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Center in Law, Economics and Organization Research Papers Series No. C13-5

Legal Studies Research Paper Series No. 13-5

March 21, 2013

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Preliminary draft
Comments are welcomed.

This draft reflects helpful comments from, among others, Rosanne Altshuler, David Hasen, Theodore Seto, the participants at the USC Gould School of Law's 16th Amendment Anniversary Conference held in February 2013, and the participants at a presentation of an earlier version at the NYU Tax Policy Colloquium in February 2012. All errors remain solely those of the author.

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CORPORATE CAPITAL AND LABOR STUFFING IN THE NEW TAX RATE ENVIRONMENT

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Federal tax legislation enacted on January 2, 2013 to resolve the "fiscal cliff" policy controversy has reintroduced substantially higher maximum individual income tax rates on ordinary income, but has retained the 2003-2012 innovation of taxing dividend income at the same relatively low rate as long-term capital gains. At the same time, corporate tax reform is likely to lead to a substantially lower statutory corporate tax rate than current law's 35 percent. The combination of these three factors will in the near future usher in the return, for the first time in a generation, of the taxable corporation as a personal tax shelter for owners of closely-held businesses.

This paper assumes that corporate headline rates in fact are lowered, and analyzes an individual's incentives in that new tax rate environment to retain corporate earnings not strictly needed to support business operations (or to inject new investment capital into the corporation), rather than to extract that capital and earn the same income through direct investment ("capital stuffing"), and to understate the labor income of corporate owner-managers, so as to treat a disproportionate amount of their income as capital income, in the form of corporate retained earnings ("labor stuffing"). To aid in that analysis, the paper offers a new mode of conceptualizing the time value of deferring a tax liability. Finally, the paper analyzes current law's tools to combat capital and labor income stuffing, and finds them wholly inadequate to the task.

I. THE RETURN OF THE CORPORATION AS TAX SHELTER.

A. Overview.

In early 2009 I gave a speech in which I predicted that in the near future the federal corporate income tax rate would be materially lower than the maximum individual income tax

rate.[1] I explained that the result would be the return, for the first time in a generation or more, of the use of corporations as individual tax shelters. I observed that the Internal Revenue Code had no robust mechanism for dealing with this issue, and I urged policymakers to begin thinking systematically about the problem and its implications for the design of capital income taxes in the United States.

The speech annoyed my then-employers, but it is likely that my prediction will soon become reality, when marginal corporate tax rates fall in the course of comprehensive corporate tax reform. And unsurprisingly, policymakers to date have cheerfully ignored the issue.

This paper essentially assumes that corporate statutory tax rates will decline materially in the near future, and seeks to clarify the circumstances in which individuals who control closely-held businesses will favor holding investment returns through the retained earnings of corporations, under the tax rate assumptions developed below. The paper tries to tease apart the interactions among different tax incentives that individuals will confront in the tax rate environment hypothesized below – the incentive to retain investment capital in corporate form in the form of retained earnings not strictly needed to support business operations (or to inject new investment capital into the corporation), rather than to extract that capital and earn the same income through direct investment ("capital stuffing"), the incentive to understate the labor income of corporate owner-managers, so as to treat a disproportionate amount of their income as capital income, in the form of corporate retained earnings ("labor stuffing"), and the incentive to hold onto corporate equity investments to defer individual-level capital gains taxes (the lock-in effect). Throughout, the examples are highly stylized, and the assumption is that an individual can control the activities and distribution policies of the corporation in which she invests.

The problems of capital and labor stuffing within a closely-held firm are largely ones of revenue and perceived fairness rather than economic efficiency, for the simple reason that there are few non-tax costs to holding one's investments inside a controlled corporation rather than directly, or classifying the return to one's labor performed for a controlled corporation as capital rather than labor income. This leaves only the relatively modest distortions attendant on a system that arguably contains tax incentives for working for oneself rather than for an unrelated

[1] *See* Amy S. Elliott, ''Kleinbard Warns of Growing Gap Between Individual and Corporate Rates,'' *Tax Notes*, Mar. 16, 2009, p. 1314, *2009 TNT 43-8*.

employer (where labor stuffing in particular is not generally available), or perhaps for saving rather than consuming (by virtue of the lower tax rate available to individuals able to engage in capital stuffing) as obvious efficiency consequences of the two phenomena.

In fact, as explained below, one ultimate recommendation is that policymakers should recognize that the impossibility of policing the capital stuffing phenomenon presents an opportunity, rather than a bug, and respond by adopting a consistent approach to the taxation of all capital income, whether earned directly or through a firm. If, on the other hand, labor income is taxed at different (presumptively higher) rates than capital income, then the policing of labor stuffing will be a substantial revenue concern in the future; its resolution requires new tools.

This paper is not a normative inquiry into whether capital income should be taxed, or if so how that income should be measured in practice, particularly given the many instances in which capital income is manifested (e.g., personal interest, rents, royalties, dividends, capital gains, and firm net business income). Nor does this paper offer normative insights into the capital income tax rate structure that ought to prevail.

The reason for avoiding these important questions is that this paper is the second of a larger project on the sorry state of capital income taxation in the United States. The first paper considered similar issues from the perspective of the experience of Nordic countries, which early on confronted both the efficiency case for lower (and consistent) tax rates on capital income than are imposed on labor income, and the concomitant problem of labor stuffing to take advantage of that rate differential, through those countries' "dual income tax" structures.[2] Those tax regimes introduced new administrative tools (which I term "tax centrifuges") to distinguish labor from capital income in a rough and ready way, when the two are intermingled in the form of the net business income of a closely-held firm. The dual income tax and its internal tax centrifuge are important conceptual contributions in thinking about capital income taxation.

This paper essentially extends the prior article's analysis to the United States, by engaging in a positivist inquiry into the implications of the tax rate environment towards which the United States apparently is drifting, and the tax administrative tools currently available to

[2] Edward Kleinbard, *An American Dual Income Tax: Nordic Precedents*, 5 Nw. J.L. & Soc. Pol'y 41 (2010).

address the capital and labor stuffing phenomena. To frame the issues more clearly, the paper lays out at length the financial stakes to taxpayers, and demonstrates that capital and labor stuffing will become large-scale problems if no new administrative tools are developed.

These problems actually have an ancient history in U.S. tax practice, going back a generation or more, when corporate and individual tax rates last diverged sharply. The principal difference between that old precedent and today is that dividends no longer are taxed at the same rate as ordinary income, thereby vastly increasing the attractiveness of capital and labor income stuffing. In prior practice, the only available means of extracting excess capital held inside a corporation was by a capital gains transaction, which in general required the taxpayer to divest his business as well as the excess capital; now, as this paper demonstrates, it will be possible to retain ownership of a closely-held C corporation and still obtain a tax advantage through capital and labor stuffing, by treating a closely-held corporation as a personal investment account as well as a business enterprise.

Prior U.S. administrative practice was unsatisfactory at policing the personal-corporate investment boundary, because prior rules could be gamed by changing the mix of income, or required elaborate "facts and circumstances" litigation to prove the government's case. Those inadequacies will only become more obvious in the new tax rate environment, for the reasons suggested in the previous paragraph. And other solutions, like increasing the tax burden on dividends and capital gains, are not as well targeted, and have serious ancillary consequences for economic efficiency, by increasing capital gain lock-in problems.

Our tax rules are particularly underdeveloped in their ability to distinguish labor from capital income in the case of the owner-manager – an individual who both provides labor inputs to an enterprise and who owns some or all of that enterprise. The "carried interest" phenomenon is the best-known modern instance of the problem, although of course that particular strategy relies on partnerships rather than corporations as the vehicles through which to transmute labor into capital income. Excepting this and a few other cases, the resulting confusion has been tolerable in an environment where labor and capital income bear the same statutory rates. It is the forthcoming confluence, for the first time, of a materially lower tax rate on corporate income than on individual income (as was the case before 1986) with the post-2003 development of a relatively low tax rate on dividends in particular (and also capital gains in appropriate

circumstances) that creates the taxpayer opportunities that this paper describes, and that makes the search for more robust solutions so urgent.

Like most countries, the United States today already has unconsciously adopted some elements of a dual income tax regime, in which some forms of capital income (e.g., capital gains) are taxed at essentially flat rates much lower than those imposed on labor income.[3] When that connection is broken, and the corporate income tax in particular becomes a flat tax imposed at significantly lower rates than those imposed on labor income, we will find ourselves drifting pell-mell towards what in practice will be a more pervasive dual income tax structure. The realistic question therefore is not whether a dual income tax is a good idea, but whether we will choose to implement a thoughtful one.

The third paper in this project will adopt a more normative agenda. It will argue that, in the world towards which we appear to be drifting, in which corporate tax rates will have been reset to be meaningfully lower than those imposed on the labor income of individuals, the most effective response to the capital stuffing problem, and independently the right analytic goal, is that capital income earned directly by individuals (in particular, interest income and net business income) should be taxed at the same lower proportional tax rates as those imposed on corporations.[4] Leaving directly-earned capital income taxed at the same rates as labor income will lead to unpoliceable capital stuffing problems. That paper will propose a comprehensive reimplementation of capital income taxation, called (after extension to address labor stuffing) the Dual Business Enterprise Income Tax.

Taxing in a consistent manner all capital income however earned fully addresses the capital stuffing problem. Making that rate in turn generally lower than labor income rates addresses efficiency concerns. At the same time, however, a true dual income tax system, in

[3] It is important to remember that the preferential tax rate on net capital gain is not constrained to sales of corporate stock, where there at least is a facially plausible argument that the lower capital gains rate ameliorates the traditional concern over the double taxation of corporate income. For example, an investor who sells a bond at a profit attributable to a decline in market yields obtains capital gains treatment, notwithstanding that the profit is a pure substitute for future ordinary income, and there is no double taxation.

[4] The text here leaves entirely to the next paper the question whether economic rents, for example, should be taxed at higher rates, even under a dual income tax. Norway's current system does just that. Kleinbard, supra n. 2, at 69-76.

which capital income however earned generally is taxed at the same proportional rate, which in turn is materially lower than the rates imposed on labor income, greatly exacerbates the problem of labor stuffing – that is, of characterizing returns to labor as returns to capital. A comprehensive solution that accepts the premise that capital income in general should be taxed at rates lower than those applicable to labor income thus must accomplish two objectives: it must implement feasible rules for measuring and taxing returns to capital, and it must incorporate a tax centrifuge to distinguish labor from capital income when the two are conjoined in the net business income of a closely-held business.

By way of foreshadowing the ultimate objective of this project, the Dual Business Enterprise Income Tax addresses capital stuffing by taxing all returns to capital once, and only once, regardless of the form of the business enterprise in question. The Dual BEIT addresses labor stuffing by employing Nordic-style dual income tax principles to distinguish labor from capital income, and thereby to restrict the ability of owner-managers to masquerade labor as capital income. The Dual BEIT thus aims to resolve the principal practical problems towards which the tax system currently is drifting.

B. Trends in Capital and Labor Income Tax Rates.

1. Assumptions Employed in Paper. This subsection reviews recent tax legislation and makes predictions about future law, all with the purpose of distilling a credible set of predicted future tax rates to use in illustrating the problems that will ensue when corporate tax rates are materially lower than the highest personal income tax rates.

For the reasons developed below, and abstracting from The American Taxpayer Relief Act of 2012, the analytical portion of this paper assumes that in the near future the corporate income tax rate in fact will be reduced to a flat rate of 25 percent, that individual income tax rates are subject to a maximum tax rate of 40 percent, and that the tax rate imposed on an individual's net capital gain and dividend income is 20 percent.[5] The corporate tax rate figure of course is entirely hypothetical, and future personal income tax rates are also ultimately

[5] In a paper on the same general topic as the ground covered in this Section, Daniel Halperin relied on the same informed hypotheticals. Daniel Halperin, *Mitigating the Potential Inequity of Reducing Corporate Rates*, 126 Tax Notes 641 (Feb. 1, 2010).

unknowable, but to this observer at least this tax regime is a set of hypotheticals conditioned by plausible predictions.

These assumptions have the additional virtue of imposing a total tax burden on currently-distributed corporate profits identical to the maximum tax rate on individual income. If there is reason to engage in capital or labor income stuffing in this facially-tax neutral environment, that reason only will become more powerful in an environment with a larger tax rate differential.

The 40 percent individual tax rate that I assume actually is somewhat lower than the effective marginal tax rate on high-income taxpayers for 2013 and thereafter, as the next few paragraphs explain. Conversely, the effective corporate tax rate actually will be somewhat lower than its headline rate, once its interactions with section 1411's new tax on net investment income are considered. Subsection I.B.4. explains those interactions.

The paper further assumes that all individuals are subject to the 40 percent tax rate on all of their income other than that derived from qualified dividends or net capital gains. This simplifying assumption reflects the fact that sophisticated tax planning is largely the province of the affluent, as is the possession of significant amounts of investment capital. I further assume that any base broadening measures in respect of the real income of firms (for example, a move from accelerated to economic depreciation) would apply to both corporate and noncorporate firms in a consistent manner, so that the only difference (if any) would be in statutory rates.

The examples that follow all deal with an individual investor facing an opportunity to earn normal returns from an investment of capital, and deciding whether to make that investment directly or through a C corporation that she controls and wishes to continue to control. For this reason, the base case focuses on income tax rate differentials between individuals and corporations, and the dividend "toll charge" incurred in extracting corporate earnings. In other words, I assume that any extraction of cash trapped inside the firm will be characterized as a distribution taxable as a dividend,[6] and that a capital gains exit (where, incidentally, the only difference when compared to a dividend is the application of basis, not a tax rate difference) also requires divestiture of some or all of the underlying business.

[6] Section 302.

I assume that investment opportunities are identical inside and outside the corporation, and that, as a result of the corporate base-broadening measures that will accompany the new lower corporate income tax rate, normal returns in fact will be taxed at the corporate level. (The Dual BEIT reverses this, and moves the taxation of normal returns to the individual owner level.)

Finally, in applying these hypothesized new rates, I assume that the price of the new corporate tax rate will include the repeal of current law's graduated tax rates on the first $10 million of corporate income, the repeal of the special zero capital gains tax rate gain recognized on sales of certain small business stock, and the repeal of the characterization of loss recognized on the sale of such stock as ordinary loss.[7]

2. Corporate tax rate. The future of capital income tax rates in the United States of course is uncertain, but nonetheless some possible trends can be suggested. First, there appears to be a surprising consensus that the statutory federal corporate income tax rate is too high. This consensus reflects the importance of non-U.S. multinational enterprises as competitors to U.S. firms, and the international mobility of corporate capital income in particular. [8] Certainly, there is abundant evidence that the U.S. statutory corporate income tax rate is higher than that of almost all other OECD countries, particularly in light of recent reductions by important trading partners (e.g., the United Kingdom). Whether U.S. *effective* corporate tax rates are outliers when compared to those of other countries has a much more ambiguous answer, but policymakers of course tend to focus on "headline" (statutory) rates.[9]

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[7] Sections 11(b), 1202 and 1244. For a recent criticism of the special zero tax rate on gains from sales of small business stock, see Victor Fleischer, *Tax Extenders that Slip Under the Radar*, New York Times, Jan. 15, 2013 (http://dealbook.nytimes.com/2013/01/15/tax-extenders-that-slip-under-the-radar/).

Current law's graduated rates are dramatically bottom weighted; for corporate taxable incomes above $75,000 but below $10 million, the benefit of the graduated rate brackets is a one percentage point difference in tax rates (34 percent versus the maximum corporate rate of 35 percent). Section 11(b). The benefits of the 15 and 25 percent graduated rate brackets are recaptured for C corporations with taxable incomes over $100,000; the benefit of the 34 percent rate bracket is recaptured for C corporations with taxable incomes over $15 million. Section 11(b).

[8] Treasury (2007); James R. Hines, Jr., and Lawrence H. Summers, How Globalization Affects Tax Design, 23 NBER *Tax Policy and the Economy* 123 (2009).

[9] If one conceives of the role of the multinational corporation as primarily a global platform from which to extract rents attributable to valuable intangibles, then in fact the marginal tax rate is the right place to focus, because by definition that is the tax rate imposed on rents.

To this end, the *President's 2012 Framework* argues that U.S. statutory corporate tax rates are much higher than global norms, while at the same time corporate effective tax rates are similar to those of major trade partners.[10] The Framework maintains that "The trade-off of a higher statutory tax rate in exchange for a narrower tax base with numerous loopholes and subsidies is a poor one."[11] The Framework therefore recommends a reduction of the corporate tax rate, combined with base broadening; the Framework's proposed corporate tax rate is 25 percent for U.S. manufacturing businesses, and 28 percent for other U.S. corporate activities.

To the same effect, Dave Camp, Chairman of the House Ways and Means Committee, published in October 2011 a "discussion draft" outlining potential corporate income tax reform, which draft included a 25 percent corporate income tax rate.[12] Again, the discussion has been couched as a roughly revenue neutral exercise.

The 25 percent figure (or one very close to it) thus has been recommended by leadership in both political parties. It has been repeated in so many other recommendations that at this point it has transcended the label of wishful thinking and has taken on the quality almost of a forgone conclusion.[13]

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[10] President's 2012 Framework at 2-3.

[11] Id. at 3.

[12] The text of the proposal and a section-by-section summary are available at: http://waysandmeans.house.gov/taxreform/.

[13] The Bipartisan Policy Center's *Domenici-Rivlin Debt Reduction Task Force Plan 2.0* recommended a corporate income tax rate of 28 percent. (Available at: http://bipartisanpolicy.org/library/report/domenici-rivlin-debt-reduction-task-force-plan-20) The National Commission on Fiscal Responsibility and Reform (better known as the Simpson-Bowles Commission) did not approve its report by the required supermajority, but the final report (available at http://www.fiscalcommission.gov/) included a recommendation that corporate tax rate be set between 23 and 29 percent. The Co-Chairs' draft recommendations (Nov. 10, 2010) included a corporate income tax rate of 26 percent.

The Hamilton Project's *A Dozen Economic Facts About Tax Reform* (May, 2012) (available at http://www.hamiltonproject.org) explained the case for a lower corporate income tax rate. The report did not make a specific recommendation, but drawing on earlier work of the Congressional Research Service, the report described a number of revisions to the corporate income tax base that could, if implemented, permit a revenue-neutral tax bill that would lower the corporate income tax statutory rate to something in the range of that described in the text.

3. Political economy considerations. The prospects for actual legislation that reduces the statutory corporate income tax rate depend on at least four factors. The first is whether Congress will separate consideration of presumptively revenue neutral corporate tax reform from individual tax reform, where there is no consensus at all on revenue targets – as seen, for example, in the competing draft Budget Resolutions for the federal government's Fiscal Year 2014 Budget prepared by the House (Republican) and Senate (Democratic) Budget Committee majorities. Second, reducing the statutory corporate tax rate in a roughly revenue neutral manner will require forgoing many corporate tax expenditures, such as accelerated depreciation (ACRS). Third, corporate tax reform requires in particular agreement on the shape of international tax policy, the most contentious issue for the large American corporations that pay the bulk of the corporate income tax. Finally, achieving roughly revenue neutral corporate tax reform conceivably could require using business tax expenditures more broadly to fund corporate tax rate reductions, but this has the effect of raising effective tax rates on unincorporated businesses, which today account for roughly one-half of net business income in the United States. Such a prospect raises obvious political concerns, notwithstanding the observation that aggrieved unincorporated businesses always retain the option to incorporate.[14]

Precisely because there is such deep political division on individual tax revenue targets, I remain more optimistic than are many other observers that at some point in the near future Congress will hive off corporate tax reform in order to address it first. In turn, if there were the political will to forgo most of the corporate tax expenditures on the usual lists prepared by the Staff of the Joint Committee on Taxation and others, including accelerated depreciation, it would be possible to bring the corporate tax rate down to somewhere between 25 and 30 percent

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Very recently the Center for American Progress released *Reforming Our Tax System, Reducing Our Deficit* (Dec. 2012). (Available at http://www.americanprogress.org.) Unlike some of the other studies referenced above, this report explicitly embraced the proposition that aggregate federal tax revenues should rise. Nonetheless, while the report made no specific corporate tax rate recommendation, it noted that "corporate income tax is ripe for reform that broadens the tax base, lowers the statutory rate, and raise[s] additional revenue."

The author himself has jumped on this bandwagon, albeit with a different international tax regime in mind than that proposed by some of the studies referenced above. Edward Kleinbard, *The Lessons of Stateless Income*, 65 Tax L. Rev. 99 (2011).

[14] Lydia Beyoud, *Passthroughs Will Not Bear Brunt of Lower Corporate Rates in Tax Reform, Beeman Says*, 53 Daily Tax Rpt. G-1 (Mar. 19, 2013).

through revenue neutral legislation.[15] I read those estimates to suggest that achieving revenue neutral legislation that reduces the corporate tax rate to 25 percent, and that relies only on corporate tax base broadening, could require eliminating all corporate tax expenditures (other than "deferral" – the treatment of active income derived by foreign subsidiaries of U.S. firms), plus either the adoption of a new regime that raises the effective U.S. tax rate on foreign income, or some sort of new general limitation on interest deductibility (e.g., a "thin capitalization" statute that applies to domestic as well as international operations), or both.

Economists frequently object to tradeoffs along the lines sketched above, on the theory that paying for a corporate statutory tax rate reduction through abandoning tax expenditures in general, and accelerated depreciation in particular, has two perverse effects: first, doing so increases the effective marginal tax rate on new investment (at least in cases where the rate reduction is insufficient to compensate for the economic cost of forgoing accelerated depreciation), and second it rewards "old capital" – existing investments made in the previous high-tax environment whose returns now enjoy the lower tax environment. In practical application this objection proves too much. First, it fights the premise that the corporate income tax is intended in fact to function as a tax on income, and therefore to burden capital income. Second, the objection would make it impossible ever to eliminate the distortions and revenue costs attendant on non-economic depreciation schedules inside an income tax, because every such transition as a practical matter has the effect of temporarily rewarding old capital. Perhaps for these reasons, most other countries that have reduced their corporate tax rates have followed exactly this path of abandoning accelerated depreciation. (Introducing new limitations on interest deductibility has different efficiency consequences, and in particular does not raise the effective marginal tax rate on equity-financed marginal investments.)

Future international corporate tax policy logically can follow one of two paths – a "territorial system with teeth," or alternatively genuine worldwide tax consolidation coupled with an attractive corporate tax rate (which I believe a 25 percent rate would satisfy).[16] While the

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[15] For a comprehensive review of recent revenue estimates for corporate base broadening and rate reduction, see Jane G. Gravelle and Thomas L. Hungerford, Corporate Tax Reform: Issues for Congress, Cong. Res. Serv. Pub. No. RL34229, Dec. 26, 2012, at 35-43.

[16] Edward Kleinbard, *The Lessons of Stateless Income*, 65 Tax L. Rev. 99 (2011).

former has attracted broader support,[17] the latter is simpler to implement, more robust to gaming and (when coupled with a tax rate squarely within world norms) reasonably "competitive."[18]

U.S. based multinational firms have argued strenuously for the adoption of a territorial tax system for their international operations, although they have not made a convincing case that worldwide tax consolidation would be unduly burdensome, assuming that the United States adopted a corporate tax rate that was at or a bit below the OECD weighted average. Looking beyond the standard arguments offered for public consumption, one possible explanation is that they believe that they will be able to game any territorial tax system that is ultimately enacted.[19]

Another reason might be the concern of U.S. multinational firms that, were they to accept the idea of worldwide tax consolidation, they would be at risk of future corporate tax rate hikes, which would vitiate a critical assumption in the original understanding. This concern can, however, tie in nicely to the very problem addressed in the remainder of this Article. If a consequence of corporate tax reform is to offer a materially lower statutory rate environment to corporations than that available to individuals (including pass-through businesses owned by individuals), and if that rate in turn induces a large number of noncorporate business owners to incorporate their firms, then for the first time in many decades the tax interests of the largest U.S. firms would be closely aligned to that of many small business owners, thereby providing those large firms with reason to believe that the new corporate rate would be more firmly anchored than they otherwise might fear. And in turn if noncorporate business tax expenditures are

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[17] See, e.g., Ways and Means Committee Chairman Dave Camp's October 2011 international tax "Discussion Draft," available at http://waysandmeans.house.gov/taxreform/.

[18] Edward Kleinbard, *The Lessons of Stateless Income*, 65 Tax L. Rev. 99 (2011).

[19] Another related explanation is that they believe that multinational firms domiciled in other countries that follow territorial tax norms will be able to continue to game the tax systems they face, to the competitive disadvantage of U.S. firms. Putting aside other objections, this belief ignores the rapid evolution in thinking of most large economies that employ territorial tax systems, which now are intently focused on reducing their exposure to aggressive international tax planning. See, e.g., Organization for Economic Cooperation and Development, *Addressing Base Erosion and Profit Shifting*, Feb. 2013, available at *http://dx.doi.org/10.1787/9789264192744-en;* Speech by David Bradbury MP, Assistant Treasurer of Australia and Minister Assisting for Deregulation, '*Stateless Income' – A Threat to National Sovereignty*, Mar. 15, 2013, available at http://assistant.treasurer.gov.au/DisplayDocs.aspx?doc=speeches/2013/003.htm&pageID=005&min=djba&Year=&DocType=.

eliminated to pay for corporate tax reform, the future incentives for noncorporate businesses to incorporate will increase, thereby further broadening the pool of taxpayers vitally interested in preserving the new lower rate. In this unexpected way the problem to which this paper is addressed (the rise of the corporation as individual tax shelter) can make it more feasible to consider worldwide tax consolidation as a simple and robust solution to the thorny problem of international business tax system design.[20]

4. Personal labor and capital income rates. The American Taxpayer Relief Act of 2012 (enacted in early January 2013) revisited the 2001 and 2003 Bush individual income tax cuts, and enacted a new set of personal income tax rates as "permanent" law.[21] For our purposes, those cuts generally were extended, except that the statutory maximum marginal individual tax rate has now returned to 39.6 percent, and the tax rate on capital gains and dividend income has increased to 20 percent.

In fact, beginning in 2013 the effective marginal tax rate on the ordinary income of high-income taxpayers actually is about 41 percent, even before considering the Medicare taxes described in the next paragraphs. The reason is that the American Taxpayer Relief Act also restored the application of section 68, known popularly as Pease, after a former Congressman. While Pease is framed as a limitation on the availability of itemized deductions, in practice it does not work that way.[22] Section 68's disallowance formula is a function of a taxpayer's adjusted gross income, not of his itemized deductions. A taxpayer with income of $1 million subject to Pease (that is, above the relevant threshold) will suffer $30,000 of lost deductions, regardless of whether those deductions pre-Pease are $31,000 or $310,000. Because almost every high-income taxpayer has an irreducible core of itemized deductions greater than 3 percent

[20] As a normative matter, for the reasons developed in the next article in this series there are good reasons to move to a system whereby all businesses are taxed as entities, and where effective tax rate incentives (if any) are addressed to small entities, rather than to unincorporated ones.

[21] The American Taxpayer Relief Act of 2012. See, e.g. Staff of Joint Committee on Taxation, JCX-1-13 (Jan. 1, 2013) for a summary of its terms.

[22] See, e.g., Center on Budget and Policy Priorities, *"Pease" Provision in Fiscal Cliff Deal Doesn't Discourage Charitable Giving and Leaves Room for More Tax Expenditure Reform*, Jan. 29, 2013 (available at http://www.cbpp.org).

of his adjusted gross income, Pease in practice just functions as a marginal tax hike of about 1.2 percent of adjusted gross income.[23]

The new tax environment means that, before considering the new Medicare tax on "net investment income" discussed below, personal capital income going forward might be taxed at 0 percent (capital gains from divestments of small business C corporation stock covered by section 1202[24]), 20 percent (net capital gain, dividends), 41 percent (rents, royalties and interest), or (again) 41 percent (net business income of proprietorships, partnerships and S corporations). In the last case, net business income often comprises an undifferentiated mixture of capital and labor income; but for the Medicare tax on net investment income, there would be no tax reason for preferring one label to another, until the possibility of investing through a C corporation is considered.

5. Medicare Tax on Net Investment Income. Beginning in 2013, section 1411 of the Internal Revenue Code (enacted as part of the 2010 Affordable Care Act) subjects high-income taxpayers to a new 3.8 percent tax on their capital income (technically, "net investment income") above a specified threshold ($250,000 for married couples filing joint returns in 2013). Although described in the heading of Chapter 2A to Subtitle A of the Internal Revenue Code as a "Medicare contribution," in fact the tax will go to the Treasury's general revenues. The analogous tax in the wage or self-employment context is described as "hospital insurance." For convenience, this paper uses the term "Medicare tax" for both capital income Medicare contributions and labor income hospital insurance.

Labor income (whether earned as wages or self-employment income) also is subject to this 3.8 percent Medicare tax above the same threshold; the difference is that the Medicare tax had applied to labor income (more accurately, income explicitly accounted for as labor income) in pre-2013 years, but at a 2.9 percent rate.[25]

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[23] 39.6% statutory rate x 3% of adjusted gross income deduction disallowance.

[24] Victor Fleischer, *Tax Extenders that Slip Under the Radar*, New York Times, Jan. 15, 2013 (http://dealbook.nytimes.com/2013/01/15/tax-extenders-that-slip-under-the-radar/).

[25] Section 1401(b). Following standard public finance analysis, the text treats the employer's portion of payroll taxes as borne by the employee. As noted, section 1401 technically is labeled a "hospital insurance" tax.

The 3.8 percent Medicare tax on net investment income does not apply to the active business income of Subchapter S corporations or firms taxed as partnerships, provided that the owner in question "materially participates" in the business in question.[26] As a result, the partnership or Subchapter S income reported by different owners of the same closely-held firm in the first instance might be subject to the 3.8 percent Medicare tax on net investment income in some cases (those investors who do not materially participate), but not in others (those who do materially participate). The tax does apply, however, to returns on a firm's working capital,[27] and to the business of trading in financial instruments or commodities.[28]

A member of a firm taxed as a partnership who does materially participate in the firm's active business therefore escapes the frying pan of the 3.8 percent tax on net investment income, but is thrown into the fire of the same tax rate, collected now in the guise of the tax on self-employment income.[29] This rule has been criticized as subjecting to self-employment tax an

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Explicit labor income is subject to the 3.8 percent tax either as wages (section 3101) or as self-employment income (section 1401). In the former case, the 1.45 percent "employer's share" is deductible in calculating the employer's taxable income. In the latter case, 1.45 percent is deductible by the self-employed individual. The section 1411 tax on net investment income is not deductible to any extent. The net effect is to reduce the tax burden of the 3.8 percent self-employment tax on an individual subject to the highest marginal rates to an effective rate of about 3.25 percent.

There is some nominal ambiguity in current law with respect to limited liability companies and the like, because Code section 1402(a)(3) provides that self-employment income does not include a "distributive share of any item of income or loss of a *limited partner*, as such . . . ." (Emphasis supplied.) The rule dates to a time when limited liability companies did not exist, and when limited partners lost their limited liability if they performed services for their partnership. Proposed regulations would clarify that the entirety of a limited liability company member's income from such an entity will constitute self-employment income, unless the member performs 500 hours or less of work per year for the entity and has no power to contractually bind the firm. Prop. reg. section 1.1402(a)-2(g) and (h).

[26] Section 1411(c)(4), and (by cross reference) section 469. New proposed regulations give more detail on the application of that standard. REG-130507-11, proposing Treasury regulation sections 1.1411-0 through 1.1411-10 (BNA Daily Tax Report Dec. 3, 2012).

[27] Section 1411(c)(3); Prop. Reg. 1.1411-6.

[28] Section 1411(c)(2)(B).

[29] The taxpayer does enjoy the benefit of deducting 1.45 percent against her income tax liability, which is not true under section 1411.

owner-manager's income that really is a return on capital (as a form of economic rent, for example),[30] but now that capital income is subject to the same tax (other than the small effective rate differential described in the notes), this seems like harmless error.

By contrast, even after 2012 owner-managers of S corporations who "materially participate" in the affairs of their firms retain an extraordinary and inexplicable tax advantage relating to their Medicare tax obligations. This often is described as the "John Edwards gambit," in homage to that former Presidential candidate – although the same strategy apparently has been relied on as well by a more recent Presidential candidate, Newt Gingrich.[31]

The basic idea is to organize one's labor-intensive business (speaking engagements and the sale of autographed books, recordings of lectures, etc., in the case of Mr. Gingrich) as an S corporation, and then to pay oneself as modest a salary as possible. Such an individual's federal *income* tax liability is unaffected by how he allocates the returns on his business between a stated salary paid by the S corporation and a distribution of the S corporation's net (after-salary) income as a dividend to himself: both streams of income flow directly to the individual owner-manager, where they are taxed at identical rates.

For Medicare tax purposes, however, the distinction matters; amounts paid to the owner-manager as "dividends" generally are not subject to any of the social contribution payroll taxes.[32]

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[30] See, e.g., Stephen Looney, Letter to the Editor, Tax Notes, Dec. 17, 2012, p. 1349.

[31] See, e.g., David Cay Johnston, *Newt and the NEWT Act* (describing the avoidance strategy and the Narrowing Exceptions for Withholding Taxes (NEWT) Act introduced by Rep. Pete Stark on February 2, 2012), http://blogs.reuters.com/david-cay-johnston/2012/02/03/newt-and-the-newt-act/; [113th Congress version of NEWT bill]; Shamik Trivedi, *News Analysis: Shades of John Edwards in Gingrich Return,* Tax Notes Today, Jan. 24, 2012. Legislation to address this issue also was introduced in 2010. See Sam Goldfarb, *Critics Attack S Corp Payroll Tax Increase in House Extenders Bill*, Tax Notes Today, June 8, 2010, 2010 TNT 109-2.

John Edwards' use of an S corporation, from which he paid himself a modest salary in relation to the corporation's earnings from his personal services, spawned a large collection of articles and letters in 2004. See, e.g., Kenneth A. Gary, *Edwards's S Corporation Not an Abusive Tax Shelter*, 104 Tax Notes 365 (July 26, 2004); Kip Dellinger, *Edwards's S Corp Can Be Abusive Even If It's Not a Tax Shelter*, 104 Tax Notes 1092 (Sept. 6, 2004); Tom Daley, *Edwards's S Corporation, Medicare Tax, and Fair Share*, 104 Tax Notes 1577 (Sept. 27, 2004); Kip Dellinger, *Edwards's S Corp: The Beat Goes On*, 105 Tax Notes 253 (Oct. 11, 2004).

[32] Revenue Ruling 59-221, 1959-2 C.B. xx. Koski, "The Application of Employment Taxes to S Corporation Shareholders—What Is 'Unreasonably Low' Compensation?" 85 *Taxes* 19 (2007).

Yet at the same time, the income remains exempt from new section 1411's tax on net investment income, because it is income derived from an active trade or business by an owner who materially participates in that business. S corporation owner-managers dance through the flames, while all others find themselves roasting in the frying pan or the fire.

The only safeguard that current law offers for policing the 3.8 percent Medicare tax on owner-managers of S corporations is the largely undeveloped notion that net business profits of an S corporation may be recharacterized as wages in those cases where the firm pays inadequate compensation. This safeguard is discussed in Section IV, below.

The ability of an S corporation's owner-manager to avoid the self-employment payroll taxes that apply to an-otherwise comparable partner is an important factor in explaining why S corporations continue to increase in popularity as a form of business organization.[33] This bizarre tax discount for S corporations had been explained as an historic anomaly, but that claim is more difficult given the attention it has received over the last decade, and the fact that section 1411 is a brand new statute.

Notwithstanding the recent minting of section 1411, this paper takes the view that the John Edwards gambit will not continue indefinitely. The result is simply too preposterous, and the revenue needs of the government too large, for this loophole to survive in perpetuity. For convenience, therefore, the tax rates assumed in the remainder of this paper ignore the new Medicare tax on certain net investment income (as well as the preexisting tax on explicit labor income); its inclusion would change the arithmetic but not the general thrust of the analysis.

New section 1411 and the Medicare tax on labor income interact with the corporate income tax in two respects. First, using the hypothetical tax rate environment set out earlier in this section, the structure of the Medicare tax favors a taxpayer's use of a C corporation,

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[33] Treasury (2007) at Table 3.2. In virtually every other respect, the limited liability company is a superior form in which to conduct business. For example, in the case of a limited liability company, and in contrast to the rules governing S corporations, there are no limits (short of becoming publicly-traded) on the number of the limited liability company's members, or on the identity of the members as individuals or other entities, there are no restrictions on the complexity of the capital structure of the entity, and complex partnership-style income allocations are possible. Yet the Treasury data cited above demonstrate that substantially more businesses (by number of businesses) are organized as S corporations than as partnerships and limited liability companies.

combined with the same John Edwards gambit described above in respect of S corporations, to convert labor income to corporate income, even if the owner-manager then extracts the resulting after-tax income on a current basis through dividends. The reason is that the Medicare tax does not apply to the fraction of a C corporation's pretax earnings paid in corporate income tax. By using the John Edwards gambit in this context, an owner-manager might reduce her Medicare tax bill on her labor income by one percentage point. [34] The same result is achieved more directly in respect of a C corporation's capital income, because the amount includible as net investment income under section 1411 is the income received by an individual shareholder, not the pretax income of the corporation from which dividends are paid. Further, it is possible to imagine that the John Edwards strategem will be foreclosed in the S corporation context without necessarily imposing a compensatory tax on the portion of C corporation pretax income that goes to pay corporate income tax. In this sense, one can interpret the interaction of the suite of Medicare taxes with the corporate income taxes as amounting to a potential effective corporate income tax rate cut of approximately one percent, relative to the statutory rate.

Second, in the tax rate environment hypothesized in this paper there is a the time value of money benefit of leaving capital in a C corporation (where returns on that capital are not subject to the 3.8 Medicare tax in any form) and then extracting the returns thereon at a later date, through, for example, a dividend: the returns compound at a higher after-tax rate inside the firm than they would if held directly.[35] This is simply another instance of the larger theme of capital stuffing developed at length in Section II. Given that the tax rates that the paper assumes are themselves completely hypothetical, and in light of the relatively small time value of money

[34] Because the Medicare tax does not apply to the fraction of corporate pretax earnings paid in corporate income tax, if that corporate tax rate is 25 percent, then 3.8 percent of 25 percent of pretax corporate earnings, or roughly 1 percent, escapes Medicare taxes. Pre-2013 law included a larger Medicare tax advantage for this strategy, but that was dominated by the dividend/capital gain tax cost of extracting those earnings.

[35] Ignoring differences between individual and corporate tax rates, the difference is between earning a stream of, say $100/year inside the firm (after corporate tax), and then paying a 3.8% tax on the accumulated sum when extracted, or earning $96.20/year outside the firm. As the next section of the paper demonstrates, this difference (again, assuming identical income tax rates, which is not the case) boils down to earning a tax-free return on the compounding of each year's $3.80 in deferred tax for the period of the deferral. As in the first interaction described in the text, this amounts to about a 1 percent effective tax rate advantage (relative to the $100/year) on the returns to this stream of $3.80/year.

advantage to deferring a 3.8 percent tax by itself, I think it makes the presentation clearer simply to ignore this point for the remainder of the paper.

My assertion that the John Edwards stratagem will not survive corporate tax reform, and the relatively small magnitude of the two interactions between Medicare taxes and the corporate income tax described immediately above, permit me effectively to ignore the 3.8 percent Medicare tax for the remainder of this paper, for four reasons. First, the tax applies to any withdrawal of corporate earnings, whether as wages, dividends or capital gains. Second, as reformed in my imagination, the tax will apply equally to all noncorporate business earnings (through the wage tax, self-employment tax or tax on net investment income[36]). Third, even under current law the 3.8 percent tax cannot be avoided in respect of investment income or returns to working capital of an S corporation. Finally, the Medicare tax does not change the fact that dividends and capital gains continue to be taxed at the same rate. The first two points mean that the sum of corporate earnings and the dividend tax cost to extract them bear roughly the same relationship to wage income whether the tax is included or not (so long as it is treated symmetrically in comparing labor and capital income tax burdens),[37] and the third point means that the relationship between dividend and capital gain tax rates (what the paper later defines as the toll charge rate-pair identity) is unaffected by Medicare taxes, because those will apply to the entirety of the labor or investment income of an individual, when recognized.

6. Exit Taxes. This paper explores the time value of money advantages to an owner-manager of using a C corporation for capital or labor stuffing in the new tax rate ecosystem that it hypothesizes. The novel confluence of the tax rates hypothesized here means that these advantages *for the first time* will inhere to an owner-manager who retains control of a C corporation while extracting investment returns from capital invested by that firm by means of a dividend. But to complete the analysis, the paper also considers the tax consequences of capturing the benefits of capital or labor stuffing in connection with the sale of the owner-manager's business. To do so, the paper must make some assumptions about the comparative advantages of "cashing out" of an unincorporated business enterprise (e.g. a partnership), on the

[36] This ignores the 0.55% effective rate preference for wages and self-employment income, due to their partial deductibility for income tax purposes. See note 10, supra.

[37] This of course ignores the two interactions described in the text above.

one hand, and a corporation, on the other. This is in turn boils down to two lines of inquiry: the seller's tax costs, and the buyer's tax basis in the acquired assets.

For our purposes, it is fair to assume that an individual cash seller of any form of business will derive net capital gain on that date, taxed at a 20 percent rate.[38] There are of course many possible exceptions to this proposition – for example, the treatment of the "unrealized receivables" of a partnership,[39] or the use of non-realization exit strategies (such as an initial public offering of stock of a corporation through a primary offering, followed by monetization of the founder's stock through borrowing against her investment), but this assumption enables a straightforward inquiry into the general incentives for capital and labor income stuffing.

The more difficult question is how to weigh the possibility that buyers will pay more for an unincorporated business entity than for stock of a C corporation, because the buyer in the former case gets a costless "step-up" in tax basis to the buyer's purchase price, and the purchaser of corporate stock does not.[40] The issue is not usually terribly important in respect of financial investments held by a firm, unless one imagines the case of a firm that has hit a "home run" investment, the gains on which have not been realized. The more common fact pattern comprises goodwill or similar intangibles created by an owner-manager. Those intangibles typically have a zero basis in the hands of the seller, but any purchase price attributable thereto can be amortized over 15 years by an acquirer that actually or constructively purchases the firm's assets.[41] The value of this tax basis step-up depends on the marginal buyer's tax rate and prevailing interest rates; the portion of that paid to the seller in turn depends on the underbidder's reserve price and

[38] For the reasons described in Section I.A., this assumption ignores the zero percent tax rate available today on sales of certain small business C corporation stock. The intuition here is not that this provision is unimportant, but that it is likely to be repealed in the quest for a revenue neutral business tax reform package that brings the corporate tax rate down to 25 percent.

[39] Section 751.

[40] The text of course assumes that the sellers are individuals, so that section 338(h)(10) is unavailable.

[41] Section 197.

the negotiating skills of the parties.[42] And of course the added sales price is itself taxable to the seller as additional net capital gain.

Recognizing that this simplifying assumption is less defensible than those that have preceded it, the paper ignores these sorts of potential valuation differences. Buyers and sellers alike simply have too many potentially relevant characteristics, and the forms that an exit might take are simply too varied, to do anything else. For example, an IPO, one of the most common forms of cash-outs, ordinarily does not entail a basis step-up; alternatively, acquisitions sometimes are structured as joint ventures.[43] Moreover, to take a potential buyer's valuation of any step-up into account would require making assumptions about the target exit date from the firm; this might be feasible when considering a private equity fund's ownership of a company, but is less so when hypothesizing a family business. Finally, the fundamental thrust of inquiry of this paper is the marginal incentive to stuff capital or labor into a C corporation; as such, it is impossible to know in advance how big a goodwill dog is wagging this tail.

In fairness, however, it must be recognized that the noncorporate form of organization almost never leads to a tax disadvantage at the time of an owner-manager's exit, and often can result in the extraction of a higher sales price. This fact cuts against the grain of the arguments developed below.

C. Implications.

In the 2003-2012 period the taxation of capital income relied on two important identities and one relative difference. First, individual and corporate tax rates were identical (the "income tax rate-pair identity"). (This identity of course actually predated 2003.) Second, net capital gain from the sale of stock and dividends were taxed at the same rate (the "toll charge rate-pair identity"). Third, the absolute level of that toll charge was quite low. While we have experience with the former identity holding when the latter did not (for example, the 1993 – 2003 period),

[42] By way of an example, for a corporate buyer taxed at 25 percent, the value of a $100 step-up in the basis of purchased goodwill is $25, amortized over 15 years (that is, $1.67/year). In turn, if one assumes an annual after-tax interest rate of 5 percent, the present value of that 15-year annuity is a little over $17. How that $17 in turn is shared between buyer and seller is another question. These numbers also ignore the fact that any additional purchase price in turn yields more amortizable tax basis.

[43] But see "busted" section 351 deals, and Victor Fleischer and Nancy Staudt, The Supercharged IPO (cite). The extensibility of this second strategy to firms outside the investment business depends in part on the application of the publicly-traded partnership rules of section 7704.

the post-2012 rate environment marks the first time (at least in living memory) where the toll charge rate-pair identity and that toll charge's relatively low rate both hold, but the income rate-pair identity does not. Looking further ahead to the hypothesized rate environment, the income rate-pair disparity will grow materially.

The combination of a corporate tax rate of 25 percent and a dividend/capital gains tax rate of 20 percent would produce an "all-in" tax burden of 40 percent on corporate income, *if* currently distributed . Hence, unlike current law, a new identity would hold – that between currently-distributed corporate earnings (i.e., post-toll charge earnings) and labor income. This fact makes this particular combination of rates particularly interesting to use as a hypothetical, because, as previously noted, this regime will mark the first time in the modern history of the Internal Revenue Code where the advantages of capital and labor stuffing will inhere to an owner-manager who retains control of a C corporation while extracting investment returns from capital invested by that firm.

If legislation were enacted along these general lines, the result would be a material change in the relative tax burdens imposed on some of the major classes of capital income. The personal income tax rate on interest income – the paradigmatic form of capital income, in that returns are directly proportionate to capital invested, and returns ordinarily reflect neither economic rents nor embedded personal services – would now amount to 40 percent (actually higher, if Pease and section 1411 are considered). So, too, would the tax rate on noncorporate business profits. As a result, the tax rate on partnership or S corporation net income would increase; moreover, an owner-manager of such an enterprise could not mitigate that rate through paying herself a higher salary.

The profits of a "C" corporation, by contrast, would enjoy a material decline in marginal statutory tax rates, although the effective tax burden conceivably could stay roughly constant or even increase, depending on the success of correlative base broadening measures. And dividend income and capital gains, while taxed at materially higher rates than in the 2003-2012 period (20 percent rather than 15 percent) still would enjoy parity with each other, and a significant rate advantage when compared to other forms of capital income.

Of all these trends, the most interesting would be the sudden gap between corporate and noncorporate capital income tax rates.[44] One obvious reaction to such a development might be to incorporate existing noncorporate businesses; following the lead of existing S corporation payroll tax planning (described above), owner-managers of such C corporations then would then pay themselves as modest a salary as their consciences and current consumption requirements permitted.

As already noted, the combination of a corporate tax rate of 25 percent and a dividend/capital gains tax rate of 20 percent produces an "all-in" tax burden of 40 percent on currently-distributed corporate income. As a result, an owner-manager would be no worse off by extracting enterprise earnings as current dividends paid from a C corporation than she would be if she extracted those earnings as salary or self-employment income[45] – or for that matter as interest income. The "double tax" on corporate earnings would have lost its sting.

In fact, far from being worse off or indifferent, the owner-manager in this environment would actually find that she could enhance her after-tax investment returns by investing capital through the corporate form, through retained corporate capital income, through injections of new capital (although this always will be somewhat disadvantaged, for reasons developed below), or through labor stuffing. Section II, below, quantifies the potential benefits that could be derived from capital stuffing in more detail. Section III then extends that analysis to labor stuffing.

It is important to emphasize that the tax rate ecosystem contemplated by this paper arguably will be *more* hospitable to capital and labor income stuffing than was true at any other point in the modern history of the Internal Revenue Code. The reason relates to the continued post-2012 toll charge rate-pair identity – the parity of dividend and capital gain tax rates,

[44] This also is the focus of Halperin, *Mitigating the Potential Inequity of Reducing Corporate Rates*, 126 Tax Notes 641 (Feb. 1, 2010).

[45] As described in the preceding subsection, an owner-manager of an S corporation (but not a C corporation) actually can come out ahead under this approach, by virtue of the strategy's payroll tax avoidance aspects – at least until the law comes to its senses.

introduced in 2003 – and the relatively low absolute rate of that toll charge.[46] Section II amplifies this point as well.

The advantage of using a C corporation in the tax rate environment hypothesized above would extend not simply to returns to capital, but also to returns to labor, if those returns could be characterized for tax purposes as income of the corporate vehicle. This possibility would appear to go beyond any justification for lower corporate tax rates; instead, it would mean that some forms of labor income (labor income of the owner-manager) would be taxed at lower rates than other labor income, because the former class, but not the latter, effectively could be described for tax purposes as returns to capital rather than returns to labor.

[46] Retained earnings also enable a C corporation's owner to defer the new 3.8 percent Medicare tax on net investment income.

II. CAPITAL STUFFING.

A. In General.

The corporate tax rate and individual rates on interest income, dividend income and capital gains interact in complex ways to favor or disfavor the corporation as an investment vehicle, and to favor or disfavor different mechanisms for extracting corporate earnings. The first calculus in particular relates to the phenomenon of what this paper refers to as capital stuffing: the deliberate use of the corporation as a tax-preferred vehicle to earn investment returns.

The second calculus describes the phenomenon of "lock-in," which refers to the economic inefficiencies that arise when the owner of a capital investment (most characteristically, a shareholder) in a tax-free environment would prefer to divest some or all of an investment, but instead is induced to retain the investment in order to minimize her tax liabilities (and thereby improve her after-tax returns).[47] Lock-in is a function of the realization system, and is made worse by an increase in capital gains rates.[48]

Consider an individual confronted under 2003-2012 law with the choice of making a marginal investment (i.e., one earning normal returns, taxed at ordinary income rates) directly in his own name or indirectly through a C corporation. Logically, the investor would choose the former. In both cases, the return on the investment would be taxed at the same 35 percent rate, but in the second case the investor would face an additional "toll charge" of 15 percent when he sought to consume or redeploy his earnings, in the form of a dividend or capital gains tax.

In other words, if pre-tax investment opportunities are identical inside and outside the corporation, then the after-tax rate of return inside a corporation on an investment will be the same as investing that cash outside the corporation, but the corporate investment will bear a second quasi-excise tax at some point in time. This explains why in the 2003-2012 tax rate

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[47] Encyclopedia of Tax Policy (capital gains heading).

[48] Alan J. Auerbach, *Capital Gains Taxation in the United States: Realizations, Revenue, and Rhetoric,* 1988 Brookings Papers on Economic Activity 595 (1988)

environment fiscally transparent business organizations (S corporations or partnerships) were superior forms for investing new equity into a business than is the traditional C corporation.[49]

Now, however, consider the hypothetical new world of a 40 percent individual tax rate and a 25 percent corporate tax rate. A toll charge (now at 20 percent) will still apply when earnings are extracted from corporate solution. Nonetheless, by virtue of the fortuitous fact that under this tax rate combination corporate earnings, if currently distributed, bear the same post-toll charge aggregate tax as do earnings taxed at the full individual rate (that is, (0.8 x 0.75) = 0.6), the investor is never worse off retaining corporate after-tax capital income.[50] Moreover, it turns out that the investor is better off the longer he leaves his money in the corporation, because those earnings will compound at a higher after-tax yield inside the corporation than they will outside the corporation. That higher after-tax yield on the corporation's original earnings – the higher after-tax interest on interest – is the net benefit to capital stuffing under these tax rate assumptions. And of course, to the extent that the individual-corporate tax rate pair diverges still more, the advantages of capital stuffing increase.

The three examples that follow explain this conclusion in the context of a simple model of investment and dividends. All these examples involve a C corporation with surplus earnings, and consider the timing choice for when to withdraw money from the corporation through a dividend. For this purpose, under both current law and the future tax rate environment hypothesized in this paper, a liquidation or sale at the end of the relevant time horizon functions the same as a dividend, because the tax rates on dividends and capital gains are identical, and because basis is recovered at the same point in time – the terminal date of the investment.

The analysis changes somewhat if the question confronting an owner-manager is to invest new capital into the firm, to be invested there. Midstream sales of part of the investment or other

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[49] The existence of the John Edwards gambit to eliminate Medicare tax on the labor income of an owner-manager applied to the owner-manager of a C corporation as well as an S corporation, but at the prohibitive cost of an additional 15 percent toll charge. In practice therefore this also counseled in favor of S corporation status, in preference not only to a C corporation but also to entities taxed as partnerships.

[50] In fact, as suggested in Subsection I.B.4., the investor is better off to the extent of a roughly 1 percent tax rate differential, because the portion of capital income paid in corporate income tax is not subject to the new 3.8 percent Medicare tax on certain net investment income.

The calculus for stuffing new money into a corporation is somewhat different. See text at note __, infra.

basis recovery techniques also have a different analysis, described in the next subsection. So, too, the analysis contained in this subsection would change if capital gain and dividend tax rates were to diverge. Subsections B and C extend the discussion to deal with these cases.

In attempting to quantify the benefits of capital stuffing, it is helpful to begin with an example that shows that there is no advantage to how one times the *distribution* of corporate income to an individual shareholder when personal investment tax rates and tax rates inside the corporation are the same (that is, the income tax rate-pair identity holds). The first two examples therefore use the 2003-2012 tax rate environment.

> Example 1. Shareholder, an individual, owns 100 percent of newly-incorporated Corporation A, in which she invests $1000. The rate environment is the 2003-2012 environment (35 percent corporate and individual rates, 15 percent dividend and capital gains rates). Corporation A earns 10 percent pretax on its assets.
>
> Shareholder takes out the after-tax earnings as dividends and reinvests those amounts at 10 percent pretax in her own name. This means that she takes $55.25 in after-toll charge dividends and invests them personally at 6.5 percent interest (after tax). After five years her total investment is $1314.58.
>
> Conversely, if Shareholder simply leaves Corporation A's returns in the company, after five years Corporation A will grow in value to $1370.09. Shareholder pays dividend tax on the liquidation of Corporation A (limited to Corporation A's earnings of $370.09) – or, if you prefer, capital gains tax on her profit of $370.09 – of $55.51. Shareholder is left with $1314.58 – the same as the first case.

There is no magic here: it must be the case that, where (i) dividends and capital gains are taxed at the same rate (toll charge rate-pair identity holds, as was true in 2003-2012), (ii) individual and corporate after-tax returns are the same (as was true in 2003-2012), and (iii) the toll charge on extracting corporate earnings through a dividend distribution is inevitable, there is no advantage to retaining earnings inside the corporation and deferring the realization of taxes on the distribution of those earnings. In each case the rate on current returns remains the same inside and outside the corporation. Moreover, the dividend distribution tax (including a capital gains tax on liquidation of the firm) functions as a quasi-excise tax: it simply reduces the investor's pile of after-tax earnings by the same percentage, regardless of when collected, and therefore does not affect the rate of return on the investment.[51]

[51] Alvin Warren, *The Timing of Taxes*, 39 Nat'l Tax J. 499, 501 (1986).

In algebraic terms, the commutative principle governs. Label the dividend tax rate as D_T and the post-income tax return on investment as R, whether earned by directly by Shareholder or Corporation A. Then for every $1 of post corporate tax income:

$$[\$1 \text{ x } (1 - D_T)] \text{ x } (1 + R)^n = [\$1 \text{ x } (1 + R)^n] \text{ x } (1 - D_T).$$

This is the key insight of the "New View" of dividend taxation. Taxing dividends paid in respect of capital already "trapped" inside the corporation does not change the timing of those dividends.

For example, at the end of Year 1, Corporation A will have earned $65. If it distributes that amount immediately as a dividend, a $9.75 toll charge is paid by Shareholder; Shareholder receives $55.25, and can invest that sum at a 6.5 percent return. Imagine instead that Corporation A earmarks that $9.75 as an inchoate liability for Shareholder's toll charge attributable to Year 1's income.[52] If Corporation A retains its Year 1 earnings for a later dividend, then all $65 – that is, both the $55.25 that Shareholder could have obtained immediately, and the $9.75 that Shareholder would have been paid as a toll charge – will grow inside the corporation at the same 6.5 percent rate. The absolute amount of the future post-toll charge distribution increases, as does the size of the future toll charge liability, but so too does the pot of money that Corporation A has notionally earmarked on Shareholder's behalf to pay that toll charge – and all increase at exactly the same rate of interest.

The same analysis applies to an investor puzzling over what to do with previously-accumulated earnings, as the next example shows.

> <u>Example 2.</u> Shareholder (an individual) owns 100 percent of Corporation Z for which he paid $800; Corporation Z has since accumulated $200 in retained earnings, and is worth $1000 today. The tax rate environment is 2003-2012 law.
>
> If Shareholder decides to extract his $200 in retained earnings today, he will pay a dividend toll charge of $30. If he then invests the remaining $170 in a personal investment, it will grow at a 6.5 percent yield to $232.91 after five years.

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[52] The text for convenience hereinafter typically describes the toll charge as if it were paid by the corporation, but of course in fact the toll charge is payable by the shareholder. This might suggest that the examples are incorrect, in forgetting that the distribution of the notional toll charge set-aside is itself subject to the toll charge, but this is reflected in the amount set aside in the first instance. That is, in the examples in the text to which this note relates, the set-aside is not 15 percent of the cash notionally viewed as the Shareholder's portion ($55.25), but 15 percent of the entire amount available for distribution ($65.00).

Following the upfront dividend, Corporation Z still has $800 in assets. That $800 will grow inside the corporation to $1096.07 after the same five years, at the same 6.5 percent yield. If Shareholder then liquidates the company, he will recognize $296.07 in gain, on which he will pay $44.41 in tax, leaving him with $1051.66 of net liquidation proceeds. That amount, together with the balance of $232.91 in his personal account, totals $1284.57.

If, on the other hand, Shareholder had refrained from taking out a dividend at the outset, the corporation's $1000 in assets would grow to $1370.09 after five years. After paying tax on his liquidation gain ($85.51 of tax on $570.09 of gain), the owner is left with the same $1284.57.

In other words, the $200 of earnings with which the example begins already bear an inchoate but unavoidable tax cost of $30. Imagine for a moment that one puts that $30 in a separate subaccount. One can pay the $30 toll charge now (by distributing the $200), or pay a larger toll charge later, but the timing of distributions will not affect the after-tax returns to the remaining $170. While the ultimate toll charge liability will grow from $30 at a rate of 6.5 percent (compounded), so too will the $30 in cash one notionally has set aside to pay that tax. Regardless of the timing of distributions, Shareholder will earn the same net return on the $170, and Shareholder *already* is notionally out of pocket the $30. (Again, this is the insight on which the "New View" of dividends is based.)

The next example shifts the analysis to the new rate environment hypothesized in this paper. It shows how lower tax rates inside the corporation create an advantage to capital stuffing – that is, reinvesting inside the corporation. The example then leads naturally into a general explanation of the quantification of that benefit.

Example 3: As in Example 1, Shareholder owns 100 percent of a newly-formed corporation, into which he invests $1000. Assume the new tax rate environment described earlier in the text, and that pre-tax interest rates are 10 percent.

Does it matter to Shareholder if he takes his after-tax profits out as current dividends, and reinvests those amounts for 10 years personally, or instead leaves the returns in the company for 10 years? In Example 1's world, the answer was no; here, though, the answer becomes yes.

In the new tax rate environment, if Shareholder never formed a corporation, and just invests $1000 directly, his after-tax yield is 6 percent. After 10 years, that investment would grow to $1790.80.

Instead Shareholder put the $1000 into a corporation. In the absence of any special rule, the $1000 investment will face an intra-corporate 25 percent tax rate, not the individual rate of 40 percent. As a result, the intra-corporate after-tax yield will be 7.5 percent, not 6 percent.

> If Shareholder extracts his corporate earnings each year (for example, as a dividend) and reinvests that amount personally, his "all-in" after-tax yield drops back to 6 percent (7.5 percent less the 20 percent toll charge), and the corporate form would offer no tax shelter for this marginal capital investment.
>
> If, however, Shareholder leaves the earnings in corporate solution, then an advantage does emerge. At the end of 10 years, the corporation will have accumulated a total of $2061.00. The owner-manager could then extract the $2061.00 at a cost of $212.20 ($1061.00 of gain or dividend x 20 percent) and have $1848.80 left after the toll charge – a superior result to the direct investment, to the extent of $58.00.

To what exactly is the $58 superior result attributable? It turns out that the owner's advantage is not in respect of the after-tax base earnings on the $1000 (6 percent after all taxes in each case, or $60/year), but rather in respect of the earnings on those earnings.[53]

One straightforward way to understand the bond mathematics here is to ignore the corporate form for a moment, and instead to visualize the owner-manager with $1000 invested through his corporation as in the same position as if he had an IRA account with an opening balance of $1000 that earned 7.5 percent interest, but as to which there was a 20 percent toll charge for withdrawing money. The taxpayer could notionally set aside in a subaccount within the IRA each year that 20 percent toll charge in respect of his $75/year return on his original $1000. Under our hypothetical, this means that he would set aside $15/year to fund the toll charge subaccount. The amount in his main IRA account (now $60 at the end of Year 1), and with it the owner's ultimate toll charge liability, would continue to compound at a rate of 7.5 percent, but so too would the prefunded amount in his toll charge subaccount. As a result, the prefunded toll charge subaccount would always keep pace with the owner's future toll charge liability.

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[53] The next several paragraphs expand on a mode of presentation first developed in a pamphlet prepared by the Staff of the Joint Committee on Taxation, titled "Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests and Related Issues, Part II," September 4, 2007 (JCX-63-07), at 6-7. As that pamphlet explains, the case considered here, the time value of deferring compensation income, and many other time value of money inquiries can all be understood by applying this same methodology of visualizing a prefunding of the flat-rate toll charge, whether denominated a dividend tax, a capital gains tax, or an income tax payable only at some future date.

For a somewhat similar explanation that reaches the same conclusion, see Daniel Halperin, *Mitigating the Potential Inequity of Reducing Corporate Rates*, 126 Tax Notes 641 (Feb. 1, 2010) and Daniel Halperin, *Rethinking the Advantage of Tax Deferral*, 62 Tax Lawyer 535 (2009).

What all this means, then, is that the owner has suffered a 20 percent cost on his yield on his original $1000 investment – his return on that $1000 is 6 percent ($60/year) after he prefunds the toll charge, *not* 7.5 percent ($75) – but he enjoys a *7.5 percent* return on the amounts deposited each year into his main IRA account ($60 each year) for however long he maintains the account. In other words, by using the notional IRA account (or, to return to the actual hypothetical, the corporate form) for 10 years, the owner effectively earns the *pre-toll charge* rate of compounding on the *after-toll charge* simple interest on his original investment.

The owner conceptually is depositing $60/year into a 10-year savings account that earns 7.5 percent interest. By contrast, if the owner had invested in his own capacity, that $60/year savings account would earn only 6 percent interest. The difference between the two hypothetical savings accounts compounded for 10 years is $58, the difference that we earlier saw between a 10-year individual investment and a 10-year corporate investment, followed by the extraction of the investment from corporate solution.

This, then, is the advantage of capital stuffing: it enables an individual to earn the pre-toll charge (but post-corporate tax) rate of return on his after-toll charge simple return on his original corporate investment. (The end of the next subsection extends the analysis to the injection of *new* investment funds into a corporation.) And of course, the longer the individual's time horizon, the more dramatic this difference becomes.

The retention of earnings inside the corporation also would preserve for the owner-manager a free option: the option to capitalize on any future reduction in capital gain/dividend rates imposed on shareholders. (Since Congress's deliberations are relatively transparent, and since Congress has demonstrated a consistent distaste for retroactive tax increases, the risk of the opposite result – an unanticipated increase in shareholder-level taxes – would appear to be remote.) Finally, if the owner-manager were patient enough to rely on the tax-free step-up in stock basis at death, the shareholder-level tax on extracting corporate earnings would disappear entirely. For all these reasons, therefore, in the tax rate environment hypothesized above, well-advised owner-managers would find a taxable corporation to be a superior vehicle for conducting business operations, compared with using a pass-through entity.

B. Disinvestment and Basis Recovery Strategies.

Examples 1 and 2 both were based on the 2003-2012 tax rate environment. Where the income tax rate-pair identity holds (as was true in that period), and there is any toll charge on extracting corporate earnings, there is no positive value to capital stuffing; in fact, there is a substantial cost associated with it. In an environment where after-tax rates are the same inside and outside the corporation, it *always* pays to take one's money out of corporate solution as soon as possible, not for abstruse reasons of the tax burden on earnings on earnings, but rather simply to avoid accumulating any future inchoate toll charges on the annual return to the investor's principal.

For example, viewed at the outset, the decision of the Shareholder in Example 2 to leave *any* portion of his original investment in corporate solution would be illogical, because the timing of the crystallization of his tax liability in respect of the $200 in existing retained earnings would not change the present value of that liability ($30, at the outset of our example), and because he always would be better off earning 6.5 percent on his $800 of principal without the burden of any further dividend/capital gains toll charge, rather than earning the same 6.5 percent, less the friction of that toll charge.

> Example 4. Continuing where Example 2 left off, Shareholder simply liquidates the company at the outset. In this case, Shareholder would have $970 in after tax proceeds. That would grow in five years to $1,328.98. The difference in aggregate returns between this sum and the first case (where Shareholder extracted his $200 in earnings immediately but left his principal of $800 in the corporation) is $44.41, which of course is the toll charge imposed at the end of five years on the owner's earnings on the $800 that he left in corporate solution in the first case.
>
> For the same reason, if Shareholder for some reason wanted to take out just $200 today, he might consider doing so by selling 1/5 of his stock, rather than by paying himself a dividend, simply because in the former transaction he would effectively recover immediately $160 of his principal (that is, his basis in the shares he sold), and thereby eliminate future toll charges on the investment of the $160. He would have to weigh against this the opportunity cost of reducing his continuing interest in the firm.

That is, under an environment like that of 2003-2012 law, where after-tax investment rates of return are the same inside and outside the corporation, it always pays to take one's money out of corporate solution as soon as possible, not for abstruse reasons of the tax burden on earnings on earnings, but rather simply to avoid accumulating any future inchoate toll charges on the annual return to the investor's principal.

Ironically, what this also means is that during the 2003-2012 period, if an investor in corporate stock were confronted by a corporate investment whose after-corporate tax but pre-toll charge returns were unsatisfactory compared to what the investor could obtain, for example, in a direct investment, the investor would have been better off selling the stock immediately and reinvesting outside the corporate sector. In this case there is a tax-induced incentive to sell immediately, not a lock-in effect of the sort described in the next subsection.

The case described above can be seen as a special case of the utility of basis recovery. Once the decision to realize some but not all of an investment is made, it is beneficial to do so in a way that minimizes current income through recovering basis. By doing so, the investor maximizes her total investment during the entire investment horizon, to the extent the current return of basis gives the taxpayer the use of more money for the entire investment horizon.

That is, when and if a taxpayer wishes to extract earnings from a corporate investment, it is desirable to do so, whatever the tax rates, through a capital gain transaction, because doing so essentially is the opposite of a lock-in problem, as described in the next Subsection. By applying basis to reduce temporarily what otherwise would be taxable income on corporate distributions, the taxpayer obtains an advantage.[54] The advantage is temporary, in that the accelerated use of basis must be accounted for, but the taxpayer has the use of the tax saved for the term of the investment. Just as in the lock-in case when applied to a marginal investment the taxpayer has to prepay taxes already provided for him, so in the basis recovery case the taxpayer is reducing tax that otherwise would be currently owed through a simple distribution.

New money invested into a firm can lead to the mirror image result. In the hypothesized new tax rate environment, a rational owner-manager would leave surplus corporate earnings in the corporation, for all the reasons developed in Section II.A. But would the rational owner-manager invest *new* money into the corporation to take advantage of the corporation's higher after-tax returns? Here the answer is a bit more complex.

If the assumption is that the owner-manager will in the future extract the returns on that new investment, but not the original investment itself, then the answer is in the affirmative; that

[54] The text obviously discounts the possibility of a world in which dividends are taxed at lower rates than capital gains on the sale of stock.

is the same case as that already covered in Section II.A. In other words, the income tax rate differential dominates the "New View" conclusion that new capital bears an incremental dividend tax; here the choice becomes earning a 7.5 percent compounded return on the investment's returns, followed by a one time 20 percent toll charge in the future,[55] compared with earning 6.0 percent compounded return on the same amount if the funds are not contributed. The former dominates the latter

On the other hand, if the owner-manager intends to withdraw at some point in the foreseeable future the new principal injected into the corporation (not just the returns thereon), the owner-manager could by doing so artificially create an adverse timing issue. The owner-manager would obtain incremental tax basis in the stock of the corporation, but if there are sufficient current or accumulated corporate earnings and profits to support characterizing the extraction of the incremental amount as a dividend, then the withdrawal of the extra capital injected into the corporation would attract a toll charge, ultimately offset by a reduced capital gain (or increased loss) on disposition of the stock.[56] As a result, the answer will depend on the value of the higher rate of return obtainable on corporate investments, minus the net cost of an artificial toll charge (i.e., the time value of money loss from creating income in one year and an offsetting loss in some future year).

C. Corporate Lock-In.

Economists rightly are troubled by the phenomenon of "lock-in," in which a taxpayer holds onto a suboptimal investment to improve his after-tax yield on the investment by deferring a realization event. Lock-in is a property of the realization principle, and therefore is directly tied to capital gain tax rates. Although the term ordinarily is applied from an investor's perspective, in the context of corporate stock it might also usefully be extended to include a corporation's aiding and abetting of the investor's tax planning, by the corporation retaining earnings to mitigate the effects of dividend taxation on investors in tax rate environments where dividends

[55] Again, the 20 percent toll charge reduces simple returns to 6.0 percent, but the difference is that the compounding is at the toll-charge free rate of 7.5 percent.

[56] Section 1014's tax-free step-up of basis on death should not be relevant here, because the injection of cash should increase tax basis and value pro tanto; thus, section 1014 ought not to convey any incremental benefit.

are taxed at higher rates than are capital gains. In each case, investment decisions are distorted relative to what they would be in a world without tax through the tax-induced deferral of gain recognition.

Outside the context of sales of corporate stock, distortions attendant on lock-in may in practice be mitigated or completely offset by conversion opportunities. For example, if an investor holds a Treasury bond bought at par more than one year ago, and interest rates sharply decline, the investor will earn unrealized income, because the value of the bond will increase. The investor can hold the bond and continue to receive ordinary interest income, albeit at higher than current market rates. Alternatively, she can sell the bond, and in doing so accelerate the present value of her greater than market rate future interest coupons into the current year (the lock-in dilemma), but at the same time reduce the tax liability on that amount to the 20 percent rate on net capital gain (the conversion opportunity). In many cases the latter will dominate the former.

The issue of corporate lock-in is related to the problem of capital stuffing, in that each encourages an investor to retain a corporate investment, but the two ultimately are different phenomena. The earlier discussion of capital stuffing in a rate environment conforming to this paper's basic hypothetical fact pattern demonstrated that the longer a marginal investment was retained in corporate solution, the bigger the advantage to capital stuffing. That advantage stems from the fact that, for a given investment, an investor can earn the post-corporate tax rate of return (rather than the individual post-tax rate of return) on the after-toll charge simple annual return to his investment, so long as the investment remains in corporate solution.

By contrast, lock-in arises because a sale of stock at a gain diminishes the investor's total investment by the amount of the tax the investor must pay the government. The tax paid "early" through a midstream sale in turn leads to a step-up in tax basis for the replacement asset, which reduces the investor's tax liability at the back end of her investment, but the investor loses for the remaining term of the investment any return on the amount paid as tax by virtue of the midstream sale.

The analytical framework developed for capital stuffing (the "prefunded" toll charge metaphor) therefore does not apply without further analysis, because in fact there is no prefunding of the midstream capital gains tax liability. The paper's prefunded toll charge

metaphor essentially applies to only to the timing of *distributions* from corporate solution (together with the special case of a sale at the end of the investment term, which acts like a liquidating distribution). In other words, the analytical framework developed for capital stuffing operates as if dividend taxes or capital gains taxes on ultimate liquidation operated like a corporate-level withholding tax on distributions.

As applied to marginal investments, lock-in can be conceptualized as a voluntary prepayment by the investor of the toll charge for which taxes have already been set aside inside the corporation. Because there is no coordination mechanism to release those set-aside taxes inside the corporation or to forgive the shareholder-level tax, there is no "true up" until the liquidation of the investment.[57] For that reason, the investor simply loses the earnings on the "prepaid" capital gains taxes. The "principal" of the prepaid taxes is not permanently lost, but rather ultimately is recovered through the true-up mechanism of measuring gain or loss at the disposition of the investment against the stepped-up basis in the replacement investment.

The reduction in net investment attributable to midstream capital gains tax, and the attendant diminution in returns for the remainder of the investment, is the lock-in phenomenon. As applied to a marginal investment, it exists because Shareholder's gain on the switch in investments triggers a shareholder level tax without reducing the inchoate taxes that Shareholder is bearing inside the corporation. That is, Shareholder's corporate returns continue to reflect a notional set aside for future toll charges, without any coordination or reconciliation to reflect the early payment by Shareholder in his personal capacity of some of these taxes prior to the liquidation of his investment.

The ultimate driver of the lock-in phenomenon therefore is not capital gains taxes as such, but rather the lack of any coordination between the notionally prefunded toll charge and shareholder capital gains imposed on midstream sales, until the final settling up through termination of the investment.

The next example illustrates these points.

[57] Note that standard corporate-shareholder "integration" schemes do not resolve this problem, because they all assume that corporate earnings will be recognized and distributed before shares are sold. They thus do *not* address the temporary "doubling up" of tax payments at the heart of lock-in. The Norwegian RISK system, now repealed, was a principal exception.

Example 5: Shareholder, an individual, owns 100 percent of newly-incorporated Corporation A, in which she invests $1000. The rate environment is the 2003-2012 environment (35 percent corporate and individual rates, 15 percent dividend and capital gains rates). Corporation A earns 10 percent pretax on its assets.

At the end of two years, Shareholder switches her investment to Corporation B, which also earns 10 percent pretax on its assets. Is there a tax disincentive to do so? What, for example, would Shareholder's terminal value for the investment be after five years if Shareholder did or did not make the switch?

In this case, Corporation A will have a value of $1134.23 after two years (that is, an after-tax corporate return of 6.5 percent per annum). Shareholder recognizes $1134.23 - $1000 or $134.23 in gain, on which she pays $20.13 in tax. Shareholder reinvests the remaining $1114.10 in Corporation Y. At the end of three more years (five total), that investment has grown to $1345.77. Shareholder recognizes $231.67 in gain ($1345.77 - $1114.10), on which she pays $34.75 in tax. Shareholder is left with $1311.02 – $3.56 less favorable an outcome than the two cases in Example 1.

This is an example of lock-in. By triggering a midstream tax, Shareholder has reduced her net investment for the last three years, and her total return at the end of five years reflects the loss of earnings on that forgone investment. More specifically, the $3.56 diminution in Shareholder's total returns represents two components: a 6.5 percent compounded return on $20.13 – the amount Shareholder paid in tax at the end of year two – or $4.19, ameliorated by the 15 percent quasi-excise tax that Shareholder did not have to pay at the end of Year 5 on these missing earnings.

The lock-in cost in Example 5 is premised on Shareholder retaining a corporate stock investment. As Example 4 demonstrated, that actually would be a foolish strategy under pre-2013 tax rate environments, if the same yield can be earned outside corporate solution.

Example 6. The facts are the same as Example 5, except that after selling his stock in Corporation A, Shareholder invests directly in a marginal investment yielding 10 percent pretax. Now the $1114.10 net proceeds earns 6.5 percent after-tax for three years. At the end of that period (five years total), Shareholder emerges with $1345.78, better than either Example 1 or Example 5.

In this case, the basis recovery/direct investment phenomenon dominates the outcome. Shareholder is better off selling at the end of Year 2, when he wakes up to the unnecessary toll charge he is incurring, and would be even better off if he woke up at the beginning of the five-year period.

While lock-in and capital stuffing are somewhat different phenomena, the capital stuffing analytical framework can be employed to explain the cost to an investor of the lock-in tax on a marginal investment. The next example shows this.

> Example 7: Shareholder owns 100 percent of Corporation X, for which he paid $800; the corporation has since accumulated $200 in retained earnings, and is worth $1000 today. Corporation X earns 10 percent pretax on its assets. Shareholder wishes to switch his investment to Corporation Y, which also earns 10 percent pretax on its assets. The tax rate environment is the new environment hypothesized in this paper; in other respects, this Example essentially tracks Example 2.
>
> If Shareholder simply holds Corporation X, it will grow in value over five years to $1435.63. When Shareholder then disposes of X, Shareholder will recognize $635.63 in gain, on which Shareholder will pay $127.13 in tax, leaving Shareholder with $1308.50.
>
> Conversely, if Shareholder sells Corporation X today for $1000, Shareholder will recognize $200 in gain, and pay $40 in tax. Shareholder can take the remaining $960 and buy that much of Corporation Y. After five years, that investment will grow to $1378.20. After selling Corporation Y, Shareholder will have $418.20 in gain, on which Shareholder pays $83.64 in tax. Shareholder is left with $1294.56.

The $13.94 difference is attributable to the fact that, by virtue of the earlier sale of Corporation X, Shareholder has lost the return on the tax paid ($40) for the five-year period of Shareholder's continuing investment. More specifically, the $13.94 represents the lost opportunity to invest $40 for 5 years in Corporation Y for 5 years, where investments compound inside the firm at 7.5 percent per annum, offset in part by a 20 percent capital gains tax on the resulting hypothetical earnings ($17.43) that Shareholder did not have to pay.

The $13.94 can also be explained using the capital stuffing analytical framework: it represents Shareholder's basic post-toll charge return of 6 percent per annum on the $40 of investment that Shareholder has dissipated by paying his capital gains tax early ($2.40/year for five years, for a total of $12.00), which basic return in turn earns interest at the pre-toll charge rate of 7.5 percent. In other words, like Example 1, the $13.94 can be seen as the value at the end of five years of a bank account into which $2.40 is deposited at the end of each year as new investment, and which account earns 7.5 percent interest. The difference is, now the government, not the taxpayer, owns the bank account. At the end of the term of the investment, the $40 "principal" is restored to the taxpayer, through a reduction in gain on the sale of the replacement

investment attributable to the stepped-up basis in that asset, but he has lost the use of that money for the term of the investment.

The same reasoning would apply (with slightly different numbers, of course) if Shareholder had begun with a $1000 basis in his Corporation X stock. Imagine, for example, that Shareholder in fact began with a $1000 basis in Corporation X, and then either (a) maintained that investment for five years or (b) switched to Corporation Y after two years. In the first case Shareholder would have $1348.50 after tax at the end of five years, and in the second case $1342.48. The shareholder-level capital gains tax acts to reduce net investment for the last three years of the investment.

In practice in the 2003-2012 environment (where capital gains and dividends were taxed at the same low rate and corporate and personal income was taxed at the same higher rate) the lock-in phenomenon was not so much about the tax burden on investments that yielded marginal returns as it was about investments that yielded unexpected returns or rents.[58] For example, imagine that a fortunate investor under that earlier regime invested $200 in a capital investment that happily yielded $100/year. In a 10 percent interest rate environment, the market value of the investment was $1,000. If, however, the investor sold the investment for $1,000, he would recognize $800 in gain, on which he would have paid $120 in tax, leaving him with $880. That $880 in turn could have been be invested in readily-available marginal investments that yielded only $88/year, a diminution in wealth to the taxpayer equal to the return that he formerly obtained on his deferred tax liability.

As the prior Subsection showed, in the 2003-2012 tax rate environment, when confronted with a corporate investment earning a marginal return, the right move was simply to disinvest from the corporate environment and earn the same return outside of corporate solution. To that extent, then, there was an incentive to sell immediately, not a lock-in effect. In the new rate environment hypothesized in this paper, by contrast, the problem of lock-in returns, because there is an advantage to corporate marginal investments where income is retained inside the corporation over direct marginal investments with the same pre-tax yield; that benefit in turn brings with it the lock-in cost for a sale in the midstream of the investor's total investment horizon.

[58] Kanemoto, "On the 'Lock-In' Effects of Capital Gains Taxation," 40 *J. of Urban Economics* 303 (1996).

D. Summary.

The capital stuffing discussion in Subsection A., above, quantified the benefit of deferring corporate distributions in the new tax rate environment hypothesized in this paper, and developed a general expression of the benefit that can be applied to different tax rate scenarios (so long as capital gains and dividends are taxed at the same rate.) The disinvestment analysis in Subsection B. pointed out that, in the 2003-2012 tax rate environment, there always was an incentive to withdraw funds that are earning marginal returns from corporate investment, assuming identical pre-tax returns can be earned directly; that is not true in the new rate environment hypothesized in this paper. And if one is determined to trigger a realization event and reinvest the proceeds, it is better to recover basis sooner rather than later.

The lock-in discussion in Subsection C., by contrast, quantified the detriment to an investor of selling all of his investment in the stock of one corporation that earns marginal returns (and retains those returns) and reinvesting the after-tax proceeds in another corporation earning identical returns. In the 2003-2012 environment, lock-in today logically was not a problem for marginal returns (because corporate disinvestment was the right strategy), but even under that tax rate environment lock-in was a problem when applied to an investor fortunate enough to have unrealized supernormal returns on a corporate investment.

The prior Subsections made two related points. First, in a world where capital gains and dividends are taxed at the same rates (the toll charge rate-pair identity), the advantage (if any) to deferring distributions from a corporation relates entirely to differentials in the corporate and individual income tax rates. (For this purpose a liquidation of the investment is analytically a distribution, regardless of whether that termination transaction is formally a liquidation or a secondary market sale.) Where corporate tax rates are materially lower than individual tax rates, there is an advantage to retaining assets in corporate solution. Where the differential is large enough (as it would be under the tax rate environment hypothesized in this paper, regardless of investment time horizon) or where the time horizon is long enough, there is an advantage to moving investment assets from individual ownership into corporate solution – what this paper terms capital stuffing. The measure of the advantage is the difference between (i) personal investment returns without diminution for any dividend/capital gain toll charge to (ii) the *pre-toll*

charge compounding (at the corporation's post-tax rate of return) of the *after-toll charge* simple interest return on original investment.

Where the toll charge rate-pair identity is satisfied, and where individual and corporate tax rates are identical (the income tax rate-pair identity also is satisfied), as was true in the 2003-2012 period, there is no advantage to capital stuffing. To the contrary, there is a disadvantage, attributable to the needless imposition of a toll charge without any concomitant tax rate benefit. Conversely, under the rate environment hypothesized in this paper, there *always* will be a benefit to capital stuffing.

The capital stuffing analytical framework explains the benefit, if any, to retaining assets in corporate solution. So long as both rate-pair identities are satisfied, as was true in the 2003-2012 period, there is no difference in returns between extracting corporate revenues as current dividends or deferring those amounts inside the corporation. (Nonetheless, both such cases are inferior to simply liquidating the investment from corporate solution immediately, to avoid future toll charges on future corporate earnings.)

Lock-in is the tax-induced incentive to retain a profitable corporate investment rather than to sell it and reinvest the proceeds elsewhere. In the case of marginal investments, lock-in can be visualized as a prepayment (or, if one prefers, duplicated payment) of taxes already provided for at the corporate level, with the consequence that the investor loses the value of any returns on the tax paid for the life of the continuing investment. "Pure" lock-in is a function of capital gains tax rates, but in practice other phenomena (like the favorable capital stuffing environment created by a lower corporate tax rate than individual rate) can create analogous behavioral responses.

The corollary to this mode of analysis is the point made in Subsection B. When and if a taxpayer wishes to extract earnings from a corporate investment, it is desirable to do so, even with current tax rates, through a capital gain transaction, because doing so essentially is the opposite of a lock-in problem: by applying basis to reduce temporarily what otherwise would be taxable income on corporate distributions, the taxpayer obtains an advantage. The advantage is temporary, in that the accelerated use of basis must be accounted for, but the taxpayer has the use of the tax saved for the term of the investment. Just as in the lock-in case when applied to a

marginal investment the taxpayer has to prepay taxes already provided for him, so in the basis recovery case the taxpayer is reducing tax that would otherwise be owed.

In short, lock-in counsels against selling appreciated corporate stock, but the basis recovery point argues that, once an investor has determined to extract cash from a corporate investment, a stock sale is the way to do it. The first goes to a tax-induced disincentive to divest; the second to the tax-induced preferred form of any predetermined disinvestment.

It is difficult to keep the capital stuffing phenomenon (differential returns driven by differences in tax rates inside and outside the corporation) separate from the lock-in phenomenon (reductions in net investment through midstream realization of shareholder gains). Moreover, the calculus of the relative costs and benefits of each constantly changes as tax rates change. For example, in the future tax rate environment hypothesized in this paper, taxpayers always earn a higher return on a marginal investment for however long it is left in the corporation: the capital stuffing impulse then dominates over a direct investment. But having chosen to make a marginal investment in corporate form, investors then will suffer the lock-in effect should they wish to switch from one such investment to another. The lock-in effect never leaves the investor worse off than a direct investment, but does vitiate the advantage of the corporate investment.

In summary, the above examples imply that in the hypothesized new tax rate environment, lock-in can still induce some distortions in the timing of shareholder gains in the case of corporations earning marginal returns (the 10 percent return freely available to all the corporations in the examples), because, first, by virtue of tax rate differentials there is a preference for corporate marginal investment, and second, because of the toll charge rate-pair identity and the relatively low rate of that toll charge, pre-2003 law's additional tax-induced distortions that disfavored dividends and encouraged the deferral of all returns from a company until liquidation of an investment no longer are binding. Moreover, the lock-in effect in practice is muted by relatively low capital gain rates and low interest rates; the latter means that the forgone earnings on the conceptual prepayment of tax are themselves relatively small.

These observations regarding the nonexistence of the lock-in phenomenon when applied to marginal corporate investments under 2003-2012 law seem at first to turn accepted wisdom on its head. It may be, in fact, that many investors were stuck in pre-2003 thought patterns (when dividends were taxed much more heavily than capital gains), or were consumed by the prospect

of the tax-free step-up at death.[59] But if one by hypothesis rules out the latter, the identity in each of the two tax rate pairs (dividends and capital gains, and inside and outside the corporation marginal investments) in the pre-2013 period eliminated tax planning from the timing of the extraction from corporate solution of returns to *marginal investments*. One was left with a modest tax benefit from deferring capital gains realizations on supernormal returns (or conversely, economic cost from the misallocations of resources due to lock-in), mitigated in turn by low capital gains rates and low interest rates during much of that period.

[59] Halperin, *Mitigating the Potential Inequity of Reducing Corporate Rates*, 126 Tax Notes 641 (Feb. 1, 2010), also speculates on whether old modes of thought are at work here.

III. LABOR STUFFING.

A. Pre-2013Labor Stuffing.

Every business enterprise represents the application of labor to capital, and the firm's resulting gross income is attributable to both factors, in proportions unique to that business. In the case of large publicly-held corporate enterprises, the division of gross income between labor and capital inputs is handled by the marketplace: employees do not own enough of the firm to manage matters by undercompensating their labor contributions, and in turn extracting income attributable in fact to their labor in the form of purported returns to capital. But in the arena of closely-held businesses, where firms often are dominated by owner-managers, exactly this phenomenon is possible and practiced, as the saga of S corporations and payroll taxes set out below demonstrates.

In the United States today roughly one-half of business profits are earned outside the corporate tax system (that is, by proprietorships, partnerships and S corporations).[60] Some of that income is attributable to large enterprises where there are sharp differences between the identities of owners and of workers, but many cases can be expected to follow the pattern of the owner-manager with significant freedom of choice in how her returns are denominated.

Since 1981, U.S. individual and corporate tax rates have been quite close to each other; what is more, in keeping with the general framework of a comprehensive income tax, individuals are taxed on one rate schedule – that is, no distinction is drawn between the labor income and capital income of an individual (other than the special cases of dividends and capital gains).[61] In consequence, an individual owner-manager's income is taxed at the same progressive rates, whether denominated as compensation or as a share of any pass-through entity's income, and the maximum rate imposed on that individual in turn is the same as the maximum rate that is imposed on a taxable "C" corporation.

[60] Treasury (2007); CBO (Jan. 2013)

[61] "Tax-exempt" municipal bond income in theory bears a full implicit tax.

This would suggest that in the pre-2013 period there was little advantage to be obtained by an owner-entrepreneur masquerading labor income as returns to capital invested in her business, and indeed in the case of C corporation there would be a significant disadvantage (the toll charge – that is, the quasi-excise tax on removing earnings from the corporation for personal consumption uses). In fact, there are two well-known examples outside the C corporation context under current law where labor stuffing is routinely practiced. The first is the highly publicized carried interest strategy; that strategy relies on an investment manager's ability to characterize his returns to his labor by reference to an entity's return to its capital (the partnership through which he earns his management fee). The second is the John Edwards/Newt Gingrich payroll tax avoidance strategy described earlier.

The carried interest rules and the "John Edwards gambit" can be viewed as anomalies in current law. But it remains the case that many owner-entrepreneurs undercompensate their personal efforts. There are nontax explanations, of course – an exigent need for cash flow in the business, a desire to show better financial results to bank lenders, and the like. But there also are practical tax considerations that animate these results. These include the ability in practice to disguise personal consumption items as business expenses, the retention of what amounts, in effect, to a free option to take advantage of future tax rate developments, and the fact that the many tax subsidies for small and medium sized businesses drive down the effective tax rate on firm earnings, and thereby offer the owner-entrepreneur more attractive investment opportunities than portfolio investments outside the enterprise he controls.

B. Labor Stuffing Tomorrow.

Once a decision is made to tax corporate income, in particular, at a rate materially lower than the general individual income rate schedule, then the question of how to separate labor from capital income passes beyond being simply an interesting intellectual exercise and becomes important as a revenue collection matter. The future tax rate ecosystem envisioned in this paper encourages owner-managers to engage in labor stuffing – to understate their personal compensation for services rendered to their firm, and instead to retain the firm income attributable to those services for as long as possible at the firm's tax rate.

The reason to do so in the tax rate environment hypothesized in this paper is *not* to convert labor income to capital income to reduce the owner-manager's tax liability in the first

instance (except insofar as Medicare taxes are concerned[62]), because any labor income not paid as salary will become subject to the dividend/capital gain toll charge, and the sum of the corporate tax and the toll charge equals the individual rate on salary income. For example, imagine an owner-manager who owns a C corporation with $200 in pretax, pre-salary net business income not required for business operations; the owner-manager wishes to set aside $120 in an investment earning normal returns. If the taxpayer extracts $200 in salary, she will pay $80 in tax today, and invest $120 in her individual capacity; the corporation will have zero taxable income, and hence tax liability. If she pays herself zero salary, then, following the approach developed in Section II, the firm will pay $50 in corporate income tax today, and notionally divide the remaining $150 into a personal investment of $120 and a "set aside" of $30 as the toll charge that the owner-manager will incur on the distribution of the $150 in total corporate earnings. In either case, she has $120 that is hers free and clear to invest.

Instead, owner-managers will prefer to understate their compensation income because doing so will enable them to earn income on the capital retained by the firm at the new, lower, corporate after-tax rate of tax. This is the same point made in Section II; the advantage to the owner-manager in understating labor income arises, not from having a larger actual or notional opening personal investment account, but in earning the higher post-corporate tax rate of return on that notional personal investment (a 7.5 percent compounded return on a 6 percent simple interest stream, to use the same numbers as in the earlier examples). As in the case of explicit capital stuffing, there will be no disadvantage to doing so, and the retained capital in turn does offer a tax advantage relative to capital held directly by the owner-entrepreneur.[63]

In short, in the hypothesized future tax rate environment, and even without regard to payroll tax collections, labor stuffing will become capital stuffing. Owner-managers will use the C corporation as a tax shelter through understating their labor incomes, not because of any *immediate* income tax advantage in the first instance (that is, in the year the decision is made), but to take advantage of the lower-taxed environment in which their returns on their retained capital can compound (as well as deferring Medicare taxes).

[62] Section I.B.4.

[63] This new impetus to engage in labor stuffing will exist in addition to any practical considerations, both nontax and tax, of the sort briefly identified in the preceding subsection.

By taking advantage of the corporation's superior after-tax compounded returns through understating income in the first instance, an owner-manager obtains another important advantage. Unlike the superficially similar case of paying himself his full value in salary and then reinvesting the after-tax amount in the corporation, an owner-manager that simply leaves the firm's profits in corporate solution can extract the *principal* of his notional investment at any time without triggering an artificial toll charge on the return of his principal (offset only at an indeterminate date in the future when the owner-manager makes use of his higher tax basis in the firm).[64]

In the future, then, the issue of distinguishing labor from capital income will be particularly important when two conditions are met: capital stuffing is attractive, and there are advantages to doing so indirectly (through undercompensating oneself) rather than directly (by taking out salary and stuffing the after-labor tax amount back into the corporation). The most important such reason is the ability to withdraw notional principal without an artificial toll charge, as described immediately above. The Medicare tax advantages described earlier are additional (if relatively modest in magnitude) reasons to undercompensate oneself.

But even without regard to these two points, there are important tactical reasons to engage in labor stuffing rather than explicit cash infusions. In short, and as developed in Section IV, to the extent that capital stuffing is addressed through some of the clumsy traditional tools described below (e.g., the accumulated earnings tax), the likelihood of tax controversy is dramatically reduced as a practical matter by making less obvious that indirect capital stuffing is afoot.

If the United States were to move towards a true dual income tax (as the next article in this project argues should be the case, for normative reasons), or if existing tax subsidies for investments in small business stock were to remain in the Internal Revenue Code,[65] then the incentives for labor stuffing will be even more dramatic than those outlined here. This is exactly the problem confronted by the Nordic countries when they adopted various versions of a dual income tax, and which led them to develop novel administrative tools (a tax centrifuge, in my

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[64] See the last paragraphs of Section II.B. The text here assumes that the firm has sufficient current or accumulated earnings and profits to characterize the owner-manager's return of principal from cash actually invested in the firm as a dividend.

[65] Sections 1202 and 1244.

terminology) to tease apart labor from capital income when both are conjoined in the net business profits of a closely-held firm. As the next Section demonstrates, whatever one thinks of the various Nordic solutions, it must be acknowledged that existing U.S. administrative tools to perform the same task are wholly inadequate.

IV. CURRENT TECHNOLOGIES TO ADDRESS CAPITAL AND LABOR STUFFING.

This Section IV reviews the tools available under current law to respond to capital stuffing, lock-in and labor stuffing, as well as a few of the reform ideas posited to date that directly consider tax rate environments similar to those hypothesized in this paper.

A. Current Law Tools to Address Capital Stuffing.

Capital stuffing has not been an issue for decades, because rational taxpayers have sought to keep capital out of corporate solution. But the new tax rate ecosystem contemplated by this paper arguably will be *more* hospitable to capital stuffing than was true at many points in the past, thanks to the preservation of the toll charge rate-pair identity (in turn at relatively low rates), combined with the divergence in the income tax rate-pair identity. By virtue of this fundamental change, individual taxpayers operating in the new tax rate environment will discover that they are *never* worse off investing through a corporation: they can always extract their corporate profits each year as a dividend, and suffer an "all-in" tax burden no different than if they had invested directly.

That was not true in the pre-1982 period. At that time, there was a tax benefit to the combination of earning income at corporate rates and then extracting those earnings as capital gains,[66] but a very large disadvantage to extracting corporate profits as dividend income. For this reason, individual tax planning for investment income focused obsessively on transforming ordinary income to capital gain, and in turn deferring the realization of those gains as long as possible (ideally, until death).

Individuals will continue to prefer to extract cash from corporate form through capital gains transactions, not because of any tax rate advantage, but to obtain the timing benefit of quicker basis recovery. But the stakes are more attenuated now than was true in the past, because the difference is now one only of timing (that is, dividend income is taxed at the same rate), and the absolute tax rate levels for dividend and capital gains are historically quite low.

[66] For example, immediately before the Economic Recovery Tax Act of 1981, the highest tax bracket for individuals' investment income (including dividends) was 70 percent. Taxpayers earning investment income through a corporation could reduce that to roughly 61 percent if they extracted their earnings as capital gains (46 percent corporate tax and 28 percent capital gains tax).

The Internal Revenue Code today contains some safeguards against capital stuffing, principally the personal holding company and accumulated earnings tax. The next few paragraphs summarize these existing safeguards, and show why they are inadequate to protect the fisc from capital stuffing in the new tax rate ecosystem contemplated by this paper.

The Code today contains two principal means of limiting tax avoidance from capital stuffing: the personal holding company rules and the accumulated earnings tax rules. (The collapsible corporation rules actually were directed at a form of labor stuffing, not capital stuffing; those rules prevented the one-time conversion of unrealized returns to human labor into present capital gains.) The personal holding company rules are mostly mechanical but incomplete to police capital stuffing in the new tax rate ecosystem; the accumulated earnings tax provisions rely on a facts and circumstances inquiry that renders them irrelevant to all but the clumsiest taxpayers.

The personal holding company provisions[67] impose a corporate-level penalty tax of 20 percent on any "undistributed personal holding company income" of a "personal holding company." The purpose of the provision is to compel affected corporations to distribute earnings currently.

A "personal holding company" is defined by reference to the character of its income and the concentration of its ownership. The ownership leg is satisfied when 50 percent or more (by value) of the stock of a corporation is owned by five or fewer individuals.[68] Ownership is determined under complex and comprehensive constructive ownership rules, so that, for example, stock owned by siblings, parents and children are all aggregated.[69] Those individuals need not act in concert, or technically even be aware of the others' existence

The income leg of the definition of a personal holding company is satisfied if a corporation derives 60 percent or more of its "adjusted ordinary gross income" from "personal

[67] Sections 541–47. In addition, investments in foreign investment companies might give rise to subpart F income (sections 951-965) or "excess distributions" taxed under the passive foreign investment company regime (sections 1291-1298).

[68] Section 542.

[69] Section 544.

holding company income" (PHCI).[70] Adjusted ordinary gross income essentially means gross income, other than gains from the sale of capital or section 1231 assets, reduced by certain special deductions (in particular, for depreciation and certain other expenses incurred in owning rental property).[71] PHCI in turn encompasses a long list of investment-type returns, including dividends, interest, and certain royalties (with exceptions designed to remove from PHCI otherwise-tainted income earned in the course of an active business that is the predominant business of the corporation).[72] In addition, PHCI includes income received by a corporation in respect of a contract for the performance of personal services, where the contract contemplates (or can be implied to contemplate) that those services will be performed by a shareholder owning at least 25 percent of the firm.[73] As can be imagined, there are numerous exceptions to the inclusion of certain categories of income in certain contexts. For example, banks, life insurance companies and certain active lending or finance businesses all are exempt.

The personal holding company regime is complex and encrusted with exceptions that may not always make perfect policy sense, but it has the virtue of being largely mechanical in application. Modern litigated cases are relatively few in number, and most frequently involve the interpretation of whether a contract contemplates the performance of personal services by a 25 percent shareholder,[74] or the classic question of whether real estate sales in particular were sufficiently frequent as to be classified as ordinary income rather than capital gain.[75]

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[70] Section 542(a)(1).

[71] Section 543(b)(2).

[72] Section 543(a).

[73] Section 543(a)(7).

[74] E.g., *Calypso Music, Inc. v. C.I.R.*, 80 TCM 388 (2000) (music editor's controlled corporation's contracts for the performance of services fell within section 543(a)(7)); *Kenyatta Corp. v. C.I.R.*, 86 T.C. 171 (1986) (similar, involving contracts for the performance by basketball star Bill Russell of services as coach of the Seattle Supersonics).

[75] In *Char-Lil Corporation v. C.I.R.*, 76 T.C.M. 1082 (1998), for example, the taxpayer was a corporation that rented real estate to other businesses. The corporation would occasionally sell a piece of real estate to an existing tenant in exchange for a note in the amount of the purchase price. Based on the circumstances of the sales, which were rare given the nature of the company's business, the court held that the interest on the purchase money notes was PCHI but the gain from the sale of the real property was not ordinary income.

Nonetheless, its bright-line definitions make it inadequate to the task of policing capital stuffing. The ownership leg of the definition probably is broad enough to serve this enhanced purpose in respect of the classic small business, but leaves open the possibility of widely-held domestic corporations that function like investment companies but that elect not to be taxed as regulated investment companies for tax purposes – subject, of course, to navigating the accumulated earnings tax regime described below. Moreover, the income definition is plainly inadequate to police capital stuffing. For example, the 60 percent threshold on passive income invites capital stuffing in closely held businesses up to that bright line. And the exceptions invite strategies like the use of closely held foreign reinsurance companies to write low-risk cover.[76]

The accumulated earnings tax is a penalty tax of 20 percent imposed on a corporation that retains earnings "beyond the reasonable needs of the business."[77] This too is designed to compel corporations to distribute excess earnings, although the accumulated earnings tax rules themselves does not care whether a corporation distributes its excess earnings as dividends or as wages.[78]

The accumulated earnings tax offers no bright-line rule; a corporation's "reasonable needs" is a question of fact, thereby raising substantial administrability and compliance issues for both taxpayers and the Internal Revenue Service.[79] "Reasonable needs" can include both current and future needs, and can encompass reserves for payments of long-term debts, taxes, working

[76] Cf. Zachary R. Mider, *Paulson Leads Funds to Bermuda Tax Dodge Aiding Billionaires*, Bloomberg News, Feb. 19, 2013, available at http://www.bloomberg.com/news/2013-02-19/paulson-leads-funds-to-bermuda-tax-dodge-aiding-billionaires.html. As a foreign corporation, the vehicle would not be subject to the personal holding company rules at all (section 542(c)(5)), and as an insurance company the vehicle would avoid the application of the passive foreign investment company rules (section 1297(b)(2)(B)).

[77] Sections 531–37. See also See also Nelson J. Luria, "The Accumulated Earnings Tax," 76 *Yale L.J.* 793 (1967). As with PHCs, the 15 percent rate is equal to the individual dividend rate. Note that a corporation that is a PHC is not also subject to the AET; one 15 percent penalty is sufficient.

[78] See *Henry Van Hummell, Inc. v. Comm'r*, 364 F.2d 746, 751 (10th Cir. 1966) ("The controlling matter is the ultimate one—whether there was retained an unreasonable amount of profits or earnings. This is simply what the statute provides.")

[79] See, e.g., *Cataphote Corp. of Miss. v. U.S.*, 535 F.2d 1225 (Ct. Cl. 1976). In *Cataphote*, the taxpayer claimed that $349,140 of accumulated earnings were necessary to pay for a fleet of trucks, but the court discounted this contention because of a lack of contemporaneous documentation. Id. at 1231. Instead, the court found that the taxpayer's reasonable needs for accumulated earnings were limited to about $45,000 in working capital and enough to pay for accrued but unpaid income tax liabilities. Id. at 1237.

capital, or anticipated acquisitions or expansions of the firm's assets or business. The fact that a company is a "mere investment company," however is prima facie evidence that the corporation has been formed or availed of for the prohibited purpose of permitting earnings and profits to accumulate instead of being distributed.[80]

Outside of the "mere investment company" case, the accumulated earnings tax requires the Internal Revenue Service to second-guess the motives of corporate management in retaining earnings. Regardless of what standard is used—whether it is based on accounting ratios, the corporation's operating cycle (the so-called "Bardahl formula" – a calculation of the capital required for a complete operating cycle from the acquisition of raw materials, to the time that any accounts receivables from sale of inventory are converted to cash), or any other rule of thumb[81]—application of the accumulated earnings tax will inevitably cause some economic inefficiencies (for example by encouraging the acquisition of a small active business solely to defeat the "mere investment company" label) while simultaneously applying unevenly (by virtue of the audit lottery) to similarly-situated taxpayers.

In the end, the accumulated earnings tax largely rewards the creative writing of corporate minutes. Indeed, The case law strongly suggests that the only way a taxpayer can lose an accumulated earnings tax case is if the taxpayer goes out of its way to avoid proposing or documenting any plausible business explanation for the accumulation of earnings.[82]

One can sense the magnitude of the failure of the accumulated earnings tax by searching for modern cases applying it. Consider, for example, the case of publicly-held U.S. multinational

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[80] Section 533(b); section 532.

[81] See Luria (1967) for a discussion of various approaches that have been used.

[82] See *Haffner's Service Stations, Inc. v. C.I.R.*, 326 F.3d 1 (1st Cir. 2003). Compare *Knight Furniture Co., Inc. v. C.I.R.*, 81 T.C.M. 1069, (2001), where the court explicitly admitted that it should be hesitant to substitute its judgment for that of the officers and directors of the corporation at issue. In *Knight* the court decided that the accumulated earnings of a furniture corporation did not exceed the business needs of the company. Those business needs included preparation for a stock redemption, anticipation of potential liability in a class action lawsuit, and repairs and renovations. See also *Otto Candies, LLC v. U.S.,* 288 F.Supp.2d 730 (E.D. La 2003) (accumulated earnings tax did not apply where corporation was accumulating earnings in order to replace the company's fleet, invest in projects associated with the company's core business, provide working capital for the company, and prepare for the possible redemption of the shares of three of the shareholders).

firms, which collectively now own foreign subsidiaries with retained "permanently reinvested earnings" (a Generally Accepted Accounting Principles term) totaling some $1.6 trillion.[83] By virtue of this designation, firms represent to their public accountants that they have no current use for these earnings in the United States. At the same time, the controlled foreign companies that hold these retained earnings keep a great deal of this extraordinary sum in U.S. dollar financial assets (money market funds, bank accounts, Treasury obligations and commercial paper).[84] When in 2004 Congress offered firms a one-year tax holiday on the tax costs of repatriating those offshore retained earnings, $312 billion was returned to U.S. parent companies over and above normal dividend levels (some $50 billion).[85] In the aggregate, these extraordinary dividends in turn largely were passed onto shareholders of the parent companies in the form of extraordinary dividends and stock redemptions.[86] And of course many U.S. firms today are lobbying for another repatriation holiday, because, as they freely acknowledge, their controlled foreign corporations have no use for the large cash hoards they hold. Finally, the accumulated earnings tax plainly applies to a controlled foreign corporation.[87]

If ever there were fertile ground for the accumulated earnings tax, it would be the multi-billion dollar cash hoards of foreign subsidiaries of U.S. firms. (To be clear, the issue is not the current returns on the liquid assets held by controlled foreign corporations, as those returns are taxed currently under subpart F: the issue is whether the long-term retention of the original active business income solely to fund portfolio investments should give rise to an accumulated earnings tax.) Yet cases appear to be nonexistent. Indeed, in adopting the passive foreign investment

[83] Edward Kleinbard, *Stateless Income*, 11 Fla. Tax Rev. 699, 745 (2011) describes the concept. Id at 743 gives the total as of mid-2011; the number of course has grown since then.

[84] Kate Linebaugh, *Firms Keep Stockpiles of 'Foreign' Cash in U.S.*, Wall St. J., Jan. 23, 2013, at A-1.

[85] Kleinbard, supra n. 72, at 743.

[86] Kleinbard, supra n. 72, at 765-67.

[87] Section 532(b) (listing corporations to which the tax does not apply, which list does not include controlled foreign corporations); section 535(b)(10) (special adjustments for controlled foreign corporations)

company rules in 1993, Congress ruefully admitted that the accumulated earnings tax had largely been abandoned as an enforcement tool in this area.[88]

The accumulated earnings tax rules do present tax advisors with an interesting dilemma: if an owner-manager causes his corporation pay him only a small salary to both stuff capital in the corporation and convert labor income into capital income, does this trigger the accumulated earnings tax? On the one hand, an insubstantial salary may indicate that the corporation retained more profits than it needed, triggering the accumulated earnings tax.[89] On the other, small salaries may be adduced as evidence that the corporation needed to retain its profits as much as possible to avoid financial difficulty, so the accumulated earnings tax does not apply.[90] In practice, given the virtual non-enforcement of the accumulated earnings tax, and the advantages of labor stuffing in general, the logical strategy is to set salaries as low as the owner-manager's lifestyle permits, and to invest a few minutes in writing elegant board minutes to explain the company's liquid financial asset reserves.

New Code section 1411 (the Medicare tax on net investment income) attempts to deal with accumulated earnings enforcement problems by subjecting to the new tax returns on the "working capital" of a partnership or S corporation.[91] Recently proposed regulations extend this

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[88] H.R. Report No. 103-111 [1993-3 C.B. 163] (Jul. 1993), at 224 ("The committee understands that, although the accumulated earnings tax nominally applies to controlled foreign corporations, it is not often applied to foreign corporations in practice. One reason for this nonapplication, the committee believes, is that the accumulated earnings tax of present law employs a subjective analysis to determine the reasonable business needs for accumulating earnings in the form of passive assets; in the case of a foreign corporation, this type of analysis is difficult to apply. Therefore, the committee believes it appropriate to impose on controlled foreign corporations a new type of limitation on accumulating deferred earnings that turns on objective rather than subjective criteria.").

[89] Atlas Tool Co. v. Comm'r, 614 F.2d 860, 870 (3d Cir. 1980).

[90] Simons-Eastern Co. v. United States, 354 F. Supp. 1003, 1011–12 (N.D. Ga. 1972).

[91] Mechanically, it does so by carving out such income from the exclusion offered by section 1411(c) for the net business income of a partnership or S corporation attributable to a member who materially participates in the affairs of the firm's "active" trade or business. Section 1411(c)(3), which in turn is a cross reference to the passive activity loss rules of section 469(e)(1)(B).

See also proposed Treasury regulation section 1.1411-6 (Dec. 3, 2012), REG-130507-11, proposing Treasury regulation sections 1.1411-0 through 1.1411-10 (BNA Daily Tax Rpt Dec. 3, 2012). Section 7 of the preamble to the proposed regulations describes "working capital" as follows:

principle to all "portfolio income" earned by a firm, relying on the passive activity loss rules of section 469 for this distinction.[92] This learning has no immediate application to the problems discussed in this paper, except perhaps as a possible avenue for Congress to explore were it interested in developing new legislation that might subject individual owner-managers of closely held C corporations with "working capital" to a new compensatory tax aimed at obviating the benefits of the corporation's lower tax rate. Since the overall thrust of my capital income project points in the opposite direction (that is, towards a uniform lower rate of tax on capital income), this idea is not pursued further here.

B. Responding to Labor Stuffing Under Existing Law.

The Internal Revenue Code today contains a few provisions that distinguish labor from capital income in order to convey a benefit on the former not available to the latter. For example, section 911 excludes from income a specified amount of an individual's "foreign earned income."[93] When applied to a U.S. owner-manager of a foreign business conducted as a proprietorship or tax partnership, the issue becomes how to determine the portion of the owner-manager's business income that qualifies for section 911's exclusion. Section 911(d)(2) unhelpfully answers the question by providing that, if both services and capital are income-producing factors, then "earned income" includes "a reasonable allowance as compensation for the personal services rendered by the taxpayer, not in excess of 30 percent of his share of the net

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"The term working capital is not defined in either section 469 or section 1411, but it generally refers to capital set aside for use in and the future needs of a trade or business. Because the capital may not be necessary for the immediate conduct of the trade or business, the amounts are often invested by businesses in income-producing liquid assets such as savings accounts, certificates of deposit, money market accounts, short-term government and commercial bonds, and other similar investments. These investment assets will usually produce portfolio-type income, such as interest. Under section 469(e)(1)(B), portfolio-type income generated by working capital is not derived in the ordinary course of a trade or business, and therefore, it is not treated as passive income. Under section 1411(c)(3), gross income from and net gain attributable to the investment of working capital is not derived in the ordinary course of a trade or business, and therefore such gross income and net gain is subject to section 1411."

[92] REG-130507-11, proposing Treasury regulation sections 1.1411-0 through 1.1411-10 (BNA Daily Tax Rpt Dec. 3, 2012).

[93] Section 911(a).

profits of such trade or business." The impulse that the measure of earned (or personal services) income should in some fashion be arbitrarily capped whenever capital is a material income-producing factor in turn has an ancient pedigree, dating back to World War I excess profit statutes.[94]

In practice, and as a matter of lore, it is probable that most taxpayers simply treat 30 percent of business profits as earned income. The arbitrariness of the rule means that he result may be excessive in some cases, and inadequate in others, but on balance one might expect that the cap applies inappropriately more frequently than taxpayers successfully employ it as a *de facto* floor to increase the earned income that they report on their tax returns. The section 911 regulations simply repeat the statute's admonition that, when capital is a material income-producing factor, a reasonable allowance for compensation constitutes section 911 earned income, up to 30 percent of the firm's net income.[95] By analogy to a related area, capital employed in the business need only be "substantial" to subject taxpayers to the 30 percent of firm income cap, and there is very little learning on how substantiality might be measured across different businesses.[96]

In the case of an owner-manager of a corporation, section 911 offers no special rules for dividing labor from capital income. As a result, the division is left to the taxpayer, in the form of the amount of firm profits the owner-manager designates as compensation. The only constraint is section 911(b)(2)'s rule that compensation must be reasonable in amount.

A similar issue arises in respect of qualified employee benefit plans.[97] Those rules also convey benefits (the qualification of the income for an employee benefits plan) on the "earned

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[94] Asimow, "The Maximum Tax on Earned Income: The First Five Years," 27 *S. Cal Tax Inst*. 191, 229-231 (1975).

[95] Treas. reg. sec. 1.911-3(b)(2). A special rule deems income from traditional professions, like law and medicine, as constituting earned income in its entirety. Treas. reg. sec. 1.911-3(b)(3).

[96] *Cf.* the rule in former Treas. reg. sec. 1.1348-3(a)(3)(ii) (1977), under the analogous maximum tax on earned income, discussed below ("Capital is a material income-producing factor if a substantial portion of the gross income of the business is attributable to the employment of capital in the business, as reflected, for example, by a substantial investment in inventories, plant, machinery, or other equipment."). See also Snyder, "Taxation with an Attitude: Can We Rationalize the Distinction Between 'Earned' and 'Unearned' Income?," 18 *Va. Tax Rev.* 241, 277-79 (1998).

[97] Section 401.

income" of a self-employed individual. In turn, "earned income" for this purpose is defined as net earnings from self-employment for purposes of the self-employment tax, except that the net earnings must arise from a trade or business for which personal services of the taxpayer are a material income-producing factor.[98] This rule effectively treats all business income derived by a proprietor or owner-manager of a partnership as qualifying income: that is, there is no attempt to exclude from the definition of "earned income" any amount attributable to a fair return on capital.[99]

Conversely, in the case of the owner-manager of a corporation, only those amounts designated as compensation are treated as such for section 401 purposes. The only limitation from this direction is the general point that only "reasonable" compensation is treated as such for tax purposes.

The same question arose under former section 1348, repealed in 1981. That section imposed a maximum tax rate of 50 percent on "earned income," at a time when the maximum individual tax rate on "unearned" income was 70 percent. Section 1348 generally followed the same rules reflected today in section 911, with all the obvious deficiencies noted, both in respect of the arbitrariness of the rule as applied to proprietorships and partnerships, and the considerable degree of electivity of the rule as applied to corporations.[100]

None of these rules appears to have been particularly successful at separating labor from capital income. The rule limiting labor income to 30 percent of firm income when capital is a material income-producing factor is plainly arbitrary, and in any event does not apply to corporations. And the qualified pension plan rule that treats all income from a proprietorship or partnership as labor income if in fact some of the income is labor income is just as arbitrary,

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[98] Section 401(c)(2)(A).

[99] For the early history, which contained just such a limitation, see Asimow, "The Maximum Tax on Earned Income: The First Five Years," 27 *S. Cal Tax Inst*. 191, 230 (1975).

[100] For the former rule, see Treas. reg. sec. 1.1348-3(a)(3)(i)(1977). For some sense of the tax planning opportunities and pitfalls of former section 1348's definition of "earned income," see Levy, "The Maximum Tax on Earned Income: An Inefficient and Inequitable Tax Shelter Deterrent," 53 *Notre Dame L. Rev*. 883, 898-910 (1977); Asimow, "The Maximum Tax on Earned Income: The First Five Years," 27 *S. Cal Tax Inst*. 191, 229 - 249 (1975).

although in the opposite direction: it systematically overstates labor income, just as the first rule systematically understates it. So the two rules are both systematically wrong and internally inconsistent.

None of the rules summarized above can be said to have as its purpose the segregation of labor from capital income for the purpose of preventing taxpayers from reclassifying what economically is labor income into what might be treated for tax purposes as capital income. The one specific anti-abuse rule in the Internal Revenue Code that can be said to have addressed this phenomenon of labor stuffing was section 341, the collapsible corporation rules; the provision was repealed in 2003.[101] That Code section was famously recondite, but for this purpose the key point is that it addressed cases where individuals formed corporations to create property through their labor (e.g., movies, or tract homes), and then sought to sell the corporate stock before the self-created property could generate significant ordinary income.

Section 341 lost its sting when the Tax Reform Act of 1986 repealed the *General Utilities* doctrine, thereby subjecting to corporate-level tax the "build and liquidate" strategy at which the provision was aimed. Even in the new rate environment contemplated by this paper, it is not clear that an advantage would reemerge to the strategy, as the all-in tax on gain from the self-created property would equal the tax rate imposed on compensation income.

Moreover, even if section 341 were reenacted and rewritten to be comprehensible, it addressed an extremely narrow instance of labor stuffing. It simply would not reach the far more common case of the owner-manager of an operating company simply choosing not to draw a salary, and thereby leave compensation income to earn a superior investment returns inside the corporation.

Two instances where the distinction between labor and capital income does matter today (although outside the C corporation context) illustrate how badly current law addresses the issue. These are the well-known carried interest debate that first exploded on the tax scene in 2007 and the "John Edwards" payroll tax avoidance gambit mentioned earlier. The payroll tax gambit at least has the advantage of having led to some modest enforcement effort, as reflected in litigation.

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[101] Former Section 341, repealed by P.L. 108-27, section 302(e)(4)(A).

The works of Victor Fleischer and others have focused both academic and popular attention on the taxation of "carried interests" (interests in future partnership profits).[102] To simplify matters, the carried interest controversy revolves around the correct treatment of the general partner of an investment partnership where (i) that partner has a small capital investment in the firm and a larger share of firm profits, (ii) the partner commits to apply his or her expertise and time to manage the firm's investments, and (iii) the firm itself realizes only capital gains from the eventual sale of the portfolio companies it acquires.

Objectors to this result have pointed out that the capital gains preference rests on an implied assumption that the gain relates to a return on the taxpayer's capital, not a third party's capital. General partners in such ventures have pointed out that there was no general doctrine of law that required them to divide their economic returns into a return on their capital, earned at the same rate as the limited partners/investors earned a return on their capital invested in the firm, and a separate return on services they provided to the firm.

It is common for private equity sponsors to argue that they are entitled to capital gains rates on the sale by an investment partnership of its interest in a portfolio company for the same reason that an individual owner of a sole proprietorship is entitled to claim as a capital gain the profit realized by that owner on the sale of his business. But this sort of argument conflates the business of the general partners of a private equity firm (the successful operation of their investment firm) with the business operations of their firm (providing services to others). It is as if the proponents had forgotten that the owner of the local pizza restaurant might obtain capital gains treatment on the sale of her restaurant, but all the pizzas sold along the way were taxed at ordinary income rates.[103] Or to put matters more directly, these sorts of arguments might justify why owners of private equity firms are entitled, at least under current law, to capital gains tax rates when they take their firms public, but are completely orthogonal to the question of the tax

[102] Victor Fleischer, *Two And Twenty: Taxing Partnership Profits in Private Equity Funds,"* 83 N.Y.U. L. Rev. 1 (2008).

[103] Staff of Joint Committee on Taxation, Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests and Related Issues, Part I, JCX-62-07, Sept. 4, 2007, at 57-58.

rate that should be imposed on their investment firms in respect of the services those firms provide in the ordinary course of their business operations.[104]

Objectors more generally argue that legislation should develop just such a division between the labor and capital inputs of the general partners in these cases, to reflect the fact that owner-manager in this case was deriving income principally in return for services provided to the firm. Legislation in fact has been introduced that would have accomplished this result, but to date has not been enacted into law; the draft legislation was the subject of intense debate, both on policy and on technical grounds.

The larger importance of the contributions of Fleischer and other scholars that have examined this area is that the attention brought to bear has sharpened our collective sensitivity to the pervasive phenomenon of returns to labor masquerading as returns to capital, usually in order to claim the capital gains preference. The owner of the pizza restaurant in the example given above is a typical case: her capital investment in the restaurant might be dwarfed by her labor investment, in the form of long hours working there while "drawing" a low salary, but policymakers reflexively assume that the entirety of her gain on the sale of the business (attributable to the goodwill/going concern value created primarily by her personal efforts) should constitute capital gain, because she is selling an asset (albeit one that was self-created), or as a subsidy for her "entrepreneurial" risk-taking or the like.

The "John Edwards" stratagem, as mentioned previously, is a device to avoid Medicare tax on net business income attributable to an owner-manager's labor contributions to the firm's net income, by understating the owner-manager's explicit salary. It relies on the anomalous fact that dividends paid by an S corporation to its shareholders are not includible in the shareholders' income, and therefore are beyond the reach of section 1411's new tax on net investment income.

[104] It apparently is the case that Bain Capital, which has been much in the news of late, has in some of its deals received carried interests of 30 percent, rather than the industry standard 20 percent, from its investment partnerships with third party investors. Governor Mitt Romney recently defended that result on the grounds that Bain Capital provided much more in the way of services to the portfolio companies that these investment partnerships acquired than do many other private equity firms, through the secondment of large numbers of Bain Capital specialists in various areas of finance and management. This implicitly argues persuasively against the treatment of any returns on these carried interests as capital gain, an irony largely lost on both the Governor and his audience.

The question of what counts as "reasonable compensation" has primarily been addressed in a different context: the deductibility of unreasonably *high* wages paid by a C corporation. Small business owners running C corporations have, at times, sought to eliminate the double taxation of a C corporation's profits by setting the owner-entrepreneur's salary just high enough so that the corporation has no (or very little) taxable income. The IRS can step in to deny a deduction for some of the purported wages—any amounts that are not "reasonable"—and reclassify some of the payments as dividends, increasing the corporation's taxable income.[105] The standard applied in high-compensation cases is the "independent investor test,"[106] which considers a range of facts and circumstances.[107]

In pursuing the converse case of inadequate S corporation compensation, the Internal Revenue Service may be whistling, if not in the dark, then at least at dusk, as almost all the reported cases to date have dealt with the easy case where an owner-manager draws no salary at all. In such circumstances, courts have recharacterized purported dividends as wages subject to payroll taxes.[108] By contrast, there appears to be only two reported cases directly on point where

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[105] See section 162(a)(1); Treas. Reg. section 1.162-7(b)(1) (1960).

[106] Timothy R. Koski, *The Application of Employment Taxes to S Corporation Shareholders – What is "Unreasonably Low" Compensation?,* at 23. This test has been used, for example, to reclassify as dividends some compensation paid to an owner-entrepreneur when his business suddenly experienced a tenfold increase in gross receipts. He had given himself a large pay increase, from $190,000 in one year to $4.3 million the next, $2 million of which the court reclassified as a dividend.

See also *Mulcahy v. C.I.R.*, 680 F.3d 867 (7th Cir. 2012), discussed at length in Kip Dellinger, *The Consequences of Compensation as a Tax Position*, 135 Tax Notes 1649 (Jun. 25, 2012), and Robert W. Wood, *Discerning Compensation from Dividends in Professional Firms*, 136 Tax Notes 205 (Jul. 9, 2012). (Accounting firm with 40 employees and multiple offices paid compensation to founders and to other employees, and also substantially larger consulting fees to entities controlled by the founders; those consulting fees reduced firm income essentially to zero. The Seventh Circuit (Posner, J.) held that the consulting payments "flunked the independent investor test."

[107] See, e.g., *Pepsi-Cola Bottling Co. of Salina v. Comm'r*, 528 F.2d 176, 179 (10th Cir. 1975) (listing nine factors).

[108] See, e.g., *Joseph Radtke, S.C. v. U.S.*, 895 F.2d 1196 (7th Cir. 1990); *Spicer Accounting, Inc. v. U.S.*, 918 F.2d 90 (9th Cir. 1990); *Veterinary Surgical Constultants, P.C. v. Comm'r*, 117 T.C. 141 (2001); *Mike J. Graham Trucking, Inc. v. Comm'r*, 85 T.C.M. (CCH) 908 (2003); *Superior Proside, Inc. v. Comm'r*, 85 T.C.M. (CCH) 914 (2003); *Specialty Transp. & Delivery Serv. v. Comm'r*, 85 T.C.M. (CCH) 920 (2003); *Nu-Look Design, Inc. v. Comm'r*, 85 T.C.M. (CCH) 927 (2003); *Water-Pure Sys., Inc. v. Comm'r*, 85 T.C.M. (CCH) 934 (2003). Cf. Daley, *Edwards's S Corporation, Medicare Tax, and Fair Share*, 104 Tax Notes 1577 (Sept. 27, 2004).

the Internal Revenue Service has successfully asserted that the stated salary of an owner-manager who was very modest about the value of the services he provided to his S corporation constituted unreasonably low compensation income.[109] Moreover, even if perfectly enforced the doctrine is inadequate to the task, because it still leaves untaxed the returns of an S corporation that can fairly be described as economic rents or the like. By contrast, all other common forms of income either constitute part of net investment income, or comprise wages or self-employment income.

Even before the very recent *Watson* case, the confusion between the capital and labor income of S corporation owner-managers was well known to specialists. For example, the Staff

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In *Joseph M. Grey Pub. Accountant, P.C. v. Comm'r*, 119 T.C. 121, 124–25 (2002), the Tax Court reclassified an owner of an S corporation who claimed also to be an independent contractor as in fact an employee, and thereby imposed payroll tax obligations on the compensation paid by the corporation.

For recent news articles, see David Cay Johnston, *Newt and the NEWT Act*, Feb. 3 2012, http://blogs.reuters.com/david-cay-johnston/2012/02/03/newt-and-the-newt-act/; Shamik Trivedi, *News Analysis: Shades of John Edwards in Gingrich Return,* Tax Notes Today, Jan. 24, 2012.

[109] The two wo recent cases are *Watson v. United States*, 714 F. Supp. 2d 954 (S.D. Iowa 2010), aff'd, 668 F. 3d 1008 (8th Cir. 2012); *Herbert v. C.I.R.*, T.C. Summ. Op. 2012-124 (Dec. 26, 2012). See generally, Robert W. Wood and Christopher A. Karachale, *Unreasonably Low S Corporation Pay*, 135 Tax Notes 893 (May 14, 2012). The cases cited in that article at fns. 10. 11 and 13 are not strictly apposite to this point, as they involve in every case S corporation owner-managers that paid themselves no express salary, and instead either extracted firm earnings as purported loans to themselves (e.g., Greenlee v. U.S., 661 F. Supp. 642 (Dist. Colo. 1985) or simply caused their firms to pay their personal expenses or distribute cash as their personal needs arose (e.g., *Joseph M. Grey Public Accountant, P.C., et al. v. C.I.R.*, 93 Fed. Appx. 473 (3rd Cir. 2004); *Yeagle Drywall Co. Inc., et al. v. C.I.R.,* 54 Fed. Appx. 100 *(3rd Cir. 2002); Joly v. C.I.R.*, 211 F.3d 1269 (6th Cir. 2000)).

In *Watson* the taxpayer paid himself a salary of $24,000/year and treated approximately $200,000/year as dividends; the District Court for the Southern District of Iowa held for the government that the salary Watson received was not reasonable compensation, and therefore imposed FICA tax on the dividends received (subject to relevant ceilings). The 8th Circuit affirmed, holding that *Radtke* and similar cases in fact established a duty to pay reasonable compensation, at least for FICA purposes.

In *Herbert*, the taxpayer was a shareholder of an S corporation that conducted delivery services. Upon liquidation, taxpayer took $60,000 out of the business, of which $2,400 he classified as wages subject to payroll tax. The Tax Court held that $2,400 was unreasonably low compensation, but the difference, $57,600 was not all wages, because some was used to pay business expenses. The court set wages based on an average of taxpayer's salary over the life of the business.

of the Joint Committee on Taxation described the issue in detail in a 2005 report.[110] Moreover, the tax revenues at stake are enormous. The JCT Staff report referenced above concluded in 2005 that revising the law to treat S corporation owner-managers as partners, and clarifying that limited liability company members were liable for self-employment taxes, would raise over $57 billion over ten years.[111] In the intervening time taxpayers' reliance on this strategy appears only to have increased. This suggests that the issue in fact may today be more important as a revenue matter than would be the revision of current law to treat some income derived from "carried interests" as labor income.

The reasonable compensation determination as applied presents obvious difficulties, not the least of which is the administrative and judicial burden of the determination and the unevenness of its application in practice. A fact and circumstances test cannot possibly be applied usefully to cover the gamut of American businesses, each with different market norms and special circumstances. Moreover, there is only one case to date that accepts the existence of an affirmative duty as a matter of law to pay a minimum reasonable level of compensation in the context of S corporations. Even if this legal standard were universally embraced, it cannot possibly be expected that the same test could usefully perform that task in the new rate environment, where the stakes will become even higher.

In summary, the Internal Revenue Code does not today contain any mechanism to address labor stuffing, and the Internal Revenue Service's efforts to police a facts and circumstances approach to measuring unreasonably low (or high) compensation has been no more successful than any other intensely fact-specific inquiry. Looking forward, it is difficult to envision how one could write a self-enforcing provision of law that would identify for taxpayers and the Internal Revenue Service alike what constitutes reasonable compensation in every instance. Another approach is needed.

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[110] Staff of the Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures*, JCS-02-05, Jan. 27, 2005, at 95-104. To the same effect, According to a 2009 Government Accountability Office report, "13 percent of S corporations paid 'inadequate wage compensation' in 2003 and 2004." Sam Goldfarb, Critics Attack S Corp Payroll Tax Increase in House Extenders Bill, Tax Notes Today, June 8, 2010, 2010 TNT 109-2. This figure by itself understates the issue, of course, because many S corporations have nominal incomes.

[111] Id at 425.

C. Incremental Reform Proposals.

1. Responses to Capital Stuffing. The Internal Revenue Code's tools for addressing the capital stuffing problem as it existed in the decades before 1982, when corporate tax rates were materially lower than individual rates, demonstrate the practical futility of policing capital stuffing through rules designed to limit 'incorporated pocketbooks,' or 'unreasonable accumulations' of earnings. These regimes are likely to be, at best, uneven and imperfect policemen of the future capital stuffing problem that will plague the tax rate environment hypothesized in this paper. Another approach is needed.

One possible incremental response to the capital stuffing phenomenon is to reject the hypothesis, or more particularly to raise the tax rate on corporate distributions.[112] A dividend/capital gain toll charge can operate to remove the advantage of lower corporate income tax rates in respect of any specified holding period, but so long as the intra-corporate after-tax rate of return is higher than the outside rate of return, there exists a holding period sufficient to compensate for the higher toll charge. As a result, higher taxes on dividends and capital gains will also always be an imperfect solution to the phenomenon.

More important, higher toll charges by their nature will exacerbate lock-in problems, by inducing investors to hold onto their corporate investments as long as possible to enjoy the higher rate of return on their corporate capital (net of the notional set-aside to fund the toll charge). Moreover, as a matter political economy, there does not appear to be any great appetite to raise dividend and capital gains taxes beyond the 20 percent level mooted by the President. For all these reasons, capital stuffing should be addressed by a solution other than higher dividend and capital gains taxes.[113]

A better approach to the problem is to take a step back and ask why we would want to tax some capital income (e.g. corporate returns) at one rate and other capital income (returns earned directly or through a fiscally transparent vehicle) at a different rate. Efficiency argues for a consistent rate on all capital income, so that allocations of capital are not distorted across different real investments and legal forms of making those investments. Moreover, if capital

[112] Halperin, *Mitigating the Potential Inequity of Reducing Corporate Rates*, 126 Tax Notes 641 (Feb. 1, 2010) comes to this conclusion.

income is to be taxed, it is likely that the most successful compromise between efficiency and immediate revenue concerns, as tempered by political economy considerations, will lie in the direction of a relatively low flat tax on capital income.[114]

The point here is not to make this case, which is the purpose of the next paper in this project. Rather, the point is to say that, in light of this ultimate goal, there is a straightforward answer to the problem of capital stuffing, which is to recognize that the problem lies in *overtaxing* capital income earned outside the corporation, not in the failure to preserve higher taxes on some forms of capital income by policing an artificial boundary between the meaningless legal form of the corporation, on the one hand, and other forms of business enterprises, on the other.

Given that corporate income tax rates must come down in response to all the larger trends identified earlier, the right move in this case is to: (i) reduce capital income taxes on individuals to the same rate as that imposed on corporations and (ii) lower, not raise, dividend and capital gains taxes on corporate stock to as close to zero as is feasible. In such an environment, returns on marginal investments would compound at the same after-tax rates inside or outside the corporation.

In short, the fundamental insight that flows from understanding the source of the capital stuffing advantage is to align individual and investor-corporate tax burdens on capital income by lowering, in particular, the tax rate on interest income earned by individuals to the same capital income rate that corporations enjoy on their net profits.

2. Lock-In. The most direct mitigation techniques for the problem of lock-in point in the direction of (i) low capital gains tax rates on sales of corporate stock, (ii) assuring identity in tax rates between dividends and capital gains, and (iii) the elimination of the tax-free step-up at death.

The first point is almost self-evident; in the absence of some mechanism to coordinate shareholder capital gains with corporate taxes, capital gains taxes are the source of lock-in. At

[114] Edward Kleinbard, *An American Dual Income Tax: Nordic Precedents*, 5 Nw. J.L. & Soc. Pol'y 41 (2010). Again, the text abstracts from the question of what tax rate ought to apply to economic rents. In many small business cases, apparent economic rent might more properly be seen as returns to labor income

the same time, it is important to recognize that the case for low capital gains taxes to mitigate corporate lock-in are much more attenuated when extended to investments not subject to double taxation: in those cases – for example, the sale of a bond at a profit, attributable to a decline in interest rates – a preferential capital gains rate creates a tax-induced distortion *in favor of sales*, in order to capture future streams of ordinary income at lower capital gains rates.

The second point addresses the quasi-lock-in problems attributable to disparities in the tax rates imposed on dividends and capital gains: if such a difference exists, investors and corporations have an incentive to retain earnings in corporate solution and to defer realization events. And the third recommendation of course goes to an additional incentive to defer the realization of gains; unlike the core lock-in phenomenon, this one is readily addressed even within the constraints of a realization system.

3. <u>Labor Stuffing</u>. Labor stuffing today is driven in large measure by some conspicuous anomalies in current law, in particular the S corporation and non-corporate capital gain conversion opportunities described earlier. In the context of corporate employers, and assuming that the "John Edwards" type strategies are separately addressed, the labor stuffing problem is really a subspecies of capital stuffing: the reason an owner-manager would undercompensate herself in the future is not the lower corporate tax rate per se (because that comes with the dividend/capital gain quasi-excise tax, which brings the aggregate rate back to labor tax levels), but rather the opportunity to leave that amount in corporate solution to compound at the superior post-corporate tax rates.

One suggestion is that all closely held corporations mandatorily be taxed as partnerships.[115] That proposal would solve the labor stuffing (and capital stuffing) issue, but without more it would do by raising substantially the tax rate on the capital income of roughly half the U.S. economy. [116] Efficiency concerns and the larger trends in capital income taxation that this paper has summarized all counsel against this approach, without further consideration to

[115] George Yin, Toward Tax Reform chapter.

[116] And in the rate environment imagined here there would be enormous effort applied to becoming a 'barely public' company to take advantage of the superior returns available to corporations described in this paper.

the rates imposed on the owners of a private firm.[117] (In effect, the Dual BEIT proposal offered in the last section of this paper does just that, by taxing the capital income of closely held firms at low capital income rates.)

If this paper is correct that the principal advantage of labor stuffing is that it affords the owner-manager the opportunity, not to avoid labor income taxes as such, but rather indirectly to engage in capital stuffing in respect of the retained corporate earnings attributable economically to labor inputs, then the solution proffered earlier for capital stuffing – to reduce the tax rate on capital income earned directly by individuals to the corporate tax rate – would address the problem, at least in the rate environment contemplated by this paper. But tax rates may change, thereby changing the dynamics, and there other reasons (e.g. the payroll tax) to develop a more comprehensive solution. For these reasons, it is worthwhile to consider how a more robust capital-labor income centrifuge might be designed.

[117] Interestingly, Norway recently has done something vaguely along the lines of what Yin suggests, by taxing the income of private firms at the maximum individual rate. To make this approach consistent with economic theory, however, Norway has also introduced a system to *exempt* normal returns (returns on marginal investments) from tax at all. The Norwegian system thus amounts to a high rate of tax only on economic rents (or disguised labor). In the absence of a Norwegian-style special rule for normal returns, raising the tax rate on all capital income not held by public corporations would seem to add significant distortions to U.S. savings and investment.