Neste ponto sim, justifica-se a proteção da intimidade. Deve-se assegurar a garantia constitucional do segredo processual também ao processo administrativo, em conformidade com o art. 5º, IX, art. 93, IX, da CF; e, também, com os arts. 155 e 815 do Código de Processo Civil; os arts. 20, 201, 207 e 745 do Código de Processo Penal. O processo administrativo merece o mesmo tratamento do segredo de justiça a que são submetidos os processos judiciais.[56]

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e sobre a natureza e o estado de seus negócios ou atividade. 3. *Crime de violação do sigilo funcional:* Código Penal Brasileiro, art. 325.

[56] *Segredo de justiça – processos judiciais:* Código de Processo Penal, art. 792

The Regulation of Corporate Groups: Can Tax Help with Regulation?[1]

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ABSTRACT: This paper proposes that the corporation income tax ("CIT") contributes, and may contribute more effectively, to the regulation of corporate groups. The paper is divided in two parts. In the first part, the paper will argue that a CIT system contributes to the regulation of corporate groups by minimizing the firm's agency problems, and by limiting and controlling managerial power. In the second part, the paper will discuss how a CIT system may be improved so that it may contribute more effectively to their regulation. The paper will argue that in a second best world, i.e., CIT's world, pure efficiency and regulatory considerations should guide tax intervention. The policy principle proposed is that, absent agency problems and other market failures, transaction costs and other sources of deadweight loss should be reduced as much as possible. Thus, the reduction or elimination of specific transaction costs and other sources of deadweight loss should be pursued only when such reduction or elimination does not adversely influence the CIT's regulatory functions. Otherwise, the specific aspects of the CIT system under consideration may often be better maintained. By following this policy approach, the CIT should be actively contributing for a better regulatory environment in the corporate sector.

I – INTRODUCTION

This paper proposes that the CIT contributes, and may contribute more effectively, to the regulation of corporate groups. The paper is divided in two parts. In

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the first part, this paper will argue that a corporate-level realization-based CIT system contributes to the regulation of corporate groups. In the second, it will discuss how a CIT may be improved so that it may contribute more effectively to their regulation.[2]

II – THE CORPORATION INCOME TAX SYSTEM AND THE REGULATION OF THE FIRM

A realization-based corporate-level income tax system contributes to the reduction of the firm's agency problems and to the limitation and control of managerial power.[3] These conclusions from a recent line of literature shed a new light over CIT's regulatory potential, especially when in face of entities such as corporate groups, renowned for their difficulty to be regulated.[4] The next section will outline the conclusions from this research before proceeding to the analysis of their consequences for current CIT policy. For purposes of this paper, the regulatory effects of a CIT system will be classified as the "Reliability Effect," the "Deterrent Effect," the "Reversal of Clientele Effect" and the "Control Effect."

1. The Reliability Effect

Levying a separate tax on corporations provides a financial incentive for the state to invest in the verification of the reliability of the firm's disclosed information regarding its operations.[5] Consequently, due to the existence of the CIT system, two distinct auditing bodies generally supervise the reliability of the firm's disclosed information, *i.e.*, external auditors and the state.[6] The level of detail of tax information,[7] coupled with the strength of the state's supervision and enforcement mechanisms,[8] turn the state into an important and differentiated inspector of the reliability of the firm's disclosed information regarding its operations.[9] Significantly, the state has an incentive to verify the reliability of the disclosed information and to enforce its rights even when the transaction costs associated with such actions are higher than the potential immediate benefit involved.[10] As Desai notes, by auditing accounts or taking legal action against a corporation, the state induces other firms to behave.[11] This supervision activity of the government should be of especial relevance for the protection of minority shareholders' interests[12] and for the accuracy of small companies' books, which are often not legally obliged to have their accounts audited.[13]

2. The Deterrent Effect

The firm's financial results often determine the amount of control shareholders exercise over, and payments made to, corporate managers.[14] Further, the financial

[2] The paper's scope is limited to corporate income tax issues (*i.e.*, personal income tax issues, indirect taxes and other forms of taxation are not considered in this study). Further, the focus of this study is a closed economy. Hereinafter, all references to "IRC Section" and "IRC Treas. Reg. Section" are to the United States Internal Revenue Code of 1986 and the regulations promulgated thereunder.

[3] *See, e.g.*, M. Desai, et al., *Corporate Governance and Taxation*, NBER, Working Paper available at http://140.247.200.140/programs/olin_center/corporate_governance/papers/03.Dyck.taxation.pdf (2003); Reuven S. Avi-Yonah, *Corporations, Society, and the State: A Defense of the Corporate Tax*, 90 Virginia Law Review 1193 (2004); Wolfgang Schon, Tax and Corporate Governance (Wolfgang Schon ed., Springer 2008); Saul Levmore & Hideki Kanda, *Taxes, Agency Costs, and the Price of Incorporation*, 77 Virginia Law Review 211 (1991).

[4] *See, e.g.*, Janet Dine, The Governance of Corporate Groups (Cambridge University Press. 2000); José Engrácia Antunes, Liability of Corporate Groups: Autonomy and Control in Parent-Subsidiary Relationships in US, German and EU Law (Kluwer Law. 1994); Phillip Blumberg, *The American Law of Corporate Groups, in* Corporate Control and Accountability (Sol Picciotto ed. 1993).

[5] *See* M. Desai, et al., *Corporate Governance and Taxation*, *supra* note 3, at 38 (CIT provides a "source of revenues that will entice the government to verify the accuracy of corporate income in a manner that only the government can.").

[6] Id. at 5 ("[E]ffective tax enforcement makes hiding and diverting profits more difficult."). *See also* Wolfgang Schon, *Tax and Corporate Governance: A Legal Approach, in* Tax and Corporate Governance (Wolfgang Schon ed. 2008), at 60 ("[T]he mere existence of the corporate tax...puts an extra layer of certification on the calculation of corporate profits, in addition to the control mechanisms applied by shareholders themselves and public accountants.").

[7] Tax compliance obliges firms to disclose a significant amount of information regarding the operation of their business. In the US, apart from the information disclosed in the corporate tax return, this includes extensive transfer pricing compliance requirements (*see* IRC Section 482) and compliance with demanding anti-shelter regulations (*see* IRC Sections 6111 and 6112).

[8] In general, the regulatory strength of the state is based on its quantity of administrative personnel, available information, legal power and availability and strength of sanctions.

[9] *See* Schon, *Tax and Corporate Governance: A Legal Approach*, *supra* note 6, at 60 ("As tax inspectors do not face the same collective action problems which shareholders encounter and – even more importantly – rarely are subject to the same conflict of interests as auditors are, the natural process of tax auditing proves to be helpful for the overall framework of corporate governance.").

[10] In other words, the state does not face a "free rider problem" in monitoring and enforcing its rights. *See* M. Desai, et al., *Corporate Governance and Taxation*, *supra* note 3, at 38.

[11] Id. (authors refer to this phenomenon as the "spillover" effect).

[12] *See* Schon, *Tax and Corporate Governance: A Legal Approach*, *supra* note 6, at 60 ("[T]he tax authorities are a major player when it comes to the protection of minority interests.").

[13] *See* id. at 66 defending this argument for Germany. Note that there is recent research presenting some evidence that tax compliance may also result in managerial benefits to small businesses. *See* Philip Lignier, *The Managerial Benefits of Tax Compliance: Perception by Small Business Taxpayers*, 7 eJournal of Tax Research 106 (2009).

[14] *See* Myron S. Scholes, et al., Taxes and Business Strategy: A Planning Approach (Pearson Prentice Hall 3rd ed. 2005), at 169 (arguing that compensation contracts for top managers are often based on accounting earnings).

results of the firm generally dictate its stock value and the willingness of investors to invest in it.[15] For these reasons, corporate management retains a natural interest in reporting the highest possible profits and the lowest possible amount of losses for financial purposes. The existence of a separate corporate tax levied on corporate profits works as a friction against this natural propensity, and, thus, as a deterrent against the disclosure of fraudulent financial results.[16] The closer the relationship between financial accounting and tax accounting, and thus, the greater the potential for an effective cross-check, the stronger should be the friction.[17] That is, the higher the conformity between financial accounting and tax accounting,[18] the easier it should be for discrepancies between book income and

[15] Id. (claiming that analysts and investors use accounting numbers to price securities – both debt and equity – and arguing that managers might be concerned that reporting lower income may lead to lower stock prices and higher interest costs).

[16] *See* JEFFREY OWENS, *The Interface of Tax and Good Corporate Governance* 37 Tax Notes Int'l 767 (2005), at 768 ("Companies in some instances might try to inflate corporate profits for financial accounting purposes. If the financial accounting rules are also used to determine profits for tax purposes, with a resulting increased tax cost, the tax rules can act as a deterrent to profit manipulation.").

[17] *See* M. DESAI & D. DHARMAPALA, *Corporate Tax Avoidance and High-Powered Incentives*, 79 Journal of Financial Economics 145 (2007) (using the book-tax difference as a measure of potential tax sheltering). For the causes and the consequences of book-tax differences *see, e.g.*, G.B. MANZON & G. A. PLESKO, *The Relation Between Financial and Tax Reporting Measures of Income*, 55 Tax L. Rev. 175 (2002).

[18] In the US, several commentators have been arguing for greater conformity between financial and tax accounting rules, based on the associated reduction of compliance costs and the increased opportunities for monitoring. In Europe, the link between tax and financial accounts – although it takes varying forms and does not result in complete book-tax conformity – is more common. *See, e.g.*, Preamble to the Portuguese CIT Code (the legislator clearly identifies the financial accounting rules as a pillar of the Portuguese CIT system). Despite the strong arguments in favor of conformity, there are also good reasons for certain divergences. Fundamentally, financial and tax accounting are based on very different concepts and cultures and fulfill different objectives. Freedman, for instance, argues that "the most likely outcome in any system, whatever the starting point, should be partial convergence." *See* JUDITH FREEDMAN, *Financial and Tax Accouting: Transparency and "Truth"*, *in* Tax and Corporate Governance (Wolfgang Schon ed. 2008), at 71. According to Freedman, separate rules could be preferable to a system that purports to integrate two sets of rules but does so without clarity. Far from removing opportunities for manipulation, the interaction of two very different systems could increase the available opportunities for obfuscation. *See* id. at 72. Freedman concludes that "rather than arguing for conformity, which would then be the subject of exceptions and, thus, lack of clarity, it would be better to accept that there are differences and to make these explicit and rooted in established principles." Id. at 78. *See also* OWENS, *The Interface of Tax and Good Corporate Governance*, *supra* note 16, at 768 ("[I]n some cases, the essentially conservative nature of financial accounting rules, aimed at the protection of creditors, may not be appropriate for determining the government's share of the company's operating results.").

taxable income to attract the scrutiny of the tax authorities.[19] Due to the penalties generally associated with wrongful tax disclosure, the interest in understating profits (and overstating losses) for tax purposes should, therefore, work as a friction against the natural propensity to overstate profits (and understate losses) for financial purposes.[20]

3. The Reversal of Clientele Effect

The clientele effect assumes that investors are attracted to different firm policies, including tax policy, and that when a company's policy changes, investors adjust their stock holdings accordingly.[21] As a result of this adjustment, the stock price changes.[22] The existence of a separate tax on corporations should contribute to a significant reversal of this effect with regard to the tax factor. That is, if investors were to be directly taxed on the firm's income, the firm's tax policy would take on a distinct dimension for them. Shareholders would be more interested in controlling the operations of the firm in order to obtain a better individual tax result.[23] This could result in additional agency problems. Further, as Levmore and Kanda note, the firm's managers, who quite often are shareholders, would be more prone to act in a way most in line with their own tax circumstances or with the circumstances of the group of shareholders most willing to support them.[24]

[19] *See* SCHOLES, et al., Taxes and Business Strategy: A Planning Approach, *supra* note 14, at 170 (arguing that large differences between book income and taxable income can lead to greater scrutiny and audit adjustments by the IRS). *See also* C. BRYAN CLOYD, et al., *The Use of Financial Accounting Choice to Support Aggressive Stock Positions: Public and Private Firms*, 34 J. Acct. Res. 23 (1996) (reporting that managers believe that conformity results in lower tax audits). This should be especially true in the US after the introduction of Schedule M-3 to the CIT return.

[20] *See* M. DESAI & D. DHARMAPALA, *Tax and Corporate Governance: An Economic Approach*, *in* Tax and Corporate Governance (Wolfgang Schon ed. 2008), at 21 ("[A]t least for this sample of firms, the threat of IRS monitoring of their taxable income loomed larger than did investor monitoring of their financial statements....managers and investors appear to appreciate the role of a tax enforcement agency as a monitor of managerial opportunism.").

[21] *See* EDWIN J. ELTON, et al., *The Ex-Dividend Day Behavior of Stock Prices; A Re-examination of the Clientele Effect: A Comment*, *in* Investments: Portfolio Theory and Asset Pricing (Edwin J. Elton & Martin Jay Gruber eds., 1999).

[22] Id.

[23] *See* SAUL LEVMORE & HIDEKI KANDA, *Taxes, Agency Costs, and the Price of Incorporation*, *supra* note 3, at 213 ("[T]he separate tax on corporations 'equalizes' shareholders preferences for corporate transactions even though shareholders are in diverse individual tax circumstances").

[24] Id. This line of argument, although applying only to publicly traded corporations, has merit in light of the substantial revenue levied over these corporations under the existing CIT. *See* AVI-YONAH, *Corporations, Society, and the State: A Defense of the Corporate Tax*, *supra* note 3, at 1208.

4. The Control Effect

Lastly, as Avi-Yonah notes, a separate corporate-level tax allows society to limit and, to a certain degree, to control managerial power.[25] CIT limits managerial power in that levying a separate tax on corporations slows down the accumulation of corporate resources, which constitute the base of managerial power.[26] In addition, through the different incentives and disincentives it introduces to corporate activity,[27] CIT may work as a tool to control corporate behavior and, thus, to channel the use of corporate assets to uses considered valuable to society.[28]

In sum, taxing business income by levying a separate tax on corporations, as occurs under a CIT system, rather than exclusively through shareholder level taxes, gives rise to significant regulatory consequences. These consequences of CIT's existence as a separate corporate-level tax should contribute to the reduction of the firm's agency problems and to the limitation and control of managerial power.

III – THE IMPROVEMENT OF THE CURRENT CIT SYSTEM

In face of CIT's regulatory significance, tax policy should actively take into consideration CIT's regulatory functions when designing or reforming rules for taxing corporate groups.[29] The following section will suggest that traditional CIT policy criteria, such as neutrality and optimality, do not provide sufficient guidance for this type of intervention. A richer criterion that takes into consideration the regulatory functions of CIT should be applied.

[25] *See* Avi-Yonah, *Corporations, Society, and the State: A Defense of the Corporate Tax*, *supra* note 3, at 1244 ("[T]he corporate tax is justified as a means to control the excessive accumulation of power in the hands of corporate management, which is inconsistent with a properly functioning liberal democratic polity.").

[26] *See* id., at 1247.

[27] Broadly, CIT may impact the firm's behavior through several incentives and disincentives, including deductibility vs. non-deductibility, credits and exemptions, recognition vs. non-recognition, deferral of recognition vs. acceleration of recognition and relative tax rates.

[28] *See* Avi-Yonah, *Corporations, Society, and the State: A Defense of the Corporate Tax*, *supra* note 3, at 1255 ("Corporate taxation is an important regulatory tool and an important element in managing the delicate balance between corporations, society, and the state.").

[29] Obviously, this denotes a clear political option defending the role of the state as regulator in the economy. This should not make lose sight of the fact that governmental intervention is also vulnerable to failure. Such failure is generally attributed to several factors such as imperfect information, market distortions, etc. *See, e.g.*, Julian Le Grand, *The Theory of Government Failure* 21 British Journal of Political Science 423 (1991).

Neutrality, Optimality and Regulation

In face of CIT's structural nature, it is utopian to think about pure neutrality in CIT. The current CIT system is inevitably distortionary. Due to its realization-based nature, it generally affects the level of risk-taking[30] and timing of transactions[31] and often distorts investment preferences, organizational design and structuring of transactions.[32]

[30] Since investment decisions are based on after-tax returns, the CIT system may discourage the undertaking of risk by taxing the rewards from an investment, and encourage the undertaking of risk by bearing a portion of the losses. In principle, pure neutrality towards risk should not be possible under a CIT system. The characteristics of the loss relief system should dictate whether a CIT system enhances or reduces the risk-taking capabilities of corporations. In general, the spectrum of loss relief under a CIT system ranges from the possibility of providing no relief for the losses incurred by a business to providing a full refund for such losses. Within these two extremes, several intermediate positions exist. In these intermediate positions, although refund is denied, a CIT system may allow for the carryover of losses to different tax years, different sources of income and/or different entities. In principle, the risk-taking consequences of these different alternatives should vary. While, theoretically, the adoption of an unlimited loss offset regime should increase the level of risk-taking, the adoption of a severely restrictive loss offset regime should tend to decrease the level of risk-taking. *See* Rebecca S. Rudnick, *Enforcing the Fundamental Premises of Partnership Taxation* 22 Hofstra L. Rev. 229 (1993), at 273-278; Martin H. David, Alternative Approaches to Capital Gains Taxation (Brookings Institution. 1968), at 140; Michelle Arnopol Cecil, *Toward Adding Further Complexity to the Internal Revenue Code: A New Paradigm for the Deductibility of Capital Losses* 1999 U. Ill. L. Rev. 1083 (1999), at 1107; Robert H. Scarborough, *Risk, Diversification and the Design of the Loss Limitations Under a Realization-Based Income Tax*, 48 Tax L. Rev. 677 (1993), at 685; Evsey D. Domar & Richard A. Musgrave, *Proportional Income Taxation and Risk-Taking*, 58 The Quarterly Journal of Economics 388 (1944), at 391ff. *See also* M. Donnelly & A. Young, *Policy Options for Tax Loss Treatment: How Does Canada Compare?*, 50 Canadian Tax Journal 429 (2002); M. Campisano & R. Romano, *Recouping Losses: The Case for Full Loss Offsets*, 76 Northwestern University Law Review 709 (1981); Alan J. Auerbach, *The Dynamic Effects of Tax Law Asymmetries*, 53 The Review of Economic Studies 205 (1986); Jack M. Mintz, *An Empirical Estimate of Corporate Tax Refundability and Effective Tax Rates*, 103 Quarterly Journal of Economics 225 (1988).

[31] The so-called "lock-in" (*i.e.*, encouragement to retain assets beyond the optimal period) and "lock-out" (*i.e.*, encouragement to sell assets before the optimal period) distortions.

[32] There is a substantial amount of research demonstrating that taxes influence corporate behavior. On the interaction of tax and corporate financial structure *see, e.g.*, Alan J. Auerbach, et al., *Taxing Corporate Income in* Dimensions of Tax Design: The Mirrlees Review (J. Mirrlees, et al. eds., 2010), at 858 (arguing that the observed reaction of borrowing to tax incentives confirms that the tax treatment of debt and equity influences corporate financial decisions); David F. Bradford, Untangling the Income Tax (Harvard Univ. Press. 1999), at 105 (noting that the tax system exerts strong incentives effects on the corporation's financial choices). *See also* John R. Graham, *Taxes and Corporate Finance: A Review*, 16 The Review of Financial Studies 1075 (2003) (reviewing specialized literature and arguing that research often finds that taxes affect corporate financial decisions); Jeffrey K. MacKie-Mason, *Do Taxes Affect Corporate Financing Decisions?*, 45 The Journal of Finance 1471 (1990), at 1472 (author provides clear evidence of substantial

Another possibility is to try to move the CIT system closer to a normative ideal. That is, use normative principles or optimal tax theory as guide for tax intervention. However, as already demonstrated by a number of commentators,[33] to determine whether a proposed reform moves us closer to the Haig-Simons ideal, or by that matter, any other normative tax policy ideal, is not a policy

tax effects on financing decisions); JULIAN S. ALWORTH, The Finance, Investment and Taxation Decisions of Multinationals (Basil Blackwell. 1988) (demonstrating the influence of taxation on corporate financial policy); ALAN J. AUERBACH, *Taxation and Corporate Financial Policy*, NBER, Working Paper No. 8203 (2001) (discussing the impact of taxation on corporate financial policy). On the impact of tax on organizational form *see, e.g.*, M. DESAI, et al., *Taxation and the Evolution of Aggregate Corporate Ownership Concentration* NBER, Working Paper No. w11469 (2005) (arguing that taxation can significantly influence patterns of equity ownership); STEVEN A. BANK & BRIAN R. CHEFFINS, *Tax and the Separation of Ownership and Control*, *in* Tax and Corporate Governance (Wolfgang Schon ed. 2008), at 157 (noting that tax can help to explain ownership structures in large companies in a particular country). *See also* R. GORDON & J. MACKIE-MASON, *How Much do Taxes Discourage Incorporation?*, 52 Journal of Finance 477 (1997) (discussing impact of taxes on incorporation); A. GOOLSBEE, *Taxes, Organizational Form and the Deadweight Loss of the Corporate Income Tax*, 69 Journal of Public Economics 143 (1998) (discussing the behavioral responses to tax incentives surrounding the choice of organizational form). On the interaction between tax and general investment decisions *see, e.g.*, BRADFORD, Untangling the Income Tax, *supra* on this note, at 108 and 112 (author notes that the corporation tax system creates strong pressures on the composition of corporate investment); DANIEL B. THORNTON., *Managerial Tax Planning Principles and Applications*, *in* Critical Perspectives on the World Economy, Vol. 4 (Simon R. James ed. 2002), at 119 (arguing that business decisions affect taxes and taxes affect business decisions); JOHN R. GRAHAM, *Taxes and Corporate Finance: A Review*, 16 The Review of Financial Studies 1075 (2003), at 1076 (showing that taxes can affect restructurings, payout policy and risk management and that corporate bankruptcy and highly levered restructurings have tax implications). *See also* MYRON S. SCHOLES & MARK A. WOLFSON, *The Effects of Changes in Tax Laws in Corporate Reorganization Activity*, 63 Journal of Business Finance S141 (1990) (authors present evidence that CIT law has an impact on M&A activity); ALAN L. FELD, Tax Policy and Corporate Concentration (Lexington Books. 1982) (author demonstrates influence of taxation on corporate concentration). On the interaction between tax rules and corporate governance *see e.g.*, JEFFREY OWENS, *The Interface of Tax and Good Corporate Governance* 37 Tax Notes Int'l 767 (2005); SCHON, Tax and Corporate Governance, *supra* note 3; STEVEN A. BANK, *Dividends and Tax Policy in the Long Run*, 2007 University of Ilinois Law Review 533 (2007).

[33] *See* DAVID A. WEISBACH, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, 84 Cornell L. Rev. 1627 (1998), at 1628 ("[T]raditional tax policy concerns, such as whether something is 'income' within the Haig-Simmons definition, are neither helpful nor relevant to most disputes."). *See also* DEBORAH H. SCHENK, *An Efficiency Approach to Reforming a Realization-Based Tax*, 57 Tax L. Rev. 503 (2004), at 519 ("In a second best world...it makes no sense to focus on whether a particular reform moves us closer to a normative definition of income since that approach contributes nothing helpful in determining whether a reform is warranted.") and SAUL LEVMORE, *Recharacterizations and the Nature of Theory in Corporate Tax Law*, 136 Uni. Pa. L. Rev. 1019 (1988), at 1061 ("The nature of corporate tax law defies normative argumentation.").

which is bound to work in CIT's world of the second best.[34] As for optimal tax research, the existing research has not yet focused appropriately on CIT issues,[35] and thus, for the time being, its application should better be restricted to secondary guidance purposes.[36]

This paper suggests that in a second best world, *i.e.*, CIT's world, pure efficiency and regulatory considerations should guide tax intervention.[37] The principle should be that, absent agency problems and other market failures, transaction costs and other sources of deadweight loss should be reduced as much as

[34] For the theory of the second best *see* R.G. LIPSEY & KELVIN LANCASTER, *The General Theory of Second Best*, 24 Rev. Econ. Stud. 11 (1956). Broadly, the introduction of an improvement towards optimality doesn't necessarily result in an overall improvement if the underlying context is itself imperfect. CIT exists in an imperfect economy, *i.e.*, an economy with transaction costs and information asymmetries. In this imperfect economy, valuation of assets, knowledge of the tax rules, compliance and administration, have associated costs. These costs are the *raison d'etre* of CIT's existence and current structure. That is, CIT's two core pillars, *i.e.*, the realization concept and the tax personality of the legal person, which, in turn, explain to a substantial extent the entire mechanical structure of a CIT system, are second best approaches to CIT design. If there were no market imperfections, other solutions (*e.g.*, mark-to-market taxation) could be preferable.

[35] Under the existing optimal tax research, the impact on behavior and utility of CIT is still fairly unknown. Also, CIT is strongly determined by administrative and compliance issues, an issue generally not explored by optimal taxation due to difficulty to model these items. *See* C. HEADY, *Optimal Taxation as a Guide to Tax Policy: a Survey*, 14 Fiscal Studies 1 (1993). *But see* Slemrod's theory on optimal tax systems, JOEL SLEMROD, *Optimal Taxation and Optimal Tax Systems*, 4 Journal of Economic Perspectives 157 (1990), at 158 ("[The theory of optimal tax systems] embraces the insights of optimal taxation but also takes seriously the technology of raising taxes and the constraints placed upon tax policy by that technology. A theory of optimal tax systems has the promise of addressing some of the fundamental issues of tax policy in a more satisfactory way than the theory of optimal taxation.").

[36] This is because of the limitations of the theoretical models of optimal tax research, which usually depart from the assumption of perfect markets and no externalities. Id.

[37] On the defense of efficiency as the most appropriate way to deal with tax issues *see, e.g.*, NOEL B. CUNNINGHAM & DEBORAH H. SCHENK, *The Case for a Capital Gains Preference*, 48 Tax L. Rev. 319 (1993), at 370-72 ("In [a second best] world, efficiency is the touchstone."); DAVID A. WEISBACH, *An Efficiency Analysis of Line Drawing in the Tax Law*, 29 Journal of Legal Studies 71 (2000), at 74 ("Doctrinal issues of the sort that tax policy makers face on a daily basis can and should be grounded in efficiency."); DEBORAH H. SCHENK, *An Efficiency Approach to Reforming a Realization-Based Tax*; *supra* note 33, at 519 ("Whether horizontal equity has any meaning in designing a tax system, it has far less meaning in a second-best world. That is because it is impossible to tax equals equally where there is a deviation from the base that cannot be eliminated (in this case, the realization rule). Therefore it is very difficult to say whether any change in a second-best world promotes the equal treatment of equals. Since any reform will result in treating some equals equally and some differentially, efficiency should control.").

possible.[38] That is, the reduction or elimination of specific transaction costs and other sources of deadweight loss should be pursued only when such reduction or elimination does not adversely influence CIT's regulatory functions. Otherwise, the specific aspects of the CIT system under consideration may often be better maintained. By following this approach, CIT is actively contributing for a better regulatory environment in the corporate sector.

The perception of the complexity of the suggested tax intervention should serve not to bar its intervention but to place very strict limitations on that intervention.[39] That is, interventions should be cautiously made, as far as possible in limited areas where it is easier to consider and control potential collateral effects of the tax rules as well as the interaction with the frictions imposed by other regulatory areas. In addition, a streamlining of current CIT policy objectives is required. Specifically, this paper is not concerned with equity and anti-concentration issues.[40]

[38] *See* DAVID M. DRIESEN & SHUBHA GHOSH, *The Functions of Transaction Costs: Rethinking Transaction Cost Minimization in a World of Friction*, 47 Ariz. L. Rev. 61 (2005), at 103 ("If a particular transaction cost serves no function at all, it constitutes waste and deserves elimination."). *See also* DAVID A. WEISBACH, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, *supra* note 33, at 1655 ("The efficiency goal for tax policy is to find the tax that causes the lowest deadweight loss.").

[39] The control of CIT's consequences on firm behavior is very complex. The behavior of a firm towards tax has been shown to vary based on many factors, namely, the tax position of the taxpayer, the strength of the tax incentive or disincentive armory, the existence of frictions or incentives in other regulatory fields and the existence and cost of alternative behavioral routes. Even more general characteristics, such as the stage of development of the firm, its financing constraints, business prospects and risk-taking profile can influence the reaction of the corporate taxpayer to the tax rules. *See, e.g.*, DEBORAH H. SCHENK, *An Efficiency Approach to Reforming a Realization-Based Tax*; *supra* note 33, at 509-512; DAVID M. SCHIZER, *Frictions as a Constraint on Tax Planning*, 101 Columbia Law Review 1312 (2001), at 1323-1334; CUNNINGHAM & SCHENK, *The Case for a Capital Gains Preference*, *supra* note 37, at 351-353; SCHOLES, et al., Taxes and Business Strategy: A Planning Approach, *supra* note 14, at 9, 155-169, 167-176; JOSEPH BANKMAN, *The New Market in Corporate Tax Shelters*, 83 Tax Notes 1775 (1999), at 1776; DANIEL B. THORNTON, *Managerial Tax Planning Principles and Applications*, *supra* note 32, at 150.

[40] Following other commentators, this paper proposes that equity issues may be better dealt with at the shareholder's level, *i.e.*, with personal income taxation rules or, alternatively, with adjustments to the CIT rate structure (*i.e.*, different tax rates applicable to different classes of corporate taxpayers). *See* DAVID A. WEISBACH, *An Efficiency Analysis of Line Drawing in the Tax Law*, *supra* note 37, at 74 (defending that decisions regarding redistribution should be left for adjustments to the rate structure). As for economic concentration, it would be better dealt with by non-tax law frictions, namely, anti-trust laws. To tam economic concentration would create a paradoxical opposing objective. It is better for CIT to pursue solidly one objective and leave other opposing objectives to be pursued by existing non-tax law frictions. *See* DAVID M. SCHIZER, *Frictions as a Constraint on Tax Planning*, *supra* note 39 (Author discusses affirmative use of non-tax law frictions in tax law).

The next section will apply these policy principles to the taxation of corporate groups. That is, it will discuss ways in which the current CIT system may be improved through reduction of deadweight loss without adversely affecting its regulatory functions. The following section will, first, analyze the fundamental traits of corporate groups and, then, based on such analysis, identify the main sources of deadweight loss that may arise when groups are taxed under the "Standard" CIT System.[41] Subsequently, based on the principles suggested above, the paper will discuss potential improvements to the CIT system.

A. The Nature of Corporate Groups

1. Unitary Economic Direction and Organized Internal Markets

Corporate group members submit to a unitary business policy.[42] This unitary business policy, which covers most business areas (including marketing, production and sales, research and development, financial and labour policy), submits group members to a global business strategy whereby assets, profits and personnel are transferred to those affiliates where the return on capital is highest (for comparable risks).[43] This allocation of the overall group resources to those members that can earn the highest rate of return has two crucial, and interrelated, consequences to the group. First, it allows the group to maximize its overall profitability (since its resources are always being put to their highest economic use) and, second, it generates a competitive market dynamic among its constituency.[44]

The internal economic dynamic that results from the interaction of these two phenomena gives the corporate group the characteristics of an "internal" or "organized" market.[45] That is, the different operating units of the corporate

[41] Hereinafter, "Standard CIT System" refers to the CIT system rules with the exclusion of Group Taxation regimes.

[42] *See* RICHARD CAVES, Multinational Enterprise and Economic Analysis (Cambridge University Press 2nd ed. 1996); DEREK F. CHANNON & MICHAEL JALLAND, Multinational Strategic Planning (Macmillan. 1978); MICHAEL BROOKE & H. LEE REMMERS, The Strategy of Multinational Enterprise (Pitman 2nd ed. 1978); PHILLIP BLUMBERG, The Law of Corporate Groups – Problems of Parent and Subsidiary Corporations under Statutory Law of General Application (Little. 1989); TOM HADDEN, *Inside Corporate Groups*, 12 International Journal of the Sociology of Law 271 (1984).

[43] Id.

[44] Id. *See also* GUNTHER TEUBNER, *The Many-Headed Hydra: Networks as Higher-Order Collective Actors*, *in* Regulating Corporate Groups in Europe (D. Sugarman & G. Teubner eds., 1990).

[45] *See* GUNTHER TEUBNER, *Unitas Multiplex: Corporate Governance in Group Enterprises*, *in* Regulating Corporate Groups in Europe (D. Sugarman & G. Teubner eds., 1990), at 82 (The modern corporate group is "an organized market...which replicates within its internal boundaries the structures of both firm and market.").

group effectively compete against each other for communal group resources in a struggle coordinated by the price mechanism: each corporate member must provide to the collective entity the highest possible return on a specific resource to keep it. However, this competition does not have the same characteristics of the one found in the open market. In the "organized internal market,"[46] the collective interest is also present. Thus, an individual unit may compete with other group members only up to the point in which its individual interests collide with the collective interest of overall profit maximization. In addition, although quasi-market principles dictate the location of group resources, it is the hierarchical decision of the headquarters that effectively allocates them to the individual group member. In this "organized internal market," the open transferability of assets and income between group members is essential to ensure that the group's resources are constantly being put to their highest economic use and, thus, to ensure the economic viability of the corporate group.

2. The "Chameleon-like" Governance Structure

In order to ensure the constant maximization of overall profits in the "organized internal market," the corporate group possesses a mechanism of self-regulation and control, based on the "double orientation" of the actions of its members. That is, in the context of a group, "individual actions...are simultaneously and cumulatively oriented both to the common goal and to the individual goals of the members"[47] with "no normative primacy of one orientation or the other."[48] As a consequence of the absence of a higher ranking guiding principle, the pondering of a corporate member's "dual-oriented" action will always involve a certain degree of decision-making subjectivity.

In this subjective process of pondering decisions according to equally ranking individual and collective interests lies the main mechanism of the corporate group for self-regulation and self-control. That is, the subjective balance of interests operated in each individual decision of group members allows the group, as a collective whole, to constantly control its constituent parts (in that incentives or disincentives may be introduced through discriminate decision-making) and to continually adapt itself to the outside environment (in that each corporation may alter the overall internal dynamic of the group through the balance of interests it introduces in each action that it takes). Thus, this internal

[46] This paper has adopted this terminology since it considers that it better encapsulates the internal economic dynamics of modern corporate groups.

[47] *See* TEUBNER, *The Many-Headed Hydra: Networks as Higher-Order Collective Actors, supra* note 44, at 50.

[48] Id., at 51.

decision-making system turns the corporate group into a "multi-stable" enterprise with an ever changing internal governance structure.[49]

Due to the action of this decision-making system, the corporate group's governance structure may assume an indeterminate variety of forms and characteristics, depending on the blending of market and hierarchy, contract and organization, strategically implemented at each moment. Thus, for instance, the corporate group's management policies may limit the parent corporation's control of subsidiary affairs to the minimum level required to ensure a common economic direction throughout the corporate group (normally, through a control of the so-called strategic management area) or, inversely, they can implement a tight monitoring of all subsidiary business activity.[50] As a result of this chameleon-like governance structure, the functional structures of corporate groups may often deviate from their legal structures.[51] Although both structures may eventually coincide, they are increasingly diverging in modern large corporate groups.[52] As will be discussed, this divergence is of extreme importance for CIT due to the emphasis it lays on legal form.

3. Organizationally-Bound Property Rights

Under the classical corporate law paradigm, self-sufficiency and self-governing characterizes a corporation.[53] That is, the corporation, endowed with legal personality, exercises sovereignty over its decisions. As a self-sufficient and self-governed legal person, the corporation owns assets and liabilities and possesses

[49] *See* TEUBNER, *Unitas Multiplex: Corporate Governance in Group Enterprises, supra* note 45, at 84.

[50] There is a significant variation in the centralization of management policies depending on such general factors as group's size, industry sector, organization of production lines or degree of group's diversification. In addition, factors such as the nationality of parent and subsidiary, subsidiary's size or overall performance and age, may also have a bearing on the definition of management policies. Substantial variations in management policies may also result from the legal and economic characteristics of the parent-subsidiary relationship or the group's economic, social and legal environment. *See* JOSÉ ENGRÁCIA ANTUNES, Liability of Corporate Groups: Autonomy and Control in Parent-Subsidiary Relationships in US, German and EU Law, *supra* note 4, at 191-208.

[51] That is, the design of a group's functional structure follows a different rationale from the one that generally underlies the design of its legal structure. The concerns associated with the legal structure include, for instance, the insulation of liability of specific parts of the group's business or legal and/or practical requirements imposed by operations in a foreign country.

[52] *See* TOM HADDEN, *Inside Corporate Groups*, 12 International Journal of the Sociology of Law 271 (1984), at 279 ("[T]here is an increasing divergence between legal and managerial structures in these large corporate groups").

[53] *See* JOSÉ ENGRÁCIA ANTUNES, Liability of Corporate Groups: Autonomy and Control in Parent-Subsidiary Relationships in US, German and EU Law, *supra* note 4, at 56-64. *See also* J. FARRAR, Company Law (Butterworths 4th ed. 1998).

organs which allow it to form its own will. However, the sovereign nature of the corporation is distorted when it is controlled by another corporate entity and, thus, submitted to an external (and potentially differing) interest.[54] In this situation, the controlled corporation may lose its status as a self-determined entity and become an entity subject to an alien hierarchical structure that favours a higher collective interest over its own.[55]

In particular, the existence of a unitary economic direction in the group (crucial for its existence as an "organized internal market") may relegate the particular economic interest of a subsidiary in support of the common objective of overall profit maximization. In addition, because a corporate group does not possess a formal organizational structure, and, thus, generally builds its structure using the organs of its members as if they were its own, intercorporate control tends to result in significant distortions to the original attributes of the corporation's organs. These distortions jeopardize the foundations of the corporation's legal personality.[56]

In particular, the main distortions to the corporation's organizational structure tend to occur at the level of the board of directors and the general meeting of shareholders. Basically, there is a dissipation of the legal powers of the general meeting of shareholders and an associated enhancement of the real powers of the board of directors.[57] In contrast to the classic corporate law paradigm where the general meeting of shareholders is the "supreme organ of the organizational hierarchy endowed with sovereign powers on major issues of corporate life," in an affiliated corporation the board of directors tends to be the core decision-making organ.[58] This "strengthened" board of directors acts strictly in

[54] Id.

[55] *See* TEUBNER, *Unitas Multiplex: Corporate Governance in Group Enterprises*, *supra* note 45, at 82ff.

[56] *See* JOSÉ ENGRÁCIA ANTUNES, Liability of Corporate Groups: Autonomy and Control in Parent-Subsidiary Relationships in US, German and EU Law, *supra* note 4, at 64-80.

[57] Id.

[58] *See* JOSÉ ENGRÁCIA ANTUNES, Liability of Corporate Groups: Autonomy and Control in Parent-Subsidiary Relationships in US, German and EU Law, *supra* note 4, at 56-80. This organizational mutation is confirmed by theories on the evolution of the modern enterprise that describe it as a constellation of corporate sub-units whose direction and coordination is achieved through a hierarchical network headed by managers. *See* ALFRED D. CHANDLER, Strategy and Structure: Chapters in the History of American Enterprise (MIT Press. 1962) at 30. *See also* ALFRED D. CHANDLER, The Visible Hand: the Managerial Revolution in American Business (Harvard University Press. 1977) at 320; MELVIN EISENBERG, *The Legal Role of Shareholders and Management in Modern Corporate Decision-Making*, 57 Univ. Cal. L. Rev. 1 (1969).

accordance with the directives of the headquarters, and, thus, possesses a mere limited sovereignty over the corporation's decisions and existence.[59]

Thus, due to the group's unitary economic direction and to the group's "appropriation" of the corporation's organizational structure, the corporation that is a member of a corporate group possesses, in practice, only limited ownership rights over its assets (instead of an autonomous patrimonial endowment) and relies on organs of other group corporations for many of its decision-making capabilities (instead of relying on its autonomous organizational structure).[60] This distorts the foundations of the corporation's legal personality (*i.e.*, its capacity of action and its legal capacity),[61] and gives rise to a different type of property rights within the groups, the so-called "organizationally-bound" property rights.[62]

In sum, corporate groups may be fundamentally defined by their unitary economic direction, organized internal market dynamics, chameleon-like governance structure and organizationally-bound property rights. The next section will analyze the problems that these characteristics pose to the Standard CIT system.

B. The Nature of the Tax Problem

As discussed above, a group requires assets and cash to be transferred between its nodes so that its organized internal market may operate efficiently. These transfers occur among different nodes of the group, such as sister to sister, subsidiary to parent or members located in different tiers.

The transfer may occur directly (*e.g.*, corporation A2 to corporation P using transactional route T5) or indirectly (*e.g.*, corporation A2 to corporation P using transactional routes T2 and T1 or T2, T3 and T1') and may assume different formal characteristics.[63] In most cases,[64] a corporate group, due to its unitary economic direction and chameleon-like structure, may with relative ease manipu-

[59] *See* JOSÉ ENGRÁCIA ANTUNES, Liability of Corporate Groups: Autonomy and Control in Parent-Subsidiary Relationships in US, German and EU Law, *supra* note 4, at 99-108.

[60] Id.

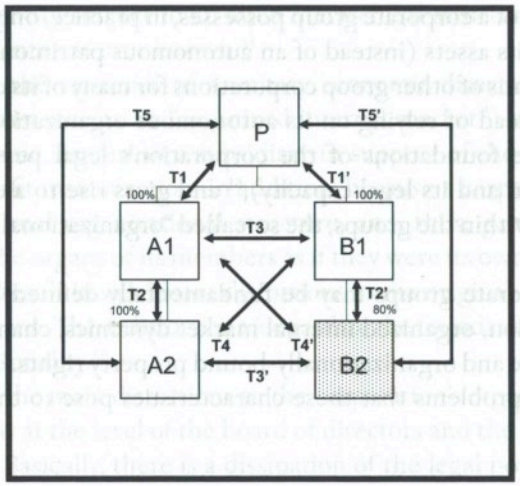
[61] Id.

[62] *See* TEUBNER, *Unitas Multiplex: Corporate Governance in Group Enterprises*, *supra* note 45; and TEUBNER, *The Many-Headed Hydra: Networks as Higher-Order Collective Actors*, *supra* note 44.

[63] For instance, a downward flow of assets (P to A1 using transactional route T1) may be structured as a capital contribution, a sale or a merger. The different formal characterization of the transaction should generally entail different tax consequences.

[64] Notable exceptions are transactions that have to forcefully be implemented in a certain way due to other business aspects. *See, e.g.*, MARTIN D. GINSBURG & JACK S. LEVIN, Mergers, Acquisitions, and Buyouts (Aspen. 1999).

late both these elements. That is, due to its nature, a group may easily select different transactional routes and legal forms to implement an intra-group transfer of assets or cash.[65]



TRANSACTIONAL FLOWCHART

Diagram # 1

The Standard CIT System, due to its characteristics, is not well adapted to deal with this type of creature. That is, the CIT system is generally based on the formal characterization of a transaction and ownership thresholds to define its tax consequences.[66] Different transactional flows present a different number of available

[65] This is because, first, each individual transaction is generally subject to the whole group interest and may benefit from the whole group resources. Second, the group has a volatile nature, in that new nodes may be introduced in the group or eliminated from it. Finally, the webs of ownership inside the group and the functions performed by each legal entity, although often subject to business and operational restraints, may also, as a matter of principle, be manipulated by the group. Therefore, even fundamental defining elements of a group such as its ownership or functional structures may sporadically be manipulated. We are in presence therefore of a very flexible entity with characteristics that significantly differentiate it from a single corporate entity. *See* discussion *supra* at section III.A.

[66] Due to the realization requirement, tax consequences occur only once there is a *qualifying* transfer of property between different legal entities. The determination of what amounts to a qualifying transfer of property for tax purposes is inextricably connected to commercial law concepts, such as control and continuity of business interest. In many cases, such concepts may be manipulated with relative ease by corporate groups. *See* discussion *supra* at section III.A.

transactions.[67] Since tax characterization is mostly based on legal classification,[68] a different formal characterization of a transaction in each of these transactional flows should often result in a different tax treatment of the transaction.

In essence, a corporate group navigates through complex transactional maps defined by tax law, which vary depending on the good to be transferred, ownership threshold in the corporate group member, and the legal form adopted to implement the intra-group transfer. Its expected behavior will be to choose the correct mix of these elements that better serves its interests,[69] namely, to transfer assets and/or cash from one subsidiary to the other minimizing the transfer costs (including taxes) and general operating costs in order to maximize profits.[70] This interest is also reflected on its interest to generate and use tax losses, which reduce taxable income, and thus, tax amount payable. Since in the current CIT system the use of tax losses is subject to asymmetries in the form of several basket restrictions,[71] groups may also often be interested in changing the character, source or timing of the loss so that it can be better availed of.

[67] For instance, on the downward and upward flows a larger number of direct transactions are available due to the direct stock relationship than on transversal flows.

[68] *See* LEWIS R. STEINBERG, *Form, Substance and Directionality in Subchapter C*, 52 Tax Law. 457 (1999).

[69] The option will generally consist in choosing between taxability and non-taxability of the transaction. This will generally depend on the tax attributes of the entities involved, fundamentally tax basis amounts and available carryovers of tax losses, and, in certain cases, the possibility offered by a transaction to carryover tax attributes. This option, when we are in the presence of a corporate group, due to its unitary economic direction, will be fundamentally different from the one of an economically independent corporation. Specifically, the group may be expected to maximize its overall tax attributes in a transaction. This attitude, fostered by the judicial culture in the US and UK that tends to defend the taxpayer's ability to legitimately reduce its tax costs, often leads to the implementation of transactions with a structure that would never exist absent the need to make use of overall group tax attributes. These tax-motivated transactions generally result in substantial deadweight loss, both for corporate groups and the state.

[70] This flexibility occurs essentially because CIT is built around realization. Specifically, in a realization-based tax system, taxpayers are relatively free to determine the occurrence, value and timing of a transfer as well as its legal characterization. When parties are unrelated, there is a differing economic interest of both parties to the transaction, which works as a friction to tax law. However, when parties are related, this friction is absent and thus the system collapses. That is, when parties are subject to a unitary economic direction, as in the case of corporate groups, these elements (*i.e.*, occurrence, value, timing and legal characterization of the transaction) may be manipulated with relative ease due to the unity of the underlying economic interest. This flexibility, coupled with the developments operated in recent years at the level of financial innovation (*e.g.*, hybrid financial products that mix debt and stock characteristics), puts an added pressure on anti-abuse rules and judicial doctrines such as substance over form and step transaction.

[71] In particular, character (*i.e.*, ordinary and capital losses may only be used to offset their respective type of income), entity (*i.e.*, entity may only use its own losses against its own income) and tax year (*i.e.*, losses may only be used in the tax year at stake or within a limited number of years) restrictions.

In short, the Standard CIT System is structurally asymmetrical and corporate groups, due to their unitary economic direction and chameleon-like governance structures, are able to manipulate with relative ease most of such asymmetries to their advantage.[72] This fact led to the development of a complex arsenal of anti-abuse rules[73] and placed additional pressure on judicial anti-abuse doctrines.[74] This, in turn, contributed to the fostering of organizational and transactional complexity within corporate groups.

This state of affairs results in substantial deadweight losses both for the state and corporate groups. As far as groups are concerned, first, the search for tax-favored treatment often leads to the implementation of more complex (and generally more costly) transactions than would be required otherwise.[75] This results in substantial deadweight loss, not only due to the increase in transaction costs,[76] but also because the increase in the complexity of internal group flows due to tax planning makes the group more opaque from an informational perspective.[77] That is, this increased internal transactional complexity makes it harder for top management and other stakeholders to be accurately informed about the operations of the group.

Second, when the tax factor is taken into consideration, often the economic efficiency gain of an intra-group transaction is not sufficient to offset its associated tax costs and, thus, the transaction is not implemented or is implemented

[72] The root of these structural asymmetries lies primarily on the policy-based distortions introduced to realization. In order to accommodate policy considerations, realization is made asymmetrical in that not all realization events necessarily result in the taxability of the transaction, *i.e.*, on a so-called "recognition event" This is a source of discontinuities in the tax law, which fosters tax planning behavior.

[73] Such as the thin-cap rules, transfer pricing rules, complex ownership standards, complex rules for determination of tax classification of legal instruments, etc.

[74] Such as the substance-over-form doctrine, step transaction, etc.

[75] For instance, implementation of a merger instead of a straight asset sale or several transactions instead of only one (*e.g.*, capital contributions in cascade instead of a straight asset sale to a lower tier subsidiary). *See* THORNTON, *Managerial Tax Planning Principles and Applications*, supra note 32, at 147 ("A corollary to the Coase Theorem is that people will engage in tax arbitrage up to the point where the marginal costs of performing the arbitrage are equal to the marginal gains.").

[76] While in certain cases transactions costs have a relevant function, in a corporate group setting there is no apparent added value in paying more or implementing more complex transactions to achieve the same end economic result. Thus, these costs should generally constitute pure deadweight loss.

[77] *See* MYRON S. SCHOLES & MARK A. WOLFSON, *The Effects of Changes in Tax Laws in Corporate Reorganization Activity*, *supra* note 32, at S144 ("[I]n designing an organization, tax considerations and information-related transaction cost considerations are often in conflict with one another.").

outside its optimal timing.[78] Accordingly, a second best option in terms of economic efficiency is maintained, in that assets or income are kept within a corporate member that does not ensure the best economic return for their use. In these situations, CIT interferes with the flexibility of corporate groups to transfer resources between their constituent parts and, thus, negatively influences their "organized internal market" dynamics.

Finally, the adaptation of corporate groups to the asymmetries of the CIT system tends to result in a rigidification of their organizational and operational structures.[79] This rigidification, in turn, reduces the corporate group's capacity of adaptation to outside disturbances, what may penalize its economic performance. As discussed above, the flexibility to create functional structures that deviate from legal structures is important to allow for the constant adaptability of corporate groups to their economic reality.

In sum, the Standard CIT System results in substantial deadweight losses for corporate groups. In addition, this state of affairs is also harmful to the state, due to the increase in administration and supervision costs. The next section will examine some technical solutions that attack the sources of these deadweight losses,[80] and consider whether their reduction or elimination limits in some way the regulatory functions of the CIT system.

[78] Apart from the cost of the tax payment itself, CIT results in significant additional transaction costs to corporate groups. This includes information costs to determine applicable rules, compliance costs and tax planning costs (including lawyer's fees and financial professional advice).

[79] This rigidity follows from three main reasons. First, tax planning may result in a higher centralization of management policies than otherwise required. *See* SCHOLES, et al., Taxes and Business Strategy: A Planning Approach, *supra* note 14, at 168. Second, due to the transaction costs associated with the definition and implementation of corporate structures, once a certain structure is implemented to benefit from a tax advantage, it is likely to remain in operation for a certain time. Finally, due to the application of anti-abuse rules, the corporate structure existing at the time of the transaction may have to be kept in place for a certain period in order for the tax treatment afforded to the transaction to be respected. *See, e.g.*, in the US, IRC Section 368 (requiring a post-acquisition continuity of business); IRC Treas. Reg. Section 1.355-2(d) (imposing restrictions on post-distribution sales); IRC Section 382 and IRC Treas. Reg. Section 1.368-1(d)(disallowing carryover unless business-enterprise continuity exists for two years after the limitation-triggering event and subjecting built-in losses to limitation if they are recognized during the five-calendar-year post-change recognition period). Although flexibility may be possible in certain cases, it usually comes at a higher cost. The situation may be especially damaging where the functional or legal structure adopted to benefit from tax advantages or avoid the application of specific anti-abuse rules is sub-optimal from a transaction cost or agency perspective.

[80] Fundamentally, the asymmetric nature of the CIT system.

C. The Curtailing of Deadweight Loss When Taxing Corporate Groups

This section will examine certain technical solutions that attack, in different ways and to a different extent, the sources of the deadweight losses discussed above. Then, it will consider whether their proposed reduction or elimination limits in some way the regulatory functions of the CIT system.

1. Technical Solution A (Full Integration)

Under the Standard CIT System, a corporation generally has three fundamental attributes, that is, the tax basis of its stock (or outside basis), the tax basis of its assets (or inside basis) and its taxable income or loss, either ordinary or capital.[81] This dual basis concept is a crucial characteristic of corporations for CIT purposes. Although the fair market value ("FMV") of stock and underlying assets is the same, each has an independent value for tax purposes.[82]

The dual basis is the source of many of the problems that the Standard CIT System faces to tax corporate groups.[83] For that reason, under Technical Solution A (*i.e.*, full integration system) there is a sole stock basis for parent and corporate group members.[84] That is, outside basis is extinguished for all corporate group members, except the parent corporation and, thus, there is no difference between inside and outside basis at the level of corporate group members.

Importantly, the elimination of outside basis allows for an associated elimination of individual tax attributes of all corporate group members, except for the parent corporation.[85] This means that there is a unified tax calculation of tax attributes for all corporate group members and that all tax tracking is operated exclusively at the parent corporation's level.

[81] Taxable loss, both ordinary and capital, may respect to prior tax years (*i.e.*, so-called accumulated tax losses).

[82] The determination of the initial amount of basis depends on the source of the taxpayer's ownership of property. *See* GLEN ARLEN KOHL, *The Identification Theory of Basis*, 40 Tax L. Rev. 623 (1985). Basis records origin, nature and life of assets and stock. Fundamentally, it records the amount of already taxed income. As Kohl notes, in many respects, the "role of basis in the tax law is to identify the portion of a taxpayer's wealth that is exempt from future income taxation." *See* id., at 623.

[83] The existence of a dual basis presupposes the creation of separate tax attributes for each corporate group member, creates potential for manipulation of asset vs. stock transactions and generates double counting problems.

[84] This technical solution requires complete or almost complete ownership. It is designed based on the US Check-the-Box regime and consists in treating corporate group members as divisions, for tax purposes, of their parent.

[85] This is because, for tax purposes, by losing stock basis the entity is actually treated as a division of its parent.

This method of taxing corporate groups reduces the opportunities for manipulation of the CIT system and its associated complexity. Intra-group transactions, in whichever form or direction, may be effectively disregarded for tax purposes. That is, within the boundaries of a fully integrated corporate group, flows of cash and assets may occur without any tax consequences, both in upward, downward and transversal flows, independently of their formal characterization (*i.e.*, irrelevant for tax purposes if transactions are characterized as loan, capital contribution, distribution, etc.) and of the corporate group member that undertakes such transaction.[86]

Thus, within the boundaries of a tax integrated group directionality and formal characterization of transactions are irrelevant. A corporate group member may transfer assets independently of their attributes for tax purposes (*i.e.*, built-in gain or built-in loss assets), in whichever direction or form, to other fully-integrated corporate group members without any tax consequences. In contrast to the Standard CIT System, line-drawing in intra group transactions is completely eliminated.[87]

This model, despite the appeal of its mechanic simplicity, has certain problems. First, and fundamentally, with incomplete ownership, the attribution of an outside basis to each corporate group member is advisable in order for the tax system to operate properly and, thus, the tax existence of group members may not be completely eliminated for tax purposes. This is due to two reasons. First, since we may be considering a corporation with listed shares, once a corporate group member has more than one shareholder, the tax system must attribute an outside basis to each shareholder for it to be able to trade freely on its stock. Second, where a flow-through regime is applicable to a corporation that is owned by more than one shareholder, the tax system might well attribute an outside basis to each shareholder in order to keep track of taxed amounts, distributions and tax attributes (*e.g.*, losses and deductions) that flow-through to the shareholders. In these cases, outside basis should allow the tax system to allocate the tax attributes of the flow-through entity among its shareholders and to avoid potential situations of double or no taxation.[88]

[86] For instance, group restructurings are facilitated in that no tax planning is required to ensure that the merger or spin-off qualifies under the relevant legislation. All intra-group restructurings are regarded as a mere internal transfer of assets (even if only stock is transferred) without any tax consequences.

[87] *See* DAVID A. WEISBACH, *An Efficiency Analysis of Line Drawing in the Tax Law*, *supra* note 37, at 71 ("Lines should be drawn so that a transaction or item is taxed like its closest substitute.").

[88] We note, however, that this second hurdle is somewhat relative. For instance, the UK tax system manages to tax partnerships without recognizing partnership interests as assets. Partners are simply considered to own the appropriate share of each asset. Thus, tax attributes associated

A further set of problems relate to the interaction of this model with the Standard CIT System. Consider the group's relationship with outside parties. Although the stock basis of Tax Group members is eliminated, their stock may still be sold to outside parties. When that occurs, the issue that arises is what should be the tax value of the stock. A straightforward solution is to treat the sale of stock as a sale of the underlying assets.[89] In such case, inside basis could dictate the amount of capital gain (or loss) on the stock sale. In principle, this capital gain (or loss) would be recognized at the level of the parent corporation, the only entity with tax attributes under this model.[90]

The treatment given to an entity's tax attributes once it enters or leaves a fully integrated tax group produces a further interaction problem with the Standard CIT System. A possible solution for pre-entry tax attributes may be to eliminate all the entity's tax attributes upon entry to the Tax Group. In such case, the outside basis of the corporate group member, together with all remaining tax attributes, would be eliminated without recognition of gain (or loss) by any member of the Tax Group. In principle, the inside basis for all assets would carryover. This type of solution, although more restrictive to the taxpayer in that all of its pre-entry tax attributes would be effectively lost, remains attractive because of its simplicity and difficulty to manipulate.[91]

An alternative solution, more beneficial to the taxpayer but with higher associated complexity, assumes a tax-free liquidation to the parent corporation upon entry of the new corporate group member and allows the carryover of old tax attributes of the new corporate member to the group's parent. In this case, all assets, liabilities, and items of income, deduction, and credit of the entering corporation would be treated as assets, liabilities, and items of income, deduction and credit, of the group's parent. In principle, the transfer of assets and

with assets are allocated to partners directly. Recognizing partnership interests (outside basis) makes it easier to keep track of items that flow through to shareholders, but also runs the risk of mismatches and adds its own layer of complexity, as we see in the US.

[89] There are more elaborate solutions for this problem such as the so-called "asset-based" model implemented under the Australian Group Taxation regime. Its high complexity, however, makes it far less appealing as a solution to this problem.

[90] This is the solution that the US CIT system adopts for entities that classify as disregarded entities under the Check-the-Box regime. Under this type of solution, since the sale of stock is the sale of the underlying assets, an issue arises as to whether stock may classify as an asset used in the trade or business and thus, under the generally applicable rules, whether the respective sale gives rise to ordinary income (or losses) instead of capital gains (or losses). This issue should be less relevant in jurisdictions, such as those in Continental Europe, that have not formally implemented an ordinary income/capital gain divide.

[91] That is, this solution eliminates the potential for tax planning operations aimed at importing losses into the fully integrated tax group by acquiring corporations with accumulated losses.

the deemed liquidation would be disregarded for tax purposes.[92] However, this solution should require complex rules to avoid abuses (*e.g.*, limiting the use of pre-entry losses to income derived by the corporate group member), and more complex tax accounting.

As for the exit of a Tax Group member, a potential solution could be to treat the departing corporate group member as a new corporation acquiring all of its assets and assuming all of its liabilities. In such case, the departing Tax Group member would take a cost-basis in its assets, which should determine the value of its new stock basis. In addition, the carryover of any attributes generated while it was a member of the Tax Group could be simply disallowed.

Thus, although the interaction of the full integration model with the Standard CIT System raises mechanic issues, they could, in principle, be dealt with using more or less restrictive mechanic solutions. Although this issue will not be subject to further development in this paper, we note that it must be carefully considered by the legislator to avoid potential loopholes or malfunctions of the tax system.

The relationship of the full integration model with other regulatory fields presents another area of trouble. Fundamentally, the implementation of this model is subject to a corporate law and accounting analysis of the feasibility of making the tax treatment independent of the corporate law treatment. In the US, as the recent experience with the Check-the-Box regime demonstrated, this should pose no insurmountable problems.[93] However, in jurisdictions that more closely align corporate law and corporate income tax law, to totally disregard the separate tax existence of a corporation for tax purposes may be more troublesome.[94]

Finally, the elimination of the separate tax existence of corporate groups raises international tax issues. Although these issues remain outside the scope of this paper, it is worth noting that the application of tax treaties to the disregarded corporate group members, the classification of disregarded corporate group members for foreign tax purposes, and the treatment of foreign losses must be analyzed once one considers the implementation of this model. The

[92] *See* similar policy for QSub corporations at IRC Treas. Reg. Section 1.1361-4.

[93] *See, e.g.*, HUGH DOUGAN, et al., *"Check-the-Box" – Looking Under the Lid* 75 Tax Notes 1141 (1997).

[94] For instance, which entities are deemed liable for the payment of the group's tax liability; what happens in terms of court proceedings, etc. *See* BERTIL WIMAN, *Equalizing the Income Tax Burden in a Group of Companies*, 28 Intertax 352 (2000), at 353. In certain countries, an issue also arises regarding the legal grounds for the tax pooling of profits and losses. For example, in Germany a legal contract between corporate group members is required in order to implement tax consolidation. *See* IFA, Group Taxation (Sud Fiscale & Financiële Uitgevers. 2004), at 43.

US experience with the Check-the-Box regime should provide a rich source of analysis of potential problems and solutions in this field.[95]

In sum, the full integration model presents considerable advantages to tax corporate groups, reducing opportunities for manipulation of the CIT system and its associated complexity. However, it presents certain implementation issues. Although the interaction of this model with the Standard CIT System raises certain mechanical issues, it appears as if they can be dealt with through the use of more or less restrictive mechanic solutions. This is an issue that the legislator must carefully consider. The model's relationship with other regulatory fields and with the international tax environment incorporates more complex issues. Fundamentally, in order to avoid complexity and abuses, careful analysis must precede potential implementation.

2. Technical Solution B (Partial Integration)

For purposes of this paper, it suffices to say that there are special taxation regimes in certain jurisdictions, including the UK, that allow for partial integration solutions.[96] A corporate group member may generally access these regimes provided that there is a significant control (*e.g.*, 75% ownership threshold in the UK and 80% ownership threshold in the US)[97] of the parent corporation over such corporate group member. Broadly, these special regimes generally allow, to a varying degree and in different ways, for the offset of profits and losses among corporate group members and for the deferral of tax on certain intra-group transfers. There are several group taxation models with different rules to attain one or both objectives.[98]

[95] In this regard, *see, e.g.*, ALICE G. ABREU, *Making Something Out of Nothing: Tax Planning With Disregard Entities in* Tax Planning for Domestic & Foreign Partnerships, LLCs, Joint Ventures & Other (Practising Law Institute ed. 2004); REUVEN S. AVI-YONAH, *To End Deferral As We Know It: Simplification Potential of Check-the-Box* 74 Tax Notes 219 (1997); DANIEL S. MILLER, *The Strange Materialization of the Tax Nothing* 87 Tax Notes 685 (2000).

[96] *See, e.g.*, DIETER ENDRES, *The Concept of Group Taxation: A Global Overview*, 31 Intertax 349 (2003); WIMAN, *Equalizing the Income Tax Burden in a Group of Companies*, *supra* note 94; IFA, Group Taxation, *supra* note 94; ANTONY TING, *Policy and Membership Requirements for Consolidation: A Comparison Between Australia, New Zealand and the US*, 3 British Tax Review 311 (2005); J. RICHARD, *Comparison Between UK and French Taxation of Group Companies*, 31 Intertax 20 (2003); ABADAN JASMAN & JUNAID SHAIKH, *Developments and New Ideas in the Group Relief Framework*, 8 IBFD Asia-Pacific Bulletin 334 (2002); DUBROFF, Federal Income Taxation of Corporations Filling Consolidated Returns (Matthew Bender. 2005).

[97] The definition of control in both jurisdictions is subject to severe standards.

[98] For example, a group taxation system may allow a corporate group to compute the tax liability of its members on a consolidated or combined basis. In other cases, as in the UK, it simply allows, on a case by case basis, for individual tax attributes to be transferred among affiliated corporations.

That is, these regimes aim to achieve similar aims to those achieved by Technical Solution A, but because the dual basis is maintained for each corporate group member, many of such objectives are not completely achieved, while others are achieved with additional complexity.

3. Technical Solution C (The "Molecular Group Taxation System")

The "Molecular Group Taxation System" proposal is based on the integration of Technical Solution A with a partial integration solution that allows, on a case by case basis, for individual tax attributes to be transferred among affiliated corporations, and that makes use of a participation exemption instead of a floating outside basis (as currently occurs under the US Consolidated Return rules) to deal with the double counting problem.[99] That is, a partial integration solution following mechanic principles similar to those of the UK Group Taxation regime. Under this proposed system, there would be two different levels of tax integration between corporate group members, that is, the intra-atomic level and the inter-atomic level. While at the intra-atomic level Technical Solution A would be applicable, the inter-atomic relationship would be subject to the partial integration solution.[100]

[99] For a discussion of the double counting problem *see* IFA, Group Taxation, *supra* note 94, at 40-42.

[100] The co-existence of full and partial integration solutions in a sole tax integration regime is not new. In practice, this already occurs in the US with the interaction of the US Consolidated Return rules with the US Check-The-Box regime. Based on the lessons from the US experience, the use of a floating outside basis should be avoided in order for this type of proposed hybrid model to work properly. That is, although the use of a floating outside basis allows for an accurate tracking of relevant intra-group events, it gives rise to very complex situations once there is a sale of stock of a Tax Group member. Also, the operation of the mechanism itself is particularly intricate. Finally, based on the current US experience, it gives rise to complex interaction problems with the remainder of the CIT system, notably with the taxation of flow-through entities. *See, e.g.*, TERRILL A. HYDE, et al., *The Use of Partnerships and LLCs in Structuring Consolidated Groups in* Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings (Practising Law Institute ed. 2005); BRYAN P. COLLINS, et al., *Consolidated Return Planning and Issues Involving Disregarded Entities*, *in* Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings (Practising Law Institute ed. 2005). Therefore, the use of a Group Taxation solution that does not require a floating outside basis should qualify as a preferable approach to the tax integration of partially owned entities within such a hybrid model. For this reason, this paper proposes that the use of a participation exemption mechanism should be privileged, even if only within the limited boundaries of the Tax Group. Thus, even in a tax system such as the US, which has not yet implemented a participation exemption under its Standard CIT System, a participation exemption may be implemented for the limited purposes of tax integration of corporate groups. Note, however, that the participation exemption, despite its mechanic simplicity, has certain problems that must be considered at the time of implementation, most especially, its potential for

Each tax atom corresponds to a corporate group node that is fully-integrated for tax purposes. Thus, inside the tax atom, the tax consequences of the transactions entered into by corporate group members are totally independent of legal formalism or the corporate veil fiction. Inside these tax atoms, assets, income and tax attributes, including losses, are freely transferable.[101]

The stock basis and tax attributes of the parent corporation of each corporate group node (*i.e.*, the filled-in square in the diagrams below) are the record keepers for tax purposes of all that occurs inside that specific node as well as of the transactions that occur between corporate group members of that node and other parties, including transactions entered into with corporate group members from different nodes. The tax atom may be conceptualized as follows:

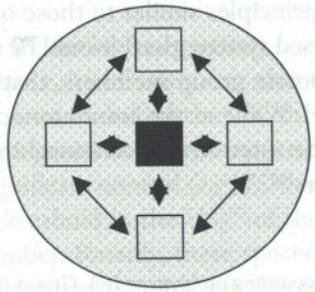


Diagram # 2

In turn, at the inter-atomic level, since the "organizationally-bound" property rights of the corporate group are, in principle, weaker than at the atomic level (*i.e.*, the control requirements for partial integration are generally lower

sheltering of unrealised gains. For instance, due to the exemption for capital gains on stock sales, corporate taxpayers may be encouraged to disguise the sale of assets, which should be taxable, as the sale of stock, which is not. By the same token, a parent corporation may acquire the shares in a subsidiary as part of a tax-free reorganization from persons that would not be able to utilize the capital gains exemption, namely, individuals and partnerships. These incentives for tax planning could add a new layer of difficulty to the government's ability to administer the tax law. For this reason, a participation exemption should generally be cumulated with additional rules to prevent abuses. For instance, restrictions preventing a non-eligible entity from avoiding capital gains taxation by transferring shares tax-free to a corporation or a step transaction doctrine enabling the tax authorities to recast a purported stock sale as an asset sale whenever deemed required. Further, the interaction of Technical Solution A with group taxation systems that require the creation of consolidated tax attributes, instead of allowing for simple transfers on a case-by-case basis as here proposed, would introduce a substantial amount of complexity that could endanger the efficiency objectives of the proposed system.

[101] *See supra* Technical Solution A.

than for full integration), realization events are not entirely eliminated. Thus, the inter-atomic relationship would be subject to a partial integration solution with the core characteristics described above. The tax molecule may be conceptualized as follows:

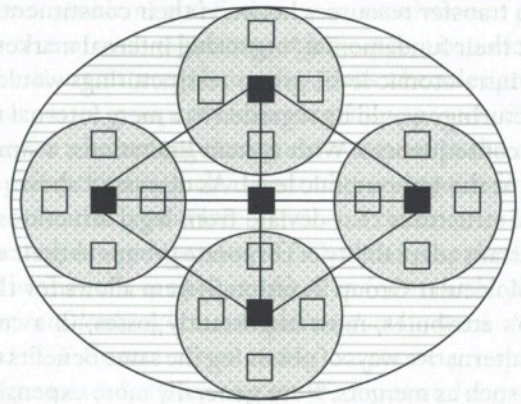


Diagram # 3

4. The Dynamic Impact of the Proposed Technical Solutions

The proposed tax regimes should impart significant benefits to corporate groups, the state and other stakeholders, when compared with the Standard CIT System. Although benefits should be stronger under full integration, partial integration solutions should also provide important advantages. The ensuing analysis will focus on the analysis of the Molecular Group Taxation System since it blends both types of technical solutions and, thus, offers a richer analytical perspective.

First, within the boundaries of the tax atom, the transfer of assets and income would most likely be implemented using simpler transactions and corporate law instruments than under the Standard CIT System due to the absence of tax related considerations (*e.g.*, straight sale instead of merger; transfer of income using a loan instead of distribution and subsequent contribution; etc.). This would result in a significant reduction of deadweight loss, not only due to the reduction in transaction costs, but also because the decrease in the complexity of internal group flows due to the absence of tax planning would make the corporate group more transparent from an informational perspective. That is, this increased internal transactional transparency should make it easier for top management and other stakeholders to be accurately informed about the operations of the group. At the inter-atomic level, these benefits should in principle be weaker, but still relevant.

Second, since the tax factor would be irrelevant in intra-atomic transfers, assets or income could be transferred, absent constraints from other regulatory fields, on the optimal business timing to the corporate member that ensured the best economic return for their use. In this case, and to a more reduced extent also at the inter-atomic level, CIT would not interfere with the flexibility of corporate groups to transfer resources between their constituent parts and, thus, should not affect their fundamental "organized internal market" dynamics.

Third, at the intra-atomic level, group restructurings would be made easier in that all restructurings would be regarded as a mere internal transfer of assets without any tax consequences. With certain limitations, a similar result could also be obtained at the inter-atomic level. As discussed above, this flexibility to create functional structures that deviate from legal structures is important to allow for the constant adaptability of corporate groups to their economic reality.

Finally, the Molecular Group Taxation System allows for the mix up of the corporate group's attributes, most importantly losses, in a cost efficient way. When available, alternative ways of obtaining the same benefits under the Standard CIT System, such as mergers,[102] are generally more expensive, complex and may often have negative collateral consequences for corporate groups.[103]

In short, the Molecular Group Taxation System could result in a significant reduction of deadweight losses for corporate groups.[104] In addition, it could also be beneficial to the state, due to the reduction in administration and supervision costs that ensue from the reduction in transactional and compliance complexity. The issue that arises is whether the proposed intervention would limit in some way the regulatory functions of the CIT system.

The transactions that the proposed system aims at eliminating (*i.e.*, mostly pure tax planning transactions) are for the most part not informational in nature. Accordingly, their reduction or elimination should not, in principle, result in negative consequences to the CIT's regulatory functions identified above. Indeed, in principle, a relative improvement of such functions could occur in that the reduction of transactional and legal complexity should result in more transparent group structures and intra-group transfers.[105]

[102] Other examples include transfer of loan receivable to loss making entity, "sale and leaseback" transactions, write-off of the shares of loss making entity, financing triangulations, "stuffing" of loss making entity, "round robin" transactions, etc.

[103] For instance, unification of business divisions.

[104] In addition, the tax integration solutions may impact the risk-taking profile of corporate groups. Note, however, that due to the different types of restrictions generally introduced to the loss offset mechanisms and to their interaction with other elements of the CIT system, the assessment of CIT's impact on risk taking is far more complex than may at first be envisaged. *See supra* note 30.

IV – THE CORPORATION INCOME TAX AND THE REGULATION OF CORPORATE GROUPS

CIT reduces agency problems and limits the accumulation of power in the corporate sector. In face of such regulatory significance, tax policy should actively take into consideration CIT's regulatory functions when designing or reforming rules for taxing corporate groups. By following this approach, CIT would be actively contributing for a better regulatory environment in the corporate sector. Traditional CIT policy criteria, such as neutrality and optimality, do not provide sufficient guidance for this type of intervention. A richer criterion that takes into consideration the regulatory functions of CIT must be applied. Specifically, the principle should be that, *absent agency problems and other market failures, transaction costs and other sources of deadweight loss should be reduced as much as possible.*

The Standard CIT System when taxing corporate groups generates substantial deadweight losses both for corporate groups and the state. This occurs because the Standard CIT System is structurally asymmetrical and corporate groups, due to their unitary economic direction and chameleon-like governance structures, are able to manipulate with relative ease most of such asymmetries to their advantage. There are alternative solutions for taxing corporate groups that result in a significant reduction of the deadweight losses generated by the Standard CIT System. Their implementation should not, in principle, result in negative consequences to CIT's regulatory functions. Indeed, a relative improvement of such functions could potentially occur in that the reduction of transactional and legal complexity should result in more transparent group structures and intra-group transfers.

[105] As for the concern with minority shareholders, as the current experience throughout the world shows, it could be solved, for example, with the existence of a right for the minority shareholders to force the majority owner to acquire the minority shares; an agreement from the minority shareholders consenting to consolidation; guaranteed dividends to minority shareholders; or the existence of compensating payments to minority shareholders. *See supra* note 96.