

2012

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Recommended Citation

Polito, Anthony P. (2012) "Constructive Dividend Doctrine from an Integrationist Perspective," *Akron Tax Journal*: Vol. 27 , Article 1.

Available at: <https://ideaexchange.uakron.edu/akrontaxjournal/vol27/iss1/1>

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CONSTRUCTIVE DIVIDEND DOCTRINE FROM AN INTEGRATIONIST PERSPECTIVE

*Anthony P. Polito**

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I. INTRODUCTION

A long standing feature of U.S. corporate taxation is a group of doctrinal devices serving to prevent taxpayer attempts to avoid double taxation of corporate earnings. This Article refers to these devices collectively as the constructive dividend doctrine (hereinafter “CDD”) and analyzes the extent to which the CDD ought to be set aside as counterproductive.

This analysis is grounded in contrasting views of the normative tax treatment of corporate enterprise. On the one hand is the perspective in which the double income taxation of corporate income is normative (the

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“Double Tax Perspective”). The Double Tax Perspective calls for taxation of corporate income¹ a first time as it is received or accrued in the corporation’s hands and a second time as those corporate earnings are distributed to shareholders. The normative shareholder treatment from the Double Tax Perspective is as full ordinary income in shareholders’ hands as corporate earnings are distributed. It treats the reduced rate capital gain taxation for most stock sales² and deemed stock sales³ as a “narrow” exception to this norm.

A contrasting perspective is one in which all income derived from a business enterprise would be taxed exactly once (the “Integrationist Norm”). Under such an idealized Integrationist Norm, all income would be imputed to individuals connected with the corporate enterprise—as shareholders or otherwise—as earned, and all income would be taxed at the individual rate schedules. In principle, the nearest one might come to such a perfect regime is the fiscal transparency of a full pass-through regime. Under such a tax regime, there would be no corporate-level tax. Instead, all of the revenue of the corporation would be taxed as income of some individual. The nearest analog is the tax treatment of partnerships.⁴

This Article is predicated on the wisdom of the Integrationist Norm. Elsewhere, in an article entitled *Advancing to Corporate Tax Integration: A Laissez-Faire Approach*,⁵ I advanced the proposition that, although systematic corporate tax integration is unlikely to be enacted in the foreseeable future, integrationism should be regarded as normative. The Laissez-Faire Approach proposes that, to the extent that legal mechanisms serve to prevent self-help corporate tax integration,

1. The term “corporate income” is associated with equity’s residual claim on corporate receipts net of the claims of all “expenses,” i.e., the claims of all other participants in the corporate enterprise. See Alvin C. Warren, Jr., *The Corporate Interest Deduction: A Policy Evaluation*, 83 YALE L.J. 1585, 1587 (1974). Yet it almost goes without saying that a corporation, as such, cannot have income in any economically meaningful sense. If taxation of “corporate income” has any justification, it is as a stand-in for the achievement of some implicit policy goal that cannot be otherwise addressed directly. See Anthony P. Polito, *Useful Fictions: Debt and Equity Classification in Corporate Tax Law*, 30 ARIZ. ST. L.J. 761, 766-70 (1998).

2. I.R.C. § 1221 (2006) (defining capital asset).

3. See *id.* §§ 302, 303, 304, 331, 356.

4. See *id.* §§ 701-777, 6221-6234. In practice, fiscal transparency cannot be effected in a manner that fully eliminates all distinctions between a business conducted directly as an individual’s sole proprietorship and an enterprise conducted through a legal structure. See LAURA E. CUNNINGHAM & NOEL B. CUNNINGHAM, *THE LOGIC OF SUBCHAPTER K* (3d ed. 2006). Nevertheless, the partnership paradigm appears to be the nearest alternative possible to the integrationist ideal.

5. Anthony P. Polito, *Advancing to Corporate Tax Integration: A Laissez-Faire Approach*, 55 S.C.L. REV. 1 (2003).

they are counterproductive, wasting valuable taxpayer, IRS, and judicial resources. This Article analyzes the CDD in light of the Laissez-Faire Approach in order to identify circumstances in which it is best to dispense with the CDD as a counterproductive mechanism that wastes resources reinforcing the double tax anti-ideal.

II. CONSTRUCTIVE DIVIDENDS IN A DOUBLE TAX WORLD

From the Double Tax Perspective, the CDD plays a vital role of policing for transactions that seek to evade full double taxation. In the world of the Double Tax Perspective, a corporate distribution to shareholders, *qua* shareholders, out of corporate earnings should be taxed at full ordinary tax rates, even to the extent it represents amounts of earnings already reduced by a corporate tax.⁶ In addition, accurate measurement of an individual's income requires that payments and property transfers made on behalf of an individual or for the benefit of an individual should be treated the same as if they were made directly to the individual and further transferred by that person.⁷ By that logic, corporate transfers that benefit shareholders in the same manner as dividends need to be classified as such, hence the perceived need for the CDD.

An economic perspective, however, makes this issue somewhat more complicated. Under idealized economic conditions, no dividend distribution—actual or constructive—increases the wealth of shareholders. It simply changes the form of wealth holding. A portion of the wealth represented by corporate shares is separated from the underlying shares.⁸ Under the less than idealized conditions of actual markets, dividend distributions and dividend policy do have actual effects on shareholder value.⁹ Tax policy, however, has never attempted

6. See I.R.C. § 301 (2006). *But see* I.R.C. §§ 302, 303, 304, 331, 356 (allowing sale treatment and capital gain rates in specified circumstances).

7. See *Old Colony Trust Co. v. Comm'r*, 279 U.S. 716 (1929).

[W]e think the question presented is whether a taxpayer, having induced a third person to pay his income tax or having acquiesced in such payment as made in discharge of an obligation to him, may avoid the making of a return thereof and the payment of a corresponding tax. We think he may not do so. . . . The discharge by a third person of an obligation to him is equivalent to receipt by the person taxed.

Id. at 729.

8. Merton H. Miller & Franco Modigliani, *Dividend Policy, Growth, and the Valuation of Shares*, 34 J. BUS. 411, 413-14 (1961). See also RICHARD A. BREALEY, STEWART C. MYERS & FRANKLIN ALLEN, *PRINCIPLES OF CORPORATE FINANCE* 397-402 (10th ed. 2011) (hereinafter "*Brealey, Myers & Allen*").

9. See *Brealey, Myers & Allen*, *supra* note 8, at 402-10. See also Polito, *supra* note 5, at 10-14.

to separately measure and tax the increment to shareholder wealth generated by dividend payout policy, regardless of whether practicable measurement of that increment could ever be possible. Instead, the tax is based on the amount of earnings separated from the corporation as an entity. An actual dividend is treated as a realization event, which, just like any other arm's length realization, does not generate wealth but changes its form.¹⁰ In the double tax system, the taxation of dividends is not a tax on a new accretion of wealth; it is a second tax on an accretion previously taxed via the taxation of the corporation.

At the same time, every corporate transaction that increases the value of a solvent corporation benefits shareholders by making their shares more valuable. However, these transactions are not treated as constructive dividends because the existing policy is the taxation of the separation of earnings from the corporation.¹¹ Because there is no policy for the tax on dividends to become a tax on share value appreciation, constructive dividends must not include corporate transactions that benefit shareholders solely by means of making their shares more valuable.¹² A constructive dividend is a corporate transaction that has the same effect of separating wealth from the corporate entity and placing it in the shareholders' separate ownership and control.¹³

This economic perspective explains the existing state of the CDD. An illuminating explanation is that a corporate transfer is a constructive dividend if: (1) the primary purpose of the transfer is to benefit shareholders rather than for a valid business purpose pertaining to the corporation as an entity distinct from its shareholders; and (2) the transfer causes property to leave the control of the transferring corporation and to be subject to direct or indirect control by shareholders.¹⁴ This form of the CDD backstops the double taxation of corporate earnings but only as those earnings depart corporate solution into the hands of shareholders.

10. See Anthony P. Polito, *Borrowing, Return of Capital Conventions, and the Structure of the Income Tax: An Essay in Statutory Interpretation*, 17 VA. TAX REV. 467, 492-96 (1998).

11. See, e.g., Robert C. Clark, *The Morphogenesis of Subchapter C: An Essay in Statutory Evolution and Reform*, 87 YALE L.J. 90, 100-04 (1977).

12. See, e.g., *Sammons v. Comm'r*, 472 F.2d 449, 451 (5th Cir. 1973); *Citizens Bank & Trust Co. v. United States*, 580 F.2d 442 (Cl. Ct. 1978); *Rapid Elec. Co. v. Comm'r*, 61 T.C. 232 (1973), *acq.*, 1974-2 C.B. 1.

13. That a constructive dividend is deemed to be immediately reinvested in the corporation does not prevent its taxation as a dividend. For example, cash dividends reinvested via a dividend reinvestment plan are nonetheless fully taxable. See Rev. Rul. 78-375, 1978-2 C.B. 130; Rev. Rul. 77-149, 1977-1 C.B. 82; Rev. Rul. 76-53, 1976-1 C.B. 87.

14. See, e.g., *Sammons*, 472 F.2d at 451.

III. AN INTEGRATIONIST PERSPECTIVE

From the perspective of the Integrationist Norm, however, this backstopping of double taxation raises important concerns. Double taxation is problematic because of the distortions to allocative efficiency and distributive equity that it generates.¹⁵ Integrationism would exactly eliminate the excess burden of double taxation and the economic and distributive distortions that double taxation entails. Elsewhere, in an article entitled *Advancing to Corporate Tax Integration: A Laissez-Faire Approach*,¹⁶ I advanced the proposition that, although systematic corporate tax integration is unlikely to be enacted in the foreseeable future, integrationism should be regarded as normative. The Laissez-Faire Approach proposes that, to the extent that legal mechanisms serve to prevent self-help corporate tax integration, they are counterproductive, wasting valuable taxpayer, IRS, and judicial resources. Thus, as outlined in this Part III, the Laissez-Faire Approach counsels dispensing with those mechanisms to the extent that they serve solely to defend the double tax anti-ideal and are not considered necessary to ensure that corporate income does not escape the normative single level of taxation, and this analysis applies as much to the CDD as to any other such mechanism.

A. *Systematic Tax Integration not a Practical Likelihood*

In principle, the nearest one that might come to a perfectly integrated regime is the fiscal transparency of a full pass-through regime. Under such a tax regime, there would be no corporate-level tax. Instead, all of the revenue of the corporation would be taxed as income of some individual. The nearest analog is the tax treatment of partnerships.¹⁷

As a practical matter, the full realization of the Integrationist Norm is not practicable because of a number of serious issues related to administrability. Any practical integration initiative would achieve less than the full Integrationist Norm, and it would require the layering of significant additional legal and administrative complexity on the existing

15. See Polito, *supra* note 5, at 6-29.

16. See Polito, *supra* note 5.

17. See I.R.C. §§ 701-777, 6221-6234 (2006). In practice, fiscal transparency cannot be effected in a manner that fully eliminates all distinctions between a business conducted directly as an individual's sole proprietorship and an enterprise conducted through a legal structure. See CUNNINGHAM & CUNNINGHAM, *supra* note 4. Nevertheless, the partnership paradigm appears to be the nearest alternative possible to the integrationist ideal.

tax regime.¹⁸ Moreover, the legislative and interest-group politics of tax policy make it unlikely that Congress will enact systematic tax integration.

Legislative action comprehensive enough to effect corporate tax integration requires a concentrated and organized constituency that will make its passage a priority. Corporate shareholders have an obvious interest in advancing the integrationist agenda, but shareholders of publicly-held corporations suffer in this context from the same collective action problems that pose the well-known variety of corporate governance issues arising in any Berle-Means corporation.¹⁹ They would need, but for a variety of reasons lack, a well-organized ally to lobby for comprehensive corporate tax integration.²⁰

The George W. Bush Administration assembled legislative majorities for two tax cutting acts²¹ that each reduced revenues by hundreds of billions of dollars, but its proposal for nearly comprehensive corporate integration²² was eclipsed by other tax cutting priorities. Instead, the Bush Administration had to settle for partial relief from double taxation in the form of taxing qualified dividends at reduced capital-gain rates. Even that relief is scheduled to expire in 2013.²³ Whether a further extension will be forthcoming is anyone's guess. At the same time, any comprehensive permanent scheme of corporate tax integration is unlikely to survive the politics of the legislative process.

18. See Polito, *supra* note 5, at 29-34.

19. Jennifer Arlen & Deborah M. Weiss, *A Political Theory of Corporate Taxation*, 105 YALE L.J. 325, 363-65 (1995). Shareholders of closely held enterprises do not face the same collective action problems, and the result is clear. Closely held enterprise investors have received a more favorable result than tax integration; they are able, as a class, to elect between functional tax integration, *see* Polito, *supra* note 5, at 37-39, and inside shelter, *see id.* at 42-45.

20. See, e.g., Arlen & Weiss, *supra* note 19; Steven A. Bank, *Corporate Managers, Agency Costs, and the Rise of Double Taxation*, 44 WM. & MARY L. REV. 167 (2002); Steven A. Bank, *Entity Theory as Myth in the Origins of the Corporate Income Tax*, 43 WM. & MARY L. REV. 447, 533-37 (2001); Herwig J. Schlunk, *The Zen of Corporate Capital Structure Neutrality*, 99 MICH. L. REV. 410, 411 n.8 (2000); Alvin C. Warren, Jr., *Three Versions of Tax Reform*, 39 WM. & MARY L. REV. 157, 173-74 (1997).

21. Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38; Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, 117 Stat. 752.

22. U.S. DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2004 REVENUE PROPOSALS 11-22 (2003).

23. Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, §§ 302-303, 117 Stat. 752, 760-64 (adopting reduced rate dividend taxation for taxable years beginning through 2008); Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, § 102, 120 Stat. 345, 346 (extending reduced rate dividend taxation through taxable years beginning in 2010); Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, §102, 124 Stat. 3296, 3298-99 (extending reduced rate dividend taxation through taxable years beginning in 2012).

B. Existing System Operates at Cross-Purposes

Notwithstanding the unlikelihood that Congress will adopt comprehensive and permanent corporate tax integration, the excess tax burden generated by the classical tax regime is an ample incentive for taxpayers to seek alternative means of escaping the excess burden of double taxation. Taxpayers have long had and used multiple important self-help tools to mitigate the burden of double taxation. At the same time, the IRS sees itself as obliged to prevent self-help tax integration. As in so many areas of the tax law, the double tax regime is actually a hybrid system. In the case of tax integration, the system as a whole operates at cross-purposes.

Double taxation coexists with numerous mechanisms that allow the benefits of integration to selected taxpayers or to aggressive taxpayers. Some of these are mechanisms that Congress has created deliberately, some mechanisms have been created by the Treasury via regulatory fiat, and others have been found—perhaps created—by aggressive taxpayer exploitation of the interstices of the existing legal regime.²⁴ Regardless of their genesis, the coexistence of conflicting paradigms is the source of ongoing tension between taxpayer and fisc that engenders much of the existing regime's legal and administrative complexity.

As long as the double tax system remains in place, taxpayers press to escape it to the degree that the rewards are worth their efforts. The IRS, for its part, sees itself as compelled to police for attempts, in whole or in part, to bypass the second level of tax and must divine the extent to which Congress is willing to allow that escape from double taxation. This is no mean feat because Congress has clearly endorsed both thesis and antithesis: double taxation and the escape from double taxation.

As long as full fiscal transparency is not achievable, some business enterprise earnings will always be subject to the excess tax burden of double taxation. At the same time, other business earnings will escape double taxation. It is impossible to realize fully the anti-ideal of double taxation, because slippage at the margins is unavoidable. The boundary is and will remain arbitrary because it is defined by the extent to which taxpayers are able to take advantage of the escape hatches in the double tax anti-ideal. Yet the IRS bears significant burdens and the legal system grows in complexity while attempting to close those escape hatches.²⁵

24. See Polito, *supra* note 5, at 36-40.

25. *Id.*

C. *The Laissez-Faire Approach to Constructive Dividends*

The Laissez-Faire Approach proposes an alternative. Even though the Integrationist Norm cannot be fully effectuated²⁶ because the realities of the political process, legal complexity, and administrative burden are its inescapable enemies, the tax law regime should nevertheless avoid operating at cross-purposes. Complicated and administratively burdensome, the legal and enforcement mechanisms that serve to defend the double tax anti-ideal should be either marked for elimination or simply disregarded, but only to the extent that those regimes reinforce the double tax anti-ideal. At the same time, given that comprehensive corporate tax integration is unlikely at best, and that the creation of new regimes will not fully achieve the integrationist agenda in any case, the Laissez-Faire Approach advances the integrationist agenda without the creation of any significant new legal paradigms or regimes. Instead, it pursues opportunities to advance the Integrationist Norm by declining to defend the escape hatches in the existing double tax regime.

The Laissez-Faire Approach seeks to advance the Integrationist Norm by taxpayer self-help rather than by assuming the burden of an active integration program. As such, elements in the Laissez-Faire Approach are designed to avoid, to the greatest extent possible, the need to fashion new legal or enforcement regimes. Instead, the elements of the Laissez-Faire Approach are designed principally to eliminate or disregard existing legal and enforcement regimes. The regimes marked for removal or disregard are those that serve to defend the double tax anti-ideal.

The Laissez-Faire Approach, however, is not a program to facilitate avoidance of income taxation entirely. The Integrationist Norm is for all income to be taxable at the level of the individual taxpayers, as if they conducted the businesses directly without the intervention of juridical business organizations. Accordingly, the Laissez-Faire Approach avoids mechanisms that would allow income to escape the full burden of the individual income tax.²⁷ In essence, the Laissez-Faire Approach facilitates escape from corporate double taxation so long as doing so preserves at least one level of taxation.

Thus, the Laissez-Faire Approach counsels dispensing with the CDD to the extent that it serves to defend the double tax anti-ideal. It also counsels retaining the CDD to the extent necessary to ensure that

26. *See id.* at 29-36.

27. The Laissez-Faire Approach is agnostic as to, and this Article does not address whether, the ideal tax base is income or consumption.

corporate earnings do not escape the normative single level of taxation. Note that the manner in which any such modifications to the CDD should be accomplished is an issue that this Article brackets. It presents and assesses the desirability of the proposed modifications purely from the perspective of advancing an integrationist agenda. It intentionally sets aside the issue of whether there is authority for effecting its proposals without explicit legislation.

IV. APPLYING THE LAISSEZ-FAIRE APPROACH

The next step in the Laissez-Faire Approach is to examine the application of the CDD under various circumstances in light of the Integrationist Norm and to determine the extent to which the CDD is counter-productive and, therefore, should be set aside. At the outset it is important to note that, because the aim of this analysis is to determine the extent to which the CDD is unnecessary, the analysis considers only transactions that otherwise would be treated as constructive dividends under existing law. Under the existing CDD, a corporate transfer is a constructive dividend if: (1) the primary purpose of the transfer is to benefit shareholders rather than for a valid business purpose pertaining to the corporation as an entity distinct from its shareholders; and (2) the transfer causes property to leave the control of the transferring corporation and to be subject to direct or indirect control by shareholders.²⁸ One manner of proving a valid business purpose is to prove that the value the corporation receives in the transaction is at least as great as the value it transfers.²⁹ Thus, the transactions under consideration are those that produce a net positive transfer from a corporation to a shareholder or to a third party on behalf of a shareholder. The CDD serves to ensure that those net transfers are subject to double taxation.

While the CDD always serves to reinforce the double tax anti-ideal, there are circumstances in which it may incidentally serve other purposes as well. As outlined below, there may be cases in which dispensing with the CDD may result in collecting less tax, either absolutely or in present value terms, than the single level shareholder tax of the Integrationist Norm. Dispensing with the CDD may introduce its own distortions into the system. Then the question becomes a second-

28. *See, e.g.,* *Sammons v. Comm'r*, 472 F.2d 449, 451 (5th Cir. 1973).

29. *See* *Palmer v. United States*, 302 U.S. 63, 69-70 (1937); *Citizens Bank & Trust Co. v. Comm'r*, 580 F.2d 442, 446-47 (Cl. Ct. 1978); *Rapid Elec. Co. v. Comm'r*, 61 T.C. 232 (1974).

best problem³⁰ of judging which distortions are more problematic; those induced by dispensing with the CDD or those induced by expending valuable resources on a doctrine that reinforces the double tax anti-ideal.

A. *Constructive Dividends via Cash Payments*

The first inquiry is into the appropriate shareholder treatment, in light of the Integrationist Norm, of the relatively straightforward scenario of a cash transfer. This is a transaction in which the corporation neither conveys property nor acquires property. Rather, the corporation either transfers cash to shareholders or transfers cash for the benefit of shareholders, but it claims no income tax deduction in connection with the transaction. It must be under circumstances that current law would treat as a constructive dividend.

Such a transaction might take the form of a loan from the corporation to a shareholder or a party related to the shareholder but for which there is no intention for the corporation to be repaid, or it might be a genuine loan initially but later be functionally cancelled by the corporation. It might be a payment by a corporation that satisfies an obligation of a shareholder. In many cases, and especially in closely held corporations, corporate payments to or for the benefit of shareholders can easily have facially ambiguous tax classifications and are reclassified as dividend distributions by the IRS. These cash distributions to or for the benefit of shareholders can have three possible sources: (1) shareholders' invested capital; (2) earnings and profits; or (3) elements of corporate value, such as unrecognized appreciation in assets and the anticipation of future earnings that have not yet been included in earnings and profits.³¹

First, the return of shareholders' capital ought not, in any case, to be subject to shareholder-level taxation. The existing regime for explicit

30. Briefly stated, the theory of the second-best instructs that, if at least one market is prevented from reaching its efficient equilibrium, it is not clear that the welfare maximizing program will be to achieve efficient equilibria in the remaining markets. It is possible that creating distortions in some markets will allow a more than offsetting reduction in distortions in other markets. Therefore, if some allocative biases are unavoidable, economic welfare is generally not maximized by eliminating all other distortions relative to optimal conditions. *See generally* R. G. Lipsey & R. Kelvin Lancaster, *The General Theory of Second Best*, 24 REV. ECON. STUD. 11 (1956) (explaining the theory of the second-best); *see also* Edward Foster Hugo Sonnenschein, *Price Distortion and Economic Welfare*, 38 ECONOMETRICA 281 (1970); Kunio Kawamata, *Price Distortion and Potential Welfare*, 42 ECONOMETRICA 435 (1974) (stating elegantly the second best proposition). For a general discussion of the theory of the second best, *see* P.R.G. LAYARD & A.A. WALTERS, MICROECONOMIC THEORY 180-88 (1978).

31. *See* I.R.C. § 301(c) (2006).

dividends acknowledges this and allows for partial classification as tax free return of shareholder capital.³² In that same degree, constructive dividends ought not to trigger shareholder-level taxation. Even under the existing CDD, the application of the ordinary stacking rules would make constructive distributions partially non-taxable return of capital to the extent that the constructive distributions exceed earnings and profits.³³ Indeed, the Supreme Court has made it clear that, in the absence of earnings and profits, the CDD cannot create a taxable dividend, even if a shareholder intentionally diverts corporate funds to support his personal expenditures.³⁴ The return of shareholders' invested capital is the simple case, but the next two possibilities present a somewhat more complicated analysis.

i. Earnings Distributions

A constructive dividend, to the extent that it is funded out of earnings and profits, represents earnings that have already been subject to corporate-level taxation.³⁵ In terms of the Integrationist Norm, corporate earnings should be subject to a single level of taxation, not two levels of taxation. If the integrationist ideal is fiscal transparency, it is the shareholder-level tax rate schedule that should apply.

In principle, the preferable solution is to impose the shareholder-level tax and allow a corresponding corporate deduction or to credit shareholders for the tax paid by the corporation. That resolution would require an act of Congress. If it were feasible to achieve this for constructive dividends, it would most likely be possible to directly achieve the same treatment for express dividends, and therefore achieve some form of systematic tax integration.

However, the legislation necessary for systematic tax integration is not feasible as a practical matter. It is precisely the unavailability of systematic tax integration that leads to this Article's examination of the

32. *Id.* § 301(c)(2).

33. *Boulware v. United States*, 552 U.S. 421, 424-25 (2008); *Hillsboro Nat'l Bank v. Comm'r*, 460 U.S. 370, 392 (1983). *See also* *FDIC v. First Heights Bank, FSB*, 229 F.3d 528, 540 (6th Cir. 2000); *United States v. D'Agostino*, 145 F.3d 69, 72 (2d Cir. 1998); *Hagman v. Comm'r*, 958 F.2d 684, 694 (6th Cir. 1992); *Estate of DeNiro v. Comm'r*, 746 F.2d 327, 332 (6th Cir. 1984); *Truesdell v. Comm'r*, 89 T.C. 1280, 1294-95 (1987), acq. 1988-2 C.B. 1, *recommended by* AOD 1988-25, 1988 WL 570761; *Barnard v. Comm'r*, 82 T.C.M. (CCH) 571, 576-77 (2001).

34. *Boulware*, 552 U.S. 421.

35. Some of these amounts are functionally subject to a zero corporate tax rate, e.g. I.R.C. § 103 (state and local bond interest), but are included in earnings and profits, *Treas. Reg.* §1.312-6(b). *See* notes 46-49 *infra* and accompanying text.

CDD in light of the Laissez-Faire Approach.³⁶ In that case, in light of the Integrationist Norm, the corporate-level tax is best seen as a surrogate for shareholder taxation. That makes the imposition of an additional shareholder-level tax an excess tax burden. As such, to the extent that the constructive dividend bails out earnings and profits, there is no need to apply the CDD to impose the full shareholder-rate tax.

There remains, however, a pair of issues that need to be examined. The first is any disparity between applicable corporate tax rates and shareholder tax rates. If the Integrationist Norm is fiscal transparency, it is the shareholder-level tax rate schedule that should apply. Surrogate corporate-level taxation could result in over taxation or under taxation. If the applicable individual tax rate is higher than the corporate tax rate, it produces under taxation. If the applicable individual tax rate is lower than the corporate tax rate, it produces over taxation.

There is good reason to estimate that the under taxation scenario would be more common in practice than the over taxation scenario. Well-advised taxpayers can easily seek to structure a transaction to be deductible by the corporation and taxable at the lower shareholder-level tax rate. For example, a transaction can be structured as a payment for services or interest, which are deductible by the corporation and included in shareholder income. If the applicable shareholder tax rate is lower than the corporate rate, such a transaction produces a lower total tax burden than bailing out previously taxed corporate earnings in a manner that produces no corporate deduction and no shareholder inclusion. In practice, therefore, if the corporate tax is accepted as the single surrogate tax, setting aside the CDD would result more frequently in the under taxation scenario than the over taxation scenario.³⁷

A simple resolution to the under taxation question would be to amend the corporate tax rate schedule to impose the maximum individual income tax rate on all taxable corporate income.³⁸ In terms of the Laissez-Faire Approach, such an amendment would not be oriented towards reinforcing double taxation³⁹ but towards encouraging self-help tax integration, with the expectation that the corporate tax would serve as a surrogate and substitute for the normative single level shareholder-

36. See *supra* notes 17-23 and accompanying text.

37. In any case, in terms of the Laissez-Faire Approach, the over taxation scenario cannot justify the continued application of the CDD. That the surrogate corporate-level tax is excessive could not justify imposing an even greater excessive tax burden by also imposing a shareholder-level tax via the CDD.

38. See Polito, *supra* note 5, at 50-51.

39. See, e.g., Jeffrey L. Kwall, *The Repeal of Graduated Corporate Tax Rates*, 131 TAX NOTES 1395 (2011).

level tax. If the adoption of such legislation is not in the offing, the question becomes how one judges the under taxation created by the disparity between surrogate taxation at corporate rates versus the normative shareholder rates.

Is preventing this form of under taxation sufficient to insist on a full second level of tax at the ordinary income tax rates?⁴⁰ A few observations about the applicable rates shed some light on the subject. The lowest two corporate tax rate brackets are relatively narrow, applying to only the first \$75,000 per year of corporate taxable income. Their benefit is fully phased out in any year in which a corporation's taxable income is at least \$335,000.⁴¹ There is a substantial 34% bracket that is lower than the maximum individual tax rate.⁴² However, under the tax rates adopted during the George W. Bush administration, that 34% corporate income tax rate became only a single percentage point below the maximum 35% individual income tax rate,⁴³ which has also been the highest corporate tax rate.⁴⁴ In fact, the maximum corporate tax rate has been higher than the maximum individual tax rate in half of the years since 1981. In the remaining years, the excess of the maximum

40. One might object that, at present, there are technically few such circumstances of under taxation because of the application of capital gain tax rates to qualified dividend distributions. I.R.C. § 1(h)(11) (2006). The maximum shareholder tax rate with respect to qualified dividend distributions is 15%, I.R.C. § 1(h), which is also the lowest income tax rate at the surrogate corporate level, I.R.C. § 11(b). However, the reduced tax rates on qualified dividend distributions were themselves adopted as a form of partial tax integration. See H.R. REP. NO. 108-94, at 27-8 (2003). See also Rosanne Altshuler, Benjamin H. Harris & Eric Toder, *Capital Income Taxation and Progressivity in a Global Economy*, 30 VA. TAX REV. 355, 357-58 (2010); Steven A. Bank, *The Rise and Fall of Post-World War II Tax Reform*, 73 LAW & CONTEMP. PROBS. 207, 207 (2010); Michael Doran, *Managers, Shareholders, and the Corporate Double Tax*, 95 VA. L. REV. 517, 525-26 (2009); Steven A. Bank, *Dividends and a Tax Policy in the Long Run*, 2007 U. ILL. L. REV. 533, 537-40 (2007). They assume full corporate-level taxation. As such, the corporate-level tax cannot be seen as a surrogate for the reduced tax on qualified dividends, because the latter were not adopted as the normative single shareholder level of tax. Instead, the appropriate baseline for judging the adequacy of surrogate corporate-level taxation is the full ordinary income tax rate. Moreover, not all distributions deemed to be dividends under the CDD would be qualified dividend distributions, and the reduced rates applicable to qualified dividends are not scheduled to apply to dividend distributions in tax years beginning in 2013 or later. See *supra* note 23.

41. I.R.C. § 11(b) (2006).

42. *Id.*

43. Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 101, 115 Stat. 38, 41-42. That maximum individual income tax rate is currently scheduled to revert to 39.6% for taxable years beginning after 2012. *Id.* § 901, 115 Stat. at 150; Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, § 101, 124 Stat. 3296, 3298.

44. I.R.C. § 11(b) (2006).

individual tax rate over the maximum corporate tax rate has been quite small, and always less than five percentage points.⁴⁵

Under those circumstances, the potential amount of under taxation by applying the corporate tax rates as a single surrogate tax is relatively small in comparison to the large amount of over taxation that applies by double taxation. While this raises an empirical question beyond the scope of this Article, it seems reasonable to conclude that the economic distortion from relatively small amounts of potential under taxation is worth the mitigation of the economic distortions from double taxation. In making this comparison, it is important to bear in mind that a contrary conclusion also incurs the deadweight loss of IRS administrative and judicial resources, and taxpayer planning and compliance costs that result from the enforcement of the CDD. As such, while this is a point on which reasonable minds might make a different judgment, so long as the corporate tax rates remain in close proximity to individual income tax rates, the Integrationist Norm makes the use of the CDD to impose a second level of tax on corporate earnings a poor use of resources. In addition, accepting surrogate taxation at the corporate rates provides an incentive for Congress to resolve the under taxation issue by imposing the maximum individual income tax rate to all taxable corporate income.

Another potential issue is the treatment of various tax preferences. Allowing the distribution of corporate earnings via constructive dividends implicitly resolves this issue. It effectively allows the benefit of preferences to be passed on to shareholders because it does not force the shareholder-level taxation of the constructive distribution of items that were not fully taxable at the corporate level.⁴⁶

45. JEFFREY L. KWALL, *THE FEDERAL INCOME TAXATION OF CORPORATIONS, PARTNERSHIPS, LIMITED LIABILITY COMPANIES, AND THEIR OWNERS* 7 (3d ed. 2005). Compare Revenue Act of 1978, Pub. L. No. 95-600, § 301, 92 Stat. 2763, 2820 (1978); Tax Reform Act of 1986, Pub. L. No. 99-514, § 601, 100 Stat. 2085, 2249 (1986); Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13221(a), 107 Stat. 312, 477 (1993) (legislating maximum corporate income tax rates), with Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 101, 95 Stat. 172, 176-85 (1981); Tax Reform Act of 1986, Pub. L. No. 99-514, § 101, 100 Stat. 2085, 2096-99 (1986); Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-58, § 11101(a), 104 Stat. 1388, 1388-403 to 1388-405; Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, §§ 13201-13202, 107 Stat. 312, 457-61; Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 101, 115 Stat. 38, 41-42; Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, § 105, 117 Stat. 752, 755 (legislating maximum individual income tax rates).

46. The analysis presumes that the existing concept of earnings and profits applies. While it is possible, in principle, to legislate a modified definition of earnings and profits that would prevent the pass-through of tax preferences, the assumption of such legislation is hard to reconcile with the premise that comprehensive tax integration is not feasible in practice. See *supra* notes 17-23 and accompanying text. The Laissez-Faire approach is premised on working within the existing tax

While some integration proposals would require a shareholder-level tax on the distribution of these earnings, others would allow for tax-exempt corporate income to be distributed without triggering a shareholder-level tax.⁴⁷ Pure integrationism treats preferences as a distinct question from the integration question. It does not address the wisdom of any particular tax benefit, but it does posit that taxpayers ought to be equally eligible for preferences regardless of the legal form in which their businesses are conducted. As such, an idealized pass-through paradigm of integration would pass the benefit of tax-exemption and most other tax preferences on to shareholders.⁴⁸ The more or less automatic pass-through of preferences by not applying the CDD in this circumstance accomplishes this end.⁴⁹

This analysis allows for a conclusion based on the Integrationist Norm. Admittedly, it is a conclusion with which one could reasonably disagree, even within that framework. That conclusion is that, to the extent that a cash transaction is not deducted at the corporate level and bails out corporate earnings and profits, it is not necessary to apply the CDD to impose a second tax at the shareholder level, so long as there remains no more than a small excess of the maximum individual tax rate over corporate tax rates. Under the Integrationist Norm, the use of the

regime, without a program of comprehensive tax integration, to facilitate self-help tax integration. It avoids, to the greatest extent possible, the need to fashion new legal or enforcement regimes. Instead, the elements of the Laissez-Faire Approach are designed principally to eliminate or disregard existing legal and enforcement regimes to the extent that they serve to backstop the double tax anti-ideal.

47. Compare U.S. DEP'T OF THE TREASURY, INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS, TAXING BUSINESS INCOME ONCE 15-20 (1992) (recommending against the extension of integration benefits to tax preference items), with ALVIN C. WARREN, JR., INTEGRATION OF THE INDIVIDUAL AND CORPORATE INCOME TAXES; REPORTER'S STUDY OF CORPORATE TAX INTEGRATION 108-12 (The American Law Institute ed., 1993) (proposing that the benefit of specified corporate tax exemptions and tax credits be passed on to shareholders in integration). See also Reuven S. Avi-Yonah, *The Treatment of Corporate Preference Items Under an Integrated Tax System: A Comparative Analysis*, 44 TAX LAW. 195 (1990) (analyzing the methods eight industrialized countries use to limit the pass-through of preferences in integration).

48. See, e.g., CHARLES E. MCLURE, JR., MUST CORPORATE INCOME BE TAXED TWICE?, 131-32 (1979) (arguing that investment tax credits should be passed through to shareholders); Harry M. Kitchen, *Canada*, in COMPARATIVE TAX SYSTEMS: EUROPE, CANADA AND JAPAN 341, 360 (Joseph A. Pechman ed., 1987); Anthony P. Polito, *A Proposal for an Integrated Income Tax*, 12 HARV. J.L. & PUB. POL'Y 1009, 1036-37 (1989) (arguing that tax preferences given to corporations should be retained "but only to the extent . . . available to taxpayers who do not avail themselves of the corporate form").

49. The application of capital gain tax rates to qualified dividends, I.R.C. § 1(h)(11), does not attempt to distinguish corporate earnings subject to full corporate-level taxation from preference items. As such, it allows the partial pass-through of preference items even as it continues to impose a reduced second level of tax on corporate earnings already subject to a full corporate surrogate tax. See, e.g., Altshuler, Harris & Toder, *supra* note 40, at 358.

CDD to impose a shareholder-level tax on earnings that have already been accounted for at the corporate level is largely counterproductive. It expends valuable judicial, IRS administrative, and taxpayer planning and compliance resources to undermine the Integrationist Norm. With that conclusion as a predicate, the next step is to consider anticipation distributions.⁵⁰

ii. Anticipation Distributions

Cash transactions treated by the CDD as dividend distributions, to the extent that they exceed both earnings and profits already taken into account by the corporation and also shareholders' invested capital, represent a distribution of corporate value that has not yet been recognized and therefore not yet included in earnings and profits.⁵¹ That value can be the anticipation either of the future recognition of built-in gain in corporate assets or of other future corporate income. The monetization of these anticipated earnings, without triggering recognition and thereby bringing them within the ambit of earnings and profits, could easily occur by means of borrowing. Those borrowing proceeds would represent value that has not been subject to previous taxation at either the corporate or the shareholder level, but rather an anticipation of future earnings that will be subject, at least in principle, to the corporate income tax at a later date.⁵²

This scenario raises the issue of deferral.⁵³ Shareholders thereby access future corporate earnings without triggering a current tax at either the shareholder or corporate level. At some time in the future, the

50. It is worth noting the possibility of a contrary conclusion that does not reject the Integrationist Norm. Such a conclusion would not imply that imposing double taxation via the CDD is beneficial in itself. It would instead be predicated on a view that the harmful distortions generated by continuing to impose double taxation via the CDD are in some sense less significant than those that would be generated by the under-taxation of the amount distributed and/or the implicit pass-through of preference items. Such a contrary conclusion would, of course, eliminate the need to proceed to the analysis of anticipation distributions because the CDD would continue to apply as at present.

51. See Treas. Reg. § 1.312-6(b).

52. One wonders how common the use of cash constructively to distribute these untaxed anticipated earnings would be in practice. Such a scenario would apply only to corporations that have managed to bail out the full amount of current and accumulated earnings and profits and an additional amount equal to shareholders' stock basis, but that nevertheless continue to transfer value out of corporate solution to their shareholders or for their shareholders' benefit. Any further comment on frequency would be sheer guesswork, but it is a fair guess that the scenario would be more likely if the CDD were no longer used to impose a shareholder-level tax on these distributions.

53. See Anthony P. Polito, *The Role of Prescription in the Interpretive Problem of Basis Determination*, 53 TAX LAW. 615, 626-27 (2000); Polito, *supra* note 10, at 505-13.

corporation presumably will need to recognize income, which will trigger full taxation at the corporate level at that future time. On the other hand, it is not possible to determine *ex ante* the extent of that deferral. Under those circumstances, is it appropriate for the corporation to be able to monetize future taxable earnings to fund constructive dividends without any current taxation at the shareholder level?

This issue arises only if the constructive dividend exceeds both current and accumulated earnings and profits and shareholders' basis in their stock, whose treatment under the CDD has already been analyzed. This is the appropriate conceptualization because, in the case of an admitted dividend, actual distributions are treated as primarily out of current and accumulated earnings and profits and secondarily as a return of shareholders' basis.⁵⁴ Nevertheless, in the case of an admitted dividend, distributions in excess of those two amounts are treated as gain on sale,⁵⁵ which generally is subject to a shareholder-level capital gains tax.⁵⁶ Here the question is whether, in light of the Integrationist Norm, a constructive dividend in excess of earnings and profits and shareholders' capital ought to be subject to some immediate taxation.

By way of comparison, if a stock redemption is treated as a sale,⁵⁷ it has the potential to bail out anticipated earnings while generating shareholder taxation at capital gain rates.⁵⁸ Such a bailout also raises the issue of deferral, but the shareholder-level capital gains tax "pays" for the deferral. The shareholder-level tax at the time of the distribution at least partially offsets the deferral benefit, in time value of money terms, of being able to anticipate corporate earnings without immediately triggering the corporate-level surrogate tax. It is not at all inconceivable that it might more than fully offset those deferral benefits.⁵⁹

In fact, to the extent that stock value reflects an anticipation of future earnings,⁶⁰ any sale of stock at capital gain rates gives access to future earnings without triggering full current taxation of those earnings.⁶¹ Nevertheless, there is a tax charge for accessing future earnings without triggering the full surrogate taxation of those earnings. In terms of the Integrationist Norm, that tax may well be considered the price for the deferral of full taxation of the anticipated earnings.

54. I.R.C. § 301(c) (2006).

55. *Id.* § 301(e)(3).

56. *Id.* § 1221.

57. *Id.* §§ 302, 303, 304, 356.

58. See Clark, *supra* note 11, at 107-17.

59. See Polito, *supra* note 9, at 66-67.

60. See Brealey, Myers & Allen, *supra* note 8, at 78-93.

61. See Clark, *supra* note 11, at 107-17.

A different point of comparison is the shareholders' ability to borrow against the value of appreciated shares, or for that matter any other appreciated property, without current recognition of income.⁶² Doing so is a well-known technique for gaining access to liquidity without current taxation.⁶³ The ultimate need to repay out of tax-paid income measures the extent of deferral. To the extent that shareholder borrowing against share value is a realistic alternative, allowing the corporation to borrow in order to fund constructive dividends without triggering any shareholder tax allows no more deferral in principle than under existing practice.

Fiscal transparency that applies only the shareholder level of tax is the Integrationist Norm. Because the partnership paradigm appears to be the nearest alternative possible to the integrationist ideal, an examination of an analogous transaction in the partnership context may provide useful insights. Because of the priority for already recognized earnings under the stacking rules for dividend distributions,⁶⁴ the analogous transaction must be one in which a partnership distributes an amount that exceeds income that has already been allocated among partners under Subchapter K.⁶⁵ In at least some circumstances, a partnership can engage in anticipation borrowing and distribute those amounts without triggering any tax.

62. See, e.g., *Woodsam Assocs., Inc. v. Comm'r*, 198 F.2d 357, 359 (2d Cir. 1952) (concluding that a nonrecourse secured borrowing transaction is not a realization event and does not increase the taxpayer's basis in the property securing the debt). Likewise, an early Treasury Regulation provides that "[i]f bonds are issued by a corporation at their face value, the corporation realizes no gain or loss." Treas. Reg. 62, Article 545 (1922). See Polito, *supra* note 10, at 481-513 (setting forth an extensive consideration of the issue of nontaxable borrowing transactions).

63. Promotional literature of the Private Client Services Group of Goldman, Sachs & Co. indicates that:

This Group is routinely asked to make presentations for clients who own concentrated stock positions on the innovative strategies that are available to monetize, diversify or hedge a stock position without selling the stock and incurring a taxable gain . . . [and the] alternatives available to a client with low basis stock, including the following:

-Borrow against your stock

-Exchanging the return of your stock for the return of a diversified portfolio

-Exchanging your stock for shares in a diversified fund

-Executing a short sale or a synthetic sale and reinvesting the proceeds in a diversified portfolio

-Selling unregistered shares to Goldman Sachs

-Hedging your risk with over-the-counter options.

Goldman, Sachs & Co. Promotional Material (June 6, 1994) (on file with the author) (emphasis added).

64. I.R.C. § 301(c) (2006).

65. *Id.* §§ 702, 705, 731 (2006).

When a partnership borrows, no income tax is triggered, just as in the case of any other borrowing transaction. Each partner is treated as having made a contribution of money to the partnership equal to that partner's deemed share of the debt incurred,⁶⁶ even if the debt is nonrecourse debt for which the partners bear no individual liability.⁶⁷ As such, each partner's basis in partnership interest is increased by the amount of that partner's share of the debt.⁶⁸ In general, money distributed to a partner is not taxable if it does not exceed the partner's newly increased basis in the partnership interest,⁶⁹ and then the basis in the partnership interest is correspondingly reduced.⁷⁰

The partnership debt presumably needs to be paid at some future time. The later income used to pay the debt is to be included in partners' distributive shares, even though they don't actually receive it because it must be used to pay the debt. That income increases their bases in partnership interests,⁷¹ but, to the extent that it is used to retire the partnership debt, the debt reduction is treated as a distribution⁷² that reduces basis by an offsetting amount.⁷³

Thus, at this later time, the partners are subject to full taxation on the income that was anticipated and distributed via the earlier debt. As such, in a partnership context, it is possible in at least some circumstances to make anticipation distributions without any current taxation. The taxation is effectively deferred until the debt is paid out of income subject to taxation.⁷⁴

What does this suggest about applying the CDD to anticipation distributions? A couple of observations oppose allowing indefinite deferral. First, notwithstanding the necessarily arbitrary nature of what

66. *Id.* § 752(a) (2006).

67. Treas. Reg. § 1.752-3.

68. I.R.C. § 722 (2006).

69. *Id.* § 731(a)(1). In particular circumstances, there may be factors that interfere with the non-taxability of this borrow and distribute scenario. For example, the borrowing and distribution may be deemed to be part of a larger disguised sale transaction, I.R.C. § 707(a). Even to the extent that distributing borrowed funds is efficacious in producing non-taxability, some might object to it to the extent that it depends upon increasing partners' basis in partnership interests on account of partnership nonrecourse debt. *See* Treas. Reg. § 1.752-3. By way of comparison, in the S corporation context, share basis is not increased on account of borrowing at the corporate level. *See* I.R.C. § 1367 (2006).

70. I.R.C. § 705(a)(2) (2006).

71. *Id.* § 705(a)(1).

72. *Id.* § 752(b).

73. *Id.* § 705(a)(2).

74. If the debt is never paid, in principle, there should nevertheless be an equal amount of cancellation of debt income that should be subject to taxation at some future date, I.R.C. §§ 61(a)(12), 108 (2006).

constitutes a realization event,⁷⁵ it is not unreasonable to see as a realization event a transaction that removes from corporate solution any value that has not yet been subject to corporate taxation. Thus, the Integrationist Norm should not necessarily object to a mechanism that forces a single level of taxation at the time of a constructive anticipation distribution.

Second, this Article is premised on the Integrationist Norm that corporate double taxation is so clearly mistaken that a Laissez-Faire Approach to self-help tax integration is amply justified, even in the absence of a systematic program to eliminate corporate double taxation. The logic of the Integrationist Norm has nothing to say, either positive or negative, about the use of a self-help tax integration mechanism to create a new opportunity for indefinite tax deferral. Prudence may well counsel against using the Laissez-Faire Approach to reach beyond the Integrationist Norm itself to create an additional unlimited deferral opportunity.⁷⁶ Creating such an opportunity would certainly do nothing—in a political sense—to advance the cause of the Integrationist Norm. While this is clearly a question upon which reasonable minds can differ, these observations present a plausible case for the desirability of continuing to apply the CDD to impose current taxation of anticipation distributions.

On the other hand, the truth is that the income tax is shot through with opportunities for tax deferral. Some of these are the result of the administrability problems of pure accretionism. Others are conscious policy choices.⁷⁷ The analysis above illustrates this. *A priori*, it is difficult to conclude why one additional deferral opportunity is more

75. See, e.g., WILLIAM WALLACE HEWETT, THE DEFINITION OF INCOME AND ITS APPLICATION IN FEDERAL TAXATION 82-83 (1925); Steven A. Bank, *Mergers, Taxes, and Historical Realism*, 75 TUL. L. REV. 1, 64 (2000); Clarissa Potter, *Mark-to-Market Taxation as the Way to Save the Income Tax—A Former Administrator's View*, 33 VAL. U. L. REV. 879, 882-86 (1999); Stanley S. Surrey, *The Supreme Court and the Federal Income Tax: Some Implications of the Recent Decisions*, 35 ILL. L. REV. NW. U. 779, 783-84 (1941).

76. If one were of the view that the appropriate tax base is consumption rather than income, one could conclude that indefinite deferral with respect to an anticipation distribution is not problematic so long as the value is not used for consumption expenditures. In the context of setting aside the CDD, however, it would be necessary to create a substitute mechanism to police the distinction between constructive anticipation distributions that fund consumption from those that do not and also another mechanism to ensure taxation no later than the time that distributed value is used to fund personal consumption. Such a program is possible but hardly in keeping with the spirit of the Laissez-Faire Approach. See *Polito*, *supra* note 5, at 40-42. In any case, the Integrationist Norm need not necessarily imply a preference for consumption taxation over income taxation.

77. See *Polito*, *supra* note 10.

problematic than any of the others already available.⁷⁸ In that sense, there is a good argument that concerns about deferral are not sufficient to justify reinforcing the double tax anti-ideal by applying the CDD to anticipation distributions.

iii. Implementation Problems of Disentangling Anticipation Distributions

The question of whether to apply the CDD to anticipation distributions may be decided by the practicability of implementation. If the conclusion is to allow the deferral created by not applying the CDD to anticipation distributions, then implementation is straightforward. The CDD would not be applied at all to the kind of cash transactions under consideration in this Part IV.A. The alternative is to ask whether it is possible to apply the CDD in a manner that taxes anticipation distributions but not distributions out of earnings already taken into account at the corporate level.⁷⁹ There are two possible scenarios; one is simple and the other is not.

The simple scenario is that of a corporation that has neither current nor accumulated earnings and profits. The Supreme Court has made it clear that, in the absence of earnings and profits, the CDD cannot create a taxable dividend.⁸⁰ Instead, the entire deemed distribution must be either non-taxable return of shareholder capital or gain from the disposition of property, i.e., an anticipation distribution that is generally taxable at capital gain rates.⁸¹

The more complicated scenario is that of a corporation that does have a positive earnings and profits account. The question is whether the CDD can be applied only to the extent that a constructive dividend exceeds corporate earnings and shareholder stock basis.⁸² The complication of implementation is keeping track of those thresholds if

78. An additional issue is the potential for under taxation because of the disparity between the corporate tax rate schedule and the normative individual tax rate schedule. Taken in isolation, the issue here is no different than it is in the case of corporate earnings distributions. *See supra* notes 37-45 and accompanying text. However, the confluence of the two issues is worth noting. In the case of anticipation distributions, if there is no shareholder-level tax, there is both an indefinite deferral of the tax and an under tax to the extent that the ultimate corporate tax rate is less than the normative individual tax rate.

79. If the conclusion of Part 4.1.1. is rejected, the CDD applies as it does today to both earnings distributions and anticipation distributions, and therefore the implementation discussion is moot because there is no change in the application of the CDD.

80. *Boulware v. United States*, 552 U.S. 421 (2008).

81. *See supra* notes 32-34, 54-56 and accompanying text.

82. *See supra* notes 32-50 and accompanying text.

earnings and profits and shareholder basis are not actually adjusted to reflect prior constructive dividend bailout transactions.⁸³ It doesn't seem appropriate to place the burden on the IRS to keep track of each corporation's cumulative constructive dividend transactions, which would be necessary in some form to determine whether a transaction crosses the threshold into the territory of anticipation distributions. The goal of the Laissez-Faire Approach is to mitigate the administrative burden of regimes operating counterproductively to the Integrationist Norm. Its purpose is not well served by creating a new administrative burden for the IRS.

The task could be accomplished informally by taxpayers keeping track of total amounts bailed out in relation to (1) earnings and profits accounts (accounting for reductions as a result of any amounts distributed via explicit dividends) and (2) shareholder basis. Perhaps taxpayers could be induced to perform this task, if it were widely understood that the IRS would not seek shareholder income tax adjustments under the CDD so long as taxpayers could prove the absence of anticipation distributions. If this were accompanied by an understanding that the CDD would be applied to the full amount of any constructive dividend in the absence of such proof, taxpayers would have an incentive to prove the absence of anticipation distributions and also to refrain from engaging in such anticipation distributions at all.

One is compelled to avoid excessive sanguinity about this possibility. So long as the CDD is being applied to impose shareholder tax in some cases, one must wonder how eager taxpayers will be to create a document trail proving that particular transactions, which they claim are not dividend distributions at all, are actually bailing out only prior corporate earnings rather than the anticipation of future earnings. Further, one is compelled to wonder how the IRS could effectively convey the assurances required. Even if the burden of proof is placed on taxpayers, the IRS would still need to examine that proof via the audit process.

On the other hand, that audit process might be much simplified in a case in which the taxpayer can prove that the amounts bailed out do not cross the threshold into anticipation distributions. There may well be cases in which an abbreviated audit process proves this to be true. In

83. The analysis has to assume that there are no such adjustments. If Congress could marshal the necessary majorities explicitly to authorize the adjustments, it presumably would also be practicable to enact explicit dividend relief that would allow earnings and profits to be distributed without shareholder taxation of an explicit dividend. The premise of this Article is that this is not possible as a practical matter. *See supra* notes 17-23 and accompanying text.

those cases, the Laissez-Faire Approach counsels that further IRS pursuit of the matter under the CDD is a counterproductive waste of resources. The question is whether the implementation problem of the limited application of the CDD to anticipation distributions can be overcome in a manner that yields a net savings in administrative resources.

If that is not possible, the matter becomes an all-or-nothing proposition of whether the CDD should be dispensed with entirely. Under the CDD, the shareholder-level charge for the deferral on constructive anticipation distributions will also include a full second level of tax for corporate earnings that have already been subject to a corporate-level tax. It is not unrealistic to predict that, in terms of the Integrationist Norm, this might be a serious overcompensation for the deferral benefit.

If the shareholder-level tax is no more than the preferential capital gains rate, as in effect for many dividend distributions through taxable years beginning before 2013,⁸⁴ the potential excess tax burden resulting from the application of the CDD is perhaps not that great. However, if the shareholder-level tax is to be imposed at the full ordinary income tax rates, then the application of the CDD might seem as a bit like overkill for the deferral issue. It might be dispensed with entirely, and some other mechanism might be created for the purpose of addressing the deferral issue within the context of the Integrationist Norm. One possibility would be to create a mechanism triggering corporate-level recognition on debt incurred to fund explicit or constructive distributions to shareholders. Because the Laissez-Faire Approach targets only existing regimes that serve to reinforce the double tax anti-ideal, the full fleshing out of such an alternative mechanism to address the deferral question is beyond the scope of this Article.

Regardless of whether an independent resolution of the deferral issue for anticipation distributions is feasible, the Laissez-Faire Approach makes a strong case for dispensing with the CDD in at least some cash transaction scenarios. If the CDD continues to apply as under current law, it is a second-best solution predicated on a judgment that deferral, or a difference between corporate and individual tax rates, or of

84. Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, §§ 302-303, 117 Stat. 752, 760-64 (adopting reduced rate dividend taxation for taxable years beginning through 2008); Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, § 102, 120 Stat. 345, 346 (extending reduced rate dividend taxation through taxable years beginning in 2010); Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, § 102, 124 Stat. 3296, 3298-99 (extending reduced rate dividend taxation through taxable years beginning in 2012).

the pass-through of preference items create more serious concerns than the distortions of double taxation. This is an empirical question beyond the scope of this Article. However, in judging which is the more serious distortion, it is important to bear in mind the deadweight loss generated to the extent that judicial, IRS, and taxpayer resources are wasted via the use of the CDD to enforce the double tax anti-ideal.

B. Overpriced Transfers of Property to Corporations

The next scenario to consider is the overpriced purchase scenario in which a corporation pays more than fair market value for assets it acquires from shareholders.⁸⁵ The application of the CDD makes the overpayment a dividend distribution.⁸⁶ For purposes of this analysis, the amount of the overpayment is no different than a cash transaction to or on behalf of shareholders. In that sense, and subject to the same caveats as an actual cash transaction, dispensing with the CDD is certainly at least as advisable from the perspective of the Integrationist Norm.⁸⁷

Further, there are circumstances that can easily overcome the concerns raised above⁸⁸ with regard to deferral when anticipated earnings are distributed via a constructive dividend without triggering a shareholder-level tax. If the transferor of the asset is a taxable domestic person, the full amount of the overpayment is taxed at that level, in many cases at capital gain rates. Thus, there is a shareholder-level tax of the overpayment.

By way of comparison, if a stock redemption is treated as a sale,⁸⁹ it has the potential to bail out anticipated earnings while generating shareholder taxation at capital gain rates.⁹⁰ Such a bailout also raises the issue of deferral, but the shareholder-level capital gains tax “pays” for the deferral. The shareholder-level tax at the time of the distribution at least partially offsets the deferral benefit, in time value of money terms, of being able to anticipate corporate earnings without immediately

85. For purposes of this discussion, an overpayment transaction between a corporation and its shareholders also includes such an overpayment to a third-party in which the overpayment is made to the third party for the benefit of a shareholder. *See Old Colony Trust Co. v. Comm’r*, 279 U.S. 716 (1929); *Baumer v. United States*, 580 F.2d 863, 882-83 (5th Cir. 1978).

86. *See* BORRIS I. BITTKER, JAMES S. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶8.05[5] (7th ed. 2006) (hereinafter “*Bittker & Eustice*”).

87. *See supra* notes 31-84 and accompanying text.

88. *See supra* notes 51-78 and accompanying text.

89. I.R.C. §§ 302, 303, 304, 356 (2006).

90. *See* Clark, *supra* note 11, at 107-17.

triggering the corporate-level surrogate tax. It is not at all inconceivable that it might more than fully offset those deferral benefits.⁹¹

In fact, to the extent that stock value reflects an anticipation of future earnings,⁹² any sale of stock at capital gain rates gives access to future earnings without triggering a full current tax of those earnings.⁹³ Nevertheless, there is a tax charge for accessing future earnings without triggering the full surrogate taxation of those earnings. As previously observed, in terms of the Integrationist Norm, that tax may well be considered the cost for the deferral of full taxation of the anticipated earnings. The counsel of the Laissez-Faire Approach is that so long as the transferor of an asset is taxable on the amount of the overpayment, even at capital gain rates, it is better not to waste valuable resources on a counterproductive application of the CDD.⁹⁴ In other cases, dispensing with the CDD in the overpayment scenario is no more objectionable than in the cash distribution scenario.

C. *Bargain Transfers of Property from Corporations to Shareholders*

The obverse of the overpayment scenario is that in which a corporation makes a bargain transfer of property to shareholders.⁹⁵ If a corporation conveys property to shareholders at a bargain price, one possibility is to ignore the discount and have the shareholder establish basis in the property at the discount price. At least in principle, the amount of discount will be subject to shareholder-level taxation upon a

91. See Polito, *supra* note 5, at 66-67.

92. See Brealey, Myers & Allen, *supra* note 8, at 78-93.

93. See Clark, *supra* note 11, at 107-17.

94. The Laissez-Faire Approach does not object to reducing the acquiring corporation's basis in the asset to its fair market value in order to avoid overstatement of depreciation deductions or understatement of gain on a subsequent disposition of the asset.

95. For purposes of this discussion, a bargain transaction between a corporation and its shareholders also includes bargain transactions between a corporation and third-parties in which the discount is given to the third party for the benefit of a shareholder. See *Old Colony Trust Co. v. Comm'r*, 279 U.S. 716 (1929); *Baumer v. United States*, 580 F.2d 863, 882-83 (5th Cir. 1978). Also included is the corporate distribution of options to acquire stock or other property from the corporation. Under present practice, if the option can be valued when issued, the relevant discount is that between the value of the option and the price the recipient pays for the option. If the option cannot be valued when issued, the relevant discount is the spread between the option's exercise price and the fair market value of the underlying property when the option is exercised or sold. See *Redding v. Comm'r*, 630 F.2d 1169 (7th Cir. 1980); *Baumer v. Comm'r*, 580 F.2d 863 (5th Cir. 1978); Rev. Rul. 70-521, 1970-2 C.B. 72. For purposes of this Article, the analysis of that discount is not materially different from any other discount sale of property to shareholders.

later disposition of the property.⁹⁶ In practice, however, there are a number of reasons that might not be considered an adequate resolution.

- The property might be subject to ordinary tax rates in the corporation's hands but preferential capital gains rates⁹⁷ in the shareholder's hands.
- The gain might never be taxed because the property's basis might be stepped up to full value at the death of the shareholder.⁹⁸
- If the shareholder is a foreign person, the gain might never be taxed because it is foreign source income,⁹⁹ if the property is not a U.S. real property interest.¹⁰⁰
- If the shareholder is a tax exempt entity, the gain might never be taxed because it is not included in unrelated business taxable income.¹⁰¹

These seem ample reason to conclude that the discount cannot be ignored entirely.

The next possibility is to continue to apply the CDD as it applies currently, but, from the perspective of the Integrationist Norm, that would be overkill. If the discount to the shareholder is a constructive dividend,¹⁰² then presumably, under existing law, an identical amount must be accounted for as additional sales price to the corporation.¹⁰³ In effect, the discounted sale should be treated the same as a cash distribution of the amount of the discount to the shareholder and then the use of that cash as part of the purchase price of the property. That produces both a corporate tax and a shareholder tax on the amount of the discount,¹⁰⁴ which is clearly contrary to the Integrationist Norm. A single level of tax is sufficient.¹⁰⁵ For this Article, the question becomes one of selecting the appropriate party to tax.

The first option is to collect the tax solely at the shareholder level, and not at the corporate level. In effect, the first option is the same

96. This possibility clearly raises a deferral issue that is itself deferred until later in the analysis. See *infra* notes 110-18 and accompanying text.

97. I.R.C. § 1(h) (2006).

98. *Id.* §§ 1014, 1022.

99. *Id.* § 865.

100. *Id.* § 897.

101. *Id.* §§ 511-515.

102. Treas. Reg. § 1.301-1(j).

103. I.R.C. § 311(b) (2006).

104. Clearly, the double tax scenario applies in the case of a discounted sale of appreciated corporate property only. See I.R.C. § 311(a).

105. Equivalent analysis applies to the tax treatment of a discount rental, leasing, or licensing of property. In principle, the CDD currently requires two levels of taxation but a single level of taxation should be normative. See *Bittker & Eustice, supra* note 86, at ¶8.05[4].

treatment as the reinstatement of the *General Utilities* doctrine¹⁰⁶ via the repeal of section 311(b). At the shareholder level, the ordinary stacking rules for dividend distributions will determine how much of the discount is a dividend out of earnings and profits, how much is nontaxable return of shareholder capital, and how much is gain from the disposition of property.¹⁰⁷

The analysis of that possibility begins with the treatment of a shareholder that is a fully taxable U.S. person. If the amount of the discount is no more than the corporation's current and accumulated earnings and profits, then, in terms of the Integrationist Norm, the result is unproblematic. The discount is fully taxable as ordinary income.¹⁰⁸ The corporation's earnings and profits are correspondingly reduced.¹⁰⁹

If the discount exceeds a threshold amount of the corporation's pre-distribution earnings and profits, however, then a portion of the constructive distribution is treated as either non-taxable return of capital or as gain on the disposition of property.¹¹⁰ The deemed distribution will not be fully taxable on a current basis at the shareholder level and will

106. See *Gen. Util. & Operating Co. v. Helvering*, 296 U.S. 200 (1935).

107. I.R.C. § 301(c) (2006).

108. *Id.* § 301(c)(1). This analysis does not hold under the current circumstances under which qualified dividend distributions are subject capital gain tax rates, with a maximum tax rate of 15%. *Id.* §1(h). The reduced tax rates on these qualified dividend distributions were themselves adopted as a form of partial tax integration. See H.R. REP. NO. 108-94, at 27-8 (2003) See also Altshuler, Harris & Toder, *supra* note 40, at 357-58; Bank, *supra* note 40, at 207; Doran, *supra* note 40, at 525-26; Bank, *supra* note 40, at 537-40. They assume full corporate-level taxation. As such, they are not a sufficient substitute for corporate-level taxation. However, the reduced rates applicable to qualified dividends are not scheduled to apply to dividend distributions in tax years beginning in 2013 or later. See *supra* note 23. The analysis is predicated on the expiration of reduced tax rates on qualified dividend distributions.

109. A potential complication for this analysis is that the lack of corporate-level taxation implies that there is no addition to the earnings and profits account as a result of that discount. Had the corporation been taxed on the amount of the discount, earnings and profits would have been increased by the amount of the tax less the marginal corporate taxes on that gain, hereinafter referred to as the "E&P Bump." Because the E&P Bump would be less than the corporation's pre-distribution earnings and profits, the failure correspondingly to increase earnings and profits is unproblematic. It is true that a portion of a future dividend distribution that would otherwise have been subject to tax as dividend would be treated as either non-taxable return of capital or as gain on the disposition of property, most likely taxable at capital gain tax rates. I.R.C. § 301(c). The Integrationist Norm, however, makes this unobjectionable because those amounts, up to the amount of the full deemed dividend, would have already been subject to a full shareholder-level tax via the taxation of the discount as a dividend. Any further tax would be an excess tax. Therefore, the shareholder-level tax is more than sufficient under these circumstances.

110. I.R.C. §301(c). If the E&P Bump were included in earnings and profits for purposes of determining the shareholder taxability of the deemed distribution from the discount, which is not practicable under existing law without triggering a corporate-level taxable gain, then the applicable threshold would be the pre-distribution earnings and profits plus the amount of the E&P Bump.

not be taxable at all at the corporate level. If the discount exceeds the threshold amount by no more than the shareholders stock basis, that excess will not be taxed at the time of the discount transaction. The shareholder's stock basis will be reduced *pro tanto*. Presumably, therefore, a greater portion of some later stock disposition realization, or a distribution treated as such,¹¹¹ will be taxed at capital gains rates. The current non-taxability will be offset, but only partially, by a deferred tax at a lower rate.

If the discount exceeds the threshold amount by more than the shareholders' stock basis, a portion of that excess will be taxed immediately as gain from the disposition of property. That excess will be taxed at the time of the discount transaction with the corporation. In addition, some increased portion of a later stock disposition realization, or a distribution treated as such,¹¹² will be taxable, generally at capital gains rates. Thus, a portion of the deemed distribution will subject to immediate partial taxation at less than full ordinary income tax rates, and the balance will be subject to deferred taxation at the same rates.

In terms of the Laissez-Faire Approach, neither of these last two possibilities is a fully satisfactory substitute for the ideal single level of taxation. As such, collecting tax solely at the shareholder level is not an appropriate resolution for the scenario of a discount in excess of the corporation's pre-distribution earnings and profits, because the scenario assumes that the corporate-level tax is eliminated not deferred.

A potential resolution to this concern would be a minor amendment of section 311(b), in place of its outright repeal. The amendment would provide that a corporate distribution or discount sale of appreciated property would trigger corporate-level gain only to the extent that the amount deemed distributed is not treated as a dividend under section 301(c). That is the corporation would continue to recognize gain to the extent that the discount exceeds the corporation's current and accumulated earnings and profits.¹¹³

Another potential issue is a concern about discount sales to taxpayers that are not fully taxable. For a domestic non-taxable entity the deemed dividend amount may not be taxable at all because it is not included in unrelated business taxable income.¹¹⁴ One might regard the non-taxability of dividends to non-profit entities as predicated on the full

111. *Id.* § 301(c)(3).

112. *Id.*

113. As previously noted, the analysis is predicated on the expiration of reduced tax rates on qualified dividend distributions. *See supra* note 108.

114. I.R.C. §§ 511-515 (2006).

taxability of corporate earnings. Likewise, for foreign taxpayers, one might take the view that income tax treaty provisions providing tax exemptions or rate reductions on dividends are predicated on the full taxability of the distributing corporations.¹¹⁵ In either case, the application of a tax solely at the shareholder level would, therefore, not be considered an adequate solution.¹¹⁶ The obvious resolution would be to continue to apply the CDD to impose a tax at the corporate level in these limited circumstances. In terms of addressing this issue by amending section 311(b), this would call for the continued application of the current rule to the corporation if the shareholder is not fully taxable.

The alternative option, either for limited circumstances in which the single shareholder tax is inadequate or for all of these discount property transactions if the shareholder-level tax cannot be made adequate, is to collect the tax solely at the corporate level, and not at the shareholder level. This surrogate taxation at the corporate level is an adequate single level of tax, subject to the caveats noted above in Part 4.1.1.¹¹⁷ The one additional potential problem is that the recognition of the full discount as corporate income normally results in an increase in corporate earnings and profits.¹¹⁸ That increase would trigger a second tax when those earnings are distributed to shareholders. The simple solution, of course, is simply not to make the earnings and profits adjustment. To the extent that it is feasible to set aside the CDD, in whole or in part, it surely must be equally feasible to make this adjustment from current practice.

Neither is a perfect resolution for all situations. The Laissez-Faire Approach can easily find a combination of the two that serves well the Integrationist Norm. In the case of domestic non-profits and foreign persons not fully taxable on dividends, the preferred solution appears to be to collect the tax at the corporate level as a surrogate for the normative individual tax. In other situations, there is a judgment that must be made. One possibility is to collect the tax at the shareholder level, collecting a corporate-level tax only with respect to the portion—if any—of the distribution not fully taxable as a dividend.¹¹⁹ If the legal

115. See, e.g., Hugh J. Ault, *Corporate Integration, Tax Treaties and the Division of the International Tax Base*, 47 *TAX. L. REV.* 565, 565-66, 567-69 (1992).

116. On the other hand, if the deemed dividend to a foreign person is subject to full U.S. net basis taxation, I.R.C. §§ 871(b), 882, or to the full 30% gross basis tax on fixed or determinable annual or periodical income, I.R.C. §§ 871(a), 881, the shareholder-level tax should be considered the normative single level of tax and therefore the fully appropriate single level of tax.

117. See *supra* notes 35-50 and accompanying text.

118. See I.R.C. § 312(b) (2006).

119. As previously noted, the analysis is predicated on the expiration of reduced tax rates on qualified dividend distributions. See *supra* note 108.

change necessary to accomplish this is feasible, it will no doubt result in over taxation in at least some circumstances. If this is not feasible, the other possibility is to forgo the shareholder-level tax and collect the tax solely at the corporate level. This may result in under taxation in at least some circumstances.¹²⁰ The Laissez-Faire Approach counsels selecting one of these alternatives rather than continuing to generate deadweight losses by consuming judicial, IRS, and taxpayer resources in an attempt to impose two full levels of taxation.¹²¹

D. Transactions Claiming Corporate-Level Deduction

In terms of the Integrationist Norm, perhaps the most straightforward cases are those in which a corporate-level deduction is paired with full taxability at the shareholder level. These transactions might take the form of corporate payments to shareholders as interest or as compensation for services or the use of property.¹²² Under existing law and practice, the IRS polices these transactions to determine whether a recharacterization is required. The obligation on which interest is paid might be recharacterized as equity rather than debt. The compensation for services might be considered unreasonably high. The result is the denial of the corporate deduction and the recharacterization of the shareholder income as a dividend.

Based on an Integrationist Norm, much of this enforcement effort is a pure waste of resources. Corporate earnings should be subject to a single level of taxation, not two levels of taxation. If the Integrationist Norm is fiscal transparency, it is the shareholder-level tax rate schedule that should apply. Therefore, so long as the shareholder is fully taxable with respect to the same amount as the corporate deduction, allowing the deduction at the corporate level is no worse than the treatment of fiscally transparency. A principle of consistency should be sufficient to resolve the issue. So long as the recipient is fully taxable with respect to the amount the corporation deducts, the allowance of a deduction to the corporation is unproblematic.¹²³ Resources consumed—by the IRS,

120. See *supra* notes 37-45 and accompanying text (outlining the argument that a level of under taxation is preferable to full double taxation under these circumstances).

121. There may be specific instances in which either the corporation or the shareholder is judgment proof with respect to the tax. In that case, the IRS might be well counseled to attempt to collect the single level of tax from the taxpayer from whom it can be collected.

122. See *Bittker & Eustice, supra* note 86, at ¶¶8.05[3], [5], [7].

123. If the recipient is not a shareholder, but the amount is paid to the recipient on behalf of the shareholder, see *Old Colony Trust Co. v. Comm'r*, 279 U.S. 716 (1929), *Baumer v. United States*, 580 F.2d 863, 882-83 (5th Cir. 1978), the Laissez-Faire Approach has no objection to assigning the

taxpayers, and the judicial system—in the challenge of the deduction serve a counterproductive end, and the challenge should be avoided.¹²⁴

V. CONCLUSION

From the perspective of the Integrationist Norm, there are clearly circumstances in which it is appropriate to dispense with the application of the CDD. In as much as it serves to reinforce the anti-ideal of double taxation, it is wasteful and counterproductive. If there are circumstances in which it is to be retained, it must be because of a judgment that the CDD serves to prevent other distortions in the tax system that are of greater concern than the distortions of double taxation. There is a need for a judgment to resolve this second best problem about which reasonable minds can differ. This Article has presented and analyzed critically multiple circumstances in which the CDD is currently applied in order to identify circumstances in which it is wise to dispense with its application, and it has identified several such circumstances in which the Integrationist Norm counsels dispensing with the CDD.

income to the shareholder, see *Lucas v. Earl*, 281 U.S. 111 (1930). This may be considered important if the pertinent shareholder is in a higher tax bracket than is the actual recipient.

124. See Polito, *supra* note 9, at 51-62 (providing equivalent analysis for corporate deductions for services compensation and interest). A potentially different case is presented if the tax treatment of the payee depends on the characterization of what it is for which the payment is made. See, e.g., I.R.C. §§ 861-65 (2006) (providing differing rules for determining whether income is foreign or domestic source depending upon the characterization of the transaction). In these cases it is appropriate to continue to police for the correct characterization at the payee level.