PRESENT LAW AND BACKGROUND RELATING TO SELECTED BUSINESS TAX ISSUES

Scheduled for a Public Hearing
Before the
SENATE COMMITTEE ON FINANCE
on September 20, 2006

Prepared by the Staff
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INTRODUCTION

The Senate Committee on Finance has scheduled a public hearing for September 20, 2006, on objectives, deficiencies, and options for reforming the U.S. business tax system. This document,[1] prepared by the staff of the Joint Committee on Taxation, provides an overview of present law related to a variety of hearing topics, including choice of business entity, corporate integration, mergers and reorganizations, cost recovery, and international tax systems.

[1] This document may be cited as follows: Joint Committee on Taxation, *Present Law and Background Relating to Selected Business Tax Issues* (JCX-41-06), September 19, 2006.

I. SUMMARY

Businesses can operate through a variety of legal forms, including C corporations, general partnerships, limited partnerships, limited liability companies, S corporations, and sole proprietorships. Both tax and non-tax concerns influence a business's choice of entity.

The income of a C corporation is taxed directly to the corporation and distributions of the corporation's after-tax income are taxed to the shareholders as dividends, although generally at a preferential rate. The income of pass-through entities such as partnerships, limited liability companies, and S corporations generally is not taxed at the entity level; instead, items of income and loss pass through to the partners or shareholders, who include the items in calculating their own taxable income.

In considering business tax reform, one potential option is to eliminate separate taxation and integrate the corporate and individual taxes (often referred to as "corporate integration"). Corporate integration would require many significant policy decisions with respect to present-law concepts, including the relative tax treatment of debt and equity, whether to pass through preferences to shareholders, and whether to ensure collection of at least one level of tax. The complex treatment of mergers and acquisitions under present law also could be examined.

Another area which may be the subject of tax reform proposals is the treatment of cost recovery. Cost recovery refers to the process by which a taxpayer recoups the cost of its investment in business or other income-producing property. Examples of cost recovery methods include straight-line depreciation, accelerated depreciation, and expensing, the latter two of which may be used as a tax policy tool to encourage investment. Another form of investment incentive is an investment tax credit.

Tax reform proposals may also arise with respect to the present law international tax rules. In a pure worldwide tax system, resident individuals and entities are taxable on their worldwide income, regardless of where the income is derived. In a pure territorial tax system, a country taxes only income derived within its borders, irrespective of the residence of the taxpayer. No country uses a pure worldwide or territorial system. Systems may be accurately characterized as predominantly worldwide or territorial, but all systems currently in use share at least some features of both approaches. The United States employs a predominantly worldwide tax system, under which U.S. persons generally are taxed on all income, whether derived in the United States or abroad.

II. OVERVIEW OF BUSINESS TAXATION

A. In General

Businesses may be organized in a number of different ways. Owners of a business sometimes conduct their activities as "sole proprietorships," which do not involve a legal entity separate from the owner. However, for a variety of business or other reasons, a business often is conducted through a separate legal entity. Common reasons to use a separate legal entity include the protection of limited liability accorded by State law to the owners of qualifying entities (but generally not to sole proprietors), and an improved ability to access capital markets for investment capital.

The tax consequences of using a separate entity depend on the type of entity through which the business is conducted. Partnerships, certain closely-held companies that elect to be taxed under subchapter S of the Internal Revenue Code of 1986, as amended (the "Code"), and limited liability companies that are treated as partnerships are treated for Federal income tax purposes as pass-through entities whose owners take into account the income (whether or not distributed) or loss of the entity on their own tax returns. Generally, an entity whose ownership interests are publicly traded is not entitled to be treated as a partnership.

In contrast, the income of a C corporation[2] is taxed directly at the corporate level. Shareholders are taxed on dividend distributions of the corporation's after-tax income. Shareholders are also taxed on any gain (including gain attributable to undistributed corporate income) on the disposition of their shares of stock of the corporation. Thus, the income of a C corporation may be subject to tax at both the corporate and shareholder levels. [3]

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[2] A C corporation is a corporation that is subject to subchapter C of the Code, which provides rules for corporate and shareholder treatment of corporate distributions and adjustments. C corporations generally are subject to the corporate-level tax rate structure set forth in section 11 of the Code.

[3] Specialized investment entities organized as C corporations, such as regulated investment companies and real estate investment trusts, and certain interests in debt instruments, such as real estate mortgage investment conduits, are effectively subject to only one level of tax notwithstanding that their ownership interests may be publicly traded. These, and other specialized entities such as cooperatives and tax-exempt organizations, are beyond the scope of this discussion.

B. Federal Income Tax Rates

U.S. individuals (citizens and residents) are taxed at graduated statutory rates ranging from 10 percent (for taxable income of up to $7,550 for single filers and up to $15,100 for married taxpayers filing joint returns or surviving spouses) to 35 percent (for taxable income over $336,550) for taxable year 2006. The intermediate rates are 15 percent, 25 percent, 28 percent, and 33 percent. The maximum tax rate on net long-term capital gains generally is 15 percent.[4] Dividends received by an individual from domestic corporations and qualified foreign corporations are taxed at the same rates that apply to capital gains.[5]

C corporations are taxed at statutory rates ranging from 15 percent (for taxable income up to $50,000) to 35 percent (for taxable income over $10,000,000). The intermediate rates are 25 percent and 34 percent. The benefit of graduated rates below 34 percent is phased out for corporations with taxable income between $100,000 and $335,000, and the benefit of the 34 percent rate is phased out for corporations with taxable income in excess of $15,000,000. Corporate long-term capital gains are taxed at the same rates as corporate ordinary income. Thus, the maximum tax rate for corporate net long-term capital gains is 35 percent.

Certain domestic production activities are effectively taxed at lower rates by virtue of a deduction equal to a percentage of the income from such activities.[6] The deduction is equal to three percent of the income from manufacturing, construction, and certain other activities specified in the statute, for taxable years beginning in 2006. The deduction is increased to six percent for taxable years beginning in 2007, 2008, and 2009. Thereafter, the deduction is increased to nine percent. Thus, when the deduction is fully phased in, the tax rate for a C corporation on its domestic production activities income is effectively 31.85 percent.[7] A similar reduction applies to the graduated rates applicable to individuals.

In addition, present law imposes a minimum tax on individuals and corporations to the extent their minimum tax liability exceeds their regular tax liability. The alternative minimum tax ("AMT") is imposed on corporations at the rate of 20 percent on the alternative minimum taxable income ("AMTI") in excess of a $40,000 phased-out exemption amount. The exemption amount is completely phased out for a corporation with AMTI in excess of $310,000.

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[4] Net gain from the sale of collectibles is taxed at a maximum 28-percent rate, while certain gain from the sale or exchange of depreciable real estate (i.e., "unrecaptured section 1250 property") is taxed at a maximum 25 percent rate. Under present law, for taxable years beginning after 2010, the maximum tax rate applicable to net long-term capital gains (other than collectibles or unrecaptured section 1250 property) will increase from 15 percent to 20 percent.

[5] Under present law, for taxable years beginning after 2010, dividends received by an individual are taxed at ordinary income rates.

[6] Sec. 199.

[7] Because of the nine-percent deduction, the taxpayer is taxed at a rate of 35 percent on only 91 percent of income, resulting in an effective tax rate of 31.85 percent.

A corporation with average gross receipts of less than $7.5 million for the prior three taxable years is exempt from the corporate minimum tax. The $7.5 million threshold is reduced to $5 million for the corporation's first three-taxable year period.

The AMT is imposed on individuals at a rate of 26 percent for the first $175,000[8] of AMTI in excess of a phased-out exemption amount and at a rate of 28 percent for amounts in excess of such amount. For taxable years beginning in 2006, the exemption amounts are: (1) $62,550 in the case of married individuals filing a joint return and surviving spouses; (2) $42,500 in the case of unmarried individuals other than surviving spouses; and (3) $31,275 in the case of married individuals filing a separate return.[9] The exemption amount is completely phased out for married individuals filing a joint return with AMTI in excess of $400,200. Similar phaseouts apply to other individual taxpayers.

AMTI is the taxpayer's regular taxable income increased by certain preference items and adjusted by determining the tax treatment of certain items in a manner that negates the deferral of income resulting from the regular tax treatment of those items. In general, the AMT applies a lower tax rate to a broader tax base. Specifically, the regular tax base is increased for AMT purposes by adding back certain items treated as tax preferences, and disallowing certain deductions and credits.

[8] $87,500 in the case of married individuals filing a separate return.

[9] For years beginning after 2006, the exemption amounts are $45,000; $33,750; and $22,500, respectively.

C. Choice of Entity

In general

The choice of business structure can have an impact on the liability of the owners of the business, the tax treatment of income and deductions, and on the options available to the business for financing projects. In practice, this results in considerable variation in the choice of entity structure. For example, in 2003, there were 2.0 million C corporation tax returns, 3.3 million S corporation tax returns, 2.4 million partnership returns, and 19.7 million non-farm sole proprietorship returns.

C corporations

A corporation is a business entity organized under a Federal or State statute, or under a statute of a Federally recognized Indian tribe, if the statute describes or refers to the entity as incorporated or as a corporation.[10] The Code taxes a corporation as an entity separate from its shareholders. A C corporation's income generally is taxed when earned at the corporate level and is taxed again at the individual level when distributed as dividends[11] to its shareholders. Corporate deductions and credits reduce only corporate income and are not passed through to shareholders.

Corporate income that is not distributed to shareholders generally is subject to current tax at the corporate level only.[12] To the extent that income retained at the corporate level is reflected in an increased share value, the shareholder may be taxed at capital gains rates upon sale or exchange (including certain redemptions) of the stock or upon liquidation of the corporation.[13]

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[10] Treas. Reg. sec. 301.7701-2(b)(1).

[11] Distributions with respect to stock that exceed corporate earnings and profits are not taxed as dividend income to shareholders but are treated as a tax-free return of capital that reduces the shareholder's basis in the stock. Distributions in excess of corporate earnings and profits that exceed a shareholder's basis in the stock are treated as amounts received in exchange for the stock which, in general, are taxed to the shareholder at capital gains rates.

[12] In addition to the regular corporate tax, the Code provides for an additional tax paid by the corporation at the top individual rate, imposed on certain corporate earnings that are not distributed to shareholders. An "accumulated earnings tax" can be imposed on certain earnings in excess of $250,000 ($150,000 for certain service corporations in certain fields) accumulated beyond the reasonable needs of the business (secs. 531-537). A "personal holding company tax" is imposed on certain undistributed personal holding company income, generally where the corporation meets certain closely held stock requirements and more than 60 percent of the adjusted ordinary gross income (as defined) consists of certain passive-type income such as dividends, interest, and similar items (secs. 541-547).

[13] If stock is held until the death of the shareholder, the stock is given a fair market value basis at death, resulting in no shareholder level income tax on appreciation prior to death if the heirs sell the stock to a third party, or receive corporate distributions in the form of a redemption–i.e. a sale of their stock to the corporation. Present law is scheduled to provide a modified carryover basis rule in the case of estates of decedents dying in the year 2011.

Foreign investors generally are exempt from U.S. income tax on capital gains, but are subject to withholding tax on dividends. Tax-exempt investors are not generally subject to tax on corporate distributions or on sales or exchanges of corporate stock.

The gain on appreciated corporate assets is generally subject to corporate level tax if they are distributed to the shareholders, yielding the same tax result as if the assets had been sold by the corporation and the proceeds distributed to the shareholders.

In general, amounts paid as reasonable compensation to shareholders who are also employees are deductible by the corporation,[14] and are taxed as ordinary income at the individual level (unless a specific exclusion applies). On the other hand, amounts paid as dividends to shareholders generally are not deductible by the corporation and are taxed as income to the shareholders (generally at the same preferential rates as apply to capital gains, for dividends received prior to 2011). However, amounts paid to corporate shareholders as dividends are generally eligible for a dividends-received deduction for the recipient corporation that results in the recipient corporation being taxed on at most 70 percent and possibly on none of the dividend received.[15]

In general, interest paid by a C corporation is deductible but dividends paid are not.[16] This creates a tax incentive that generally favors debt over equity in a corporation's capital structure. However, in some situations equity may be preferred to debt. Shareholders of a C corporation receive different treatment depending upon whether an instrument is characterized as equity or debt for tax purposes.[17] The corporate dividends-received deduction and the dividend rate reduction for dividends received by individuals may provide shareholder incentives to invest in stock rather than debt. An issuing corporation with losses may prefer to issue preferred stock

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[14] Annual compensation in excess of $1 million that is payable to the chief executive officer or the four other most highly compensated employees of a public corporation is not deductible unless the compensation qualifies as performance-based compensation or another exception applies. Sec. 162(m).

[15] The recipient corporation can generally claim a 100 percent dividends-received deduction if the recipient corporation owns 80 percent or more of the distributing corporation. If the recipient corporation owns less than 80 percent but at least 20 percent of the distributing corporation, the dividends-received deduction is 80 percent. If the recipient corporation owns less than 20 percent of the distributing corporation, the dividends-received deduction is 70 percent. There is no corporate exclusion with respect to interest received.

[16] If certain requirements are satisfied, dividends paid on stock held by an employee stock ownership plan are deductible by the corporation. Sec. 404(k).

[17] Debt and equity investments also provide different consequences to certain investors in the pass-through regimes of partnerships and S corporation. For example, tax-exempt and foreign investors are generally not taxed on interest income from a partnership if they are debt investors, but generally would be taxed in their share of partnership income from business activity of the partnership if they are equity investors. The subchapter S rules do not permit foreign investors or certain tax-exempt investors to own stock of an S corporation. Those tax-exempt investors that may own S corporation stock are subject to an unrelated business income tax on their share of S corporation income. These factors can lead to a preference for structuring partnership or S corporation investment by such investors as debt.

with characteristics similar to debt, effectively passing through some of the benefit of its losses to shareholders.[18] Foreign shareholders may prefer either dividend or interest income, depending on the tax treatment in their country of residence and the applicable U.S. tax withholding rates.

The distinction between debt and equity depends on a number of factors. This determination requires an examination of the substance of the instrument. Generally, debt requires a promise to pay a fixed sum by a date certain, with a reasonable expectation that payment is made. Debt instruments can be constructed to have features of both debt and equity, including (1) contingent payments up to a high yield or (2) a significant economic risk that all payments may not be made. Similarly, equity instruments can be constructed to have features of debt, including dividend incentives or put-call arrangements under which the issuer is expected to pay specified dividends and return the initial investment by a date certain.[19] Section 385 authorizes the Treasury Department to issue rules distinguishing debt from equity. Several sets of regulations have been proposed, but none has been finalized and retained.

The analysis of whether an instrument is debt or equity for Federal income tax purposes is not identical to the analysis of whether such instrument is characterized as debt or equity for financial reporting purposes. As a result, financial instruments are sometimes specifically structured to obtain desired differing treatment for tax and financial reporting purposes.

Shareholders receive different treatment depending on whether a corporate equity distribution is characterized as a dividend or as a payment in exchange for stock that is entitled to both capital gain treatment and basis recovery. While the tax rates for dividends and capital gains on stock are generally the same under present law, capital gain treatment permits basis

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[18] Distributions to shareholders by a loss corporation are taxed as dividends, with accompanying dividend treatment to shareholders, if the loss corporation had prior year earnings and profits that have not yet been distributed. If all earnings and profits have been distributed, distributions to shareholders would be nontaxable return of capital distributions, reducing the shareholders' basis in the stock.

[19] The Code limits the corporate interest deduction in specified situations. The Code provisions are based in part on case-law factors that distinguish debt from equity, but each Code provision turns on different facts and is narrowly applied to specific situations. The provisions include the following sections of the Code: Section 163(i) denies interest deductions on certain high-yield[19] deferred payment discount obligations. The disallowed portion is treated as a dividend. Section 163(j) denies interest deductions for certain payments to tax-exempt related parties that exceed 50 percent of income if there is a greater than 1.5 to 1 debt equity ratio. A carryover is allowed. Section 163(l) denies interest deductions on certain debt if a substantial amount of the principal or interest of the debt is payable in, or determined by reference to, equity of the issuer at the option of the issuer or a related party. The rules also apply if the choice to receive equity or amounts determined by reference to equity is at the option of the holder of the debt or a related party, if there is "substantial certainty" that the option will be exercised. Section 172(h) denies net operating loss carrybacks attributable to interest after certain corporate equity reduction transactions (generally, if there has been an acquisition of 50 percent of corporate stock, or an "excess" distribution). Carryforwards are allowed. Section 279 denies interest deductions for certain narrowly defined "corporate acquisition indebtedness."

recovery.[20] A number of Code provisions have attempted to provide guidance in this area. For example, section 302 provides rules to determine whether a shareholder whose stock has been partially redeemed has experienced a sufficient contraction in his or her interest to be treated as having sold the stock rather than as having received a dividend. Section 304 provides additional rules intended to deal with sales of stock to commonly controlled corporations.

An affiliated group of corporations may elect to file a consolidated return in lieu of separate returns.[21] A condition of electing to file a consolidated return is that all corporations that are members of the affiliated group must consent to all the consolidated return regulations prescribed prior to the last day prescribed by law for filing the consolidated return. The Treasury department has issued extensive consolidated return regulations under its authority to provide such rules. The regulations are generally directed toward preventing double taxation of income earned within the group, while preserving tax if assets or corporations that were members leave the group and preventing avoidance of tax due to shifting of attributes in the course of intragroup transactions.[22]

A C corporation is generally the entity of choice if a corporation anticipates a public offering, because publicly traded partnerships are generally taxed as corporations, and S corporations (discussed below) are not permitted to have more than 100 shareholders.[23]

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[20] Foreign shareholders, in addition, may not be subject to tax at all on capital gains, though they are taxed (often at a reduced rate under tax treaties) on dividends. On the other hand, some corporate shareholders may prefer dividend treatment if they are eligible for the dividends-received deduction.

[21] An affiliated group for this purpose includes a parent corporation that directly owns 80 percent of the vote and value of the stock (excluding certain nonvoting preferred stock) of at least one subsidiary (causing that subsidiary to be a qualified member of the group) and other corporations of which qualified upper tier members in turn hold such stock ownership. Foreign corporations and certain other entities are not eligible to be members of such a group.

[22] Section 1502 of the Code states that "The Secretary shall prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be returned, determined, computed, assessed, collected, and adjusted in such manner as clearly to reflect the income-tax liability and the various factors necessary for the determination of such liability, and in order to prevent the avoidance of such tax liability. In carrying out the preceding sentence, the Secretary may prescribe rules that are different from the provisions of chapter 1 that would apply if such corporations filed separate returns."

[23] In some circumstances, it is possible that non-publicly traded entities also might choose to operate as C corporations, for example in order to obtain the benefit of a separate corporate rate bracket or the benefit of special corporate treatment (e.g., the dividends-received deduction) for earnings that are to be retained in the corporation. Appreciation in corporate assets generally is subject to corporate level tax when the assets are distributed to shareholders; and there is no lower rate for corporate capital gains. These factors generally would be a deterrent to placing assets into a C corporation. Nevertheless, there may be situations where lower effective corporate rates could provide benefits.

Partnerships

Pass-through treatment

Business owners may choose to operate or invest through a "pass-through" entity, such as a partnership, limited liability company, or S corporation, either to avoid corporate tax treatment or for non-tax business reasons. Noncorporate tax treatment may be preferred because: (1) owners may not wish business earnings to be subject to two levels of tax (once when earned, and again when distributed); (2) the average or marginal tax rates for the individual shareholders may be lower than that of the corporation; and (3) owners may wish to use losses generated by the business to offset income from other sources.

Federal income tax treatment of partnerships

Partnerships generally are treated for Federal income tax purposes as pass-through entities, not subject to tax at the entity level.[24] Items of income (including tax-exempt income), gain, loss, deduction and credit of the partnership are taken into account in computing the tax of the partners (based on the partnership's method of accounting and regardless of whether the income is distributed to the partners). Each partner takes into income such partner's distributive share of the partnership's taxable income and the separately allocable items of income, gain, loss, deduction, and credit.[25] A partner's deduction for partnership losses is limited to the amount of the partner's adjusted basis in his or her partnership interest.[26] To the extent a loss is not allowed due to a limitation, it generally is carried forward to the next year. A partner's basis in the partnership interest generally equals the sum of (1) such partner's capital contribution to the partnership, (2) the partner's distributive share of partnership income, and (3) the partner's share of partnership liabilities, less (1) such partner's distributive share of losses allowed as a deduction and (2) any partnership distributions.[27]

Partnerships provide partners with a significant amount of flexibility to vary their respective shares of partnership income. Unlike corporations, partnerships may allocate items of income, gain, loss, deduction and credit among the partners, provided the allocations have substantial economic effect. In general, an allocation is permitted to the extent the partner to which the allocation is made receives the economic benefit or bears the economic burden of such allocation, and the allocation substantially impacts the dollar amounts to be received by the partners from the partnership independent of tax consequences.

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[24] Sec. 701.

[25] Sec. 702(a). The recognition of income under this rule does not necessarily correspond with any distribution of cash from the partnership to cover the tax liabilities of individual partners.

[26] Sec. 704(d). In addition, "passive loss" and "at-risk" limitations limit the extent to which certain types of income can be offset by partnership deductions. These limitations do not apply to corporate partners (except certain closely held corporations) and may not be important to individual partners who have partner level "passive income" from other investments.

[27] Sec. 705.

Limited liability companies

In the last 30 years,[28] States have enacted laws providing for another form of entity, the limited liability company ("LLC"). LLCs are generally treated as partnerships for Federal income tax purposes. They are neither partnerships nor corporations under applicable State law, but they generally provide limited liability to their owners for obligations of the business. Under regulations promulgated in 1996, any domestic non-publicly traded unincorporated entity with two or more members generally may elect to be treated as either a partnership or a corporation for Federal income tax purposes, while any single-member unincorporated entity may elect to be treated as a corporation or to be disregarded (i.e., treated as not separate from its owner[29]) for Federal income tax purposes.[30] These regulations, known as the "check-the-box" regulations, were a response, in part, to the growth of LLCs.

S corporations

An S corporation provides the Federal income tax advantage of pass-through treatment, and also retains the non-tax advantages of corporate status under Federal securities laws and State law. An S corporation and its shareholders are generally treated, for Federal income tax purposes, more like a partnership and its partners than like a C corporation and its shareholders. In order to make an election to be treated as an S corporation, a corporation must meet certain requirements primarily regarding its capital structure and the identity of its shareholders.

To be eligible to elect S corporation status, a corporation may not have more than 100 shareholders and may not have more than one class of stock. Only individuals (other than nonresident aliens), certain tax-exempt organizations, and certain trusts and estates are permitted shareholders. A corporation may elect S corporation status only with the consent of all its shareholders, and may terminate its election with the consent of shareholders holding more than 50 percent of the stock.[31] Although there are limitations on the types of shareholders and stock structure an S corporation may have, there is no limit on the asset size of such a corporation (as there is no limit on the size of a C corporation or partnership).

For Federal income tax purposes, an S corporation is generally not subject to tax at the corporate level.[32] Items of income (including tax-exempt income), gain, loss, deduction and credit of the corporation are taken into account in computing the tax of the shareholders (under the corporation's method of accounting and regardless of whether the income is distributed to the

[28] The first LLC statute was enacted in Wyoming in 1977. All States (and the District of Columbia) now have an LLC statute, though the tax treatment of LLCs for State tax purposes may differ.

[29] Thus, where the single member is an individual, such a disregarded LLC will be treated as a sole proprietorship. Where the single member is a corporation, the LLC will be treated as a branch.

[30] Treas. Reg. sec. 301.7701-3.

[31] Sec. 1362.

[32] Secs. 1363 and 1366.

shareholders). A shareholder's deduction for corporate losses is limited to the sum of the shareholder's adjusted basis in the S corporation stock and the indebtedness of the corporation to such shareholder. To the extent a loss is not allowed due to this limitation, the loss generally is carried forward to the next year. The shareholder's basis in the S corporation stock (and debt) is reduced by the shareholder's share of losses and (in the case of stock) by distributions and is increased by the shareholder's share of the corporation's income and contributions to capital.[33]

There are two principal exceptions to the general pass-through treatment of S corporations. Both are applicable only if the corporation was previously a C corporation and are generally intended to prevent avoidance of otherwise applicable C corporation tax consequences. First, an S corporation is subject to tax on excess net passive investment income (but not in excess of its taxable income, subject to certain adjustments), if the corporation has subchapter C earnings and profits and has gross receipts more than 25 percent of which are passive investment income for the year.[34] Second, for the first 10 years after a corporation that was previously a regular C corporation elects to be an S corporation, certain net "built-in" capital gains of the corporation attributable to the period in which it was a C corporation are subject to tax at the corporate level.[35]

In general, an S corporation shareholder is not subject to tax on corporate distributions unless the distributions exceed the shareholder's basis in the stock of the corporation or the corporation was formerly a C corporation and has undistributed earnings and profits.[36] To the extent of such earnings and profits, corporate distributions are treated as dividends of C corporations and generally are subject to tax as such in the hands of the shareholders.

<u>Comparison of pass-through entities</u>

Notwithstanding that they both provide for pass-through treatment, there are several significant Federal tax differences between S corporations and partnerships. First, corporate liabilities (other than those owed to its shareholders) are not included in a shareholder's basis of their interest in an S corporation. Thus, unlike a partner who can take deductions supported by certain partnership indebtedness, S corporation shareholders who wish to obtain similar types of deductions are required to individually borrow and contribute or re-lend such amounts to the S corporation. Further, S corporations may have only one class of stock and, thus, do not offer the

[33] Sec. 1367.

[34] Sec. 1375. C corporation earnings and profits generally refers to the earnings of the corporation prior to its subchapter S election which would have been taxable as dividends if distributed to shareholders by the corporation prior to its subchapter S election. If the S corporation continues to have C corporation earnings and profits and has gross receipts more than 25 percent of which are passive investment income in each year for three consecutive years, the S corporation election is automatically terminated (sec. 1362(d)(3)).

[35] Sec. 1374.

[36] Sec. 1368.

same flexibility as partnerships to allocate income and losses to different investors. Below is a list of the major differences in the taxation of the two types of entities and their owners:

Table 1.–Major Differences in Taxation of Partnerships and S Corporations

Item	Partnerships	S Corporations
Maximum number of equity interests	No maximum number. (Partnerships with over 100 partners may elect a special pass-thru regime.)	Maximum number of shareholders is 100.
Classes of equity interests	No limitation.	One class of stock. (Voting rights disregarded in making this determination.)
Ineligible entities	Generally, partnerships with equity interests that are publicly traded.	Financial institutions using reserve method of accounting; insurance companies; possessions corporations; DISCs and former DISCs.
Eligible shareholders	All persons eligible.	Eligible shareholders include individuals, estates and certain trusts, charities, and qualified retirement plans.
Foreign taxpayers	Eligible to be a partner; effectively connected income subject to withholding tax.	Ineligible to be a shareholder.
Tax-exempt taxpayers	Eligible to be a partner; income subject to generally applicable unrelated business income tax	Tax-exempt taxpayers (other than charities and qualified retirement plans) ineligible to be a shareholder; all items of income and loss of charities and qualified retirement plans (other than ESOPs) included in unrelated business taxable income; items of income and loss of ESOPs not included in unrelated business taxable income.
Trusts	Eligible to be a partner; usual trust taxation rules apply.	Only qualified subchapter S trusts and electing small business trusts eligible as shareholders; special taxation rules apply.
Allocation of income and losses	Allocation in accordance with partnership agreement so long as allocation has substantial economic effect.	Pro rata among shares on a daily basis.
Limitation on losses	Losses limited to basis in partnership interest, which includes partner's share of partnership debt.	Losses limited to basis in stock and indebtedness of corporation to shareholder; no inclusion of corporate debt in shareholder basis.
Contributions of property	Tax-free; built-in gain or loss allocated to contributing partner.	Tax-free (if control requirement met); no special allocation rules.

Item	Partnerships	S Corporations
Distributions of property (liquidating or otherwise)	Generally tax-free; carryover or substituted basis to partner; partnership may elect to make basis adjustment in partnership property to reflect adjustments to distributee partner.	Gain taxed to corporation; fair market value basis to shareholder; no basis adjustments to corporate property.
Transfer of equity interests	Gain treated as ordinary income to extent of ordinary income on assets held by partnership; partnership may elect to adjust basis of its assets with respect to transferee partner to reflect purchase price.	No ordinary income look-thru provision; no adjustments to basis of corporate property.
Termination of entity	Termination if sale or exchange of 50 percent or more of partnership interests within 12 months.	No provision.
Treatment of C corporation converting to partnership or S corporation.	Corporation must liquidate and gain or loss is recognized to corporation and shareholders.	Generally no taxation upon election; corporate tax is imposed on built-in gain if assets sold during 10 year period after election effective; distribution of subchapter C earnings and profits taxable as a dividend; special rules applicable to a corporation with accumulated earnings and excess net passive investment income.
Mergers, etc. with corporations	Not eligible to engage in tax-free reorganization with corporation.	Eligible party to a tax-free corporate reorganization.
Corporate tax rules of subchapter C	Rules inapplicable.	Rules generally applicable.
Application of employment taxes	Except in the case of a limited partner, each partner's share of net business income is net earnings from self-employment.	Amounts paid as compensation are wages; no amounts are net earnings from self-employment.

III. DATA ON THE NUMBER AND SIZE OF BUSINESS ENTITIES IN THE UNITED STATES

Trends in use of business entities, 1978-2003

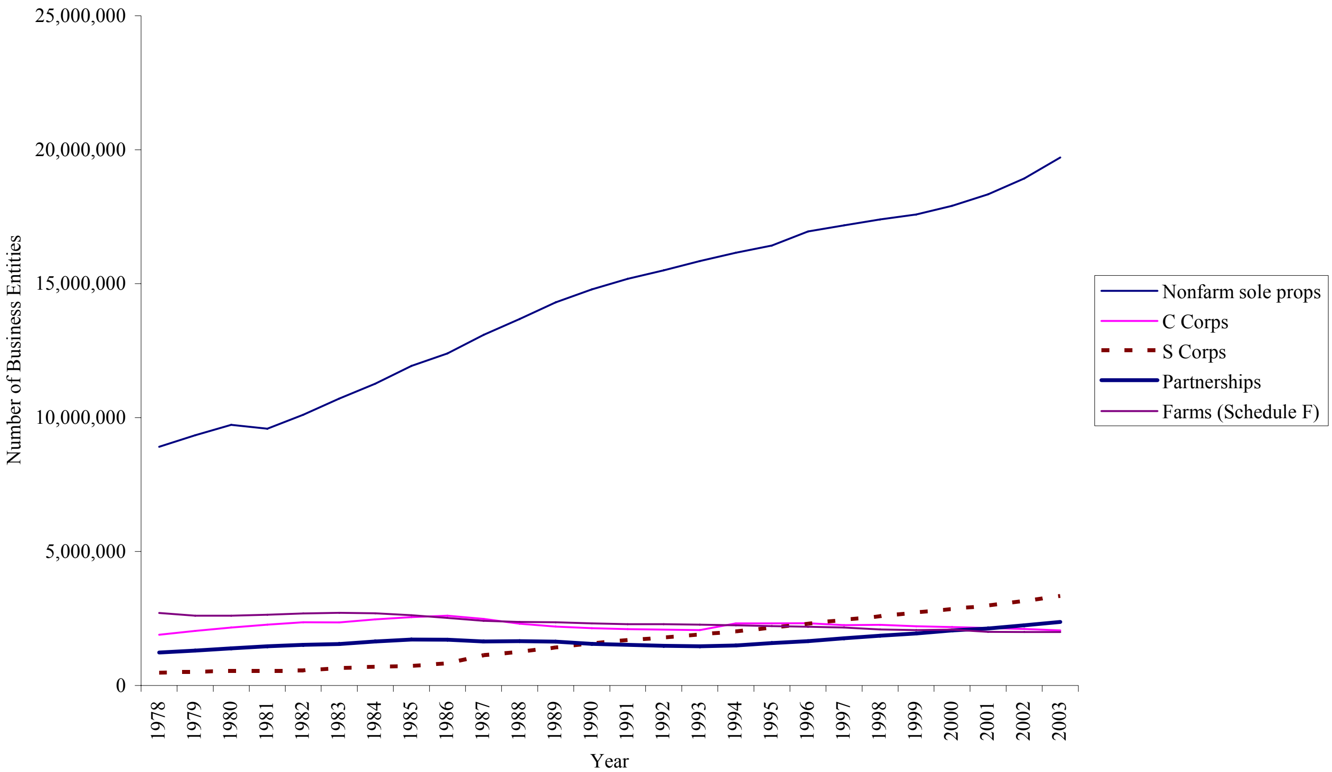
Returns filed by C corporations, S corporations, partnerships, non-farm sole proprietors, and farming enterprises

Figure 1 and Table 1 show data from the Internal Revenue Service's Statistics of Income ("SOI") regarding the number of tax returns filed by different forms of business organizations from 1978 to 2003.[37] In these data, farms are measured solely by reference to those taxpayers who report income (or loss) on Schedule F of Form 1040. Other taxpayers engaged in agricultural enterprises may use a separate entity. When this occurs, the data reported below report that entity among the totals of C corporations, S corporations, or partnerships.

Throughout the period 1978 to 2003, nonfarm sole proprietorships made up the vast majority of businesses. The S corporation is the second most numerous business form. In 2003, S corporations constituted 11.3 percent of all business entities. Over the past two decades S corporations have grown from approximately 3.5 percent of all business entities to over 10 percent. The growth in the number of S corporations was most dramatic immediately following 1986, while the number of C corporations and partnerships declined each year from 1987 through 1993. The number of farm returns generally declined through the 25-year period.

[37] These data are based upon returns filed by individuals and entities. The numbers reported for nonfarm sole proprietorships and for farm returns are based upon the number of taxpayers who file a business return as a sole proprietor (Schedule C to Form 1040) and who file a farm income return (Schedule F to Form 1040). One taxpayer may report more than one business organized as a sole proprietorship; the data reported here count only one sole proprietorship. On the other hand, the data for C corporations, S corporations, and partnerships count the number of tax returns and information returns filed by C corporations, S corporations, and partnerships. One taxpayer may own more than one corporation. When this occurs, unlike the case in sole proprietorships, the data reported here count each corporation as a separate entity. Thus, the data are not perfectly comparable across entity classification.

Figure 1.–Number of Different Types of Business Returns, 1978-2003



Source: Internal Revenue Service, Statistics of Income, published and unpublished data.

Table 2.–Number of Different Types of Business Returns Relative to All Business Returns, 1978-2003

Year	Sole Proprietorships	C Corporations	S Corporations	Partnerships	Farms	Total
1978	8,908,289	1,898,100	478,679	1,234,157	2,704,794	15,224,019
1979	9,343,603	2,041,887	545,389	1,299,593	2,605,684	15,805,674
1980	9,730,019	2,165,149	545,389	1,379,654	2,608,430	16,428,641
1981	9,584,790	2,270,931	541,489	1,460,502	2,641,254	16,498,966
1982	10,105,515	2,361,714	564,219	1,514,212	2,689,237	17,234,897
1983	10,703,921	2,350,804	648,267	1,541,539	2,710,044	17,954,575
1984	11,262,390	2,469,404	701,339	1,643,581	2,694,420	18,771,134
1985	11,928,573	2,552,470	724,749	1,713,603	2,620,861	19,540,256
1986	12,393,700	2,602,301	826,214	1,702,952	2,524,331	20,049,498
1987	13,091,132	2,484,228	1,127,905	1,648,035	2,420,186	20,771,486
1988	13,679,302	2,305,598	1,257,191	1,654,245	2,367,527	21,263,863
1989	14,297,558	2,204,896	1,422,967	1,635,164	2,359,718	21,920,303
1990	14,782,738	2,141,558	1,575,092	1,553,529	2,321,153	22,374,070
1991	15,180,722	2,105,200	1,696,927	1,515,345	2,290,908	22,789,102
1992	15,495,419	2,083,652	1,785,371	1,484,752	2,288,218	23,137,412
1993	15,848,119	2,063,124	1,901,505	1,467,567	2,272,407	23,552,722
1994	16,153,871	2,318,614	2,023,754	1,493,963	2,242,324	24,232,526
1995	16,423,872	2,321,048	2,153,119	1,580,900	2,219,244	24,698,183
1996	16,955,023	2,326,954	2,304,416	1,654,256	2,188,025	25,428,674
1997	17,176,486	2,257,829	2,452,254	1,758,627	2,160,954	25,806,150
1998	17,398,440	2,260,757	2,588,081	1,855,348	2,091,845	26,194,471
1999	17,575,643	2,210,129	2,725,775	1,936,919	2,067,883	26,516,349
2000	17,902,791	2,184,795	2,860,478	2,057,500	2,086,789	27,092,353
2001	18,338,190	2,149,105	2,986,486	2,132,117	2,006,871	27,612,769
2002	18,925,517	2,112,230	3,154,377	2,242,169	1,995,072	28,429,365
2003	19,710,079	2,059,631	3,341,606	2,375,375	1,997,116	29,483,807

Source: Internal Revenue Service, Statistics of Income, published and unpublished data.

The growth of limited liability companies

The use of the limited liability company ("LLC") as an entity is a development of the past decade. Most LLCs filed the partnership reporting form for Federal reporting purposes and their numbers, assets, and gross receipts are counted among the partnership data reported in Table 1 and Figure 1 above. Table 3 and Figure 2, below, decompose the number of partnerships for the period 1990 through 2003 into general partnerships, limited partnerships, and LLCs.[38] Figure 5

[38] The data in Table 2 may not sum to the total number of partnerships reported in Table 1 because of rounding. Also, this decomposition exclude those businesses that checked either the "limited liability partnership" box, the "other" box, or those partnerships that identified themselves as foreign partnerships on Form 1065, Schedule B, line 1. See, Alan Zempel, "Partnership Returns, 1998," *SOI Bulletin*, 20, Fall 2000, Bill Pratt, "Partnership Returns, 2000," *SOI Bulletin*, 22, Fall 2002, and Tim Wheeler and Nina Shumofsky, "Partnership Returns, 2003," *SOI Bulletin*, 25, Fall 2005.

documents the rapid growth of LLCs relative to other partnership forms over the past several years. Since 1996, LLCs have grown at a rate of approximately 25 percent per year.

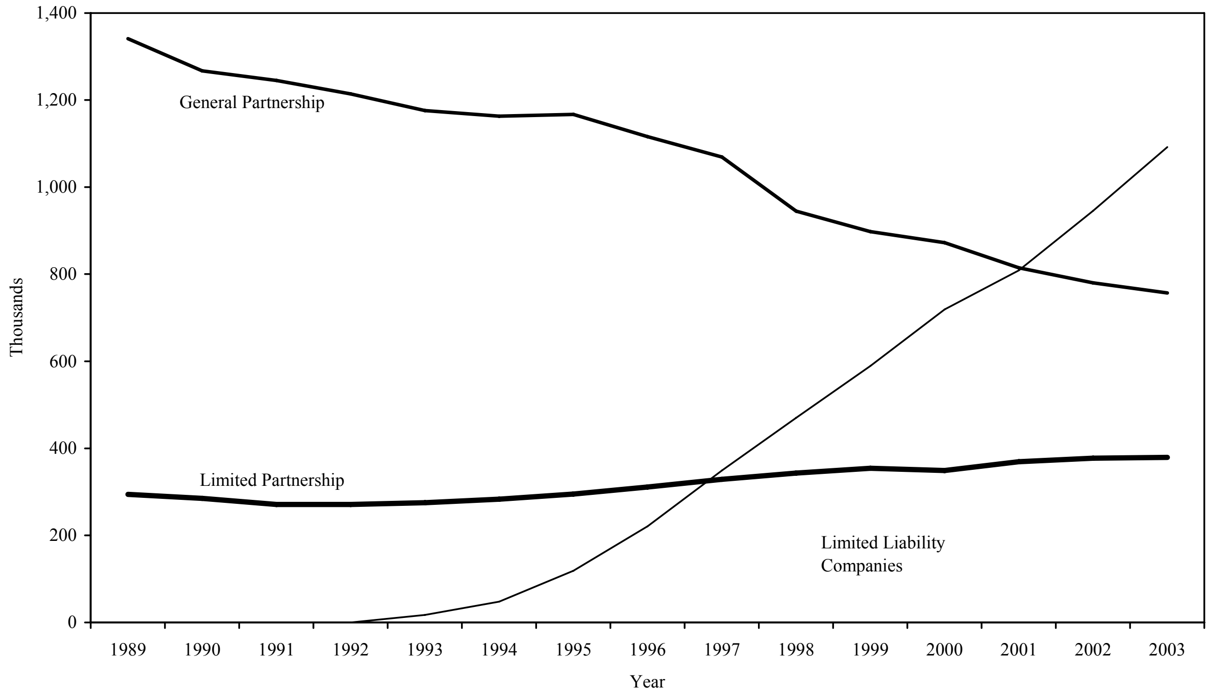
Table 3.–Number of Partnership Returns by Type, 1990-2003
Type of Partnership

Year	General Partnerships (thousands)	Limited Partnerships (thousands)	Limited Liability Companies (thousands)
1990	1,267	285	n.a.
1991	1,245	271	n.a.
1992	1,214	271	n.a.
1993	1,176	275	17
1994	1,163	283	48
1995s	1,167	295	119
1996	1,116	311	221
1997	1,069	329	349
1998	945	343	470
1999	898	354	589
2000	872	349	719
2001	815	369	809
2002	780	377	946
2003	757	379	1,092

n.a. - not available.

Source: Bill Pratt, "Partnership Returns, 2000," *SOI Bulletin*, 22, Fall 2002 Tim Wheeler and Nina Shumofsky, "Partnership Returns, 2003," *SOI Bulletin*, 25, Fall 2005.

Figure 2.–Partnership Returns by Type of Partnership, 1989-2003



Source: Bill Pratt, "Partnership Returns, 2000," *SOI Bulletin*, 22, Fall 2002 Tim Wheeler and Nina Shumofsky, "Partnership Returns, 2003," *SOI Bulletin*, 25, Fall 2005.

Size distribution of C corporations, S corporations, partnerships, and non-farm sole proprietorships

While one may often associate small businesses with organization in the form of a sole proprietorship, a partnership, or an S corporation, there is not an ironclad correspondence between the size of the business and the form of organization. While many small businesses are arranged as a sole proprietorship, a partnership, or an S corporation, not all businesses organized in those forms are small and not all businesses organized as C corporations are large. One can use SOI data on assets and gross receipts to measure the size of businesses in order to sort out how small businesses are arrayed across the different forms of organization.

Tables 4 through 7 display 2003 SOI data on C corporations, S corporations, partnerships, and nonfarm sole proprietorships. For the first three forms of organization, the tables classify all taxpayers using that form of organization both by the size of assets and gross receipts. For sole proprietorships (Table 6), there is no tax data on assets, so the table uses only gross receipts as a classifier. When businesses are classified by asset size, one can see that there are a significant number of C corporations of small size. More than 850,000 corporations have assets under $50,000, approximately 40 percent of the total number of C corporations. For S corporations, approximately one half have assets under $50,000.

The concentration of assets differs among the three entity forms. C corporations have the largest disparity in asset holding. Firms with over $100 million in assets, which represent 0.9 percent of all C corporations, hold 96 percent of the assets in C corporations. By comparison, partnerships with $100 million or more in assets constitute 0.4 percent of all partnerships and these businesses own only 67 percent of all assets owned by partnerships. S corporations with $100 million or more in assets constitute only 0.06 percent of all S corporations and account for 26 percent of all assets owned by S corporations.

When businesses are classified by gross receipts, a picture emerges that is similar to that seen in the asset data. There are a substantial number of quite small C corporations (more than 450,000 corporations with gross receipts less than $25,000, nearly 23 percent of the number of C corporations). But across the other forms of organization there are higher percentages of businesses with small amounts of gross receipts. For nonfarm sole proprietorships, 68 percent have gross receipts under $25,000. For S corporations, 25 percent report gross receipts of $25,000 or less.

As with assets, the dispersion of gross receipts across the classifications is more skewed for C corporations and partnerships than for S corporations. C corporations with over $50 million in gross receipts, which represent approximately 0.73 percent of all C corporations, collect over 80 percent of gross receipts of all C corporations. For partnerships, approximately the 0.2 percent of partnerships with gross receipts in excess of $50 million report 67 percent of all partnership gross receipts. For S corporations, 0.3 percent of S corporations with gross receipts in excess of $50 million report 30 percent of S corporation gross receipts. For non-farm sole proprietorships, fewer than 0.001 percent of such businesses report gross receipts in excess of $50 million, and these businesses report less than two percent of all non-farm sole proprietorship gross receipts.

Table 4.–Distribution of C Corporations, 2003

Firms classified by assets	Number of Returns	Total Assets (millions)	Cumulative Percent	
			Returns	Total Assets
$0 or less	225,406	0	10.94%	0.00%
$1 to $25,000	451,718	3,461	32.88%	0.01%
$25,001 to $50,000	191,802	6,491	42.19%	0.02%
$50,001 to $100,000	235,533	16,064	53.62%	0.05%
$100,001 to $250,000	327,419	52,150	69.52%	0.15%
$250,001 to $500,000	215,538	76,577	79.99%	0.30%
$500,001 to $1,000,000	157,822	111,309	87.65%	0.52%
$1,00,001 to $10,000,000	201,051	555,141	97.41%	1.60%
$10,000,001 to $50,000,000	27,933	609,856	98.77%	2.78%
$50,000,001 to $100,000,000	6,839	486,576	99.10%	3.73%
More than $100,000,000	18,570	49,540,577	100.00%	100.00%
Total	2,059,631	51,458,202		

Firms classified by receipts	Number of Returns	Total Receipts (millions)	Cumulative Percent	
			Returns	Total Receipts
$0 or less	245,523	-283	11.92%	0.00%
$1 to $2,500	48,411	50	14.27%	0.00%
$2,501 to $5,000	30,490	113	15.75%	0.00%
$5,001 to $10,000	40,057	300	17.70%	0.00%
$10,001 to $25,000	103,902	1,735	22.74%	0.01%
$25,001 to $50,000	125,957	4,637	28.86%	0.04%
$50,001 to $100,000	179,644	13,421	37.58%	0.14%
$100,001 to $250,000	326,671	53,945	53.44%	0.51%
$250,001 to $500,000	267,119	96,492	66.41%	1.17%
$500,001 to $1,000,000	245,357	173,069	78.32%	2.35%
$1,000,001 to $10,000,000	384,193	1,102,312	96.97%	9.91%
$10,000,001 to $50,000,000	47,284	960,598	99.27%	16.49%
More than $50,000,000	15,023	12,182,314	100.00%	100.00%
Total	2,059,631	14,588,703		

* Details do not add to total due to rounding.

Table 5.–Distribution of S Corporations, 2003

Firms classified by assets	Number of Returns	Total Assets (millions)	Cumulative Percent	
			Returns	Total Assets
$0 or less	399,425	0	11.95%	0.00%
$1 to $25,000	941,803	7,608	40.14%	0.35%
$25,001 to $50,000	377,169	12,827	51.42%	0.93%
$50,001 to $100,000	409,527	28,768	63.68%	2.25%
$100,001 to $250,000	479,170	75,059	78.02%	5.68%
$250,001 to $500,000	289,998	102,812	86.70%	10.38%
$500,001 to $1,000,000	185,017	128,551	92.23%	16.26%
$1,00,001 to $10,000,000	231,258	638,129	99.15%	45.45%
$10,000,001 to $50,000,000	23,881	463,027	99.87%	66.62%
$50,000,001 to $100,000,000	2,438	167,966	99.94%	74.31%
More than $100,000,000	1,920	561,836	100.00%	100.00%
Total	3,341,606	2,186,583		

Firms classified by receipts	Number of Returns	Total Receipts (millions)	Cumulative Percent	
			Returns	Total Receipts
$0 or less	464,406	-763	13.90%	-0.02%
$1 to $2,500	85,361	96	16.45%	-0.02%
$2,501 to $5,000	40,381	153	17.66%	-0.01%
$5,001 to $10,000	75,469	566	19.92%	0.00%
$10,001 to $25,000	165,633	2,799	24.88%	0.07%
$25,001 to $50,000	218,687	8,011	31.42%	0.26%
$50,001 to $100,000	341,945	25,321	41.65%	0.87%
$100,001 to $250,000	601,343	98,337	59.65%	3.23%
$250,001 to $500,000	451,434	162,104	73.16%	7.13%
$500,001 to $1,000,000	374,646	266,141	84.37%	13.52%
$1,000,001 to $10,000,000	459,793	1,243,554	98.13%	43.39%
$10,000,001 to $50,000,000	52,777	1,101,059	99.71%	69.85%
More than $50,000,000	9,731	1,255,170	100.00%	100.00%
Total	3,341,606	4,162,548		

* Details do not add to total due to rounding.

Table 6.–Distribution of Partnerships, 2003

Firms classified by assets	Number of Returns	Total Assets (millions)	Cumulative Percent: Returns	Cumulative Percent: Total Assets
$0 or less	653,446	-59,510	27.51%	-0.62%
$1 to $25,000	272,468	2,242	38.98%	-0.59%
$25,001 to $50,000	111,953	4,070	43.69%	-0.55%
$50,001 to $100,000	131,916	9,686	49.25%	-0.45%
$100,001 to $250,000	258,981	43,267	60.15%	0.00%
$250,001 to $500,000	227,650	82,588	69.73%	0.85%
$500,001 to $1,000,000	231,739	167,153	79.49%	2.58%
$1,00,001 to $10,000,000	413,173	1,225,312	96.88%	15.24%
$10,000,001 to $50,000,000	56,917	1,149,937	99.28%	27.13%
$50,000,001 to $100,000,000	7,732	544,931	99.60%	32.76%
More than $100,000,000	9,400	6,505,377	100.00%	100.00%
Total	2,375,375	9,675,053		

Firms classified by receipts	Number of Returns	Total Receipts (millions)	Cumulative Percent: Returns	Cumulative Percent: Total Receipts
$0 or less	1,465,925	0	61.71%	0.00%
$1 to $2,500	56,996	56	64.11%	0.00%
$2,501 to $5,000	33,107	118	65.51%	0.01%
$5,001 to $10,000	44,948	316	67.40%	0.02%
$10,001 to $25,000	78,718	1,311	70.71%	0.07%
$25,001 to $50,000	84,049	3,111	74.25%	0.19%
$50,001 to $100,000	101,523	7,542	78.53%	0.48%
$100,001 to $250,000	159,177	26,273	85.23%	1.49%
$250,001 to $500,000	109,916	39,210	89.85%	3.01%
$500,001 to $1,000,000	89,370	62,959	93.62%	5.44%
$1,000,001 to $10,000,000	129,550	362,599	99.07%	19.42%
$10,000,001 to $50,000,000	17,057	357,156	99.79%	33.20%
More than $50,000,000	5,039	1,731,694	100.00%	100.00%
Total	2,375,375	2,592,346		

* Details do not add to total due to rounding.

Table 7.–Distribution of Nonfarm Sole Proprietorships, 2003

Firms classified by receipts	Number of Returns	Total Receipts (millions)	Cumulative Percent: Returns	Cumulative Percent: Total Receipts
$0 or less	845,281	0	4.29%	0.00%
$1 to $2,500	3,865,401	4,523	23.90%	0.44%
$2,501 to $5,000	2,221,661	8,053	35.17%	1.21%
$5,001 to $10,000	2,793,606	20,277	49.35%	3.17%
$10,001 to $25,000	3,679,544	59,269	68.01%	8.89%
$25,001 to $50,000	2,416,372	85,911	80.27%	17.17%
$50,001 to $100,000	1,775,671	126,018	89.28%	29.33%
$100,001 to $250,000	1,361,294	208,563	96.19%	49.45%
$250,001 to $500,000	457,951	158,382	98.51%	64.72%
$500,001 to $1,000,000	197,727	133,870	99.52%	77.64%
$1,000,001 to $10,000,000	93,816	185,477	99.99%	95.53%
$10,000,001 to $50,000,000	1,593	27,889	100.00%[1]	98.22%
More than $50,000,000	162	18,476	100.00%	100.00%
Total	19,710,079	1,036,708		

* Details do not add to total due to rounding.

Note: The actual figure is 99.9992 percent which rounds to 100.00 percent.

IV. CORPORATE INTEGRATION

A. Background and Issues

The present law structure of a separate entity level tax on corporate income has long been recognized to create a variety of economic distortions. The two levels of tax on corporate form income (entity and individual level), as compared to the single individual level tax imposed on pass-through entities (S-corps, partnerships, LLCs), create a bias against the corporate form of organization; this in turn limits investors' access to publicly traded equity investment, which may impose a particular burden to smaller investors who are less likely to have significant access to equity investments in pass-through entities. To the extent that the two levels of tax impose a higher level of tax on investment generally, the incentive to save is reduced. The resulting increase in the cost of capital needed to finance new investment will lead to lower capital formation, thereby reducing future output and productivity. An additional distortion resulting from the present law corporate income tax rules is the incentive to finance new investments from debt rather than equity on account of the deductibility of interest payments on debt but no comparable deduction for dividends paid on equity.[39] Over-reliance on debt financing can increase bankruptcy risk. Finally, there may be incentives created for the retention of earnings in the corporation, which may lead to distortions in the allocation of capital to the extent that corporations with current earnings have less favorable investment opportunities than would their shareholders.[40] In addition, present law results in considerable complexity and tax planning as taxpayers seek to structure the most tax-favorable form of doing business and providing returns to investors.

At the same time, proposals to eliminate separate corporate and shareholder levels of taxation (referred to as "corporate integration") involve significant policy decisions and can also produce considerable complexity. Under present law, although the Code provides rules for imposing separate tax at the corporate and at the shareholder level, this does not always result in actual payment of two levels of tax. In some cases, the amounts that are distributed to

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[39] Some investors, however, may prefer equity to debt. See discussion of C corporations under section II.C. "Choice of Entity", supra.

[40] The two-tier tax on dividend distributions can make it more desirable for a corporation to use retained earnings rather than new equity for its investments. Shareholders can find such earnings retention attractive (subject to the accumulated earnings tax and personal holding company rules described at footnote 12 supra), if the shareholder expects to defer tax on capital gains for a substantial period or to hold stock until death (so that appreciation can be passed to his heirs free of individual income tax).

There also may be an incentive under present law to retain earnings if the corporation's effective tax rate on reinvestment is lower than the shareholder tax rate on distributed earnings. By contrast, if the shareholder's tax rate is significantly lower than the corporation's effective tax rate–for example, if the shareholder is a tax-exempt entity or is entitled to a corporate dividends-received deduction or to the lower rates on dividends to individuals, or if the distribution can be structured as a stock buyback eligible for capital gains rates and basis recovery–there may be a tax incentive to distribute earnings or a reduced incentive to retain earnings.

shareholders may have borne less than a full tax at the corporate level due to the operation of various deductions, deferrals, or other provisions that have reduced or eliminated corporate level tax. Also, in some cases, shareholders are tax-exempt, or the rate of tax the shareholder may pay is reduced due to capital gains treatment, the lower rates for dividends of individuals, the dividends-received deduction for corporations, step-up in basis of stock at death, or other provisions. Thus, under present law, the combined individual and corporate tax rates on corporate earnings that are distributed to shareholders may not be as great as two full levels of tax, and may be less than a single full level of tax. If a decision were made to increase corporate integration, policy decisions would need to be made regarding those situations in which at least one level of tax should be collected and at which level (corporate or shareholder) it should be collected. Complexity would be involved in co-ordinating the tax results at the entity and individual levels.

As one example, consider a corporation whose earnings are subject to little or no tax due to tax incentives or preferences for particular types of investment or business activities. Under present law, earnings of such a corporation distributed to taxable investors, or gains of such investors from retained earnings, may still be taxed to the investors at the "second level" of tax. In considering a form of corporate integration, decisions would have be made whether to collect at least one full level of tax or whether to pass through the tax benefits to investors. If the latter decision is made, issues may still arise regarding the appropriate investors to receive the benefit and how to treat situations where shares have changed hands between the time of the tax benefited activities and the time of the distribution. Present law rules for partnerships contain elaborate rules that attempt to prevent the misallocation of certain tax benefits to partners.

As another example, consider a corporation that conducts a business activity and that has tax-exempt shareholders. Under present law, the income from the business activity is taxed at the corporate level although the tax-exempt shareholders are not taxed on dividend income or capital gain from their investment. Under present law, the single-level-of-tax regimes do collect a business income tax from business activities, even when there are tax-exempt investors. Thus, if the tax-exempt corporate shareholders of C corporation conducting a business were instead equity owners of a partnership or of an S corporation that conducted the same business, they would be subject to unrelated business income tax on their share of partnership or S corporation income from such business, whether or not distributed. In considering a form of corporate integration, a decision would have to be made whether to continue the present law approach that the presence of tax-exempt equity investors does not exempt business income from tax.[41]

Foreign investment situations also present issues relating to the adoption and design of an integrated system. As one example, under present law, the U.S. collects a corporate level tax on U.S. corporate income and a withholding tax on dividend distributions to foreign shareholders.[42]

[41] Because present law does not impose tax on interest payments to tax-exempt investors paid by partnerships or S corporations engaged in business activity, there is an incentive for tax-exempt investors to hold debt rather than equity of business conducted in such pass-through forms under present law. In considering approaches to integration, consideration may be given to whether to continue this type of difference in the treatment of debt and equity when imposing only a single level of tax.

[42] However, interest paid to foreign shareholders is generally not taxed by the U.S.

Integration proposals that would unilaterally reduce the tax on dividends to foreign investors or provide refundable credits for any U.S. corporate tax paid could raise issues if foreign countries do not provide similar benefits to U.S investors.

B. Integration Approaches

A number of methods could be used to achieve full or partial integration, each of which has associated policy and administrative considerations.[43]

One form, known as "full" integration, involves passing through all items of corporate income and deduction to shareholders, including the pass-through of items of a publicly-traded corporation. This approach would tax investors currently on their share of corporate income even if such income is not distributed to them. Full integration is considered to involve administrative difficulties in determining a shareholder's appropriate share of income, especially when stock changes hands during a corporate taxable year.

Other forms of integration include reduction of the corporate tax on distributed or retained corporate earnings, or of the individual tax on distributed earnings or on capital gains attributable to undistributed earnings. Complexity can arise, however, if it is desired to design a system that will assure the collection of one level of tax, because of the necessity for mechanisms that assure that the amounts exempted at either the shareholder or corporate level in fact are taxed at the other level.

The principal approaches to integration usually discussed involve forms of dividend relief and thereby apply only to distributed earnings. One approach would give relief by allowing the corporation or shareholders to deduct or exclude a portion of dividends. Another approach provides a credit to shareholders for taxes paid by the corporation. In 1992, the Treasury Department published a report containing a prototype for a form of dividend relief through exclusion of previously taxed dividends from shareholder income.[44] In 1993, the American Law Institute published a proposal involving a credit system based on the model used by a number of

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[43] For a more extensive discussion of the background and issues relating to integration, see Michael J. Graetz and Alvin C. Warren, Jr., *Integration of the U.S. Corporate and Individual Income Taxes* (Tax Analysts, 1998); Joint Committee on Taxation, *Federal Income Tax Aspects of Corporate Financial Structures,* JCS-1-89 (January 18, 1989).

[44] U.S. Department of the Treasury, *Integration of the Individual and Corporate Tax Systems, Taxing Business Income Once* (1992). This study also considered alternative integration prototypes. One was a "shareholder allocation" prototype that would tax both distributed and retained earnings at the shareholder's tax rate. Another was a "Comprehensive Business Income Tax" prototype that would, in effect, extend a dividend exclusion system to payments of interest, and deny interest deductions, in order to equalize the treatment of debt and equity; and that would tax corporate and noncorporate businesses in the same manner. (See introduction to the study at p.15). This study and a general introduction on corporate integration can be found reprinted in Graetz and Warren, *op.cit., supra.*

other countries.[45] Other proposals relating to approaching a single level of tax on business income are discussed in the 2005 Report of the President's Advisory Panel on Tax Reform.[46]

In 2003, the President's budget proposals to the Congress contained a dividend relief proposal that attempted to provide relief to shareholders of corporations on dividends attributable to previously taxed income of the corporation and also to provide a basis adjustment in a shareholder's stock for undistributed previously taxed income allocated to such stock.[47] Subsequently, The Jobs Growth and Tax Relief Act of 2003, following a dividend relief approach, temporarily reduced and conformed (but did not eliminate) the tax rates on dividends and capital gains, through the end of 2008. The Tax Increase Prevention and Reconciliation Act of 2005 extended this rate structure though 2010.

As noted previously, a determination whether to adopt a particular form of integration involves significant policy determinations. Among the policy decisions are whether to pass through any corporate business level tax benefits to individual investors; how to treat income attributable to tax-exempt investors; how to treat international transactions; and how to treat existing corporate equity investments. Some decisions may be more easily implemented if the basic form of relief is structured as a dividend exclusion at either the corporate or shareholder level. Other issues may be more readily addressed by giving shareholders a credit for their share of the corporate tax when they receive dividends.

In addition, a system imposing only one level of tax would not necessarily be simpler than present law. For example, the rules for taxing income of partnerships (which is subject to tax only at the partner level) are quite complex. Similarly, those integration approaches that provide dividend relief and that also seek to collect at least one level of tax can involve complexity. This can result from the need to provide rules that track whether income has borne one level of tax when earned at the corporate entity level (or instead has enjoyed tax benefits that reduce or eliminate the corporate level tax), and whether the particular type of shareholder to which the income is distributed would otherwise generally pay tax on the distribution, absent integration relief.

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[45] Alvin C. Warren, Jr., *Integration of Individual and Corporate Income Ta*xes (American Law Institute, 1993). This study and a general introduction on corporate integration can be found reprinted in Graetz and Warren, *op.cit., supra*.

[46] The President's Advisory Panel on Tax Reform; *Simple, Fair and Pro-Growth: Proposals to Fix American's Tax System* (November 2005), Chapters 7, 8 and 9 (discussing a proposal for a business tax reform while retaining some individual tax on investment returns, and also including discussions of value added and sales taxes as alternatives to an income tax).

[47] Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2004 Revenue Proposals,* February 2003.

V. MERGERS, ACQUISITIONS, AND RELATED TAX-FREE TRANSACTIONS

A. Taxable Corporate Transactions

In general, if a corporate shareholder exchanges a stock investment in one corporation for a stock investment in another corporation, the exchange is a taxable event, treated as a sale of the transferred stock for the fair market value received and a purchase of the new stock with an equivalent cost basis. Also, corporations generally are subject to tax on the disposition of appreciated assets (including the disposition of appreciated stock of a subsidiary). Taxable dispositions generally include distributions of assets or the stock of a subsidiary to shareholders, as well as the disposition of such assets or subsidiary stock to an unrelated acquiror.

Under present law, corporations and shareholders are taxed separately. There also are different tax results depending on whether stock of a corporation is sold and the shareholders receive the proceeds, or whether assets of a corporation are sold and the shareholders receive the proceeds as a distribution from the corporation.

If the stock of a corporation is sold, the selling shareholders pay tax on any gain from their sale of stock. The acquiror of the corporation holds the acquired stock at its purchase price basis, but the basis of assets inside the acquired corporation does not change to reflect the stock purchase price unless an election is made to pay "inside" corporate level tax on any gain associated with this "inside" asset basis change. Such an election may be made only if 80 percent of stock[48] was acquired by a purchasing corporation, within any 12-month period, in a taxable purchase.[49]

If the assets of a corporation are sold, the seller pays corporate level tax and the buyer obtains a purchase price basis for the assets. If the proceeds of the sale then are distributed to the shareholders of the selling corporation, the shareholders generally are subject to shareholder level tax on such distribution.[50]

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[48] The 80-percent stock test refers to 80 percent of the vote and value of the stock of the acquired corporation, excluding certain nonvoting preferred stock (the same test that applies for purposes of eligibility to file a consolidated return). Sec. 338.

[49] Section 338 provides rules for making the election. If the election is made, the acquired corporation pays tax on a deemed sale of its assets, in addition to any tax the shareholders paid on their sale of stock. Under a special rule, if the seller corporation was filing a consolidated return with the purchased subsidiary (and in certain other circumstances), the seller and purchaser can jointly elect to treat the acquisition of subsidiary stock as if it had been an acquisition of the subsidiary's assets. This results in a single level of tax on the seller, measured by the "inside" asset basis of the acquired corporation's assets (rather than by the seller's stock basis for the acquired corporation's stock). The corporate buyer then holds the acquired subsidiary with a basis for the assets inside the acquired subsidiary determined by reference to the purchase price for the stock. Sec. 338(h)(10).

[50] Appreciated corporate assets are generally subject to corporate level tax if they are distributed to the shareholders, yielding the same corporate tax result as if the assets had been sold by the corporation and the proceeds distributed to the shareholders. Shareholders generally are taxed with reference to the

B. Tax-Free Corporate Transactions

In general

A number of special provisions enable corporations to combine or separate their businesses, and permit the corporate shareholders to shift their investment interests to the combined or separated enterprises, without the tax impact that otherwise generally would occur on an exchange of appreciated corporate assets for other assets, or of shareholder investment interests for other interests.

Some rules are directed at "acquisitive" transactions, in which one corporation acquires the stock or assets of another. Other rules are directed at "divisive" transactions, in which one corporation divides its business or subsidiaries into entities separately owned by the corporate shareholders. In practice, an acquiror may wish to acquire less than all the assets of a "target" corporation, so that there may be preliminary divisions of assets, or separations of subsidiaries, to accommodate the needs of a particular transaction. The ease with which such changes can occur as part of a transaction and still retain tax-free treatment varies among the different provisions.

Corporate reorganizations

In general

One set of rules establishes several specific types of "corporate reorganizations."[51] Such reorganizations include statutory mergers as well as certain transactions in which either 80-percent stock control,[52] or "substantially all" the assets, of one corporation is acquired for voting stock of another corporation.[53] The "reorganization" rules also address certain combinations and divisions of corporations that were under common control,[54] transactions that are recapitalizations or reincorporations, and bankruptcy restructurings.

The "corporate reorganization" rules allow tax free treatment in a number of different types of situations, provided the proper amount and type of stock consideration is given to the shareholders, and provided that a sufficient amount of stock or assets of the target corporation is

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fair market value of the assets received in the distribution, and obtain a fair market value basis in such assets.

[51] Secs. 354-368.

[52] "Control" for this purpose is defined as 80 percent of the value of all voting stock and 80 percent of the value of each other class of stock. Sec. 368(c).

[53] The rules also allow certain transactions in which stock of the acquiring corporation's parent corporation is given to former shareholders of the target company in the acquisition, instead of stock of the acquiring company itself.

[54] For purposes of this "common control" provision, control is defined as ownership of at least 50 percent of the vote or value of stock.

acquired. The types of reorganizations often are referred to by reference to the particular subsection of Code section 368 (defining such transactions) in which they are described.

If a transaction qualifies as a "reorganization," the shareholders generally are not taxed on an exchange of stock in one corporation that is a party to the reorganization for stock of another corporation that is a party to the reorganization. However, the shareholders are taxed to the extent they receive cash, securities in excess of securities surrendered, or other "boot" property that may not disqualify the reorganization[55] but that is not permitted to be received by shareholders without tax to them. Certain "nonqualified preferred stock" is treated as "boot" for this purpose.[56] Shareholders generally substitute the basis of their stock or securities surrendered as their basis for the stock or securities received. However, such basis is reduced for nonqualified consideration (not permitted to be received tax-free) and is increased to the extent gain was recoginized.

If a transaction qualifies as a "reorganization," a corporation that is a party to the reorganization also generally is not taxed on its transfers of assets or stock to another party to the reorganization. In most cases, assumptions of liabilities of the transferor corporation are not treated as taxable consideration to the transferor. Generally, a corporation that is a party to a reorganization takes a carryover basis in property received in the reorganization in exchange for its own stock or stock of its parent corporation.[57]

Most types of reorganizations are subject to a number of "substance over form" rules that originated in litigated court cases. A version of these rules has been adopted by the Internal Revenue Service ("IRS") in administrative guidance regarding the circumstances in which the IRS will permit a transaction to be characterized as a reorganization without challenge. These include a "continuity of shareholder interest"[58] rule; a "continuity of business enterprise"[59] rule,

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[55] The extent to which property other than stock or securities can be received without also disqualifying a transaction from "reorganization' treatment varies for the different types of reorganizations.

[56] This is certain stock that is redeemable within 20 years or that has dividend rights that vary with interest rates or other specified indices. Secs. 351(g), 354(a)(2)(C). The Treasury Department has authority to issue regulations that could prescribe the treatment of such stock for other purposes.

[57] In certain situations involving the importation of built-in losses, the basis of loss property must be reduced to its fair market value. Sec. 362(e)(1).

[58] The Treasury regulations stating the "continuity of shareholder interest" rule generally require that a substantial part of the value of the proprietary interests in the target corporation be preserved. Treas. Reg. sec. 1.368-1(e). Historically, IRS ruling guidelines provided a "safe-harbor" if stock representing at least 50 percent of the value of an acquired corporation is exchanged for stock of the acquiror. Rev. Proc. 77-37, 1977-2 C.B. 568. More recent regulations adopted in 2005 allow a 40-percent continuity. Treas. Reg. sec. 1.368-1(e)(2)(i) and -1(e)(2)(v), examples 1 and 2; T.D. 9225 (September 16, 2005).

[59] The Treasury regulations stating the "continuity of business enterprise " rule generally require a continuation of the target corporation's historic business, or use of a significant portion of the target corporation's historic business assets in a business. Treas. Reg. sec. 1.368-1(d).

and a “business purpose”[60] concept. In spite of the fact that these rules originated as “substance over form” concepts, form is extremely important in determining whether a transaction qualifies as a reorganization.

Statutory merger or consolidation (type “A” reorganization)

One basic type of acquisitive reorganization is a statutory merger, or “A” reorganization. (sec. 368(a)(1)(A)). This type of reorganization offers relatively flexible rules for structuring a transaction. Although such a reorganization is subject to the non-statutory “substance over form” concepts described above, there is no specific statutory requirement that a particular percentage or type of stock consideration must be given to old “target “ company shareholders, or that a particular percentage of the target corporation’s historic business assets must be transferred in the reorganization.

Treasury regulations at one time required that the statutes pursuant to which the merger be effected must be those of the United States, a State, the District of Columbia, or a U.S. territory. That requirement was recently dropped; so that qualifying transactions can be effected under foreign statutes. The regulations do require that the effect of the transaction under the statute be an acquisiton of all the assets and liabilities (with certain exceptions) of a combining entity and cessation of the separate existence of the combining entities. Thus, in one situation in which a new state law defined a divisive transaction as a “merger”, the IRS announced that it would not treat such a divisive transaction as a statutory merger for purposes of the reorganization rules.[61]

Acquisition of corporate stock “control” solely for voting stock (type “B” reorganization)

Another type of basic acquisitive reorganization is the acquisition by one corporation of stock of another corporation, solely for voting stock either of the acquiror or of its direct parent corporation (but not both). Immediately after the acquisition, the acquiror must own 80-percent control of the acquired corporation. The presence of any consideration that is not voting stock can prevent a transaction from qualifying under this provision.

Acquisition of “substantially all” the corporate properties “solely for voting stock” (type “C” reorganization)

A third type of basic acquisitive reorganization is the acquisition by one corporation of substantially all the properties of another corporation, solely for voting stock of the acquiror or the direct parent corporation owning 80-percent control of the acquiror. IRS ruling guidelines

[60] See, e.g., Treas. Reg. secs. 1.368-1(c) and 1.368-2(g); *Gregory v. Helvering*, 293 U.S. 465 (1935).

[61] Rev. Rul. 2000-5, 2000-5 I.R.B. 436; Treas. Reg. sec. 1.368-2(b)(1), T.D. 9242 (Jan. 26, 2006).

define "substantially all the properties" as 90 percent of the net value of assets and 70 percent of the gross value of assets.[62]

Transfer of substantially all of the assets of a corporation to a related corporation (acquisitive type "D" reorganization)[63]

Another acquisitive type of reorganization is one in which all or a part of a corporation's assets are transferred to another corporation, if immediately after the transfer the transferor or one or more of its shareholders own 50 percent of the vote or value of the transferee, and if the transferor corporation distributes stock or securities of the corporation to which the assets were transferred in a transaction that qualifies under certain other Code provisions (secs. 354, 355, or 356). In order for the distribution to qualify under section 354, the transferor corporation must liquidate and the corporation to which the assets are transferred must acquire substantially all the assets of the transferor.[64] The consideration need not be all voting stock but can include cash or other boot.

The ownership requirement for this type of reorganization differs from that for other acquisitive reorganizations. One purpose of this particular provision is to cause reorganization treatment, with accompanying dividend treatment to individual shareholders, if the shareholders attempt to liquidate a corporation, take out cash at capital gains rates, and then reincorporate the remaining assets.[65]

There also is a type of "D" reorganization that is divisive, which also must satisfy the "spin-off" rules of section 355 to qualify as tax-free.

Other "reorganizations"

Other transactions that qualify as reorganizations are a recapitalization (type "E"), a "mere change in identity, form, or place of organization" of one corporation (type "F"), and a bankruptcy reorganization (type "G").

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[62] Rev. Proc. 77-37, 1977-2 C.B. 568.

[63] Section 368(a)(1)(D) requires a distribution of the properties received in a transaction that qualifies under 354, 355, or 356. Section 355 provides rules for divisive transactions, in which substantially all the assets do not need to be transferred. Section 354 provides the rules governing an "acquisitive" D reorganization, namely, that substantially all the assets of the transferor must be transferred, and the transferor must liquidate. Section 356 provides rules for treatment of consideration that is taxable to shareholders, if any is received in addition to stock of the transferee.

[64] Sec. 354(b)(1).

[65] *See* Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS-41-84), December 31, 1984, at 192-194.

Other statutory forms permitted

The Code also contains specific rules allowing: (1) assets of the acquired corporation to be directly transferred to the acquiring corporation's controlled subsidiary in exchange for stock of the parent ("forward subsidiary merger")(368(a)(2)(D)); or (2) a subsidiary of the acquiror to be merged into the target corporation with the acquired target corporation as the surviving corporation ("reverse subsidiary merger") (368(a)(2)(E)). These special situations can resemble the other basic forms of reorganizations such as "statutory mergers" or stock acquisitions, but involve some different requirements.

Definition of "control" for reorganizations

Under the reorganization provisions, the definition of "control" that applies to the necessary acquisition of stock and to the determine permitted parent-subsidiary relationships is generally 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation. (sec. 368(c)).

Transfers to a controlled corporation

Another set of rules governs the general contribution of assets (including stock) to a corporation.[66] These rules permit the tax-free transfer of assets or stock to a corporation whose stock is, in the aggregate, owned at least 80-percent by the transferors who engaged in the transfer. The 80-percent control test used here is the same as the control test used for purposes of reorganizations, described above. Persons making a transfer generally can receive stock in the transferor tax-free, but cash or other "boot" generally is taxed. Certain non-qualified preferred stock is treated as "boot" for this purpose.[67]

Any person who is part of the transferring group can receive qualified stock tax-free, without regard to whether the other transferors receive stock, so long as immediately after the transfer all the transferors in the aggregate own 80 percent of the transferee.

The transferee generally takes a carryover basis in the stock or other contributed property it receives, and the transferor generally takes a basis in the stock of the transferee corporation that is the same as that of the property contributed, decreased by any taxable property received and increased by any gain recognized.[68]

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[66] Sec. 351.

[67] This is certain stock that is redeemable within 20 years or that has dividend rights that vary with interest rates or other specified indices. Secs. 351(g), 354(a)(2)(C).

[68] In certain cases involving transfers of loss property, either the property must take a fair market value basis in the hands of the transferee or the transferor must reduce the basis of its stock in the transferee to reflect the fair market value of the contributed property. Sec. 362(e)(2).

Liquidation of corporate subsidiary into parent corporation

Another rule permits the combination of related corporations in the form of a tax-free liquidation of an 80-percent owned subsidiary corporation into its parent corporation.[69] For purposes of the liquidation rule, the definition of 80-percent control is the same as that for whether corporations can file a consolidated return.[70]

Divisive "spin-off" and similar transactions

In general

Special rules govern transactions in which one corporation separates its subsidiaries or businesses in a divisive "spin-off" or "split up" transaction, in which shareholders of the original parent corporation receive stock of one or more corporations that were 80-percent controlled by the distributing corporation.[71]

The requirements for tax-free treatment under these rules include restrictions that have evolved over the years in response to a number of different concerns.

Anti-"bail out" rules

One set of restrictions for tax-free treatment was intended to prevent a corporation from distributing excess liquid assets to shareholders in a form that enabled the shareholders to avoid dividend tax. For example, if a corporation distributed excess cash to its shareholders as a dividend, they would pay ordinary income tax on the cash they received. However, if the corporation could put that cash into a separate corporation and distribute (or "spin off") the stock of that corporation to shareholders, then the shareholders could sell the new stock separately, or could liquidate the new corporation, in each case obtaining capital gains treatment on the value of the cash received.[72]

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[69] Sec. 332.

[70] "Control" for this purpose is the ownership of 80 percent of the vote and value of stock, excluding, however, all nonvoting stock that is limited and preferred as to dividends and that does not participate in corporate growth to any significant extent. This definition differs from the definition of "control" under the corporate reorganization provisions (sec. 368(c)).

[71] Sec. 355.

[72] *See, e.g., Gregory v. Helvering*, 293 U.S. 465 (1935), in which the major shareholder, Mrs. Gregory, attempted to spin off investment assets through this method. Even before the enactment of section 355, the U.S. Supreme Court denied tax-free treatment, stating that the transaction did not have an adequate business purpose and was done solely to avoid dividend tax.

A corporation can distribute excess cash in the form of a redemption of its shareholder's stock that results in capital gains treatment to the shareholders if the transaction results in a meaningful reduction of the shareholders' interests. *See* sec. 302.

In an attempt to limit such transactions, section 355 requires that both the distributing and distributed corporations be engaged in an active business that was not acquired in a taxable transaction within five years,[73] and that the transaction not be a "device" to distribute earnings and profits. Generally, a pre-existing arrangement by a shareholder to sell the stock for capital gain would indicate such a device. In addition, common law and IRS rules require that there be a corporate business purpose for the distribution.

Anti-"sale" provisions

The Tax Reform Act of 1986 generally repealed what remained of the so-called *General Utilities* rule that had permitted the sale or disposition of an entire corporate business without corporate level tax.[74] After the 1986 Act, section 355 remained as a potential method for disposing of a subsidiary without corporate level tax. Some such transactions could be structured that would provide the acquiror with a fair market value basis in the stock of the subsidiary. Other transactions did not necessarily produce a fair market value basis but might otherwise be considered "sale-like" in that they involved a plan to dispose of stock to new owners in connection with the distribution.

Several special rules were enacted in an attempt to address such transactions. One restriction imposes a corporate level tax if an acquiror obtains control of a distributing corporation or its separately distributed subsidiary (but not both) in a divisive transaction where the acquiror recently purchased the stock that it controls (sec. 355(d)). Another, later-enacted restriction imposes corporate level tax if 50 percent or more of a corporation or its distributed subsidiary is acquired by new shareholders as part of a plan related to a spin-off (sec. 355(e)).

Tax free treatment is also denied to certain distributions involving disqualified investment corporations with specified amounts of investment assets (as defined). This rule attempts to limit tax-free transactions that may resemble otherwise taxable redemptions or distributions with respect to a shareholder's stock.[75]

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[73] The active business rules allow the distributed and distributing corporate groups to apply the active business test aggregating the activities of all members of each such group respectively. Sec. 355(b)(3). The respective groups are determined using the control test of section 1504, applicable to corporations eligible to file consolidated returns, but including foreign and certain other corporations.

[74] *See General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935). The actual case involved a dividend distribution of stock of a subsidiary to shareholders, followed by a sale of the stock to an acquiror. The court upheld the taxpayer's position that this was not in effect a taxable sale by the corporation but was entitled to tax-free treatment on the distribution, under the then existing statute. By the time of the 1986 Act, statutory changes had significantly narrowed the cases in which a corporation could distribute appreciated stock or assets without corporate level tax. The 1986 Act eliminated the statutory provisions that had permitted such a result in an acquisition or liquidation of the entire distributing corporation. However, the 1986 Act retained the tax-free spin-off rules of section 355.

[75] Sec. 355(g).

Partnership rules

Partnership rules permit corporations to combine their assets without tax through joint venture or other partnership operations, and to separate assets out of partnership structures, often also without tax.[76] These rules differ from the corresponding rules for transferring assets in and out of corporate structures. In general, the partnership rules permit a greater range of tax-free transfers than do the corporate rules. However, in some situations the corporate rules might more readily permit certain types of transfers.

[76] Secs. 721-737.

C. Issues Relating to Mergers and Acquisitions

In general

The different rules permitting particular corporate transactions to receive tax-free treatment are varied and frequently inconsistent. In some cases, more than one rule could apply to the form of a particular corporate transaction. The statute and the administrative pronouncements of the IRS over the years have attempted to resolve overlap situations and to provide guidance regarding other interpretive issues.

The structure of present law is in part a result of the historical development and aggregation of provisions. The structure also reflects reactions to judicial decisions interpreting particular provisions, and reflects legislative developments establishing new rules and accompanying concern that existing provisions, if not limited, might conflict with or undermine the new rules.

The different, and often overlapping, variations within the merger and acquisition rules can be viewed as a significant source of complexity. On the other hand, these rules, as they have been interpreted and clarified over the years through administrative pronouncements, provide a large amount of taxpayer selectivity and certainty. Taxpayers are relatively assured of obtaining a specific tax result so long as the transaction satisfies the formalistic requirements of the chosen merger and acquisition provision. Moreover, comprehensive reform of these rules and the imposition of consistency could not generally be accomplished without recommending fundamental changes in the tax policy reflected by one or another of the provisions.

Discussion of certain proposals

Elective carryover basis for "qualified acquisitions"

An approach that has been suggested by a number of commentators in the past would generally permit a corporation to dispose of a business for any type of consideration, including cash, and elect to pay no corporate level tax, provided the consideration received is distributed to shareholders and that they pay tax (if they are taxable shareholders) on any cash or other consideration that is not a qualified continuing stock interest. The acquiring corporation would not obtain a stepped-up fair market value basis in the acquired corporate assets if the election were made not to pay corporate level tax. Only certain transactions that involved the acquisition of a significant amount of the stock of another corporation or the assets of a corporate business would qualify for this election.

Such a proposal was included in a 1985 report prepared by the Staff of the Senate Committee on Finance.[77] That proposal also included other conforming changes in its attempt to substitute a single approach for the present law varied rules affecting tax-free acquisitions. For example, the proposal would have conformed the various definitions of "control" under present law to the definition for filing a consolidated return.

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[77] *The Subchapter C Revision Act of 1985, A Final Report Prepared by the Staff,* Committee on Finance, United States Senate, S. Prt. 99-47 (May, 1985).

Another version of such a proposal was presented at, and appears in the report of, an invitational conference addressing subchapter C issues sponsored by the American Bar Association and New York State Bar Association Tax Sections in 1987.[78] An earlier proposal of this type was made by the American Law Institute.[79]

This type of proposal involves a specific policy choice to abandon the existing statutory requirements for continuity of shareholder interest. The proposal would exempt a corporation from tax on a sale of its assets, even if the corporation receives cash consideration for the transfer of a business, so long as the cash is distributed to shareholders and the assets transferred retain a carryover basis.

Several policy arguments can be made in favor of such a change. First, as long as assets do not obtain a stepped up basis, there is corporate level tax in the future as the recipient corporation earns income and retains the low basis assets. Second, as long as shareholders pay tax on any cash that is received, this single tax is sufficient as a current tax. Third, the corporate reorganization provisions are complex and can be manipulated; and an explicit election would simplify corporate tax planning.

Several policy arguments can also be made against such a change. When assets are transferred from one corporation to another for cash, the transferring corporation is generally taxed on gain at the time of the transaction or when the cash is received. Payment of tax in the future, if the recipient corporation pays more because of a carryover basis, is not the economic equivalent of payment of tax at the time of the transaction, but is significantly less due to the time value of money. Questions may arise where to draw the line that would allow certain transfers of corporate assets, such as a transfer of a “business,” to be exempt from corporate level tax while other transfers, such as sales in the ordinary course of business, would not be so exempt. Interpretations of the line so drawn would be required. In addition, proposals for such restructuring have often involved new sets of rules such as rules regarding the definition of control or other issues. New rules could also involve further interpretation and could lead to new uncertainty and complexity.

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[78] Ginsburg, Levin, Canellos, and Eustice, “Reexamining Subchapter C: An Overview and some Modest Proposals to Stimulate Debate”, (copyright 1987 by Martin D. Ginsburg); *reprinted in Corporate Tax Reform, A Report of the Invitational Conference on Subchapter C*; American Bar Association Section of Taxation, New York State Bar Association Tax Section (1988) pp. 39-80; *see, e.g.,* Proposals VII-VIIC and IX-XI.

[79] “Proposals on Corporate Acquisitions and Dispositions” adopted by the American Law Institute June 13, 1980, published in American Law Institute, *Federal Income Tax Project Subchapter C* (1982).

Provide one set of consideration and continuity rules for acquisitive reorganizations

There have been a number of proposals to conform the consideration rules for acquisitive reorganizations to require a specified percentage of stock consideration (*e.g.*, 50 percent) and to conform the rules as to whether the stock must be voting stock.[80]

One policy issue related to such recommendations is the determination what type of stock is counted in determining continuity and for purposes of determining whether shareholders are taxed. For example, one version of such a proposal suggested that all stock would count (thus eliminating a voting stock requirement) but made an exception for certain preferred stock that is redeemable within five years. [81]

The recommendations are typically made only for the reorganization rules contained in section 368. Frequently, no change is recommended to the non-reorganization rules relating to transfers to controlled corporations under section 351.[82] Under this type of proposal, if the rules for non-reorganization transfers to controlled corporations under section 351 are not modified, then many of the same planning choices that exist under present law would continue to be available. Unless the rules of section 351 are tightened to conform to the new 368 rules in cases that resemble acquisitive reorganizations, it is arguable that little general consistency would be accomplished.[83] On the other hand, such a modification that limited the application of section 351 could be viewed as a policy decision to tighten the rules relating to acquisitive transactions.

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[80] *See, e.g., American Bar Association recommendation 1981-5*, 107 ABA Repts. 559, 34 Tax. L. 1386 (1981).

[81] *American Bar Association recommendation 1981-5, supra.*

[82] The American Law Institute Proposals that included a provision for elective carryover basis, described above, did include a provision overriding section 351 for certain qualified acquisitions. However, since the basic proposal for qualified acquisitions abandoned a shareholder continuity of interest requirement for qualified acquisitions, the impact of overriding section 351 in those cases was confined to a much narrower range of issues.

[83] Partnership rules also could continue to offer different planning approaches to combining businesses and assets in some circumstances.

VI. ISSUES RELATED TO CAPITAL COST RECOVERY

A. In General

Capital cost recovery raises a number of issues with respect to business taxation. The choice of cost recovery rules has an effect on the after-tax rate of return from business assets. Policy issues arise as to whether cost recovery rules should be neutral as to a taxpayer's choice whether or in which assets to invest or should be used to encourage investment generally or investment in particular kinds of assets. This section describes the concept of cost recovery and provides numerical examples to illustrate certain economic and tax effects of various forms of cost recovery rules, illustrates how cost recovery can be used to influence investment decisions, and summarizes the present law tax rules for cost recovery.

B. Concept of Cost Recovery[84]

In business taxation, cost recovery refers to the process by which a taxpayer recoups the cost of its investment in business or other income-producing property.[85] The tax rules permit this recoupment through the allowance of deductions for depreciation. In his opinion in the 1927 U.S. Supreme Court case *United States v. Ludey*, Justice Brandeis provided the following explanation of depreciation:

> The depreciation charge permitted as a deduction from the gross income in determining the taxable income of a business for any year represents the reduction, during the year, of the capital assets through wear and tear of the plant used. The amount of the allowance for depreciation is the sum which should be set aside for the taxable year, in order that, at the end of the useful life of the plant in the business, the aggregate of the sums set aside will (with the salvage value) suffice to provide an amount equal to the original cost. The theory underlying this allowance for depreciation is that by using up the plant, a gradual sale is made of it. The depreciation charged is the measure of the cost of the part which has been sold. When the plant is disposed of after years of use, the thing then sold is not the whole thing originally acquired. The amount of the depreciation must be deducted from the original cost of the whole in order to determine the cost of that disposed of in the final sale of properties.[86]

The American Institute of Certified Public Accountants ("AICPA") has provided a similar explanation:

> Depreciation accounting is a system of accounting which aims to distribute the cost or other basic value of tangible capital assets, less salvage (if any), over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner. It is a process of allocation, not of valuation. Depreciation for the year is the portion of the total charge under such a system that is allocated to the year.[87]

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[84] Portions of this discussion are drawn from Boris I. Bittker & Lawrence Lokken, *Federal Taxation of Income, Estates and Gifts* (3d. ed. 1999) at ¶23.1.

[85] The tax rules allow cost recovery both for tangible assets and for intangible property such as copyrights and patents with limited useful lives. The term "depreciation" sometimes is used only when referring to cost recovery for tangible property, while "amortization" is used in describing cost recovery for intangible property such as patents and copyrights. Section 167(a), however, which allows a depreciation deduction for "the exhaustion, wear and tear (including a reasonable allowance for obsolescence) of property used in the trade or business, or of property held for the production of income," encompasses both tangible and intangible property.

[86] 274 U.S. 295, 300-301 (1927).

[87] AICPA, Accounting Terminology Bulletin No. 1 (1953).

Both Justice Brandeis's and the AICPA's explanations refer to salvage value. Although for many years the tax rules required taxpayers to estimate the salvage value of depreciable assets and permitted depreciation deductions only to the extent that a taxpayer's cost basis in an asset exceeded the asset's salvage value, since 1981 the depreciation rules have ignored salvage values and a taxpayer is permitted to take deductions for the depreciation of an asset until its adjusted basis in the asset has been reduced to zero.

The Supreme Court and the AICPA explanations differ in their description of the role of valuation in determining depreciation allowances. Justice Brandeis writes that a business's depreciation deduction for a year "represents the reduction, during the year, of the capital assets through wear and tear." The AICPA definition, by contrast, states that depreciation accounting "is a process of allocation, not of valuation." The AICPA's statement is a more accurate reflection of the role of valuation in the present tax rules than is Justice Brandeis's. The amount of a depreciation deduction allowed to a taxpayer in any given year for a capital asset generally does not reflect the actual reduction in the value of that asset in that year.

Valuation can be seen, however, as part of the theoretical basis of the depreciation allowance. Justice Brandeis writes that the theory of this allowance is that by using up an asset over time, a taxpayer makes a "gradual sale" of that asset, and the depreciation deduction in a given year measures the cost of the portion of the asset "sold" in that year. This "gradual sale" theory reflects the tension between the principles of realization and income measurement. Under an ideal income tax, tax liability would be determined in part by changes in the value of a taxpayer's assets even in the absence of a realization event such as a sale of those assets. In fact, however, changes in asset value generally do not affect tax liability unless there is a realization event. If a depreciation deduction were a proxy for the decline in the value of an asset that a taxpayer does not sell, the allowance of the deduction might be seen as moving the tax rules toward true income measurement and away from realization. Justice Brandeis rationalized this departure from realization through the fiction of a partial sale of an asset each year, with the value of the portion fictionally sold represented by the amount of depreciation allowed as a deduction. The amount of a depreciation deduction under present law, though, generally does not approximate the decline in value of a taxpayer's assets (or, if it does approximate economic depreciation, it does so coincidentally).[88] Consequently, in any year, the depreciation allowance for a particular asset may cause a taxpayer's taxable income attributable to that asset to be either more or less than the taxpayer's economic income from the asset.

The fact that depreciation deductions cause a mismeasurement of economic income from an asset when those deductions do not reflect the decline in value of the asset might not, in itself, be cause for concern. As described previously, if salvage value is ignored and a taxpayer is permitted to recover over time the entire cost of an asset, its depreciation deductions over the life of an asset is the same, and its taxable income from the cash flow generated by the asset is the same, regardless of the manner in which the taxpayer allocates those deductions over time. As is illustrated next, however, the timing of depreciation deductions can vary greatly depending on

[88] While present-law depreciation deductions do not approximate economic depreciation, assets with shorter economic lives generally are assigned shorter recovery periods and assets with longer economic lives generally are assigned longer recovery periods under present law.

the particulars of the chosen rules, and timing differences can have a significant effect on the real cost of a taxpayer's tax liability.

C. Examples: Methods of Cost Recovery

The following examples illustrate the economic and tax effects of several possible methods of cost recovery: (1) straight-line depreciation, a method in which a taxpayer's depreciation deduction for a given asset is the same each year; (2) accelerated depreciation, under which a taxpayer's depreciation allowance for an asset is greatest in the first year in which the asset is used and declines over time; (3) expensing, in which a taxpayer is permitted to deduct the entire cost of an asset in the year in which the taxpayer acquires the asset; and (4) use of a tax credit to provide cost recovery or recovery of amounts different from the cost of the asset.[89]

Each example assumes the following facts. A taxpayer buys a machine for $10,000. The machine is used for five years. It generates $3,000 net cash flow annually. It has no salvage value. The taxpayer's tax rate is 35 percent. The discount rate is six percent. The taxpayer is assumed to derive other taxable income so that any net decrease in income tax liability (shown in each table as a negative number) attributable to the machine can be used to offset the taxpayer's tax liability from its other income sources. The present value ("PV") figures in the tables are derived by assuming that nominal dollars are paid (in the case of taxes) or received (in the case of cash flow) at the end of each year and by discounting these nominal dollars back to when the machine was purchased, the beginning of year one. Thus, nominal year one dollars paid or received are discounted one year in deriving the present value of those dollars, nominal year two dollars are discounted two years, and so forth.

Table 8.–Straight Line Depreciation

	Unrecovered Cost	Dollars Received	Cost Recovery	Taxable Income	35-Percent Tax	PV of Tax Liability	After-Tax Cash Flow	PV of After-Tax Cash Flow
Year 1	$10,000	$3,000	$2,000	$1,000	$350	$330	$2,650	$2,500
Year 2	8,000	3,000	2,000	1,000	350	311	2,650	2,358
Year 3	6,000	3,000	2,000	1,000	350	294	2,650	2,225
Year 4	4,000	3,000	2,000	1,000	350	277	2,650	2,099
Year 5	2,000	3,000	2,000	1,000	350	262	2,650	1,980
End/total	$0	$15,000	$10,000	$5,000	$1,750	$1,474	$13,250	$11,162

[89] These examples provide a comparison of the cash flow and tax effects of the different methods of cost recovery. Other issues such as the relative complexity of each method, record-keeping and administrability aspects of each method, and the use of methods in combination with each other also would have to be taken into account in selecting among cost recovery methods.

Table 9.−Accelerated Depreciation

	Unrecovered Cost	Dollars Received	Cost Recovery	Taxable Income	35 Percent Tax	PV of Tax Liability	After-Tax Cash Flow	PV of After-Tax Cash Flow
Year 1	$10,000	$3,000	$4,000	-$1,000	-$350	-$330	$3,350	$3,160
Year 2	6,000	3,000	2,400	600	210	187	2,790	2,483
Year 3	3,600	3,000	1,440	1,560	546	458	2,454	2,060
Year 4	2,160	3,000	1,080	1,920	672	532	2,328	1,844
Year 5	1,080	3,000	1,080	1,920	672	502	2,328	1,740
End/total	$0	$15,000	$10,000	$5,000	$1,750	$1,349	$13,250	$11,287

Table 10.−Expensing

	Unrecovered Cost	Dollars Received	Cost Recovery	Taxable Income	35 Percent Tax	PV of Tax Liability	After-Tax Cash Flow	PV of After-Tax Cash Flow
Year 1	$10,000	$3,000	$10,000	-$7,000	-$2,450	-$2,311	$5,450	$5,142
Year 2	0	3,000	0	3,000	1,050	934	1,950	1,735
Year 3	0	3,000	0	3,000	1,050	882	1,950	1,637
Year 4	0	3,000	0	3,000	1,050	832	1,950	1,545
Year 5	0	3,000	0	3,000	1,050	785	1,950	1,457
End/total	$0	$15,000	$10,000	$5,000	$1,750	$1,122	$13,250	$11,516

<u>Economic and tax results</u>

Several observations can be made about these examples. First, in each example, by the end of year five, the last year in which the machine is used, the taxpayer has recovered the entire cost of the machine, $10,000. Second, measured in nominal or total combined annual dollars, the total amount of cash flow ($15,000), income after cost recovery ($5,000), and tax paid ($1,750) is the same under each of the three methods of depreciation. Third, the amount of the taxpayer's total eventual tax liability expressed in present value terms at the outset of the taxpayer's investment − the number printed at the bottom of the third to last column of each example − varies significantly among the three examples. The present value of after-tax cash flows likewise varies among the examples. The initial present value of all future tax liabilities attributable to the income generated by the machine is greatest under straight-line depreciation, somewhat less under accelerated depreciation, and least under expensing. The present value of after-tax cash flows is the smallest under straight-line depreciation, greater under accelerated depreciation, and greater again under expensing. The reason for these relationships is that expensing accelerates cost recovery relative to accelerated and straight-line depreciation, and accelerated depreciation yields more up-front cost recovery than does straight-line. In the end, the entire cost of the machine is recovered under all three methods, but front-loading of depreciation deductions and the concomitant lessening of a taxpayer's tax liability in the early years increase the present value of cash flows.

Tax depreciation compared with economic depreciation

In the examples above, straight-line depreciation is the least favorable method of cost recovery for taxpayers. An even less taxpayer-favorable rule might require a taxpayer to wait until an asset is used up or sold before recovering any portion of the cost of the asset. The rate of cost recovery − straight-line, accelerated, or immediate deduction − is not the only variable that affects the present values of taxes and cash flows associated with an asset. The period over which costs are recovered also has an effect on these present values.

To analyze how closely any combination of recovery rates and periods replicates economic depreciation, the pattern of an asset's economic depreciation must be understood. Under the assumption that an asset produces level cash flows over its useful life − not always a realistic assumption because of the declining efficiency of some assets and, relatedly, because of increasing maintenance costs as some assets age − the asset declines in value more slowly in its early years than in its later years.

The value of an asset or, put differently, the amount someone would pay for the asset, at any time is the value at that time of all income the asset is expected to generate in the future. An asset's value, in other words, is the present value of its expected future cash flows. The decline in value of an asset from the beginning of one year to the end of that year − the asset's economic depreciation − is represented by the difference between the present values of the expected future cash flows at the beginning and at the end of the year.

Assume an asset generates $1,000 in cash flow each year for five years, and assume a discount rate of 6 percent. The value at the beginning of year one of the future cash flows ($1,000 each year for five years) is $4,212; this is the amount a taxpayer would pay for the asset. By the end of year one, the value of the future cash flows ($1,000 each year for four years) declines to $3,465. In its first year of use, the asset thus has declined in value by $747. The pattern of depreciation over the five years is illustrated in the following table:

Table 11.−Economic Depreciation

Year	PV at Beginning	PV at End	Depreciation
1	$4,212	$3,465	$747
2	3,465	2,673	792
3	2,673	1,833	840
4	1,833	943	890
5	943	0	943

As can be seen in this table, the depreciation in the value of the asset is smallest during the first year and increases with each subsequent year. For an asset that generates constant cash flows, therefore, tax depreciation rules that matched economic depreciation would backload cost recovery to a greater extent than straight-line depreciation rules do.

D. Incentives for Capital Investment

Expensing

Matching economic depreciation is only one possible goal of cost recovery rules. Another possible goal is to provide an incentive for capital investment. Expensing − under which, as illustrated previously, a current deduction is allowed for the entire cost of an asset − is one way to provide this incentive.[90] Under certain assumptions, including that tax rates are the same at the beginning and at the end of an investment, allowing a current deduction for the cost of an investment is equivalent to exempting from tax the return on the investment.

A simple example can illustrate this point. Assume a taxpayer earns $1,000 in taxable income (in addition to taxable income from other sources) and invests the amount remaining after tax is imposed on the $1,000. The asset yields a 10-percent return and is sold after one year. The tax rate is 35 percent. In the first scenario, no deduction is allowed for the cost of an investment, but the return on the investment is exempt from tax. The taxpayer therefore is taxed on the $1,000 when it is earned and is left with $650 ($1,000 - .35($1,000)) to invest. The $650 investment yields a 10-percent return. After one year, the investment has grown to $715, and when the investment is sold, the proceeds are exempt from tax. In the second scenario, the taxpayer is allowed a deduction for an investment (that is, the taxpayer is allowed to expense the investment) but is taxed when the proceeds from the investment are used for consumption. The deduction for the cost of the investment (which can be used as an offset against other taxable income) has the effect of eliminating the tax on the $1,000 of earnings, and the taxpayer can invest the entire $1,000. After one year, the investment is worth $1,100. The taxpayer sells the investment (and does not use the proceeds for a deductible investment). The $1,100 in proceeds therefore is subject to a 35-percent tax, and the taxpayer is left with $715 ($1,100 - .35($1,100)) after tax. The taxpayer is in the same position as where no deduction was allowed for the initial investment but the return on the investment was free of tax.

Investment tax credit

Expensing is one way of providing an incentive for capital investment. Another method is through the use of tax credits. For much of the period from 1962 through 1985, the tax rules included an investment tax credit for the purchase of tangible property and certain other kinds of property for use in a business or profit-seeking activity. The credit amount initially was seven percent of the cost of the property and was increased to 10 percent.[91] The following table shows the effects of a five-percent income tax credit under the assumptions used in Tables 1 through 3: A machine with a five-year life is purchased for $10,000, the machine generates annual cash flow (net of expenses) of $3,000, and the discount rate is six percent. As is shown in the table, the five-percent investment credit generates a $500 tax savings (five percent of $10,000) in year one and requires the taxpayer to reduce its basis in the machine by $500 in that year (from

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[90] Any method of cost recovery that is faster than economic depreciation provides a tax incentive for investment in the property for which the recovery method is available.

[91] See Boris I. Bittker & Lawrence Lokken, *Federal Taxation of Income, Estates and Gifts* (3d. ed. 1999) at ¶27.2.1.

$10,000 to $9,500). The table assumes the taxpayer then is required to use straight-line depreciation in recovering its remaining cost.

Table 12.−Investment Tax Credit

	Unrecovered Cost	Dollars Received	Cost Recovery	Taxable Income	35 Percent Tax	PV of Tax Liability	After-Tax Cash Flow	PV of After-Tax Cash Flow
Year 1	$9,500*	$3,000	$1,900	$1,100	-$115**	-$108	$3,115	$2,939
Year 2	7,600	3,000	1,900	1,100	385	343	2,615	2,327
Year 3	5,700	3,000	1,900	1,100	385	323	2,615	2,196
Year 4	3,800	3,000	1,900	1,100	385	305	2,615	2,071
Year 5	1,900	3,000	1,900	1,100	385	288	2,615	1,954
End/total	$0	$15,000	$9,500***	$5,500	$1,425	$1,151	$13,575	$11,487

* After initial basis reduction for 5-percent investment credit equaling $500.

** Including $500 investment credit.

*** Not including $500 initial basis reduction from investment tax credit.

Table 12 reveals that under the assumptions of the depreciation examples discussed above, the combination of the investment tax credit and straight-line depreciation produces a greater present value after-tax cash flow than does accelerated depreciation in the absence of the investment credit, and it produces slightly less present value after-tax cash flow than does expensing. More broadly, however, through the choice of, among other features, a credit rate, an investment credit can be designed to replicate the economic and tax results of a given set of depreciation rules.

The most favorable cost recovery method described above, expensing, can, as discussed previously, have the same after-tax effects as would exempting from tax the return on an investment. Certain rules (including investment credits) can produce a result better than exemption. From 1981 until 1986, "the tax benefits of the combination of the investment tax credit and accelerated depreciation were more generous for some equipment than if the full cost of the investment were deducted immediately − a result more generous than exempting all earnings on the investment from taxation."[92] This result had the effect of encouraging investment in equipment qualifying for generous treatment even if the investment would have been unprofitable in the absence of the tax rules.

[92] Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), May 4, 1987, p. 98.

E. Present-Law Cost Recovery Tax Rules

In general

The present-law cost recovery rules are not as simple as any of the stylized approaches described above (though the pattern of cost recovery in the accelerated depreciation example matches the pattern of cost recovery under one permitted method of depreciation described below), but they do include features of some of the approaches. The cost recovery rules do not match tax depreciation with economic depreciation. In most circumstances, the rules permit accelerated depreciation, and in some cases require (or permit) straight-line depreciation. In some cases the rules permit limited expensing. Furthermore, the benefit of tax depreciation deductions in excess of economic depreciation may be augmented by use of a tax-deferred transaction such as like-kind exchange.

Depreciation provisions

A taxpayer is allowed to recover through annual depreciation deductions the cost of certain property used in a trade or business or for the production of income. The amount of the depreciation deduction allowed with respect to tangible property for a taxable year is determined under the modified accelerated cost recovery system ("MACRS"). Under MACRS, different types of property are generally assigned applicable recovery periods and depreciation methods. The recovery periods applicable to most tangible personal property (generally tangible property other than residential rental property and nonresidential real property) range from three to 25 years. The depreciation methods generally applicable to tangible personal property are, as the MACRS name suggests, forms of accelerated depreciation. The permitted methods are the 200-percent and 150-percent declining balance methods, switching to the straight-line method for the taxable year in which the depreciation deduction would be maximized.[93]

Recovery periods for real property generally are longer than those for personal property, and the depreciation method is less favorable to taxpayers. In general, the recovery periods applicable to real property are 39 years for non-residential real property and 27.5 years for residential rental property. The depreciation method for real property is the straight-line method.

Under MACRS, a taxpayer is permitted to recover its full basis in depreciable property over the applicable recovery period; there is no need to estimate salvage value. Moreover, under MACRS the applicable recovery period need not (and typically does not) correspond to the actual economic life of the asset subject to depreciation. In general, however, MACRS generally provides for longer recovery periods for longer lived assets.

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[93] For certain property, including tangible property used predominantly outside the United States, tax-exempt use property, tax-exempt bond-financed property, and certain other property, the MACRS "alternative depreciation system" of section 168(g) applies, generally increasing recovery periods and requiring straight-line depreciation.

Expensing provisions

Since 1958, the Code has permitted limited expensing. Under present-law section 179, a taxpayer with a sufficiently small amount of annual investment costs may elect to deduct at least a portion of those costs currently. For taxable years beginning in 2003 through 2009, the maximum amount a taxpayer may expense is $100,000 of the cost of qualifying property placed in service for the taxable year.[94] In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. The $100,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $400,000. The $100,000 and $400,000 amounts are indexed for inflation.[95] Certain additional rules govern section 179 computations and eligibility and the coordination of section 179 with other rules.[96]

[94] Additional section 179 incentives are provided for qualified property used by a business in the New York Liberty Zone (sec. 1400L(f)), an empowerment zone (sec. 1397A), a renewal community (sec. 1400J), or the Gulf Opportunity Zone (sec. 1400N(e)).

[95] For taxable years beginning in 2010 and thereafter, a taxpayer with a sufficiently small amount of annual investment may elect to deduct up to $25,000 of the cost of qualifying property placed in service for the taxable year. The $25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000.

[96] The amount eligible to be expensed for a taxable year may not exceed the taxable income derived in that year from the active conduct of a trade or business (determined without regard to section 179). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations). No general business credit under section 38 is allowed with respect to any amount for which a deduction is allowed under section 179. An expensing election is made under certain rules prescribed by the Secretary.

VII. INTERNATIONAL TAX ISSUES

A. In General

A country's tax system can generally be classified as either "worldwide" or "territorial" based upon how such system treats income earned by taxpayers from sources outside of the taxing jurisdiction. The United States currently employs a predominantly worldwide tax system.

Worldwide tax system

In a pure worldwide tax system, resident individuals and entities are taxable on their worldwide income, regardless of where the income is derived. Double taxation of foreign income is mitigated through the allowance of a foreign tax credit. Proponents of a worldwide tax system argue that it promotes economic efficiency, because it does not distort the decision of whether to locate investment at home or abroad. A resident has no tax incentive under a worldwide system either to move activities abroad or to keep them within the taxpayer's country of legal residence (the "residence country") − in either case the income generally is subject to tax at the residence-country rate. Thus, investment-location decisions are governed by business considerations, instead of by tax law. This efficiency norm is referred to as "capital export neutrality."[97]

Common deviations from the "pure" form of the worldwide tax system, such as the foreign tax credit limitation and deferral, reduce this neutrality. For example, although a pure worldwide tax system would allow the unlimited use of foreign tax credits to offset all worldwide income (including "domestic" income, i.e., income earned from sources within the residence country), in practice the credit is generally limited to ensure that the residence country preserves its right to tax income derived within the residence country. Also, because corporations are generally respected as separate entities, foreign-source income earned by a resident through a foreign corporation generally is not subject to tax until repatriated. This mechanism is known as "deferral."[98] In the United States, complex anti-deferral regimes apply as exceptions to this general rule and tax U.S. shareholders currently on certain mobile or passive income derived through certain foreign corporations.

A worldwide tax system arguably preserves the residence-country tax base more effectively than a pure territorial system. If foreign-source income is entirely exempt from taxation, then resident taxpayers will have an incentive to shift investment and income into lower-tax jurisdictions, thus eroding the residence-country tax base. For this reason, even those countries that employ predominantly territorial systems (e.g., France) typically provide for

[97] However, as discussed below, proponents of a territorial system argue that it better promotes a different form of neutrality.

[98] By contrast, a pure worldwide tax system would generally not offer deferral. Instead, income earned by wholly-owned foreign corporations would be subject to current taxation in the parent corporation's residence country; as in the case of a "classic" worldwide system, double taxation would be mitigated through the allowance of a foreign tax credit.

current taxation of certain types of foreign-source income that may easily be earned in tax havens − a significant departure from "pure" territorial taxation.[99]

Territorial tax system

In a pure territorial tax system, the country taxes only income derived within its borders, irrespective of the residence of the taxpayer. Thus, unlike in a worldwide tax system, foreign-source income earned by a resident is exempt from residence-country tax. There is no need for a foreign tax credit, because exemption generally eliminates the possibility of double taxation of foreign income. There also is no need for complicated anti-deferral rules, because foreign-source income is exempt from tax in the first place. As a practical matter, however, countries that have adopted territorial-type tax systems generally have included exceptions to the principle of territoriality for certain cases deemed to be abusive, using mechanisms similar to the U.S. anti-deferral rules and foreign tax credit.

Proponents of a territorial system argue that it promotes economic efficiency, because a territorial system treats all investment within a particular country (the "source country") the same, regardless of the residence of the investor. This efficiency norm is referred to as "capital import neutrality." Thus, if a residence country adopts a pure territorial system, residents of that country, when investing abroad in a particular source country, do not bear any greater tax burden (by virtue of their country of residence) than similarly situated investors residing either in that source country or in another country with a territorial tax system. For example, if a source country provides low effective tax rates on manufacturing income, a taxpayer resident in a country with a territorial tax system will fully enjoy the benefits of the lower source-country rate, while a taxpayer resident in a country with a worldwide tax system generally will not. In a world with diverse tax systems and rates, it is generally impossible to fully achieve both capital import neutrality and capital export neutrality at the same time. Thus, difficult balancing decisions are unavoidable, and there is no consensus as to which of the two goals should take precedence.

Mixed systems

No country uses a pure worldwide or territorial system. Systems may be accurately characterized as predominantly worldwide or territorial, but all systems currently in use share at least some features of both worldwide and territorial approaches.

[99] Likewise, both worldwide and territorial tax systems may employ various rules to limit the improper shifting of income from high-tax to low-tax countries (such as transfer pricing and expense allocation rules).

B. The U.S. International Tax System

1. Tax treatment of foreign activities of U.S. persons

In general

Under the current United States tax system, domestic corporations[100] generally are taxed on all income, whether derived in the United States or abroad. Income earned by a domestic parent corporation from foreign operations conducted by foreign corporate subsidiaries generally is subject to U.S. tax when the income is distributed as a dividend to the domestic parent corporation. Until that repatriation, the U.S. tax on the income generally is deferred. However, certain anti-deferral regimes may cause the domestic parent corporation to be taxed on a current basis in the United States on certain categories of passive or highly mobile income earned by its foreign corporate subsidiaries, regardless of whether the income has been distributed as a dividend to the domestic parent corporation. The main anti-deferral regimes in this context are the controlled foreign corporation rules of subpart F[101] and the passive foreign investment company rules.[102] A foreign tax credit generally is available to offset, in whole or in part, the U.S. tax owed on foreign-source income, whether the income is earned directly by the domestic corporation, repatriated as an actual dividend, or included in the domestic parent corporation's income under one of the anti-deferral regimes.[103]

Foreign tax credit

The United States generally provides a credit for foreign income taxes paid or accrued.[104] In the case of foreign income taxes paid or accrued by a foreign subsidiary, a U.S. parent corporation is generally entitled to an indirect (also referred to as a deemed paid) credit for those taxes when it receives an actual or deemed distribution of the underlying earnings from the foreign subsidiary.[105] The foreign tax credit generally is limited to the U.S. tax liability on a taxpayer's foreign-source income. This limit is intended to ensure that the credit serves its purpose of mitigating double taxation of foreign-source income without offsetting the U.S. tax on U.S.-source income.[106]

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[100] A domestic corporation is generally any corporation created or organized in the United States or under the law of the United States or of any state (or the District of Columbia). Sec. 7701(a)(4). Some other countries determine the residency of a corporation by looking to the predominant location of the corporation's management and control, regardless of the country of legal incorporation.

[101] Secs. 951-964.

[102] Secs. 1291-1298.

[103] Secs. 901, 902, 960, 1291(g).

[104] Sec. 901.

[105] Secs. 902, 960.

[106] Secs. 901, 904.

To determine the amount of allowable foreign tax credits after taking into account the foreign tax credit limitation, a taxpayer must allocate gross income and expenses between U.S. and foreign sources. Under present law, interest expense that a U.S.-based multinational corporate group incurs in the United States is allocated between U.S. and foreign sources based on the gross assets located in the United States relative to those located abroad (measured either by basis or by fair market value).[107] Thus, a U.S.-based multinational with a significant portion of its assets overseas must allocate a significant portion of its U.S. interest expense to foreign-source income. This allocation has the effect of reducing the foreign tax credit limitation and thus reducing the credits allowable (even though the interest expense incurred in the United States is generally not deductible in computing the actual tax liability under applicable foreign law).[108]

To reduce the extent to which excess foreign taxes paid in a high-tax foreign jurisdiction can be applied to offset the residual U.S. tax (or "cross-credited") on low-taxed foreign-source income, the foreign tax credit limitation is applied separately to different types of foreign-source income. This sort of cross-crediting is constrained by rules that require the computation of the foreign tax credit limitation on a category-by-category basis.[109] For taxable years beginning prior to January 1, 2007, section 904(d) provides eight separate baskets as a general matter, and effectively many more in situations in which various special rules apply.[110]

Special rules govern the ability of a taxpayer with excess foreign tax credits (that is, an amount of foreign tax credits which exceeds the foreign tax credit limitation for the taxable year) to offset such excess credits against tax liability arising in a prior year (credits so utilized are said to be carried back) or in a subsequent year (carried forward).[111] In general, excess credits generated in a taxable year are permitted to be carried back to the immediately preceding taxable year and carried forward ten taxable years (in chronological order), and are usable only as a

[107] Sec. 864(e); Temp. Reg. sec. 1.861-11T.

[108] The American Jobs Creation Act of 2004 ("AJCA"), Pub. L. No. 108-357, made certain changes to the interest expense allocation rules, effective for taxable years beginning after December 31, 2008, intended to mitigate this effect. AJCA sec. 401.

[109] Sec. 904(d). To illustrate, suppose a taxpayer pays foreign tax at an effective rate of 45 percent on certain active income earned in a high-tax jurisdiction, and pays little or no foreign tax on certain passive income earned in a low-tax jurisdiction. In the absence of the separate limitation rules, earning untaxed (or low-taxed) passive income could permit the taxpayer to claim a credit for the otherwise uncreditable excess foreign taxes paid to the high-tax jurisdiction by increasing the foreign tax credit limitation without increasing the amount of foreign taxes paid. The separate limitation rules are intended to prevent this cross-crediting by placing the passive income and the active income into separate limitation categories (or "baskets"), so that the low-taxed passive income does not increase the foreign tax credit limitation applicable to the credits arising from the high-taxed active income.

[110] AJCA reduced the number of baskets from nine to eight (eliminating the 10/50 basket) for taxable years beginning after December 31, 2002, and further reduced the number of baskets to two for taxable years beginning after December 31, 2006. AJCA sec. 404.

[111] Sec. 904(c).

credit (not as a deduction), and only to the extent that there is excess foreign tax credit limitation in the carryover or carryback year.[112] If credits cannot be utilized within the one-year carryback and ten-year carryforward period, they expire and are permanently disallowed.

Anti-deferral regimes

In general

Generally, income earned indirectly by a domestic corporation through a foreign subsidiary corporation is subject to U.S. tax only when the income is distributed to the domestic parent corporation because corporations generally are treated as separate taxable persons for Federal tax purposes. However, this deferral of U.S. tax is limited by anti-deferral regimes that impose current U.S. tax on certain types of income earned by certain corporations. These anti-deferral rules are intended to prevent taxpayers from avoiding U.S. tax by shifting passive or other highly mobile income into low-tax jurisdictions. Deferral of U.S. tax is permitted, on the other hand, for most types of active business income earned abroad.

Subpart F

Subpart F,[113] applicable to controlled foreign corporations and their shareholders, is the main anti-deferral regime of relevance to a U.S.-based multinational corporate group. A controlled foreign corporation generally is defined as any foreign corporation if U.S. persons own (directly, indirectly, or constructively) more than 50 percent of the corporation's stock (measured by vote or value), taking into account only those U.S. persons that own at least 10 percent of the stock (measured by vote only).[114] Under the subpart F rules, the United States generally taxes the U.S. 10-percent shareholders of a controlled foreign corporation currently on their pro rata shares of certain income of the controlled foreign corporation (referred to as "subpart F income"), without regard to whether the income is distributed to the shareholders.[115] In effect, the United States treats the U.S. 10-percent shareholders of a controlled foreign corporation as having received a current distribution out of the corporation's subpart F income.

Subpart F income generally includes passive income and other income that is readily movable from one taxing jurisdiction to another. Subpart F income consists of foreign base company income,[116] insurance income,[117] and certain income relating to international boycotts

[112] In addition, excess credits are carried forward or carried back on a separate limitation basis. Thus, if a taxpayer has excess foreign tax credits in one basket for a taxable year, those excess credits may be carried back and forward only as taxes allocable to that basket, notwithstanding the fact that the taxpayer may have excess foreign tax credit limitation in another basket for that year.

[113] Secs. 951-964.

[114] Secs. 951(b), 957, 958.

[115] Sec. 951(a).

[116] Sec. 954.

[117] Sec. 953.

and other violations of public policy.[118] Foreign base company income consists of foreign personal holding company income, which includes passive income such as dividends, interest, rents, and royalties, and a number of categories of income from business operations, including foreign base company sales income, foreign base company services income, and foreign base company oil-related income.[119]

The U.S. 10-percent shareholders of a controlled foreign corporation also are required to include currently in income for U.S. tax purposes their pro rata shares of the corporation's earnings invested in certain items of U.S. property.[120] This U.S. property generally includes tangible property located in the United States, stock of a U.S. corporation, an obligation of a U.S. person, and certain intangible assets, such as patents and copyrights, acquired or developed by the controlled foreign corporation for use in the United States.[121] There are specific exceptions to the general definition of U.S. property, including for bank deposits, certain export property, and certain trade or business obligations.[122]

Exceptions to Subpart F

As described above, one category of subpart F income is foreign personal holding company income. This category includes passive income such as dividends, interest, rents, and royalties. Foreign personal holding income generally does not, however, include dividends and interest received by a CFC from a related corporation organized and operating in the same foreign country in which the CFC is organized. It also generally does not include rents and royalties received by a CFC from a related corporation for the use of property within the country in which the CFC is organized. The recently-enacted Tax Increase Prevention and Reconciliation Act of 2005 ("TIPRA")[123] added a new exclusion from foreign personal holding company income for dividends, interest, rents, and royalties received by one CFC from a related CFC (with relation based on control) to the extent attributable or properly allocable to non-subpart-F income of the payor.[124] The exclusion applies for taxable years beginning after 2005 and before 2009.

Under a provision enacted in 1997 and originally applicable only for one taxable year,[125] there is an exclusion from subpart F income for certain income of a controlled foreign

[118] Sec. 952(a)(3)-(5).

[119] Sec. 954. AJCA eliminated the category of foreign base company shipping income.

[120] Secs. 951(a)(1)(B), 956.

[121] Sec. 956(c)(1).

[122] Sec. 956(c)(2).

[123] Pub. L. No. 109-222 (2006).

[124] TIPRA sec. 103(b).

[125] Pub. L. No. 105-34, sec. 1175.

corporation that is derived in the active conduct of a banking or financing business ("active financing income").[126] Congress has extended the application of section 954(h) several times, most recently in TIPRA.[127] The exception from subpart F for active financing income now applies to taxable years of foreign corporations starting before January 1, 2009 (and to taxable years of U.S. shareholders with or within which those corporate taxable years end).[128] A similar provision excludes from subpart F income certain income of a controlled foreign corporation that is derived in the active conduct of an insurance business.[129]

Passive foreign investment companies

The Tax Reform Act of 1986 established an anti-deferral regime for passive foreign investment companies. A passive foreign investment company generally is defined as any foreign corporation if 75 percent or more of its gross income for the taxable year consists of passive income, or 50 percent or more of its assets consists of assets that produce, or are held for the production of, passive income.[130] Alternative sets of income inclusion rules apply to U.S. persons that are shareholders in a passive foreign investment company, regardless of their percentage ownership in the company, each designed to ensure that U.S. shareholders do not improperly benefit from the deferral of tax on the income of the passive foreign investment company.

Temporary dividends received deduction for repatriated foreign earnings

Section 421 of AJCA added to the Code section 965, a temporary provision intended to encourage the repatriation of certain low-taxed foreign earnings. As discussed above, the U.S. tax rules generally allow a U.S. corporation to defer U.S. income tax on the active foreign-source income earned abroad by its CFCs until such income is returned to the United States. By providing a present-value benefit to U.S. taxpayers who keep low-taxed CFC earnings offshore, these rules operate as a disincentive to repatriate such earnings. In addition, U.S. generally accepted accounting principles ("U.S. GAAP") may provide a further (and related) disincentive for publicly traded companies to repatriate low-taxed CFC earnings.[131]

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[126] Sec. 954(h).

[127] TIPRA sec. 103(a)(2); Pub. L. No. 107-147, sec. 614 (2002); Pub. L. No. 106-170, sec. 503 (1999); Pub. L. No. 105-277 (1998).

[128] TIPRA sec. 103(a)(2); Code sec. 954(h)(9).

[129] Sec. 954(i).

[130] Sec. 1297.

[131] In particular, Accounting Principles Board Opinion 23 ("APB 23") provides an exception to the general rule of comprehensive recognition of deferred taxes for temporary book-tax differences. (For a general overview of the financial accounting rules relating to book-tax differences, see Joint Committee on Taxation, *Present Law and Background Relating to Corporate Tax Reform: Issues of Conforming Book and Tax Income and Capital Cost Recovery* (JCX-16-06), May 8, 2006.) The exception applies to temporary differences related to undistributed earnings of foreign subsidiaries and foreign corporate joint

Under section 965, certain dividends received by a U.S. corporation from its controlled foreign corporations were eligible for an 85-percent dividends-received deduction.[132] The deduction is subject to a number of general limitations.[133] Under section 965(d), no foreign tax credit (or deduction) is allowed for foreign taxes attributable to the deductible portion of any dividend.[134] In addition, deductions are disallowed for expenses that are directly allocable to the deductible portion of any dividend.

In enacting section 421 of AJCA, the Congress emphasized that this tax reduction is a temporary economic stimulus measure, and that there is no intent to make the measure permanent, or to "extend" or enact it again in the future.[135]

2. Tax treatment of U.S. activities of foreign persons

The United States asserts taxing jurisdiction over nonresident alien individuals and foreign corporations ("foreign persons") only with respect to income that has a sufficient nexus to the United States. Foreign persons are subject to net-basis U.S. tax on income that is

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ventures that meet the indefinite reversal criterion in APB 23 (such earnings are said to be "permanently reinvested"). Under U.S. GAAP, a U.S. multinational company generally includes the pre-tax income of its CFCs in the U.S. parent's consolidated financial statements (thereby increasing its reported earnings to reflect the foreign income of its CFCs); however, if the APB 23 exception applies, the company is not required to make an accrual for the residual U.S. tax that will be imposed when the earnings are repatriated (thereby avoiding a reduction of its reported earnings to take into account the U.S. tax liability which would be due upon repatriation). The rationale for this exception is that, when management of the company asserts that certain low-taxed foreign earnings will never be repatriated, it would be inconsistent with the objectives of U.S. GAAP (including the objective of providing investors with accurate information) to require a current accrual for future U.S. taxes that management, according to such assertion, expects that the company will never be required to pay. Instead, under APB 23, the company reduces its reported consolidated income to reflect the residual U.S. tax on the CFC's earnings only at the time such earnings are repatriated (or when such earnings no longer qualify as "permanently reinvested," if earlier). Thus, just as taxpayers can often defer the cash payment of U.S. tax until foreign income is repatriated, so too publicly-traded U.S. multinational companies can often avoid reporting this tax expense in their public financial statements until the foreign income is repatriated.

[132] At the taxpayer's election, this deduction was available for dividends received either during the taxpayer's first taxable year beginning on or after October 22, 2004, or during the taxpayer's last taxable year beginning before such date.

[133] First, it applied only to cash repatriations generally in excess of the taxpayer's average repatriation level calculated for recent taxable years. Second, the amount of dividends eligible for the deduction was generally limited to the amount of earnings shown as permanently invested outside the United States on the taxpayer's recent audited financial statements.[133] Third, in order to qualify for the deduction, dividends must have been described in a domestic reinvestment plan approved by the taxpayer's senior management and board of directors.

[134] Section 965 did not provide for any specific adjustment to the foreign tax credit limitation of a taxpayer that paid qualifying dividends, as the deduction itself had the effect of appropriately reducing the taxpayer's limitation.

[135] H.R. Rep. No. 108-548, at 43 (2004); S. Rep. No. 108-192, at 50 (2003).

"effectively connected" with the conduct of a trade or business in the United States. Effectively connected income generally is taxed in the same manner and at the same rates as the income of a U.S. person.[136]

Foreign persons are also subject to a gross-basis U.S. tax at a 30-percent rate on certain categories of non-effectively-connected income derived from U.S. sources (interest, dividends, rents, royalties, and other similar types of income), subject to a few exceptions.[137] One major exception is that certain types of interest (for example, interest from certain bank deposits and from certain portfolio obligations) are not subject to the tax.[138] The tax generally is collected by means of withholding by the person making the payment to the foreign person receiving the income.[139]

The Code includes certain rules, known as "thin capitalization" rules, intended to prevent foreign corporations from eliminating or inappropriately reducing the income of their U.S. subsidiaries through excessive interest deductions. Those rules provide, in part, that the interest paid or accrued by a domestic corporation is nondeductible if it is paid or accrued to a related party, no tax is imposed on the payment, and the domestic corporation has a debt-equity ratio exceeding 1.5 to one. The amount that is nondeductible generally is limited to the excess of the domestic corporation's net interest expense − that is, interest expense less interest income − over its taxable income (with certain adjustments).[140]

3. Transfer pricing

Due to the variation in tax rates and tax systems among countries, a multinational enterprise, whether U.S.-based or foreign-based, may have an incentive to shift income, deductions, or tax credits among commonly controlled entities in order to arrive at a reduced overall tax burden. Such a shifting of items between commonly controlled entities could be accomplished by establishing artificial, non-arm's-length (i.e., non-market) prices for transactions between group members.

Under section 482, the Secretary of the Treasury is authorized to redetermine the income of an entity subject to U.S. taxation when necessary to prevent an improper shifting of income between that entity and a commonly controlled entity. The statute generally does not prescribe any specific reallocation rules that must be followed; it establishes the general standards of preventing tax evasion and clearly reflecting income. Treasury regulations adopt the concept of

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[136] Secs. 871(b) and 882.

[137] Secs. 871 and 881. As discussed in section VII.B.4, below, tax treaties frequently reduce this rate of tax for payments made to residents of treaty partners.

[138] Secs. 871(h)-(i), 881(c)-(d).

[139] Secs. 1441, 1442.

[140] Sec. 163(j).

an arm's length standard as the method for determining whether reallocations are appropriate.[141] Thus, the regulations generally attempt to identify the respective amounts of taxable income of the related parties that would have resulted if the parties had been uncontrolled parties dealing at arm's length.

4. Treaties

In addition to the U.S. and foreign statutory rules for the taxation of foreign income of U.S. persons and U.S. income of foreign persons, bilateral income tax treaties limit the amount of income tax that may be imposed by one treaty partner on residents of the other treaty partner. For example, treaties often reduce or eliminate withholding taxes imposed by a treaty country on certain types of income, such as dividends, interest and royalties, paid to residents of the other treaty country.[142] For another example, treaties set the standard for the taxation by a treaty country of the business activities of a resident of the other treaty country (known as a "permanent establishment"). Treaties also include provisions governing the creditability of taxes imposed by the treaty country in which income is earned in computing the amount of tax owed to the other country by its residents with respect to that income. Treaties further provide procedures under which inconsistent positions taken by the treaty countries on a single item of income or deduction may be mutually resolved by the two countries.

The United States has a network of 58 bilateral income tax treaties covering 65 countries. This network includes all other 29 OECD member countries. It also covers the vast majority of foreign trade and investment of U.S. businesses.

[141] The tax systems of most other countries likewise endorse the arm's length standard. The Organisation for Economic Co-operation and Development ("OECD"), for instance, explicitly incorporates the arm's length principal in its 1995 Transfer pricing Guidelines as well as in the OECD Model Tax Treaty.

[142] Recently, the United States has entered into a series of bilateral tax treaties that eliminate withholding tax on dividends paid by one corporation to another corporation that owns at least 80 percent of the stock of the dividend-paying corporation (often referred to as "direct dividends"), provided that certain conditions are met. The elimination of withholding tax under these circumstances is intended to reduce further the tax barriers to direct investment between the two treaty countries. Many bilateral tax treaties to which the United States is not a party eliminate withholding taxes in similar circumstances. Over the last three years, the Senate has given advice and consent to ratification of U.S. treaties and protocols containing zero-rate provisions with the United Kingdom, Australia, Mexico, Japan, the Netherlands, and Sweden. In addition, the United States has recently signed, but has not yet ratified, protocols with Denmark, Finland, and Germany which all include zero-rate provisions.