How to Save the Corporate Income Tax

By M. Carr Ferguson

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Introduction

The honor of offering the Richard Crawford Pugh Lecture is increased by my long friendship with Dick. Since one of my proposals is a smaller role for legislators and a larger one for judges in developing the corporate tax law, it seems fitting that we first worked together in the 1960s while he was serving in the Department of Justice as the Deputy Assistant Attorney General of the Tax Division. He and Mitchell Rogovin, the Division's Assistant Attorney General, were preparing a study of the jurisdiction of the various federal courts over tax disputes and requested my assistance. The work proceeded congenially. Their report recommending efficiencies in the system was thorough, clear and compelling; and, like many such reports, it disappeared down the political well without a splash. For me, the reward of the project was Dick's friendship and the chance to renew friendships with career attorneys with whom I had served in the Division as a trial attorney over a decade earlier.

Actually, it was 57 years ago — over half the life of the modern income tax — when I tried my first tax case for the government, a matter involving the corporate World War II excess profits tax. Life was simpler then. The Internal Revenue Code, printed in one slender volume, could be understood. Tax disputes which it engendered were frequently issues of fact or intent rather than statutory ambiguity. The stakes, however, were high. Through the Korean War years, the high tax rates of World War II still prevailed. The top rate for individuals was 91% and for corporations, 52%. Capital gains were taxed at a comparatively modest 25%. Today's top tax rates have been reduced for individuals to 40%, corporations to 35% and capital gains to 15%, a rate dispensation which has been extended to dividends as well. In 1954, the individual income tax accounted for somewhat over half of all federal revenues; the corporate income tax another third, with the rest coming from employment taxes, principally Social Security, along with tariffs, estate and excise taxes. Last year, by contrast, collections of individual income taxes and employment taxes were each about 43% of federal tax revenues while more than half of the remaining 14% came from customs, excise and estate taxes. The corporate income tax has shrunk from one third of our revenues when I started practice to less than 7% today,[1] prompting at least one Congressman to claim that multinational companies like GE practically set their own rate.[2] Indeed, as embarrassing publicity about General Electric's tax returns shows, some of our largest corporations, earning huge profits within the United States and around the globe, are able to pay little or no corporate income tax. A belated announcement by a GE public relations officer that the company had discovered it could report a small amount of US income tax on last year's US earnings of over $5 billion does not disguise the hard truth that the effective tax rate for our largest corporations is nowhere near 35% of their profits.

This spring, Congress is conducting hearings and gathering the testimony of various experts, many with reforms to suggest or sacred cows to defend. Large issues of integration, geographic limitations, and even desirability of any corporate income tax will be debated, no doubt. These issues are worthy of discussion among these all-knowing foxes. The homely points this hedgehog would like to think

[1]*See* David Kocieniewski, ''At G.E. on Tax Day, Billions of Reasons To Smile,'' *The New York Times*, Mar. 25, 2011, at A1.

[2]*See id.* (describing the great success General Electric has had in minimizing its U.S. federal income tax bill and quoting Rep. Lloyd Doggett, D-Texas, as stating, ''That G.E. can almost set its own rate shows how very much we need reform.'').

about with you this afternoon are probably below their radar, but they are important, whether seismic changes in the taxation of corporations occur or not.

What has happened to the corporate income tax during my half century at the tax bar? The tax refund suits which I defended in the 1950s were about evenly divided between corporate and individual tax issues. Many involved efforts to substitute for the confiscatory individual income tax rates the lower corporate rates or still lower individual long-term capital gain rates. The need to distinguish between capital gains and ordinary income, separate individual income from corporate income, and address schemes for postponing taxation prompted Congress to pass ever more carefully described statutory limitations and refinements. As I watched the Code swell into an obese volume barely contained within paper covers, I decided to pursue an advanced tax degree while I could still carry the Code to classes.

Laptop computers have come to the rescue of today's students, for not even the strongest could carry our multi-volume Internal Revenue Code, much less its six-volume set of regulations to class, and not even the brightest of our talented students browse today's immense Code for a sense of its organization. In many places, its meaning has sunk into a bog of trailing dependent clauses sometimes hundreds of words long, passive voices with no ascertainable subjects, overgrown with cross-references, defined terms and exceptions. It has become *lex incognita.* Bad things happen when law is occult. In the private sector, taxpayers seek out the most optimistic advice. Conservative advisors are driven out by the bold. On the government side, delays and gaps grow in providing guidance, which, when it comes, may be defensively arbitrary with little more foundation in the statute than the aggressive advice of some private practitioners on the opposite side. In frustration, Congress has yielded to IRS calls for new, no-fault penalties to increase the effective tax rates for taxpayers who guess wrong on how the law will be applied. But penalties do not clarify.

How did the income tax descend from Mr. Justice Holmes' acceptance of it as "the price we pay for civilization" to Jimmy Carter's disdainful remark that "the Internal Revenue Code is a disgrace to the human race?" Tax theorists have long recognized that a good tax law must be effective in meeting the fiscal needs of government, fair in distributing its burden and sensitive to the abilities of taxpayers to pay. Furthermore, it should interfere as little as possible with human and business affairs as they would otherwise be conducted. Tax lawyers would add that it also should be sufficiently comprehensible that taxpayers can anticipate how it applies before taking action and can reliably report their tax at year-end. These are simple first principles. They are not challenged. Yet the writers of the Code have long ignored them. This has been due less to bad politics than to bad drafting habits aimed at displacing administrators and judges from their natural roles by an opaquely complex set of statutory rules. Nowhere is this more obvious than in the provisions of our corporate income tax.

Drafting Corporate Tax Legislation: Who Is in Charge?

Today's corporate income tax provisions suffer from changes in the way the law is made and re-made. For the first 25 years of the tax, Congress would pass a revenue act in each session. By 1938, Congress decided to consolidate the revenue acts into a permanent Internal Revenue Code which would remain the law beyond the life of each Congressional session. It was this 1939 Internal Revenue Code, with periodic amendments, which underlay the rising tide of tax litigation I stepped into in 1954. Some of the traditions of the biennial revenue acts still survived, however. The Treasury Secretary, as the first witness in Ways & Means' hearings on new tax legislation, would present administration proposals drafted with the help of his Tax Legislative Counsel and lawyers in the Legislation and Regulations office of Internal Revenue's Chief Counsel. The proposals would have been through several layers of review before presentation. The tax writing committees were chaired by highly qualified and responsible senior legislators secure in their seats, who were briefed by the thoroughly experienced career staff of the Joint Committee on Internal Revenue. The head of this staff worked closely with the chairs of the Ways & Means Committee and the Senate Finance Committee, using the legislative process to improve the administration's proposals. They controlled the extent to which individual members of their tax writing committees participated in the process. Part of the task of the legislators in the days of periodic revenue acts had been to review intervening regulatory and judicial interpretations of a provision of prior law, and reenactment without change was seen as tacit approval. Conference committees designated by the two houses to reconcile differences operated with the same technical discipline. The resulting revenue acts were cohesive, and cogently explained in general and technical committee reports.

These legislative niceties seem rarely observed today. The Code's bulk alone discourages periodic review or careful integration of new provisions with the old. While the administration may suggest general reforms, the Treasury, instead of reducing these to finished statutory proposals, tends to react to those fomented in Congress. Centralized control of tax legislation on the Hill and the old authority of the Chief of Staff of the Joint Committee and committee chairs of Ways & Means and Finance have given way to a decentralized system in which any number of players can take part. Individual tax committee members no longer need rely on the Joint Committee Staff for technical assistance in drafting tax proposals. They have their own staffs of lawyers, with separate groups for the majority and minority parties in each chamber. Their voices do not swell in chorus but in cacophony. Sunshine legislation, which keeps committee meetings open, ironically relegates special interest proposals to telephone conversations. Individual members put forward highly specific loopholes crafted by anonymous hands for anonymous corporate taxpayers more interested in a particular tax saving than integrating their particular "reform" into an overall statutory scheme. About the only defense to such proposals is the Joint Committee's revenue projection of their impact, a chancy process even if the real goal of the proposal is fathomed. At the end of the process, in reconciliation of the two chambers' differences, last-minute drafting — sometimes involving well-timed special interest politics as egregious as earmarking in appropriations bills — combines with inadequate review to complicate the problem. The price we pay for a decentralized tax writing process can be seen in its result. With deeper resources and narrower focus than the tax writing committees, corporations have manipulated passage of so many seemingly innocuous new provisions that the corporate income tax may soon have to be put on the list of endangered revenue species right next to the machine gun tax.

The Dangers of Overwriting

A second trend in tax legislation is the rise of a drafting style better suited to Abbott and Costello than to tax administrators. In 1953, President Eisenhower and Secretary of the Treasury George Humphrey decided it was time to scrap the 1939 Code, by then festooned with amendments, and create a new, balanced and integrated law for the ages. Wise and honest people were summoned to Washington to accomplish this. Nothing could go wrong. Unfortunately, they came to town with the conviction that the old Code's lack of clarity had been a breeding ground for confusion and wasteful litigation before courts with better things to do. What was needed, they were convinced, was a carefully detailed statute greatly expanding the length and specificity of the 1939 Code, adding precise definitions, cross references, conditions, balances and interactive parts. If ingeniously designed and meticulously constructed, it would operate automatically, free of messy questions of fact like purpose, or economic substance, as silently and efficiently as a Swiss watch. Unfortunately, practitioners in and out of government soon sensed that the new creation required the tax equivalent of a master watchmaker to appreciate its workings. The authors of this new 1954 Code failed to recognize that even highly specific rules are only *a priori*, waiting to be employed in real world situations. When events did not quite fit its language, this new army of mechanical draftsmen persisted in the belief that the problem could be fixed prospectively by even more careful articulation. Alas, naiveté and arrogance are minted from the same base metal. After a half century of continuously heightened specificity, it would seem that only the inexperienced believe we are just one more refinement away from perfection. Probably the reverse is true, for the number of tax lawyers employed by the government and corporations to master its intricacies has risen in inverse proportion to the decline in the revenue from the corporate income tax.

This need not continue. Some basic definitional tensions in the law have subsided, reducing the significance of many of the more baroque provisions. For most of the years the 1954 Code was in effect, corporate tax rates continued to be around 20 percentage points less than individual rates and dividends were taxed at least twice as heavily as capital gains. For decades, changes in the corporate tax law were aimed at protecting these rate distinctions. As rates dropped, these discrepancies shrank or disappeared. This rendered superfluous some of this earlier legislation. Vigorous pruning and redrafting are in order, but they take time. "Deadwood" bills and technical correction acts may be shelved for more pressing new proposals. Delay leaves a mothball fleet of elaborate provisions, veterans of past battles, whose guns have been pulled by later amendments. They may float aimlessly over the pages of the Code for decades until repealed or until future changes in the law give them new purpose.[3]

Speaking of dreadnoughts, Dick Pugh, an old naval officer, may be familiar with the fate of two historic battleships, symbols of imperial ego in centuries past, whose exhumed remains are now displayed as a moral for us all. One is the *Mary Rose*, the pride of Henry VIII and the other is the *Vasa*,

[3]An example is the fate of section 341, which policed conversion of dividend income into capital gains through the use of tax-free liquidations. Although section 341 was largely made obsolete when tax-free liquidations ended in 1986, the section was not repealed until 2003. *See* P.L. 108-27, section 302.

pride of Sweden's Gustavus Adolphus. Goliaths of their countries' navies, the kings lavished their superstructures with outsized new cannons, vats of quicklime, towering masts with battle platforms, bells and shining adornments and crowded their decks with imposing forces of fighting men, even cavalry, trained to destroy foes in every imaginable way. Top heavy, the *Mary Rose*, in 1545, and the *Vasa* on her maiden voyage 83 years later, capsized and sank of their own weight and the conceit of their kings.

Similarly, layers of corporate income tax amendments have so overbalanced the corporate income tax that it is dangerously top-heavy. It needs to be taken down and rebuilt from the keel up. In undertaking this, Congress would not be inhibited by royal ego or pride of authorship. New legislators need only break free from old mind sets and habits. These include the bankrupt belief that each new layer of language clarifies, and that the more highly articulated a tax provision becomes the more inexorable will be its application. If a statutory recipe is detailed enough, literalists urge, all will know how to apply and rely on it, leaving no room for lawyers' schemes or judges' retrospective interpretations to obscure its clarity. Experience teaches us the contrary. Complexity leads not to clarity but to confusion. A shorter, simpler corporate income tax can be written by Congress, if the drafters can agree on first principles and then set them out in more broadly stated rules. This would leave room for flexible application by administrators, lawyers and judges whose natural function is to provide interstitial interpretations. The uncertainties they resolve are unavoidable and salutary. The power of courts to interpret and apply the law retroactively to transactions completed years earlier is a healthy brake on tax avoidance and promotes compliance. Conversely, the ability of administrators and ultimately the courts to apply the law is diminished by the labyrinthine complexities of the Code. Better informed of the facts and frequently better advised, large corporations have the Service at a disadvantage. The ability of the Service to detect and anticipate new tax schemes may be aided by new procedures for forced disclosure, but the Service still must rely more on taxpayer self-assessment than on enforcement. As the recent reports of GE's token liabilities demonstrate, self-assessment by large corporations only comes after careful self-examination and planning. IRS auditors are limited in their ability to isolate questionable return positions, and, even if new schemes are detected, they may be triumphant exploitations of a defective provision of the law. Corporate audit controversies today arise just as frequently from disagreement about facts as they did a half century ago, but they have been joined by an army of questions spawned by disagreement about how a statute is to be applied to those facts.

Marty Ginsburg, a dear friend and fellow laborer in this odd corner of the law, enjoyed recalling the story in Exodus of the Pharaoh's pain when a rod of authority suddenly turned into a serpent and threatened to bite him. Marty saw every arbitrary rule imposed by Congress or the Commissioner as just such a rod which could become a snake to bite back at the Commissioner. The history of our tax law is rich in such parables. I shall burden you with only three: one from tax planning accidentally discovered in the aftermath of a famous transaction, another from tax litigation, showing how far off track a strictly syntactical approach to a corporate tax statute can take respected judges, and a final one from tax legislation, showing how a bedrock of corporate taxation, rarely questioned but dubiously adopted, has driven generations of tax writers to thrust up Sisyphean repairs which roll back down the Hill as heavily faulted as ever.

Seagram/DuPont and Section 1059

The first story began thirty years ago when Conoco, a major oil producer, became the target of merger-hungry companies. Seagram, the Bronfman family's giant Canadian whisky company with a bankroll which had been building since America's Prohibition years, began assembling Conoco's public shares. Conoco's management, perhaps unsure of continued employment, protested that whisky and gasoline didn't mix and fled to DuPont, a kindlier suitor. A deal was struck, converting all Conoco shares to DuPont stock.[4] While the exchange value was nicely above Seagram's cost for its Conoco stock, neither the Bronfman family nor DuPont's managers fancied Seagram lurking around as a grumpy major DuPont shareholder. Even less did Seagram relish a huge income tax on its gain or DuPont the depressing effect on its share value if Seagram dumped its stock on the market.

When Edgar Bronfman, Jr. was ready to sell Seagram's stake in DuPont, a tax solution appeared as if in a dream. They could turn on its head an inflexible rule which sometimes converted shareholders' capital gains on share redemptions into highly taxed dividend income.[5] The rule denied

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[4]*See* Thomas L. Friedman, ''DuPont Victor in Costly Battle To Buy Conoco,'' *The New York Times*, Aug. 6, 1981, at A1.

[5]Section 302 addresses the tax treatment of stock redemptions. Section 302(b) lists four tests, and if none of the tests is met, a distribution in redemption of stock is treated as a dividend under section 301. If, however, one of the four tests is met, the redemption is treated as a sale or exchange of the stock. One of the tests, described under section 302(b)(2), considers

(Footnote continued on next page.)

capital gains even to shareholders who redeemed all or most of their stock by continuing to treat them as shareholders to the extent they had a right to reacquire the redeemed shares.[6] A dividend, though, was just the ticket for a corporate taxpayer, since, to avoid multiplying the tax on intercorporate dividends, corporate shareholders like Seagram could shield 80% of their dividend income from taxation.[7] Gleefully, the companies arranged for DuPont to redeem the vast majority of Seagram's shares — about 95% — for $8.3 billion in notes and cash, and, all-importantly, options giving Seagram the right to buy back exactly the same number of DuPont shares it had surrendered.[8] The punitive option rule — really aimed at individuals — converted Seagram's redemption into a dividend. Seagram's $1.5 billion after-tax coup, while announced proudly to its shareholders, was not equally admired by Congress, which reacted to prevent such a result in the future.[9]

The added wrinkle to this tale is that Congress, just one decade earlier, had actually already inserted a provision into the Code to prevent corporate misuse of the redemption rule. That provision reduced the remaining basis of a corporate shareholder whose stock redemption was treated as a dividend by the untaxed portion of that dividend. But in their enthusiasm for specificity, the drafters of that new Code section were at pains to spell out precisely when and how a corporation was to reduce its basis for the excluded portion of such dividends. Gratuitously, they had inscribed a rule that the corporate shareholder's basis reduction would occur when it sold its stock.[10] Seagram's small remaining block of DuPont stock was thus allowed to reflect Seagram's entire historic investment in Conoco until such a sale. No doubt that stock certificate is encased in Lucite and kept safely inside a magnum of Seven Crown at some undisclosed location in Montreal. Certainly, it will not be sold. The legislative fix following Seagram's redemption was equally specific, tweaking the basis adjustment provisions to reduce basis when the dividend occurred and to tax the excess over the stock's basis as capital gain at the same time.[11] The fix was a change in the law with only prospective effect — too late to spoil Seagram's party.

Must tax writers really be so helpless when it comes to future misuse of their creations? Congress no doubt thought it had prevented corporate misuse of the redemption rule, but it was wrong. The real problem lay in the complexity of the provisions. Congress will never divine every creative solution taxpayers will devise when faced with large tax bills. For this reason, legislators should cultivate modesty in drafting for the future and retreat from such precision. A humbler, broader rule, such as excluding corporations altogether from the redemption-as-dividend rules, would have prevented such an unintended end run around the statute.

Gitlitz and Section 108(b)

Our next story sees the Justices of the Supreme Court taking up what seemed a simple conflict between two circuits over whether shareholders of an insolvent small business corporation could have a double benefit from its cancelled debts.[12] The shareholders of small business corporations report their shares of the companies' items of income and expense, thus eliminating the need for a corporate tax altogether. But their share of company losses cannot exceed their stock investment. Further losses are suspended until they can be applied against future income. When a creditor of a company cancelled some of its debt, the law allowed the company to exclude this item of income from tax to

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whether the distribution "is substantially disproportionate with respect to the shareholder" by comparing the shareholder's stock ownership immediately after the redemption to its ownership immediately before the redemption. *See* section 302(b)(2)(C).

[6]Section 302 incorporates by reference, with some modifications, the constructive ownership rules of section 318(a). *See* section 302(c). Section 318(a)(4) provides that owning an option to acquire stock is treated as owning the underlying stock.

[7]*See* section 243. Generally, a corporation that receives dividends from another domestic corporation is entitled to a deduction of 70 percent of the dividends it receives. However, if the corporation receiving the dividends owns at least 20 percent of the other corporation, the deduction increases to 80 percent, and it increases to 100 percent if the corporation receiving the dividends owns more than 80 percent of the dividend-paying corporation. Seagram owned about 24 percent of DuPont's stock.

[8]*See* Jay Mathews, "DuPont Sets Huge Buyback of Stock," *The Washington Post*, Apr. 7, 1995, at F1.

[9]*See, e.g.*, Allan Sloan, "For Seagram and DuPont, a Tax Deal that No One Wants To Brandy About," *Wash. Post*, Apr. 11, 1995, at D3 (describing the tax strategy days after the stock redemption was announced). Legislation was introduced within a month of the transaction, on May 3, 1995, which then became the effective date of the amendments to section 1059 that were finally enacted as part of the Taxpayer Relief Act of 1997. In its report, the Senate Finance Committee specifically referenced the Seagram/DuPont transaction, stating, "[I]t has been reported that Seagram Corporation intends to take the position that the corporate dividends-received [deduction] will eliminate tax on significant distributions received from DuPont Corporation in a redemption of almost all of the DuPont stock held by Seagram, coupled with the issuance of certain rights to reacquire DuPont stock." S. Rep. No. 105-33, at 137 n.84 (1997).

[10]*See* section 1059(d)(1) as it existed prior to the enactment of the Taxpayer Relief Act of 1997.

[11]*See* section 1059(a)(2), (d)(1).

[12]*Gitlitz v. Commissioner*, 531 U.S. 206 (2001).

the extent it was insolvent.[13] Exactly how this exclusion was to be done was originally left to regulations; but when this part of the Code was reworked thirty years ago, a new generation of legislators decorated the statute with detailed steps to follow and, fatally, the order in which the steps were to be taken.[14] Nosing dubiously around this statutory maze, eight of the Justices, including our full complement of literalists, trailed their way down the densely walled verbal chute formed by these ordering rules into a pen from which they saw no exit, a pen which compelled their conclusion that the excluded debt cancellation income should first be allowed to increase the shareholders' basis in their stock, unlocking the suspended losses, even though the company was in fact not taxed on the excluded income.[15] Justice Thomas, writing for the bewildered majority, admitted they were upholding an undeserved double benefit, but blamed ''the Code's plain text'' for the result.[16] Only Justice Breyer stood back from the Code's language, which he found ambiguous, to consider what Congress must have intended. Preferring an interpretation of ''closing, not maintaining loopholes,'' he would have upheld the lower court's alternative reading of the sequencing rules and would have applied the corporation's exclusion of the cancelled debt before considering whether there was any corporate level income to attribute to the shareholders.[17] This, of course, would have avoided the majority's nonsensical double benefit.

One may ask whether our highest court should dirty its fingers in such trivialities, but in doing so, the two opinions in *Gitlitz* illustrate the opposing views of what legislator and judge should be doing in making tax law. The literalists felt their task began and ended with parsing the text of the statute, keeping their eyes studiously averted from what legislators might have been trying to accomplish. If Congress did not like the absurd destination reached by the parsers, Congress, not the parsers, was to blame and must revise the imperfect expression of its will. Congress promptly did so, of course, and with such a narrow focus and an even wordier ordering rule limited only to pass-through corporations,[18] that practitioners were left to guess whether the legislation was pregnant with the negative inference that other corporations were free to rely on *Gitlitz* to achieve similar double benefits.[19] Justice Breyer, conversely, approached his task by first seeking to understand what the statute was designed to accomplish and then examining its imperfect language to see if it could be read to achieve that end. In grading Congress' composition more leniently, he might have had in mind Mr. Justice Frankfurter's admonition that ''[w]ords are clumsy tools and it is easy to cut one's fingers with them, and they need the closest attention in handling; but they are the only tools we have, and imagination itself cannot work without them.''[20] The lesson for us is the same as in the Seagram parable. Gratuitous statutory specificity leads not to clarification but to confusion. The statute could have remained innocent of ordering rules, leaving the IRS scope to grow them from its experience with the basic statutory idea.

The Tax Penalties of Being American

A last example of the futility of piling complexity upon complexity is provided by Congress' struggle with the global reach of our corporate income tax. Citizens and residents of the United States are taxed on their income ''from whatever source derived''[21] which has long had not only a qualitative meaning but a geographical one as well. A deeply ingrained, largely unquestioned article of tax policy, extends this concept of taxation on global income to U.S. corporations, while foreign corporations are taxed only on profits generated within our borders. How discriminatory can this worldwide tax system be for U.S.-based corporations? According to a *Wall Street*

[13]*See* section 108(a)(1).

[14]*See* section 108(b)(1), (2)(E); Bankruptcy Tax Act of 1980, P.L. 96-589, section 2.

[15]*Gitlitz*, 531 U.S. at 218 (''The sequencing question is expressly addressed in the statute. Section 108(b)(4)(A) directs that the attribute reductions 'shall be made after the determination of the tax imposed by this chapter for the taxable year of the discharge.' . . . In order to determine the 'tax imposed,' an S corporation shareholder must adjust his basis in his corporate stock and pass through all items of income and loss. . . . Consequently, the attribute reduction must be made after the basis adjustment and pass-through.'') (internal citations omitted).

[16]*Id.* at 219-220 (''[C]ourts have discussed the policy concern that, if shareholders were permitted to pass through the discharge of indebtedness before reducing any tax attributes, the shareholders would wrongly experience a 'double windfall': They would be exempted from paying taxes on the full amount of the discharge of indebtedness, and they would be able to increase basis and deduct their previously suspended losses. Because the Code's plain text permits the taxpayers here to receive these benefits, we need not address this policy concern.'') (internal citations omitted).

[17]*Id.* at 223.

[18]*See* P.L. 107-147, sec. 402(a), which added '', including by not taking into account under section 1366(a) any amount excluded under subsection (a) of this section'' after ''corporate level'' in section 108(d)(7)(A).

[19]This eventually was chilled by simply adding a clause to the section 108(d) regulations requiring the adjustments to be made by the corporate successor to the debtor. *See* Treasury regulations section 1.108-7(c).

[20]Felix Frankfurter, *Some Reflections on the Reading of Statutes* 29 (1947).

[21]Section 61(a).

Journal article from 2002, one expatriated industrial giant estimated that its escape from the U.S. tax system would bring down its overall tax rate from 32% to something in the range of 20% to 25% and increase the company's available cash by $55 million.[22] With stakes this high, it is no wonder that U.S. corporate businesses often seek to relocate income-producing assets and activities offshore in more tax-congenial climes — or that Congress just as often seeks to make it less attractive to do so.

The straightforward approach of taxing domestic and foreign corporations on a similar footing seems to be tax heresy. Instead, we have watched Congress after Congress burdened with an imagined duty to keep American corporations onshore and yet taxed globally, struggle with one flawed regime after another. Meanwhile, our largest companies continue to depart.[23] As early as 1932, Congress established an exit tax on businesses slipping offshore.[24] While the provision became increasingly complex over the years, it proved more a nuisance than a barrier. Thirty years later, Congress reduced the benefit to American companies of moving earnings offshore by taxing them on income of foreign subsidiaries unless attributable to businesses conducted in the local foreign jurisdiction under a new Subpart F regime.[25] The income of other foreign subsidiaries remained untaxed until they paid dividends to their American parent, when it would be taxed as if earned domestically, with a foreign tax credit allowed if foreign income taxes had been paid by the subsidiary.[26] An accompanying provision converted capital gain from the sale of stock in other, "active" foreign subsidiaries to dividends, to the extent their earnings had not been repatriated earlier.[27] This rule evinced a suspicion that corporations otherwise would delay receiving dividends from their foreign subsidiaries until they could claim gentler capital gains rates on disposition of the subsidiary stock.[28] In 1976, this rule was extended to simple distributions of foreign subsidiary stock to the corporate parent's shareholders[29] but the more specific and complex this tangle of tripwires grew, they still left gaps in the plan for motivated corporations to explore.

Such a company was McDermott, Inc. ("McDermott"),[30] a Delaware corporation with a large and profitable international ocean drilling subsidiary organized in Panama ("International"). International's retained earnings, if reinvested passively abroad, would face the Subpart F regime taxing them currently to McDermott.[31] Similarly, if McDermott caused International to distribute cash to it,

[22]Susan Pulliam, "Reincorporating Companies Find Bermuda A Place to Shed Some of Those Extra Taxes," *The Wall Street Journal*, Feb. 19, 2002, at C4. In the case of Stanley Works, reincorporating its U.S. parent corporation in Bermuda was expected to have resulted in annual tax savings of $30 million by removing Stanley Works' foreign income — which apparently accounted for 28% of the company's income — from the U.S. tax system. *Id.*

[23]According to Prof. Michael J. Graetz, 18 of the world's 20 largest companies were headquartered in the United States in 1960. By 1985, that number was down to twelve and just 20 years later only nine were left. Graetz, *100 Million Unnecessary Returns: A Simple, Fair, and Competitive Tax Plan for the United States* 117 (2008).

[24]*See* section 367. In 1932, Congress began its efforts to narrow the escape hatch by enacting section 112(k), the predecessor to today's Section 367(a). *See* H. Rept. No. 708 (1932), reprinted in *Seidman's Legislative History of Federal Income Tax Laws, 1938-1861*, at 452 ("Property may be transferred to foreign corporations without recognition of gain under the exchange and reorganization sections of the existing law. This constitutes a serious loophole for avoidance of taxes."). Unless specific exceptions apply, section 367 generally requires U.S. transferors to recognize gain upon the transfer of property to a foreign corporation in transactions that would otherwise be nonrecognition transactions. Section 367 generally operates by denying corporate status of the foreign transferee, and hence tax-free treatment to the transferor. *See* section 367(a)(1) ("If, in connection with any exchange described in section 332, 351, 354, 356, or 361, a United States person transfers property to a foreign corporation, such foreign corporation shall not, for purposes of determining the extent to which gain shall be recognized on such transfer, be considered to be a corporation.").

[25]*See* section 951. Section 951 was added to the code by P.L. 87-834, sec. 12(a) (1962). Section 951 and the other elements of the "subpart F" regime apply to U.S. shareholders of foreign corporations if more than 50 percent of the voting stock or value of the foreign corporation is owned by U.S. persons each of whom owns at least 10 percent of the voting power of the foreign corporation. *See also* sections 957, 951(b).

[26]*See* section 902.

[27]*See* section 1248. Section 1248 was added to the code by P.L. 87-834, sec. 15(a) (1962). Section 1248 was enacted to impose "full U.S. tax" when foreign-earned income was repatriated to the United States by recasting the proceeds as a dividend. S. Rep. No. 87-1881, at 107 (1962). The portion that is recast is "the portion of such gain attributable to the earnings and profits of the foreign corporation allocable to the stock surrendered." *Id.* at 108.

[28]S. Rep. No. 87-1881, at 107 (1962) ("Through an ordinary taxable liquidation or sale or exchange, it [was] possible to bring earnings accumulated by a foreign corporation back to this country merely by paying a capital gains tax on such earnings included in the gain.").

[29]P.L. 94-455, sec. 1042(b) (1976).

[30]McDermott's departure strategy was devised in the offices of Davis Polk and Wardwell by my revered partner of many years, John P. Carroll Jr.

[31]According to the company, the aggregate amount of subpart F income (for a 5-year period) would grow from $20 million to $585 million as the company's Panamanian subsidiary's operations grew — the resulting increase in U.S. tax was projected to be more than $210 million. *See* McDermott International Inc. exchange offer prospectus (Nov. 24, 1982) (hereinafter "Prospectus"), at 17. In addition, the IRS was prepared to assert

(Footnote continued on next page.)

McDermott would have to pay corporate income tax on income not previously subject to U.S. corporate rates, before being able to pay dividends from the remainder to its shareholders.[32] This would be true even if McDermott distributed the shares of International to its shareholders, since the new rules would tax McDermott as if it had first received the dividend — a result made particularly painful by the lack of a dividends-received deduction for dividends from a non-U.S. subsidiary.[33]

McDermott's solution was to make itself a subsidiary of International and let its new corporate parent pay McDermott's shareholders their expected dividends directly from its offshore earnings. To accomplish this, International tendered its own shares for the outstanding McDermott shares, plus cash. International's inclusion of cash ensured treatment of the share swap as a taxable exchange, not a reorganization, permitting most McDermott shareholders to report capital losses on their stock at currently devalued market prices.[34] The announcement accompanying the offer that International, not McDermott, would pay the dividends going forward assured success of the exchange.[35] Afterwards, now publicly owned, International was no longer a foreign subsidiary of a domestic corporate parent enmeshed in the tangle of taxes just described.[36] It and its new subsidiary, McDermott, were exultantly free of the entire tangle of legislative tripwires.

McDermott was not shy about explaining its motivations,[37] and when Treasury and Congress became aware of the McDermott escape, legislation was quickly passed to prevent such tax-painless inversions of domestic parent and foreign subsidiary from happening again.[38] The new law, too late to draw McDermott back into the net, painstakingly tracks the facts of the McDermott transaction[39] and requires U.S. corporate parents to report dividend income upon flipping from parent to subsidiary. This repair, however, is so specifically targeted to the McDermott inversion[40] that it practically invites taxpayers to look for other forms of inversion to escape the forced dividend rules. Inevitably, those new forms of escape have been developed and exist today. The seemingly endless process of legislative repair can be expected to continue. Other deterrents, as we have seen, are also awkward and frequently ineffective. The Section 367(a) "exit tax" on expatriating corporations, for

that McDermott had erred in determining its subpart F income and owed an additional $200 million in taxes. *Id.* at 60-61.

[32]*See* Prospectus, *supra* note 31, at 16.

[33]*See* section 1248(f); section 243(a) ("there shall be allowed as a deduction an amount equal to the following percentages of the amount received as dividends from a domestic corporation").

[34]The tax disclosure, drafted by McDermott's tax counsel at Davis Polk and Wardwell, stated that the transaction would be treated as an exchange, and not as a distribution by either International or McDermott and that a holder's receipt of cash and shares of International would be a taxable exchange (not a tax-free reorganization), which would give rise to gain or loss to the holder. Prospectus, *supra* note 31, at 29. Efforts by the IRS to have the courts recharacterize the inversion as a taxable dividend of International's shares by the Delaware parent foundered in *Bhada v. Commissioner*, 892 F.2d 39 (6th Cir. 1989).

[35]Prospectus, *supra* note 31, at 4.

[36]The exchange prospectus that International filed with the SEC included a statement of opinion of Davis Polk and Wardwell that "the reorganization . . . will enable the McDermott Group to avoid future Subpart F income tax costs because, after the exchanges . . . International will no longer be a [controlled foreign corporation]." Prospectus, *supra* note 31, at 17. Not content with winning one tax play, McDermott's plan of reorganization also provided that McDermott would retain 10 percent of the voting power of International "to enable [McDermott] to claim foreign tax credits for income taxes paid to foreign countries." Prospectus, *supra* note 31, at 4.

(Footnote continued in next column.)

[37]The exchange offer prospectus made explicit that the "principal purpose of the reorganization is to enable the McDermott Group to retain, reinvest, and redeploy earnings from operations outside the United States without subjecting such earnings to United States income tax." Prospectus, *supra* note 31, at 16.

[38]*See* section 1248(i), which was added by P.L. 98-369, Sec. 133(a) (1984). Congress noted that section 1248 had generally been successful at carrying out the policy of taxing accumulated profits of active foreign corporations upon repatriation, but that it had become aware that certain transactions could "circumvent the statutory rules." *See* H. Rep. No. 98-432, pt. 2, at 1326 (1984). Without calling out the McDermott exit by name, the House Committee Report observed that "taxpayers have taken the position that section 1248 does not apply if a foreign corporation that is wholly owned by a widely held U.S. corporation issues new shares and pays a small amount of cash in exchange for shares representing a majority interest in the U.S. corporation." *Id*.

[39]*See* section 1248(i) ("If any shareholder of a 10-percent corporate shareholder of a foreign corporation exchanges stock of the 10-percent corporate shareholder for stock of the foreign corporation, such 10-percent corporate shareholder shall recognize gain in the same manner as if the stock of the foreign corporation received in such exchange had been . . . issued to the 10-percent corporate shareholder, and . . . then distributed by the 10-percent corporate shareholder to such shareholder in redemption or liquidation (whichever is appropriate).").

[40]Congress was very clear about its intention to plug the hole through which McDermott had just slipped, with the House Ways and Means Committee noting that the "ability to avoid ordinary income tax by causing a foreign corporation to engage in a transaction with the shareholders of its U.S. parent corporation would make a mockery of the principle of taxing accumulated earnings and profits of foreign corporations upon repatriation." H. Rep. No. 98-432, pt. 2, at 1327 (1984).

example, is keyed to appreciation in U.S. stock or assets and gains little traction where there is no significant growth in value.[41] Even if there is significant appreciation, the long-term tax advantages for a global business of incorporating abroad may outweigh the ''toll charge,''[42] especially for shareholders who are not U.S. persons. Furthermore, because the toll charge is imposed only upon the otherwise tax-free transfer of stock or corporate assets, it does not apply at all to other exit strategies.

The McDermott story is but a symptom of a fundamental failure in our approach to dealing with the taxation of global corporate businesses. Congress will run out of fingers to stick in the dike ''protecting'' global taxation of domestic corporations as more leaks keep springing open. The more specific Congress' legislative patches, the weaker they will prove to be. It is past time to ask whether we need such a dike at all, and to reexamine our conventional wisdom that the taxation of international business should depend so drastically on whether its parent corporation is American or foreign. While perfect convergence may be both difficult and unnecessary, much could be done to reduce current tax discriminations. Even if such an approach is rejected, simpler and more efficient ways of reinforcing our current system need to be constructed. One idea, similar to the treatment of expatriating individuals, which simply ignores their change of nationality for a period of time, has been developed and has not yet been so encrusted with special rules as to lose its basic thrust.[43] Whether these ideas or others emerge, a new set of corporate tax rules for international businesses, clearly and broadly expressed, should reduce traps and windfalls like the McDermott transaction.

[41]*See, e.g.*, Pulliam, *supra* note 22 (quoting Robert Willens ('''the shareholder toll is low' for many companies, 'if it exists at all right now''')).

[42]*See, e.g.*, Phyllis Plitch, ''Stanley Holders Barely Approve Controversial Tax-Haven Plan,'' *The Wall Street Journal*, May 10, 2002, at B2 (quoting the vice president of investor relations of Stanley Works who was defending the shareholder tax cost, saying that ''the $30 million a year in tax savings for the company will increase earnings a share by about 35 cents, which is expected to drive shares higher. 'It shouldn't take long for them to recover what they lost.''').

[43]Section 7874, which was enacted in 2004, disregards (and eliminates the benefits of) the expatriation of a U.S. corporation if the owners of the old U.S. corporation are largely the same owners of the new foreign corporation, unless the corporate expatriate conducts ''substantial business activities'' in the foreign country where it is located.

Conclusions

These three little tales could be replaced by scores of others without changing their lesson. Congress cannot weave a statute fine enough to screen out the next generation of schemes in avoidance. To attempt it is a fool's errand, for it breeds complexity. Now more voluminous than Rome's entire Corpus Juris Civilis, the very bulk of the Internal Revenue Code contributes to the erosion of the corporate income tax. With tax reform hearings currently underway in Congress, our lawmakers appear to have reached the same conclusion. Among the sweeping proposals for simplification that have thus far been made in the hearings are some I've already touched upon here, including moving to a territorial system of taxation and eliminating the myriad special credits and deductions that now account for so many of the Internal Revenue Code's pages. If these or other reforms move forward in the legislative process, their success will depend on Congress' ability to avoid the trends that have led its predecessors astray in recent decades. After each story told above, a few suggestions were made in this regard, but let me conclude with a few more general suggestions for those who would rebuild the tax system.

At this point, they are probably obvious. *First*, the corporate income tax must be protected from corporations. Whatever rights to free speech their ''personage'' may guarantee them to influence the law, we should know who is writing our tax laws and understand the source and intent of proposed new legislation. A more disciplined, public process in Congress, featuring Treasury's participation early and often, would help level the playing field. *Second*, we need a basic overhaul in the corporate income tax to eliminate loopholes — intended or unintended — and to lower its rate to compensate for a broader definition of corporate income more in line with reported earnings. If big business were to pay only 15-20% of their U.S. earnings as corporate income tax — a rate urged by some reformers,[44] corporate tax revenues might actually increase. *Third*, style is substance. Writers of a new corporate tax law must leash their pens and write terser provisions of broader application, trusting the Commissioner and the courts to interpret and apply them sensibly.

Finally, let us turn away from the game theory of Pharaoh's rod to another passage appearing much later in the Bible. Saint Paul's Second Letter to the

[44]*See* Graetz, *supra* note 23, at 125.

Corinthians reminded them they are ministers not of the letter of the New Testament but of its spirit, for ''the letter killeth but the spirit giveth life.'' Judge Learned Hand, in his celebrated *Gregory* opinion 77 years ago,[45] refused to stop short in his analysis of a corporation's transfer to its shareholder, which was in form a tax-free distribution of a subsidiary. He looked through to its substance, which was a taxable dividend of portfolio securities. ''It is quite true,'' he wrote, ''that as the articulation of a statute increases, the room for interpretation must contract; but the meaning of a sentence may be more than that of the separate words, as a melody is more than the notes, and no degree of particularity can ever obviate recourse to the setting in which all appear.''[46] More recently, Judge David Laro of the Tax Court and our own tax faculty was confronted with a similar case arising from a taxpayer's attempt to take advantage of what the Commissioner had intended to be an inflexible rod: a tax penalty in the form of accelerating taxes when property is sold for a contingent deferred price.[47] It did not take taxpayers long to see that the artificial gain imposed by the Commissioner's rod in the early years could be allocated to a nontaxable partner, leaving a taxable partner to benefit from the later year's corresponding artificial loss. Judge Laro, excusing the Commissioner from his own regulation, stated, ''We do not suggest that a taxpayer refrain from using the tax laws to the taxpayer's advantage. In this case, however, the taxpayer desired to take advantage of a loss that was not economically inherent in the object of the sale, but which the taxpayer created artificially through the manipulation [of the regulation]. . . . ''[48]

Judges Hand and Laro, like Justice Breyer, saw the need to understand the purpose of a provision and the intent behind a transaction before applying the law. Edwin Cohen, a supporter of the corporate tax provisions in the 1954 Code, told of delivering a lecture on the evils of subjective tests in the Code.[49]

[45]*Helvering v. Gregory*, 69 F.2d 809 (2d Cir. 1934).

[46]*Id.* at 810-811.

[47]*See ACM Partnership v. Commissioner*, T.C. Memo. 1997-115 (1997), *Doc 97-6453*, *97 TNT 44-17*, *aff'd in part and rev'd in part*, 157 F.3d 231 (3d Cir. 1998), *cert. denied*, 526 U.S. 1017 (1999).

[48]*Id.* Since *ACM Partnership*, the Supreme Court confirmed that the *Chevron* doctrine requires the courts to defer to tax regulations, whether ''legislative'' or ''interpretative.'' *Mayo Found. for Med. Educ. & Research v. United States*, 131 S. Ct. 704 (2011). However, the holding does not require judges to elevate regulatory language over the words of the statute or to apply *Gregory* any differently. Presumably, therefore, Judge Laro's reading of the regulation would be no different today than it was before the Court's decision in *Mayo*.

[49]*See* Edwin S. Cohen, *A Lawyer's Life: Deep in the Heart of Taxes* 291-292 (Tax Analysts, 1994).

The evening before he was to speak at the Tulane Tax Institute, a reporter for the New Orleans Times Picayune, detailed to cover the proceedings, asked him to describe his topic. Trying to simplify things, Ed explained that he was speaking about taxes that depended on a taxpayer's state of mind, and that he was against them. The next day's headline read ''N.Y. Attorney Urges Repeal of Tax on State of Mind.''[50] Having now experienced fifty years of efforts to objectify the corporate tax, this New York lawyer begs to disagree with his old friend.

Careful tax lawyers are conscious of the spirit's ability to triumph over the letter of the law. Whether acting as counsel for the government or the taxpayer, they know the limited capacity of the Code and regulations to anticipate future events or plans. Simpler is better. A leaner statute can be better understood, interpreted, and administered. Once confident that the Service and courts will apply such a Code retroactively to our clients' decisions this way, we can rediscover a virtuous cycle of more conservative advice, better compliance and, finally, a renaissance of faith in the system.

[50]*Id.*