an entitlement to $1 - y(m)$ into an entitlement to $(1 - y(m))[(1 + (1 - t)s)(1 + s')/(1 + s)]^n$. Or by scaling up, they can convert \$1 into $[(1 + (1 - t)s)(1 + s')/(1 + s)]^n$.

Consider now the same corporation under the current corporate income tax regime. Let the nominal tax rate be t' and the “average” effective tax rate be t . Suppose the corporation’s taxable income is equal to $\delta t/t'$ of its economic income, for some $\delta > 0$.⁷⁹ Thus, if the corporation earns economic income at the rate s' , it earns taxable income at the rate $\delta t s'/t'$, and it pays tax at the rate $\delta t s'$. Thus, it is able to accumulate income at the after-tax rate of $(1 - \delta t)s'$, resulting in an effective tax rate of δt . Suppose during the n year period under consideration, $\delta = [(1 + s')s]/[s'(1 + s)]$. A little algebra shows that in this case, the corporation would have exactly the same amount of dollars available for distribution to private equity holders under the current corporate tax regime as it would have under the CCT. Accordingly, the increment of “tax-free compounding” available under the CCT can be perfectly replicated under the current corporate tax regime,

⁷⁹ δ may differ from one for a variety of reasons. In particular, δ may be less than one because the corporation earns an unusually high fraction of its economic income through unrealized appreciation. Alternatively, the corporation may simply successfully exploit a series of perfect tax shelters—that is, those that throw off tax benefits for merely moving cash around in a circle. Such shelters do not affect economic income (abstracting from transactions costs), but do reduce δ .

provided only that a corporation has a sufficiently low effective tax rate.⁸⁰

G. *An Odd Bird*

The CCT envisions that the fisc is permanently and/or would become periodically a phantom and/or real equity holder in each domestic corporation. To be sure, the fisc would be passive (in the sense of lacking voting rights), but an equity holder nonetheless. This may strike the reader as an odd way to structure a tax, but it is much less odd than it at first appears. Consider the following:

The current corporate income tax is a claim by the fisc to a certain fraction—the effective tax rate—of corporate income. The claim results in a series of cash flows made by each corporation to the fisc. As with any series of cash flows, those flowing from a corporation to the fisc can be thought of as a financial instrument. Among the hallmarks of the fisc's financial instrument are (1) it is based on the corporation's income, (2) it makes payments currently, (3) it has priority over most other claims, (4) it is nontransferable, and (5) it is nonvoting. While it is generally intellectually meaningless to characterize a given instrument as debt or equity, I nonetheless note that the "instrument" the fisc holds under current law would quite likely be characterized as equity for tax purposes. The reason is that its single equity feature—the relationship of payments under the instrument to corporate income—is so significant as to swamp the other features. In short, the fisc's claim participates; it does nothing but participate.

Thus, it is no real stretch to say that the fisc is already an equity holder—albeit without an instrument (other than the Code) formalizing its stake—in every domestic corporation. But more is true. As noted in deriving the iterations of the CCT, the fisc is already the holder of an equity instrument that is—under certain assumptions—equivalent to the one it would receive under the CCT. Formalizing this relationship with explicit equity is thus the very opposite of odd. It is natural. And it makes the true nature of the fisc's relationship to other equity owners manifestly more transparent.

⁸⁰ Under iteration #3, for public corporations, there may actually be less ability to reinvest "tax-free" under the CCT than under current law, at least to the extent that the definition of invested capital takes market value into account. The reason for this is that the market value of the equity of public corporations generally should reflect their above-market opportunities. Hence, the equity itself would be priced to yield merely market returns. Thus, if the Rule 1.3B excess accumulation penalty is based on market value, rather than historic invested capital (as it presumably would be for a private corporation), the ability to earn partially tax-free compounded returns based on the infirmities of the latter measure entirely disappears (albeit with a likely lag).

At least on some intuitive level, the joint ownership or “partnership” between shareholders and the fisc is something that is well understood by U.S. CFOs. It is not at all unusual to hear CFOs refer to the Service as the corporation’s “partner”: an unwanted partner, a partner to be stiffed at every turn, but a partner nonetheless. The beauty of formalizing the partnership between the shareholders and the fisc through explicit equity ownership is that it places the partners on a more equal footing: eviscerating many opportunities for the shareholders and their representatives to strategically expropriate the value of the fisc’s stake.

H. It Walks Like a Duck

Although the CCT is clearly a tax, it is less than obvious that it is an income tax.⁸¹ On one level, the best response to that observation is: Who cares? So long as the CCT “works,” so long as it raises the requisite revenues from the desired sources with less distortion and lower transaction costs than the current tax, it should not matter whether it falls into any given pigeonhole. Particularly when the pigeonholes themselves—income tax, property or wealth tax, consumption tax, cash flow tax—are not as distinct as language makes them out to be.

In order to determine whether the CCT—or any tax—is a tax on corporate income, it is necessary to know what is meant by corporate income. Practitioners have no trouble with this question: They know corporate income when they see it. Academicians and other deep-thinkers are more skeptical. One particularly poignantly observed: “A corporation cannot have income, any more than it can have a blood type.”⁸² The skepticism is well-founded. Personal income has had a relatively accepted definition for many years: the sum of (1) the taxpayer’s consumption during a given tax period and (2) the taxpayer’s change in wealth during the given period.⁸³ But this definition does not carry over to corporations. There is no useful sense in which corporations can be said to consume anything (at least not in the way humans consume things). Nor is there any useful sense in which corporations can be said to possess wealth, changing or otherwise (since all corporate assets are held merely to satisfy the claims of various interest holders).

⁸¹ For an interesting debate on “what’s in a name,” see Jeff Strnad, *Taxation of Income from Capital: A Theoretical Reappraisal*, 37 *Stan. L. Rev.* 1023 (1985); Louis Kaplow & Alvin Warren, Jr., *An Income Tax by Any Other Name—A Reply to Professor Strnad*, 38 *Stan. L. Rev.* 399 (1986); Jeff Strnad, *The Bankruptcy of Conventional Tax Timing Wisdom Is Deeper Than Semantics: A Rejoinder to Professors Kaplow and Warren*, 39 *Stan. L. Rev.* 389 (1987).

⁸² Victor Thuronyi, *The Concept of Income*, 46 *Tax L. Rev.* 45, 78 (1990).

⁸³ Henry C. Simons, *Personal Income Taxation* 50 (1938).

Ultimately, a corporation is no more than a convenient shell through which various people conduct business and distribute returns from such business. It is these returns, in a partially-netted form (that is, after making allowances for claimants other than equity holders), that the current corporate income tax attempts to measure and tax. But it does so in a wholly arbitrary way, since the taxed returns bear no relationship to any potentially relevant real world metric such as *economic* income or free cash flow. At the end of the day, corporate taxable income, as currently defined, is nothing more than an arbitrary number produced by applying the Code to a corporation's manifold activities. Perhaps the only truism that can be stated is that it is a measure that attempts to determine something supposedly of relevance to the corporation's *equity holders*.

The CCT never explicitly produces a number that represents "income." What it does produce is a tax payment based on certain things that are of the greatest relevance to the corporation's equity holders: The payment of cash to such holders and the share of the corporation owned by such holders. But it does no violence to the word "income" to call the CCT an income tax. In iterations #2 and #3, it is an income tax payable partially or exclusively in shares. In iterations #1 and #3, it is an income tax based partially or exclusively on a very strict notion of realization: Tax is only due with respect to amounts that demonstrably (by virtue of distribution) have been irretrievably earned, never again to be lost. No mismeasurement is possible under these schemes. Unlike in the case of market-to-market-based corporate income taxes, the market's temporary over-exuberant valuation of a corporation would never lead to excessive tax collections, nor would the market's overly pessimistic assessment ever lead to insufficient tax collections.

IV. THE GENERALIZED CCT

A. THE GENERALIZED CCT AND THE "NEW VIEW"

Let α represent the cumulative tax effect of all shareholder taxes assessed with respect to corporate distributions. Then, under the so-called "new view" of dividend taxation, in an efficient market, an investor will rationally pay only $(1 - \alpha)$ for \$1 of cash invested in corporate solution.⁸⁴ Suppose now that a corporation is able to invest—in perpetuity—at a pretax rate of return of s' . Thus, if it invests \$1 for n

⁸⁴ For brief summaries, see Daniel Halperin, Commentary, Will Integration Increase Efficiency? The Old and New View of Dividend Policy, 47 Tax L. Rev. 645 (1992); George R. Zodrow, On the "Traditional" and "New" Views of Dividend Taxation, 44 Nat'l Tax J. 497 (1991). For empirical support for the new view, see Alan J. Auerbach, Taxes, Firm Financial Policy, and the Cost of Capital: An Empirical Analysis, 23 J. Pub. Econ. 27 (1984).

years, and if corporate tax is imposed at an effective rate of t , the corporation will have $[1 + (1 - t)s']^n$ at the end of n years. From an investor's perspective, this amount of value—buried in corporate solution—has a future value of $(1 - \alpha)[1 + (1 - t)s']^n$, and hence a net present value of $(1 - \alpha)[1 + (1 - t)s']^n / (1 + r)^n$. In market equilibrium, this present value must equal $(1 - \alpha)$. Thus, it must be the case that, in market equilibrium, $s' = r / (1 - t)$. Following prior notation, this is just the condition that the market rate of return with respect to corporate investment s must equal $r / (1 - t)$, combined with the fact that no corporation can in perpetuity earn above-market returns.

Consider now a new iteration of the CCT, which will be called the generalized CCT, under which the following three things are true:

- First, unlike in prior iterations, there are no shareholder-level taxes of any type with respect to corporate income.
- Second, the phantom share exaction with respect to new equity issues (analogous to Rule 1.1 or 1.3A) is at the rate α , rather than at the rate t .
- Third, there is no excess accumulation penalty (of the type in Rule 1.3B) but there is a permanent “reinvestment provision” (of the type in Rule 1.2), pursuant to which the fisc's share of equity of every corporation automatically increases annually, irrespective of the level of corporate distributions. Thus, $y(n + 1) = 1 - (1 - y(n))[(1 + (1 - t)s)/(1 + s)]$. Since r is presumably more readily observable than s , and since $s = r / (1 - t)$, this can be rewritten as $y(n + 1) = 1 - (1 - y(n))[(1 + r)/(1 + r/(1 - t))]$.

Consider a newly-formed corporation facing the generalized CCT. During the first n years of its existence, the share of the corporation owned by private shareholders inexorably would decay from $(1 - \alpha)$ to $(1 - \alpha)[(1 + r)/(1 + r/(1 - t))]^n$. Assume, as above, that the corporation could find a limitless supply of investments yielding a pretax rate of return of s' . Thus, if the corporation invested \$1 for n years, it would have $(1 + s')^n$ at the end of such period. Thus, the future value of the share of this wealth owned by private shareholders would be $(1 - \alpha)[(1 + r)/(1 + r/(1 - t))]^n (1 + s')^n$. This, in turn, would have a net present value of $(1 - \alpha)[(1 + r)/(1 + r/(1 - t))]^n (1 + s')^n / (1 + r)^n$ or $(1 - \alpha)[(1 + s') / (1 + r/(1 - t))]^n$. In market equilibrium, this must simply equal $(1 - \alpha)$. Thus, once again, $s' = r / (1 - t)$.

In other words, the market equilibrium with respect to corporate investment under the generalized CCT is identical to the market equilibrium with respect to corporate investment under current law as understood by the “new view” of dividend taxation (taking both corporate and shareholder taxes into account). Thus, the net effect on corporate investments of the generalized CCT is *in all respects* equal

to the net effect on corporate investments of *all corporate and shareholder taxes* under current law as understood by the “new view” of dividend taxation. Thus, the generalized CCT, without more, can serve as a “perfect” substitute for any and all current taxes imposed with respect to corporate income.

B. *Virtues and Detriments*

Perhaps the greatest virtue of the generalized CCT—aside from doing away with not merely the corporate tax regime, but the shareholder tax regime as well—is that it would provide a uniform margin for corporate reinvestment decisions. That is, under the generalized CCT, a corporation’s reinvestment decisions would be based solely on the availability of projects with returns exceeding $s = r/(1 - t)$. In order not to destroy shareholder value, this reinvestment criterion must apply to all corporate reinvestment of earnings, including the reinvestment of prior windfalls. In particular, this means that in cases where it is impossible to measure the effects of prior windfalls—that is, private corporations—the generalized CCT would function every bit as well as in cases in which it was possible to measure such effects.⁸⁵

Perhaps the greatest detriment of the generalized CCT is that, absent sales of shares by the fisc, there would be an inexorable march of the fisc to 100% ownership of each and every corporation. That is, rewriting the reinvestment provision as $y(n + 1) = 1 - (1 - y(0))[(1 + r)/(1 + r/(1 - t))]^{n+1}$, it is clear that $y(n + 1)$ tends to 1 as n tends to ∞ . Thus, the residual value of each corporation is—in the limit—entirely owned by the fisc.

This both is and is not a problem. It is not a problem in the sense that the *amount* of residual value of any corporation owned by private shareholders would continue to rise; it would simply rise less fast than the *amount* owned by the fisc. For if the corporation has an initial value of $v(0)$, is able to reinvest its capital in perpetuity at the market rate $r/(1 - t)$ and never makes a distribution,⁸⁶ the amount of value owned by private shareholders at time $(n + 1)$ would be $v(n + 1) = [1 - y(n + 1)][1 + r/(1 - t)]^{n+1}v(0)$. This, in turn, is just $(1 - y(0))[(1 + r)/(1 + r/(1 - t))]^{n+1} [1 + r/(1 - t)]^{n+1} v(0)$, or $(1 - y(0)) (1 + r)^{n+1}v(0)$. As n tends to ∞ , this amount also tends to ∞ . Thus, while the fisc may appear to be expropriating from private shareholders in some relative sense, it is not in fact expropriating in any absolute sense.⁸⁷ Private shareholders would do just fine.

⁸⁵ Iteration #2, but not iteration #3, of the simple CCT has this feature as well.

⁸⁶ If the corporation made distributions, the value owned by private shareholders would not be so simple to state, but the point would remain correct.

⁸⁷ Assuming, that is, that one supports the general idea of corporate income taxation.

Nonetheless, having the fisc's relative share of every corporation rise over time towards 100% raises problems from a corporate governance perspective. It should not per se lead to bad investment decisions on the part of corporate managers, for such managers—if they try to maximize shareholder value with respect to the privately owned portion of the corporation—should continue to make proper investment decisions.⁸⁸ Rather, there is likely to come a point in time when politicians, seeing their essentially 100% ownership of a corporation, would be unlikely to remain content with nothing more than a passive voice in management. For while it might seem reasonable to be passive as a 20% or a 30% shareholder, it might seem less reasonable as a 50% shareholder, and less reasonable still as a 95% shareholder.

C. The Equivalence of the Reinvestment Provision and a Temporally-Neutral Shareholder Tax

The foregoing discussion treated the generalized CCT as a combination of the corporate tax and the shareholder tax in the current corporate tax regime. And while, as already noted, it is generally meaningless to break out a single component of any two-level tax, it is, in this case, instructive to think—for a moment—of the reinvestment provision as a “shareholder” tax and to examine the nature of such tax.

Suppose, at time n , that v is the market value that a given corporation would have if no portion of such corporation were owned by the fisc. Thus, the value of the corporation's shares that are in the hands of private investors under the generalized CCT would be $(1 - y(n))v$. Without loss of generality, suppose that investor J purchased all of the corporation's shares not owned by the fisc. J would pay $(1 - y(n))v$ for such shares. Finally, suppose that J intended to hold the shares for a period of m years, and that J believed that the corporation was able to generate returns on its capital over such period at the rate of s' . Thus, absent the reinvestment provision, J would expect her investment to grow to $(1 - y(n))(1 + s')^m v$. This means that J would expect to reap a total gain over such period of $(1 - y(n))(1 + s')^m v - (1 - y(n))v$, or $[(1 + s')^m - 1] (1 - y(n))v$. In fact, however, the reinvestment provision would cut into this gain. Indeed, at the time of projected sale, the

⁸⁸ In the case of most publicly traded corporations, managers currently own a negligible fraction of equity. The agency costs that result from this ownership pattern are essentially the same as those that would arise under the CCT. In the case of privately held corporations, however, the CCT would appear to create new agency costs. But this appearance is deceptive. Owners of privately held corporations already behave in ways that benefit themselves at the expense of the fisc. Properly viewed, such behavior is an agency cost. The CCT, by formalizing the fisc's equity interest in privately held corporations, would simply serve to make this agency cost explicit.

value of J 's share of the corporation would be only $(1 - y(n + m))(1 + s')^m v$. Thus, the total tax J would pay is $(1 - y(n))(1 + s')^m v - (1 - y(n + m))(1 + s')^m v$. This is just $(1 - y(n))(1 + s')^m v - (1 - y(n))[(1 + r)/(1 + r(1 - t))]^m (1 + s')^m v$, or $[1 - [(1 + r)/(1 + r(1 - t))]^m](1 - y(n))(1 + s')^m v$.

Note that the total tax would be a function solely of the interest rate r , the holding period m , and what might be termed the "gross proceeds from realization"—that is, the amount that would have been realized but for the reinvestment provision— $(1 - y(n))(1 + s')^m v$. These are the *same* three variables that determine the tax imposed under the original formulation of the GCFT (that is, the formulation without basis recovery).⁸⁹ This is not surprising, since the foregoing formula—aside from being in discrete rather than in continuous time—is identical to the GCFT. But it does have one advantage: The tax accrues automatically and annually, without any need for complicated shareholder-specific calculations at the time of ultimate realization. Thus, the generalized CCT can be seen as a potentially palatable way to implement a regime equivalent to the GCFT, and hence satisfying holding period neutrality (at least with respect to equity interests in corporations).

Just to complete the analysis of the reinvestment provision of the generalized CCT, it is possible to derive the effective m -period tax rate it produces, which is just the ratio of tax to gain. Thus, the effective tax rate is $\{[1 - [(1 + r)/(1 + r(1 - t))]^m](1 + s')^m\} / [(1 + s')^m - 1]$. Since an efficient capital market requires that the expected rate of return $s = r/(1 - t)$, this can be substituted into the equation. This yields an expected effective tax rate of $[(1 + r/(1 - t))^m - (1 + r)^m] / [(1 + r/(1 - t))^m - 1]$. To calculate the per-period effective tax rate, one simply sets $m = 1$. Doing this, the equation yields a per-period expected effective tax rate of t . Thus, the "corporate" tax rate under the generalized CCT doubles as an expected "capital gains" tax rate.

D. *Discrete vs. Continuous Time*

The excess accumulation penalty of iteration #3 of the simple CCT, or the reinvestment provision of iteration #2 and/or the generalized CCT, would adjust the fisc's ownership share of corporations on an annual basis. This poses some mechanical issues and a theoretical one. The first mechanical issue concerns the time for applying these provisions. That is, when during a taxable year does the fisc receive its incremental shares? The second mechanical issue concerns how the provisions apply during the first year after any new share issuance. Recall that under Rules 1.1 and 1.3A, the fisc would be given phantom

⁸⁹ See note 27 and the accompanying text.

shares corresponding to newly minted corporate shares at the precise moment of issuance. But such issuance can occur at any time during a corporation's taxable year. Thus, the question is whether the periodic provisions should apply so as to immediately begin to "dilute" any newly-issued equity, particularly if such equity is issued late in a corporation's taxable year. My (unscientific) proposal would be to deal with these mechanical issues in the following admittedly ad hoc manner:

Rule 1X: Timing of Issuance of Supplemental Shares. The excess accumulation penalty or reinvestment provision shall be applied on the last day of each taxable year. Such provisions shall apply only to shares that were outstanding on the first day of the taxable year. Thus, in particular, newly-issued shares are given a "grace period" prior to "dilution."

Example 13: Iteration #3 of the CCT is in effect, with a tax rate of $t = 20\%$. XYZ was incorporated on January 15, 2001, and issued 80 shares of XYZ common stock to noncorporate investors and 20 phantom shares to the fisc. XYZ's taxable year is the calendar year. Assuming inadequate distributions, on December 31, 2002, XYZ, for the first time, would issue additional shares of common stock to the fisc in respect of the excess accumulation provision of Rule 1.3B.

Under the timing rule, any corporation contemplating a distribution would seek to make such distribution immediately before rather than immediately after the end of its taxable year all else being equal. Even though a desire to "expropriate" the fisc encourages such distributions, the predicted behavior is hard for the fisc to object to. After all, from the fisc's perspective, the CCT functions best if it encourages distributions.

Nevertheless, as a matter of mathematical purity there is no need for the CCT to create the incremental incentive to make distributions immediately before the end of the taxable year. Nor is there any theoretical need to provide a grace period with respect to new issues of shares.⁹⁰ Both of these "errors" could be corrected by applying the excess accumulation penalty or the reinvestment provision on a continuous time basis. The question really boils down to whether the gains from mathematical (and economic) purity outweigh the losses. I

⁹⁰ The grace period should marginally reduce the cost of new share capital. Thus, for proponents of the new view, who may believe the CCT would provide incremental disincentive for corporate investment—more or less along the same lines as the current corporate tax regime—the grace period should provide at least some measure of counterbalance to this disincentive.

have opted for discrete time because I do not believe that they do. Continuously compounding interest notwithstanding, most humans—including most legislators—have some difficulty with calculations that must be adjusted continuously. Indeed, it is not entirely clear what it would mean to issue shares to the fisc on a continuous basis. Finally, in the tax realm, annual accounting and the taxable year are well-ingrained in the psyches of tax practitioners. Thus, in my view, it would be manifestly easier to sell the notion of the CCT in its discrete time form. That is why I have presented it in that form.

V. DETAILS, DETAILS, DETAILS

So far, I have set forth the basic rules of the CCT (in several alternative iterations). Sadly, the complexities of modern financial life are such that additional rules are required. This Section sets forth some such rules. These rules generally will apply to any of the iterations of the CCT. All the rules below, to the extent that they speak of shares owned by the fisc, apply both to Rule 1.1 and 1.3A phantom shares, and Rule 1.2 and Rule 1.3B real shares (unless they state otherwise). If both kinds of shares are held by the fisc (that is, under iteration #3 or the generalized CCT), all actions with respect to the fisc's shares must be pro rata, due to the different characteristics of the two types of shares.

A. Recapitalizations

Since the goal of the CCT is to give the fisc pro rata equity participation in every corporation, corporations should have no ability to affect the fisc's ultimate share of cash through restructuring their equity ownership interests. This means that the fisc must be able to participate in recapitalizations to the same extent as any other shareholder.

Rule 7: Recapitalizations. As and when shares of a class of corporate equity are exchanged for shares of a different class of corporate equity, the fisc's shares of the former class will be exchanged for shares of the new class in exactly the same manner as are the shares of private shareholders. To the extent that shares of a class of corporate equity are exchanged in part for nonequity interests, the distribution of such interests shall be treated as a distribution of property other than stock and therefore shall be governed by Rule 4.1, 4.2 or 4.3, as the case may be. To the extent that existing equity holders contribute new capital to the corporation as part of a recapitalization, such con-

tribution shall be treated as a new share issue subject to Rule 1.1 or Rule 1.3A, if applicable.⁹¹

Example 14: XYZ Corporation has 100 shares of common stock outstanding in private hands and has an additional 50 shares of common stock owned by the fisc. Pursuant to a recapitalization, each share of XYZ common stock is exchanged for one share of new XYZ common stock and two shares of new XYZ class A preferred stock. After such recapitalization, the fisc would own 50 shares of new XYZ common stock and 100 shares of new XYZ class A preferred stock.

If, instead, each share of XYZ common stock were exchanged for one share of new XYZ common stock and an XYZ debenture with a fair market value of \$20, the fisc would be entitled to receive 50 shares of new XYZ common stock and \$1,000 of cash (50 shares times \$20 per share) in lieu of the debenture.

Suppose, instead, that shareholders of XYZ were entitled to and did exchange one share of common stock and \$10 for two shares of new XYZ common stock. At the time of the exchange, the fair value of the old XYZ common stock was \$30 per share. Effectively, each share of old XYZ common stock is exchanged for 1.5 new shares. Thus, the fisc would receive 75 shares of new XYZ common stock in respect of its prior ownership interest. In addition, if Rule 1.1 or Rule 1.3 were applicable, and assuming $t = 20\%$, the fisc would receive 12.5 additional shares of XYZ common stock in respect of the deemed new issuance of 50 such shares for the private shareholders' aggregate cash contribution of \$1,000.⁹²

⁹¹ See Sections III.A. and E.

⁹² Application of this provision is clearly complicated in the private company context. That is, private corporations would have the incentive to "reduce" the fisc's effective ownership interest by having old shares valued at low levels in cases of recapitalizations. Thus, for example, if each old share in the example had a fair market value of only \$10 instead of \$30, the fisc's post recapitalization ownership interest would be 75 shares rather than 87.5 shares. Nor is this a problem that can be solved simply by requiring that new cash be paid only for new classes of equity, for that would still allow private companies to expropriate value from one class (the class disproportionately owned by the fisc) in favor of a second class (the newly-issued class). This problem is another of the reasons that the CCT is, like most of its market-based brethren, easier to apply in the public company context.

B. *Options and Other Equity Interests*

Pursuant to Rule 1.1 or 1.3A,⁹³ the fisc would be granted phantom equity as and when such equity is issued to noncorporate investors. I have already noted that, for this purpose, equity does not include debt. The reason for this is unscientific: The modest goal of the CCT is to replicate current law, rather than to rationalize distinctions made by such law concerning capital classification. Thus, the CCT should treat debt in the same manner as current law. But this glib answer does not necessarily answer the question of what it means to treat debt in the same manner as under current law. Nor does it answer the question of whether equity should be defined as outstanding stock or as something more.

To be consistent with the goal of having the CCT essentially replicate the current corporate tax regime, a corporate instrument should be classified as equity only to the extent that it yields payments that are neither deductible under current law nor are treated as a return of capital. That is, the current corporate income tax base excludes the “return” to any instrument to the extent that a corporation can deduct such return. The CCT therefore should exclude such instruments from its definition of equity. In particular, this means that the fisc should not be issued equity in respect of employee nonqualified stock options, corporate derivative transactions, instruments treated as debt under current law (to the extent such instruments provide for deductible “interest” payments), and the like. On the other hand, the fisc should be issued equity interests with respect to noncompensatory warrants to purchase stock and debt instruments that provide for payments that are not deductible. Some examples hint at the complexities and the mechanics.

Example 15 (Warrant): In connection with a debt financing, XYZ issues to Bank a warrant to purchase 100 shares of XYZ common stock for \$10 per share, exercisable for a period of n years. The fair value of the warrant is \$3 per share, or \$300. Economically, Bank has contributed this \$300 to XYZ in exchange for a junior class of equity. Thus, the fisc should participate in this new issue. Under iteration #3, for example, if $t = 20\%$, the fisc thus would receive a phantom warrant with respect to 25 shares.⁹⁴

⁹³ See Sections III.A and E.

⁹⁴ Alternatively, one could argue that the issue of new XYZ equity is not complete until and unless Bank exercises the warrant. Under this view, there would be no reason to issue phantom shares until exercise. Support for this view would come from the observation that corporations in general do not distribute cash in respect of warrants. But such observation is overly simplistic. Corporations in fact frequently distribute cash in respect of

After n years, suppose the fisc's phantom warrant—pursuant to the excess accumulation penalty—turned into a warrant with respect to 40 shares. If *Bank's* warrant expired worthless, a class of *XYZ* equity would disappear without any cash leaving corporate solution. Thus, the fisc's warrant would expire as well.

Alternatively, if *Bank* exercised its warrant by paying \$1,000 to purchase 100 shares of *XYZ* common stock, this is functionally equivalent to a recapitalization coupled with a contribution of new capital. Thus, pursuant to the rules governing recapitalizations, the exercise would be treated in part as an exchange of one class of equity (the warrant) for another (common stock), and in part as a simple issuance of new common stock. The fisc would participate pro rata in the exchange, and would receive new phantom shares under Rule 1.3A with respect to the new issuance.

Example 16 (Convertible Debt): *XYZ* issues debt convertible to 100 shares of *XYZ* common stock. The debt instrument is treated as debt under the current tax regime, although *XYZ* would be allowed no deduction with respect to the conversion feature (that is, in the case of a redemption at a premium). Thus, the instrument is partly a debt instrument and partly an equity instrument in the eyes of the CCT. Under iteration #3, the fisc would receive a phantom interest in the naked conversion feature—that is, a phantom right to convert debt into 25 shares of *XYZ* common stock.

Suppose, at the debt's maturity date, the excess accumulation penalty caused the fisc's right to grow into a right with respect to 50 shares of *XYZ* common stock. If the debt was redeemed at par, the conversion feature would expire worthless, both for the debt holders and for the fisc. Alternatively, if the debt was redeemed at a premium, such premium would be in respect of the debt's equity feature. Thus, suppose, a payment of \$500 in excess of par is made to the debt holders. Such payment is in the amount of \$5 per underlying share of common stock. Thus, the fisc should receive a payment of \$250 with respect to its 50 rights.

Finally, assume the debt was converted into 100 shares. To calculate the effects of the conversion, suppose the total par value of the debt was \$1,000 and that *XYZ's* common stock

warrants—but in the form of redemptions. The fisc should participate in such distributions. The only way to insure such participation is to grant phantom warrants to the fisc at the time the warrants are acquired by *Bank*.

had a fair market value of \$4,000. Thus, the conversion can be viewed as an exchange in which \$3,000 of conversion value is exchanged for 75 shares of common stock and \$1,000 of cash is exchanged for 25 shares of common stock. This, again, is a combination of a recapitalization and a new issue. The fisc would receive 37.5 shares of *XYZ* common stock with respect to its conversion right and 6.25 phantom shares of *XYZ* common stock with respect to the new issuance.

C. *Mergers and Acquisitions and other Consolidation Issues*

Under Rule 2 the fisc would receive cash whenever shares of one domestic corporation—the target corporation (*Target*)—were acquired from noncorporate investors (for consideration other than stock) by a second domestic corporation—the acquiring corporation (*Acquiror*).⁹⁵ The reason is simple. The CCT would establish the fisc's rights to corporate cash whenever dollars flow *into* corporate solution (or, more or less equivalently, whenever dollars remain there). But the fisc's actual receipt of cash would be deferred until dollars flow *out of* corporate solution. When *Acquiror* purchases shares of *Target* from noncorporate investors, cash flows out of corporate solution. Yet such a flow cannot in any useful sense be considered a payment made by *Acquiror* to its own shareholders, so the fisc's level of ownership of *Acquiror* should be irrelevant for determining the fisc's share of the flow. Instead, such a flow must be considered (and treated as) a payment by *Target* to its shareholders.⁹⁶ Accordingly, Rule 2 requires *Acquiror* to acquire a pro rata amount of the fisc's shares of *Target*.

A structurally similar rule must apply—albeit without collection of tax, since no cash flows out of corporate solution—when *Acquiror* acquires stock of *Target* in exchange for *Acquiror* stock. The following rule protects the fisc's rights to future cash in this circumstance.

Rule 8: Stock Acquisitions. If one domestic corporation acquires shares of a second domestic corporation in exchange for its own stock, the acquiring corporation must acquire a pro rata amount of the fisc's shares of the target corporation for like consideration.

Example 17: XYZ Corporation has 100 shares of common stock outstanding in private hands and has an additional 50

⁹⁵ See Rule 2 at text accompanying note 49.

⁹⁶ Indeed, one could model such flow as (1) a purchase of newly-issued shares of *Target* by *Acquiror* followed by (2) a redemption by *Target* of all its shares other than the shares held by *Acquiror*.

shares of common stock owned by the fisc. *ABC* Corporation has 80 shares of common stock outstanding in private hands and has an additional 20 shares of common stock owned by the fisc. If *XYZ* acquires 40 shares of *ABC*'s common stock from private shareholders in exchange for 20 newly-issued shares of *XYZ* common stock, it must also acquire 10 *ABC* shares from the fisc in exchange for five newly-issued *XYZ* shares.

After shares of *Target* have been acquired by *Acquiror*, two issues must be confronted. First, if *Acquiror* paid cash—and so was forced to acquire shares from the fisc—it is necessary to decide what becomes of such shares. That is, does *Acquiror* succeed to any rights with respect to the shares? The answer, of course, turns on whether the shares involved are Rule 1.1 or 1.3A phantom shares, or whether they are Rule 1.2 or 1.3B real shares that are fully transferable by the fisc. In the latter case, *Acquiror* simply succeeds to the rights of any other shareholder. But what happens in the former case? Second, and related, once *Acquiror* owns shares of *Target*, whether acquired for cash or for stock, are those shares treated identically—especially from the perspective of the excess accumulation penalty or reinvestment provision—with shares held by other private shareholders?

Example 18: *ABC* Corporation has 80 shares of common stock outstanding in private hands, and the fisc owns an additional 20 (Rule 1.1) phantom shares. Ignoring the possibility of a return-of-capital provision, *ABC*'s shares are worth \$2 apiece. If *ABC*'s assets were liquid and were liquidated, private shareholders would receive \$160 and the fisc would receive \$40. Suppose *XYZ* purchased 20 shares of *ABC* stock from private shareholders for \$40 and hence also would be required to purchase five phantom shares from the fisc for \$10. After the acquisition, does *ABC* have 80 “real” shares outstanding—20 owned by *XYZ* and 60 owned by private shareholders—or 85 shares—25 owned by *XYZ* and 60 owned by others? If the answer is 80 shares, then on an immediate liquidation of *ABC*, *XYZ* would receive \$42.11, private shareholders would receive \$126.32, and the fisc would receive \$31.58. If the answer is 85 shares, then on an immediate liquidation of *ABC*, *XYZ* would receive \$50, private investors would receive \$120, and the fisc would receive \$30.

Note that *Acquiror* suffers immediate dilution with respect to its purchase, unless the phantom shares *Acquiror* purchases from the fisc

are treated as real shares. Moreover, this is not the type of dilution generally required under Rule 1.1 to implement the CCT. It is incremental dilution, or equivalently an untoward multiplication of tax. The multiplication of tax is fundamentally the same as would be found in the current corporate income tax regime if such regime made no allowance for consolidation. As *Example 18* makes clear, one possible solution is to treat phantom shares acquired by a second domestic corporation as real shares, thus effectively making them transferable. But this is not the only solution. The better solution (that is, a solution that leaves the fisc's phantom shares nontransferable), is to correct the problem with a consolidation rule.

Rule 9: Consolidation. Let $z\%$ be the threshold set for consolidation.⁹⁷ If a domestic corporation, *Acquiror*, acquires stock of a second domestic corporation, *Target*, and after such acquisition owns less than $z\%$ of the real shares of such class of *Target* stock,⁹⁸ then *Acquiror* is not treated as a domestic corporation for purposes of applying the CCT. In particular, *Acquiror* is not required to acquire *Target* stock of the fisc in tandem with its acquisition of *Target* stock from private investors. On the other hand, if *Acquiror* acquires sufficient *Target* stock so that after such acquisition *Acquiror* owns at least $z\%$ of the real shares of such class of *Target* stock, then *Acquiror* is required to "consolidate" its stake in *Target*. In particular, this means that *Acquiror's* stock of *Target* would *not* be subject to "dilution" by the fisc's phantom *Target* stock.⁹⁹

Example 19: As in *Example 18*, except that 25% is greater than or equal to the consolidation threshold z , so that *XYZ* and *ABC* must consolidate after *XYZ's* acquisition of *ABC* stock. In connection with its acquisition of *ABC* stock, *XYZ* must purchase five phantom *ABC* shares from the fisc for

⁹⁷ As a matter of theory, z could (even should) be set at zero. This might prove impractical, however, since the consolidation rules—which are nontrivial in their informational requirements—then would need to be applied in contexts where it does not make much economic sense to apply them. This, in turn, might affect the liquidity of capital markets, since it would raise an impediment to the purchase of small amounts of corporate stock by other corporations. My recommendation, therefore, is to set z sufficiently high so as to exclude small portfolio holdings from consolidation. Setting z at 5% or greater should suffice.

⁹⁸ Note that I am applying the threshold z on a class-by-class basis. This means that corporations always could opt into consolidation. I have written the rules in this way because of my prejudice that consolidation is the "right" answer. If legislators took the opposite view, z could be set with respect to all of an issuer's equity.

⁹⁹ Functionally, this is not unlike treating *Acquiror's Target* stock as a separate class of *Target* stock, a class in which the fisc has no phantom stake. There is one crucial difference, however. *Target* could not make distributions to the subclass owned by *Acquiror* without also making distributions to the subclass owned by private shareholders and the fisc.

\$10. After the acquisition, *ABC* would have 80 real shares outstanding—20 owned by *XYZ* and 60 owned by private investors—as well as 15 phantom shares owned by the fisc. *ABC*'s “real” shares would not all be equal, however: The 20 shares owned by *XYZ* would not be subject to the fisc's claim. Thus, mechanically, *XYZ* would be entitled to 25% (20/80) of all distributions made by *ABC*, and the remaining 75% of such distributions would be shared based on the relative shareholdings of private investors and the fisc. If *ABC* were to immediately liquidate, *XYZ* would receive \$50, other investors would receive \$120, and the fisc would receive \$30. Thus, the rights to cash distributions of both *XYZ* and the fisc would be preserved.

If, instead, 25% is less than the consolidation threshold z , *XYZ*'s purchase of 20 shares of *ABC* stock would *not* be accompanied by any purchase of phantom stock from the fisc. Thus, after the acquisition, *ABC* would have 80 real shares outstanding—20 owned by *XYZ* and 60 owned by private investors—and 20 phantom shares in the hand of the fisc. If *ABC* were to immediately liquidate, *XYZ* would receive \$40, other private investors would receive \$120, and the fisc would receive \$40. Thus, again, the rights to cash distributions of both *XYZ* and the fisc would be preserved.

Rule 9A: Issuing Shares to Domestic Corporations. If a domestic corporation issues stock of any class to another domestic corporation, and after such issuance, the recipient corporation owns less than $z\%$ of the real shares of such class, the issuance is fully subject to Rule 1.1 or Rule 1.3A (if applicable). Thus, the fisc would receive additional phantom shares by virtue of the issuance. If, however, after the issuance, the recipient corporation owns at least $z\%$ of the real shares of such class of the issuing corporation's stock, the issuer is neither required nor permitted to issue any phantom equity to the fisc with respect to the issuance. Thus, for example, the fisc would own no phantom equity in any wholly-owned subsidiary of any corporation.

Example 20: *XYZ* has 100 shares of common stock outstanding in private hands, and the fisc owns an additional 50 shares of which 30 are phantom shares. Let $z = 25\%$ be the threshold for consolidation. If *XYZ* issued 40 shares of common stock to *ABC*, a domestic corporation, in a single transaction, then since $40/160 = 25\%$, *XYZ* would not issue any additional phantom shares to the fisc.

If one domestic corporation owns stock in another, the operation of the Rule 1.2 reinvestment provision (or the Rule 1.3B excess accumulation penalty) theoretically could lead to untoward multiplication of corporate taxes. Thus, the following clarification is necessary (as is an analogous provision in the case of Rule 1.3B).

Rule 1.2A: Reinvestment Provision With Respect to Consolidated Subsidiaries. If a domestic corporation (*Parent*) owns at least $z\%$ of the real shares of a given class of another domestic corporation's (*Subsidiary's*) equity, then the regular Rule 1.2 reinvestment provision would apply only to the shares of such class owned by individuals other than *Parent*. Mechanically, this means two things. First, if in Year n , $\mu(n)$ is the fisc's fractional share of the rights with respect to such class owned by individuals other than *Parent*, then $\mu(n + 1) = 1 - (1 - \mu(n))[(1 + (1 - t)s)/(1 + s)]$. Second, *Parent* would need to be issued sufficient additional real shares of *Subsidiary* equity in order to keep its interest in the relevant class of equity constant.

Example 21: XYZ Corporation has 100 shares of common stock outstanding in private hands, and the fisc owns an additional 50 shares, 20 of which are real and 30 of which are phantom. *XYZ* has net assets of \$600, so in the event of a liquidation, private shareholders would receive \$400 and the fisc would receive \$200.

Suppose *XYZ* owns 20 common shares, or 25% of the real equity, of *ABC*. In addition, *ABC* has 50 shares of common stock outstanding in private hands, and the fisc owns 10 real shares and 15 phantom shares. If *ABC's* net assets are worth \$200, then if *ABC* were liquidated, *XYZ* would receive \$50, other private shareholders would receive \$100, and the fisc would receive \$50.

Assume that $s = 10\%$ and $t = 20\%$. Also assume that *XYZ* and *ABC* each have only marginal investment opportunities, so that they reinvest at a pretax rate of 10%. Over the course of the year, *ABC* earns \$20 on its \$200 of assets, and so has \$220 to distribute. *XYZ* earns \$55 on its \$550 of assets (other than its \$50 stake in *ABC*), and so has \$605 to distribute before taking into account any cash received from *ABC*.

Applying Rule 1.2A, the fisc's stake in *ABC* would rise from 25% to 25.9%.¹⁰⁰ Accordingly, a liquidation of *ABC's*

¹⁰⁰ Under these facts, $\mu(n) = 33.33\%$. Thus, $\mu(n + 1) = 1 - (1 - .33)[1 + (1 - .2) \times .1]/(1 + .1) = 34.45\%$. Thus, since *XYZ's* share remains constant at 25%, the fisc's share rises from 25% = $.3333 \times 75\%$ to 25.91% = $.3455 \times 75\%$.

\$220 would result in distributions of \$55 to XYZ (25%), \$108 to private shareholders (49.09%), and \$57 to the fisc (25.91%). Note that the net present value of \$108 at an 8% discount rate is exactly \$100. Thus, as desired when reinvestment opportunities are marginal, private equity holders in ABC would be indifferent between an immediate liquidation of ABC and the contemplated reinvestment.

A liquidation of XYZ in turn would result in distributions of \$660 (\$605 plus \$55 received from ABC's liquidation). Under regular Rule 1.2, the fisc's phantom stake in XYZ would have risen from 33.33% to 34.55% (assuming no significant corporate ownership of XYZ's stock). Thus, \$432 would be distributed to private shareholders and \$228 to the fisc. Again, note that the net present value of \$432 at an 8% discount rate is \$400. Thus, as desired when investment opportunities are marginal, shareholders would be indifferent between XYZ's immediate liquidation and its reinvestment of its funds.

In *Example 21*, note that the ownership by XYZ of shares of ABC did not result in any incremental tax (or equivalently in any reduction in the value of equity held by private investors) because Rule 1.2A protected XYZ's stake in ABC from "dilution." Without Rule 1.2A, Rule 1.2 would have applied to all of ABC's shares, thus increasing the fisc's stake from 25% to 26.36% rather than 25.91%.¹⁰¹ Thus, the rule accomplishes its goal of preventing the untoward multiplication of corporate tax, solely due to corporate ownership of shares in other corporations.

D. Corporate Sales, Spin-Offs, and other Deconsolidation Issues

As already noted, under the CCT, the fisc's right to corporate cash distributions would be established whenever cash flows into corporate solution.¹⁰² Thus, if a domestic corporation, *Parent*, that owned stock in a *consolidated* corporation, *Subsidiary*, sold some or all of such stock to noncorporate investors, Rule 1 in one of its guises must apply, for cash literally would have flowed into corporate solution. (Note that Rule 1 would not be implicated if *Subsidiary* were not consolidated, for in such case, pursuant to Rule 9, *Parent* would be treated as a noncorporate shareholder.)

¹⁰¹ $y(n + 1) = 1 - (1 - .25)[1 + (1 - 0.2) \times 0.1] / (1 + 0.1) = 26.36\%$.

¹⁰² See Rules 1.1 and 1.3A, which establish a direct link. But Rules 1.2 and 1.3B have the same effect, since the fisc's share first begins to accrue when cash enters corporate solution.

One may be tempted to treat a sale of stock of a consolidated *Subsidiary* as being analogous to a secondary offering by *Parent*. After all, the proceeds flowed into *Parent's* coffers. But such treatment would overtax *Parent's* shareholders, for *Parent* merely swapped one asset (shares of *Subsidiary*) for another (cash). More importantly, such treatment would leave *Subsidiary* entirely free of tax (as the fisc would have no Rule 1.1 or Rule 1.3A stake in *Subsidiary*). Thus, the right answer must be that the fisc should, if applicable, receive phantom shares in *Subsidiary*. To reach this result, it is necessary to think of the sale of *Subsidiary* stock as occurring in two steps. First, *Subsidiary* issues stock to new private shareholders and hence, under Rule 1.1 or 1.3B, to the fisc as well. Second, *Subsidiary* redeems the requisite number of *Parent's* shares in *Subsidiary*.

Rule 10: Sales of Subsidiary Stock. If *Parent* sells stock in a consolidated *Subsidiary* to noncorporate investors, under iterations #1 and #3, such stock sale would be accompanied by an issuance of phantom *Subsidiary* stock to the fisc in an amount determined under Rule 1.1 or 1.3B.¹⁰³ On the other hand, if a corporation sells stock in an unconsolidated *Subsidiary*, such stock sale would not be accompanied by an issuance of phantom *Subsidiary* stock to the fisc.

Example 22: XYZ owns 20 shares of ABC common stock, other private shareholders own 60 shares, and the fisc owns 20 shares. If z is sufficiently high (for example, $z > 25\%$) ABC would not be consolidated. If XYZ sold 10 shares of ABC stock to private investors, no additional phantom shares of ABC stock would be issued. Suppose instead that the consolidation threshold was sufficiently low so that z would be consolidated (for example, $z \leq 20\%$). Let the Rule 1.1 tax rate be 20% (which implies that four of the fisc's shares are real). Now if XYZ sold 10 shares of ABC stock to private investors, ABC would be required to issue 2.5 additional phantom shares to the fisc.

Now, suppose ABC was consolidated and ABC's fair market value was \$200. Since XYZ's share of ABC was 23.8% (that is, 20 out of 84 real shares) it would be worth \$47.62, or \$2.38 per share. The remaining shares, those held by the public and by the fisc, accordingly would be worth \$1.90 apiece (\$152.38/80) in a liquidation (ignoring return of capital).¹⁰⁴ If XYZ indeed sold 10 shares, and the sale caused a

¹⁰³ The effect of this rule is that the selling corporation would suffer the detriment occasioned by the Rule 1 phantom stock issuance to the fisc.

¹⁰⁴ They are worth \$2.38 in a nonliquidation context, since that is the amount of capital required to replicate ABC.

deconsolidation, then after the sale all shares of *ABC* would “look alike.” Thus, *ABC*’s \$200 of assets would be spread ratably over a share base containing 102.5 shares. Each share accordingly would be worth \$1.95 in a liquidation and \$2.44 in a nonliquidation context. In order to prevent this windfall from accruing to *ABC*’s shareholders, it would be necessary to issue an additional 2.5 phantom shares to the fisc. That is, on deconsolidation, the fisc must be issued new phantom shares with respect to all previously-consolidated shares, not merely those that are sold.

An alternative route to deconsolidation is to have *Subsidiary* redeem *Parent*’s *Subsidiary* stock. A possible way to handle such redemption is as follows.

Rule 9B: Redeeming Shares From Domestic Corporations. If and only if a domestic corporation owns at least $z\%$ of the shares of any class of equity of another domestic corporation, redemption of such shares by the second corporation could be treated two ways. First, there could be a pro rata redemption requirement. That is, if $x\%$ of the parent’s stock is redeemed, then $x\%$ of the public’s stock (and hence $x\%$ of the fisc’s) also must be redeemed. This is what Rule 2 in its various guises requires in the nonconsolidated context. Alternatively, since no cash leaves corporate solution by means of the redemption, one could simply ignore it. The rationale would be that the fisc’s rights to cash are fully protected so long as the subsidiary’s noncorporate shareholders are able to protect themselves from expropriation by the parent. I opt for the former rule, largely because I have little confidence in the ability of noncorporate shareholders to protect themselves, and hence the fisc.¹⁰⁵

Example 23: *ABC*, a domestic corporation, owns 40 shares of common stock of *XYZ*, a domestic corporation. Additionally, *XYZ* has 100 shares of common stock outstanding in private hands, and the fisc has 25 phantom shares. Let $z = 25\%$ be the threshold for consolidation, so that *XYZ* is consolidated. If *XYZ* redeemed 20 shares from *ABC*, under Rule 9B, *ABC* also must redeem 50 shares from private shareholders and 12.5 phantom shares from the fisc. Note that *XYZ* would remain consolidated.

¹⁰⁵ The alternative rule would require, after a redemption that produced deconsolidation but did not entirely eliminate *Parent*’s ownership interest in *Subsidiary*, an issuance of phantom shares to the fisc in respect of the shares retained by *Parent*. Otherwise, as in Example 22, a windfall to private shareholders (including *Parent*) would result.

Finally, the shares of a previously consolidated subsidiary can find their way into the hands of noncorporate investors by means of a spin-off. Since spin-offs do not involve any fresh flows of cash into or out of corporate solution, they are not an occasion for changing the fisc's phantom stakes. Rather, care simply must be taken to insure that the fisc's interests are protected.

Conceptually, if the fisc directly owns $(t + \phi)$ of a parent corporation, where t represents the fraction of phantom shares and ϕ represents the fraction of real shares, the fisc indirectly owns $(t + \phi)\%$ of such parent's share of any wholly-owned or partially-owned subsidiaries. Thus, if such parent chooses to "spin-off" a subsidiary (whether or not consolidated) in a pro rata distribution to shareholders, the fisc should receive $(t + \phi)\%$ of the distributed shares. The following rule mechanically explicates such a pro rata distribution.

Rule 11: Spin-Offs. Suppose that the fisc owns $(t + \phi)\%$ of *Parent's* equity, that *Parent* owns a consolidated $\lambda\%$ stake *Subsidiary's* equity and that the fisc owns $(t + \mu)\%$ of *Subsidiary's* equity that is not owned by *Parent*. Then, if *Parent* spins off its stake in *Subsidiary*, the fisc's share of *Subsidiary* would rise by $(t + \phi)\lambda$ from $(t + \mu)(1 - \lambda)$ to $t + \mu(1 - \lambda) + \phi\lambda$. The portion of such shares that are phantom shares, of course, would be t .

Example 24 (Spin-off): XYZ has 25 shares of common stock outstanding in private hands and 15 real and 10 phantom shares held by the fisc. XYZ owns a consolidated 40% interest in ABC, represented by 40 shares of common stock. Of the remaining 60 shares of ABC stock, 42 are owned by private investors, 6 are real shares owned by the fisc, and 12 are phantom shares owned by the fisc. If XYZ spun off its interest in ABC, the fisc would receive 8 additional phantom ABC shares and 12 additional real ABC shares, while private investors would receive 20 real ABC shares. Thus, when the dust settled, the fisc owns directly the same 38% of ABC that it previously owned partially indirectly.

E. Foreign Provisions

The current corporate income tax essentially attempts to tax domestic branches of foreign corporations as if they were themselves domestic corporations. Such an attempt could be replicated under the CCT.

Rule 12: Branches of Foreign Corporations. Any foreign corporation would be required to issue equity to the fisc in an amount established by Rule 1 with respect to all activities effectively connected

with the conduct of a trade or business in the United States. The fisc's equity would be entitled to share in all cash payments (1) flowing from the activities to the foreign corporation with respect to the foreign corporation's ownership interest in the activities or (2) made to any person to the extent such payments exceed the fair transfer price for goods and services provided by such person.

Example 25: Assume iteration #3 is in effect with a tax rate of $t = 20\%$. *FOR*, a foreign corporation, conducts business in the United States through its branch *B*. The fisc would receive a phantom equity stake of 20% in *B*. If *B* made a \$100 cash payment to *FOR* with respect to *FOR*'s equity in *B*, *B* must make a \$25 cash payment to the fisc as well. The same result would obtain if, for example, *B* made a \$100 loan to *FOR*. In such case, however, the repayment of the loan and the subsequent repatriation of the \$100 to *FOR* would not result in a second payment to the fisc.

Suppose *B* makes a \$100 cash payment to *FOR* for management services provided by *FOR* to *B*. *FOR* must make a \$25 payment to the fisc if, and only if, *FOR*'s management services were deemed to be effectively connected with a U.S. trade or business.

Suppose *B* makes a \$100 cash payment to any third person *C* (presumably a related person) for \$40 of goods or services provided by *C*. Since this is the equivalent of moving \$60 of equity value out of the United States, *B* must make a \$15 payment to the fisc.¹⁰⁶

It is also necessary, under the CCT, to decide what, if any, allowance to make with respect to foreign taxes paid by domestic corporations. Since the CCT is not per se a tax, but rather a form of equity participation, one possible logical treatment of foreign taxes is to simply ignore them. That is, any such taxes paid would dollar for dollar

¹⁰⁶ As a technical matter, the consolidation rules should apply to prevent multiple taxation in cases where domestic corporations can be said to be owned by foreign branches (that is, where such domestic corporation's activities are part of the branch's effectively connected trade or business). In particular, this would mean that cash flows out of the domestic corporation and to the branch would not be taxed, but rather that taxation would be deferred until such cash is repatriated out of the branch and to the foreign parent. In addition, in *Example 25*, the payment to the fisc should be suspended in the unlikely event that *C* is a domestic corporation. Note that while such technical refinements may be desirable to protect the "purity" of the CCT, they add incremental complexity, and thus are likely not worth the trouble. Moreover, since the lack of such rules can act only to the detriment of taxpayers—and not to the fisc—one should not be concerned by their absence. Taxpayers will simply need to engage in some very basic common sense structuring to avoid paying incremental tax.

reduce the cash available for distribution to the domestic corporation's shareholders, and thus would dollar for dollar reduce the tax base from which the fisc's participation operates. This is equivalent to allowing a deduction (as opposed to a credit) for the foreign taxes.

Alternatively, one could structure a foreign tax credit-type scheme, albeit not without considerable incremental complexity. Under such a scheme, payment of income taxes to foreign governments would reduce payments to the fisc dollar for dollar, but only to the extent that the effective tax rate on the foreign income was not in excess of the effective U.S. tax rate. One problem with implementing such a scheme is that it requires a determination of the effective foreign tax rate. That, in turn, requires a determination of the amount of foreign income, which, in turn, requires a definition of income. One of the beauties of the CCT is that there has so far been no definition of income.

Moreover, there is a second implementation issue, which concerns the mechanics of actually crediting foreign tax payments. What logically is required is that a corporation should be allowed to distribute cash to its shareholders in an amount equal to the deemed amount distributed to the fisc (by virtue of the payment of the foreign tax). When, however, the corporation has multiple classes of equity, this means that—absent additional rules—there would not necessarily be a unique amount distributable to private shareholders with respect to the foreign tax payment.

Example 26: XYZ has 30 class A common shares outstanding in private hands and the fisc has 10 real class A common shares and 10 phantom class A common shares. In addition, private shareholders have 80 class B common shares and the fisc has 20 phantom class B common shares. Assume that $t = 20\%$. Due to its operations in a foreign country, XYZ pays \$20 of foreign income taxes. If the foreign tax rate is deemed to be less than the notional 20% U.S. effective tax rate, and a tax credit mechanism is in place, the entire \$20 would be creditable. This amount is equivalent to \$1 per class A share (real and phantom) owned by the fisc. Thus, XYZ arguably should be able to distribute \$30 to its private class A shareholders. Alternatively, the foreign tax payment would be equivalent to \$1 per class B phantom share owned by the fisc. Thus, XYZ arguably should be able to distribute \$80 to its private class B shareholders without making any accompanying distribution to the fisc.

To break this kind of impasse, and provide a unique level of tax-free distribution, one would need a rule such as the following.

Rule 12A: Foreign Tax Credit. Corporations shall be allowed to reduce the required payments to the fisc under Rule 2 on a dollar-for-dollar basis by certain amounts paid as income taxes to foreign governments. Amounts creditable shall be limited to the product of the Rule 1 tax rate imposed under the CCT and the amount of foreign income as determined under some reasonable measure of such income. If Rule 1.1 or 1.3A is applicable, payments shall be credited against the earliest subsequent distributions otherwise due to be made to the phantom equity corresponding to the most junior (residual) class of equity. If Rule 1.2 is applicable, payments shall be credited against the earliest subsequent distributions to be made to the most junior (residual) class of equity.

Example 27: As in *Example 26*, except that the class B stock is limited and preferred. Thus, the \$20 foreign tax payment would be allocated solely to the fisc's phantom class A shares at a rate of \$2 per share. In this case, XYZ would be able to make distributions to the class A stock (including the fisc's 10 real shares) of \$2 per share without making any accompanying distribution to the fisc's phantom class A stock. XYZ, however, would not be able to make any distribution to the class B stock without an accompanying payment to the fisc.

If, instead, Rule 1.2 applied, so that all of the fisc's shares were real shares, then (still assuming that the class A stock was junior) the \$20 foreign tax payment would be allocated solely to the fisc's class A shares at a rate of \$1 per share. In this case, XYZ would be able to make distributions to the privately-owned class A stock of \$1 per share without making any accompanying distribution to the fisc's class A stock. XYZ, however, would not be able to make any distribution to the class B stock without an accompanying payment to the fisc. Note that while this rule works so long as the fisc owns its shares, it does not work if the fisc transfers some of its class A shares (which under iteration #2 it is allowed to do).

Note that whether the treatment of foreign taxes under the CCT implicitly follows a deduction scheme or explicitly follows a foreign tax credit scheme, much of the current foreign income tax regime for corporations would disappear. In particular, the subpart F regime has no place under the CCT since all available deferral occurs at the level of the ultimate domestic corporate parent. That is, since a corporation could choose to defer payments to the fisc simply by not making any

distributions to its equity holders, there is no need or ability to provide incremental deferral in respect of the repatriation or lack thereof of foreign earnings.

F. Legislative Matters

So far the additional details have concerned how the CCT should handle certain types of corporate transactions. Not everything that affects the corporate tax, however, is initiated in the corporate sector. In particular, legislators have a penchant for wanting to tinker with the corporate income tax.

One form of congressional tinkering is to make changes to the basic corporate tax rate. Thus, for example, the tax rate could be changed from the $t=20\%$ assumed in every preceding example to say $t=25\%$. Such a change should have no effect on the “real” share ownership of the fisc under iterations #2 and #3, since real shares are distributed to the fisc in lieu of taxes on current income. Thus, all such shares owned by the fisc at the time of a tax rate change would reflect taxes collected in earlier periods. There is no reason in logic or otherwise to retroactively change such amounts. Of course, on a going forward basis, the reinvestment provision or the excess accumulation penalty would need to be applied using the new tax rate.

As regards the fisc’s existing phantom shares, the question is equally easy, at least in iteration #3 of the simple CCT (which is the iteration that “works”). In that case, the phantom shares represent a right to distributions which, if not made, result in the issuance of real shares to the fisc. Thus, the fisc collects all “tax” on an ongoing basis. A tax rate change, accordingly, must be reflected fully in the fisc’s ownership of phantom shares. Thus, the fisc would simply be issued new phantom shares (or in the case of a tax rate reduction, would return phantom shares) in such amount so that, following the new issue, the fisc had a phantom share ownership level reflecting the new tax rate. Of course, any new share issuances to private shareholders following the rate change would result in phantom share issuances commensurate with the new rate.¹⁰⁷

Example 28: At a time when the Rule 1 tax rate is $t=20\%$, XYZ has 70 shares of common stock outstanding in private hands, with the fisc owning an additional 10 real shares and 20 phantom shares. The tax rate is changed to $t=25\%$. The fisc would be issued an additional 6.67 phantom shares, so

¹⁰⁷ In the case of the generalized CCT, a tax rate change can affect either or t . As above, a change in t would have purely prospective effects, and a change in would require a readjustment of the fisc’s number of phantom shares.

that its number of phantom shares (26.67) was equal to 25% of the total number of (real and phantom) shares outstanding (106.67).

A second frequent area of congressional tinkering is the attempt to provide, through the Code, specific incentives for corporations to engage in certain types of behavior. Such incentives can occur only by creating a wedge between taxable income and economic income (these are the category one tax shelters I spoke of at the beginning of the Article). By design, the CCT does away with all such incentives. But they could be restored, if and when desired, in one of two ways. First, such incentives could be handled outside of the tax system, through direct transfer payments. As already noted, there is an advantage to handling them in this manner, rather than in the manner they are handled under the current Code: Instead of having a taxpayer take a return position that it is entitled to the benefit, which has great value, even if incorrect, simply because it may never be challenged, the taxpayer would affirmatively have to establish its entitlement prior to getting the benefit. The second way to handle such incentives would be to coordinate them with the CCT in the same manner that was outlined for a possible foreign tax credit in the prior Subsection. That is, the taxpayer would establish its entitlement to the benefit, and that would reduce its need to make payments to the fisc with respect to certain phantom shares owned by the fisc.

VI. CONCLUSION

A. *Reprise: Stacking the CCT Up Against the Competition*

Of the alternative tax regimes described at the outset of this Article, the one most similar to the CCT is arguably the market value tax, for it is only the MVT that preserves a corporate tax as a second incremental extraction, yet tries to base such extraction on actual market returns. Generally, the CCT shares with the MVT the primary benefit that it does not in any obvious way create perverse corporate incentives to misstate taxable income. Since managers generally want to maximize aggregate shareholder value, under the MVT, they would affirmatively strive to maximize their tax burdens. But maximizing aggregate shareholder value also generally means maximizing the value of the equity owned by the corporation's various equity holders. Under the CCT, the fisc would be such an equity holder. Thus, managers confronted with the CCT would also work to maximize the value of their tax burdens. As with the MVT, incentives generally would be aligned.

Iterations #1 and #3 of the CCT and the MVT also share a similar limitation. Those iterations of the CCT are at best imperfectly applicable to privately-held corporations; the MVT is not applicable at all. But this limitation disappears under iteration #2 and the generalized CCT, each of which is fully *and perfectly* applicable to privately held corporations. Thus, the CCT in fact could bridge one of the arbitrary distinctions of tax law, while the MVT could not.

Of course, application of iteration #2 or the generalized CCT to privately held corporations would force the Service to continue to confront various constructive dividend issues, exactly as under current law. But since the relative benefit to be gained by shareholders from constructive dividends would not be significantly greater under the CCT than under current law—it still would be essentially a matter of converting potentially twice-taxed income into once-taxed income—the magnitude of this issue should not be much different than it is under current law.¹⁰⁸

Finally, unlike the MVT, the CCT raises no corporate liquidity issue. If the value of a corporation explodes due to some “unrealized” income, or the market’s perception of the possibility of such unrealized income, there would be no immediate tax due. The fisc’s shares would simply rise in value, as would everyone else’s. For the same reasons, and again unlike the MVT, the CCT would pose no refundability issue. Since tax would be collected only as corporate income was irretrievably earned—never to be relinquished—there could never be a cognizable corporate loss.¹⁰⁹

The MTM system and GCFT are more analogous to the generalized CCT than to the various iterations of the simple CCT since they are both “integrated” tax regimes. Mechanically, they are different, of course. Where the generalized CCT collects “tax” solely from corporations, the MTM system and GCFT collect tax solely from shareholders. But this difference is of little moment.

Again, those regimes, *viewed as corporate income tax regimes*, align the incentives of the corporation, its shareholders, and the fisc. So they provide the same basic benefit as the generalized CCT. Moreo-

¹⁰⁸ The calculus may not be so simple. Since the CCT would wipe away large numbers of current tax planning opportunities to depress corporate taxable income, those few that remained—including the constructive dividend—presumably would face relatively more exploitation. On the other hand, the Service would have fewer tax avoidance issues to police under a CCT, and thus should be able to devote relatively more resources to monitoring the constructive dividend divide.

¹⁰⁹ Under the simple CCT, in each of its three iterations, one would allow shareholders to deduct the loss in cases where they pay more for shares—whether at original issue or otherwise—than they ultimately recoup. There is no mechanism, however, to multiply the benefit of such losses, by also allowing them to be taken at the corporate level. Under the generalized CCT, in contrast, there is no mechanism to allow even one loss deduction.

ver, all three regimes share the feature of shareholder holding period neutrality. Still, the generalized CCT provides certain incremental benefits over these regimes. In the case of the MTM system, it provides the benefits of not explicitly imposing a tax on shareholders in the absence of realization and of being fully applicable to privately held corporations. In the case of the GCFT, it provides the benefit of turning the computationally complex tax imposed on shareholdings into an automatic corporate exaction.

Finally, the CCT is in some ways quite analogous to a lump sum tax, since the periodic erosion provided by the reinvestment provision is essentially an *ex ante* tax imposed annually on the (perhaps indeterminate) value of each corporation. The *ex ante* nature of the tax again has the salutary effect of generally aligning the incentives of corporations, their shareholders, and the fisc. The chief advantage of the CCT, however, is that the CCT imposes no valuation issues with regard to setting the lump sum. That is, as a tax collected on certain actual cash flows, the CCT is easy to impose not only on easily-valued publicly traded corporations, but on hard-to-value privately held corporations as well.

B. Panacea?

The CCT is designed to deal with one problem of the current Code and one problem only: the incentives on the part of corporate managers to create and/or exploit divergences between the economic income of a corporation and its taxable income. It removes the incentive essentially by doing away with any computation of corporate taxable income.

Given human nature, one can expect that at least some of the resources currently devoted to depressing corporate taxable income would be rerouted to any remaining opportunities for corporate tax reduction. Possibly the most significant of these would be the use of instruments that could avoid the designation of equity. This is not a new problem. Under the current corporate tax, the tax base (taxable income) is reduced through the use of debt. Under the MVT, the tax base (change in the market value of equity) is reduced through the use of debt. Under the MTM system or GCFT, the tax base also is reduced through the use of debt, albeit for the less objectionable reason that these regimes are integrated, so that the reduction is not in effect a reduction. Finally, under the CCT, the tax base (outstanding equity) is reduced through the use of debt. The difference between the unintegrated regimes—the MVT or the CCT and current law—is that there would likely be relatively more pressure on the nonrobust debt-

equity distinction under the former two systems, for the simple reason that most other avenues of tax base reduction would be gone.¹¹⁰

A second significant area for remaining tax base erosion is the use of inflated transfer prices under circumstances where a domestic corporation is making a payment to any person other than a domestic corporation. The purely domestic paradigm is the payment by a closely held corporation of excessive compensation to a shareholder; the foreign paradigm is any payment for goods, services, use of funds or intellectual property, or the like by a domestic subsidiary to a foreign related party. Again, these are not new problems. With fewer other remaining avenues for base erosion, however, their significance is likely to increase.¹¹¹ A final area for base erosion is the use of noncorporate entities to conduct business. Again, this is not a new problem nor is it a problem that is likely to be significantly exacerbated in relation to current law.¹¹²

C. Where It All Ends, I Cannot Fathom My Friends

In this Article I attempt to replicate as closely as practicable the current corporate tax with a cashless corporate "tax." The CCT is not a perfect replica, of course, but it is very close in some respects. And it is a replica that neuters many of the baser instincts of corporate tax practitioners.

¹¹⁰ This problem is easy to combat in each of the three regimes. Under the current corporate tax, one could eliminate the interest deduction. Under the MVT, one could include the value of debt instruments (assuming away measurement problems) in determining the change in corporate market value. Under the CCT, one could issue phantom debt instruments in the same manner as phantom equity instruments. One probably would not want to do so, however, unless return-of-capital provisions were fully implemented.

Even with fully operational return-of-capital provisions, however, there is an additional issue raised with debt. That is the question of when a credit relationship rises to the level of debt capital, and when it does not (that is, when the debt is "trade debt"). This is not a trivial question. It is possible to punt on the question, however. Thus, to the extent that a debtor-creditor relationship arises in a trade context, and such debt is payable within a short period of time, there would be no need for the issuance of phantom equity. Moreover, so long as the putative lender is itself a corporation, this would produce no loss of revenue to the fisc, at least so long as the CCT were implemented with full consolidation. Thus, the only leakage would be short-term trade debt to noncorporate taxpayers, and that ought to be a small number.

¹¹¹ Transfer pricing issues, which tend to be indeterminate, are not at first impression either easier or harder to address under the CCT than under either the current corporate tax regime or the MVT. In general, they would pose less difficulty under integrated regimes, however.

¹¹² Under each of the MVT, the CCT, and the current tax regime, the easiest way to eliminate the problems caused by single-taxed entities is to eliminate their existence. This poses no particular problem under the current corporate tax or under the CCT (where one could issue the fisc phantom equity interests in partnerships). It does pose valuation issues under the MVT, however. Again, the integrated tax regimes have a certain advantage in this regard.

Still, one thing that certain iterations of the CCT make clear, and that some readers may find offensive, is that the project of a corporate tax is in part the rough equivalent¹¹³ of a confiscation by the fisc of at least a fraction—dictated by the tax rate—of any equity invested in a corporation. This toll charge is not unlike a very hefty property tax. And this confiscation, of course, is *in addition to* any taxes levied on investors with respect to their own returns. I suspect—although one may never know—that if the corporate tax were reformulated along the lines of the CCT, thus making visible the extent of the confiscation (particularly in the case of the iterations of the CCT where the fisc's relative ownership of corporations slowly rises to essentially 100%), there would be considerably less support for a corporate tax. That is, I suspect that the corporate tax, if made more transparent by means of the CCT, would slowly lose popular and congressional support and disappear.

¹¹³ The exact equivalent, if return-of-capital provisions are ignored.

