TAXATION, PROPERTY AND MARKET: THE CASE OF THE CORPORATION INCOME TAX

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ABSTRACT: This article builds on Professor Saldanha Sanches' insight that there is a "profound interconnection between taxation/property/market," by analyzing the nature of these interrelationships in the context of a corporation income tax (CIT). The article adopts the United States Federal CIT system as the standard model of corporate income taxation. In certain cases, the Portuguese and the British CIT systems are also analyzed. The article discusses the relationship between CIT and property, the nature of the correlation between CIT and market, and assesses the tax policy implications of the connection between property and market. The study concludes by demonstrating the significance of these interrelationships for corporate tax policy. Specifically, the article argues that, in face of these interrelationships, the design and operation of a CIT system is subject to several constraints and distortions, and proposes that to simply look at how far a certain policy is from optimality may be insufficient to determine whether an incremental improvement occurs. The study proposes a new approach to CIT policy whereby the pursuit of incremental improvements requires the minimization of transaction costs and other sources of deadweight loss and the taking into account of the collateral effects of a CIT system, including its interaction with market imperfections, the behavioral and operational nature of business entities, its interaction with related regulatory fields, and its political significance.

Karl Popper once said that a theory can take thirty years to mature [1]. The final work of Professor Saldanha Sanches provides live testimony to

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(1) *See* KARL POPPER, O Conhecimento e o Problema Corpo-Mente (Edições 70. 2009), at 138.

Popper's dictum. The uncommon clarity and perspicacity that time lends to thought informs *Justiça Fiscal* [2]. Among other valuable reflections, Professor Saldanha Sanches points out that there is a "profound interconnection between taxation/property/market" [3]. The aim of this article is to build on this insight by analyzing the nature of such interrelationships in the context of a CIT. For purposes of this study, the United States ("US") Federal CIT system will be adopted as the standard model of corporate income taxation [4]. In certain cases, the Portuguese and the British CIT systems will also be analyzed. First, the article will discuss the relationship between taxation and property. Then, it will investigate the nature of the correlation between taxation and market, and assess the tax policy implications of the connection between property and market. The study will conclude by demonstrating the significance of these interrelationships for corporate tax policy.

A) Taxation and Property

1. The Corporation Income Tax

There are several policy options to tax the corporate sector. The different models currently available may be placed into three major categories, namely, accretion, consumption and realization-based (also known as transaction-based) tax systems [5]. Within each of these categories, different options are available depending on whether a corporate-level tax is imposed or not [6]. This

[2] *See* J. L. SALDANHA SANCHES, Justiça Fiscal (Fundação Francisco Manuel dos Santos. 2010).

[3] Id. at 25. Author's translation.

[4] 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. In turn, the Portuguese *Código do Imposto Sobre o Rendimento das Pessoas Colectivas* is referred to as "CIRC".

[5] *See* ALAN J. AUERBACH, *et al.*, *Taxing Corporate Income in* Dimensions of Tax Design: The Mirrlees Review (J. Mirrlees, *et al.* eds., 2010), for an alternative, economic-based, typology of CIT systems based on the type of tax base, *i.e.*, taxes on the return to equity investment, taxes on economic rent and taxes on the return to all capital.

[6] For a discussion of "accretion" models (also designated as "accrual" or "mark-to-market") *see, e.g.*, DAVID F. BRADFORD & U. S. TREASURY TAX POLICY, Blueprints for Basic Tax Reform (Tax Analysts 2nd ed. 1984) at 5, 81; EDWARD A. ZELINSKY, *For Realization: Income*

article will focus on the study of the CIT model. This type of realization-based income tax system, currently the basis of most corporate tax systems around the world [7], including the Portuguese, is characterized by two core structural elements. First, the adoption of the realization principle as the yardstick to determine whether and when tax is levied [8]. Second, the taxation of corporations at rates unrelated to those of shareholders.

Taxation, Sectoral Accretionism, and the Virtue of Attainable Virtues, 19 Cardozo L. Rev 861 (1997), at 880-881. For partial accretion models *see, e.g.*, DAVID A. WEISBACH, *A Partial Mark-to-Market Tax System*, 53 Tax L. Rev. 95 (1999); ALAN J. AUERBACH, *Restrospective Capital Gains Taxation*, 81 Am. Econ. Rev. 167 (1991). For consumption-based corporate tax models *see, e.g.*, CHRIS EDWARDS, *Replacing the Scandal-Plagued Corporate Income Tax with a Cash-Flow Tax*, 484 Cato Institute Policy Analysis 1 (2003); ALAN J. AUERBACH, *et al.*, *Taxing Corporate Income*, *supra* note 5; JACK M. MINTZ & JESUS SEADE, *Cash Flow or Income? The Choice of Base for Company Taxation*, 6 World Bank Research Observer 177 (1991); MARTIN SULLIVAN, Flat Taxes and Consumption Taxes: A Guide to the Debate (American Institute of Certified Public Accountants. 1995); HENRY AARON & HARVEY GALPER, Assessing Tax Reform (Brookings Institution. 1985).

[7] *See, e.g.*, HUGH J. AULT, *et al.*, Comparative Income Taxation: A Structural Analysis (Kluwer Law International 3rd ed. 2010), at 232-237 (discussing the nature of the realization principle in France, Japan, Netherlands, Germany, United States, United Kingdom, Sweden, Canada and Australia).

[8] The requirement that income and capital gains must be "realized" in order to be taken into account for tax purposes is a structural characteristic of the CIT model. The contours of the principle are clear when considering the taxation of capital assets. In general, a gain or loss is realized only if property is sold, exchanged, or otherwise disposed of. Until such time, any change in value of the property resulting in an accrued gain or loss in respect of the property should not be relevant. With respect to business income, the realization principle has slightly different contours. As Ault and Arnold explain: "Income from a business is usually computed on an 'accruals' rather than a 'cash receipts and disbursements' basis. In this setting, realization is not synonymous with a cash method of accounting. For example, under a system based on realization, business income from the performance of services is usually realized when the services are performed and billed, although the collection of the fees may only take place at a later time. Thus, *in the business context, the realization principle means that income arises only when a transaction, such as the performance of services, occurs*" (emphasis added). *See* HUGH J. AULT, *et al.*, Comparative Income Taxation: A Structural Analysis, *supra* note 7, at 232-233. *See also* PETER HARRIS & DAVID OLIVER, International Commercial Taxation (Cambridge University Press. 2010) at 11 (authors take a slightly different approach and characterize the role attributed to "payments" as constituting the building block of realization-based tax systems. That is, realization generally involves an exchange with another person. In turn, an exchange typically involves a payment. For this

Consider the first of the structural building blocks of the CIT model, the realization principle. This principle, although common to the US CIT system and to most CIT systems around the world, has certain specificities under the US CIT system that must be clarified to allow for a proper understanding of the analysis undertaken below. In the US, the CIT system has developed its own set of accounting rules. Thus, while in a CIT system where the tax treatment of transactions is closely intertwined with their financial accounting treatment, as occurs in Portugal, the content of the realization principle is frequently determined with reference to the financial accounting rules, in the US the task of defining the content of the realization principle for tax purposes is left exclusively to the tax legislator. This means that certain of the issues that the US legislator faces are under a CIT system such as the Portuguese left to the financial accounting rules to solve.

Despite this structural difference, as will be demonstrated, the richness and profundity of American scholarship is truly exceptional in the different consequences it derives from the adoption of the realization principle on the structure and operation of a CIT system and on the study of its consequences on the behavior of business entities. Both these aspects are of the utmost relevance for the improvement of the Portuguese and European understanding of the consequences associated with the operation of our CIT systems and for the development of our corporate tax policy.

2. The Realization Principle and Property Transfers

Under the American formulation of the realization principle, tax may be due when a transfer in the sense of a sale, an exchange or the receipt of proceeds, which constitute earnings rather than a return of capital, occurs [9]. The fact that realization requires a *qualifying transfer* for tax consequences to arise has fundamental consequences for the design and behavioral impact of a CIT system [10]. This section will start by discussing the design issues associated with the treatment of transfers of corporate assets. Then, the article will move on to the behavioral issues.

Consider the following. Under the realization principle, the transfer of an asset's ownership through a sale to an unrelated party is a taxable event while possession of an asset is not. However, a substantial array of possibilities between these two extremes exists [11]. The determination of the tax treatment of asset transfers that fall in these intermediate categories requires their classification as either sales or the mere holding of property [12].

The classification of real life transactions under these artificial legal categories is particularly problematic due to the need of denying tax significance

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purpose, Harris and Oliver conceptualize a "payment" not in the narrow sense of a cash transfer, but in the broad sense "of any manner in which one person may *bestow value* (capable of monetary quantification) on another person") (emphasis added). Note that although the concept of realization is a core building block of the CIT system model, under many CIT systems certain areas, such as the taxation of certain financial instruments and the taxation of certain foreign companies, are based on accrual or "mark-to-market" methods of taxation. *See* HUGH J. AULT, *et al.*, Comparative Income Taxation: A Structural Analysis, *supra* note 7, at 233. For the issues surrounding the capital/business income divide in CIT systems, frequent in common law jurisdictions, but not, at least formally, in continental Europe, *see infra* note 68.

[9] *See* DANIEL N. SHAVIRO, *An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax*, 48 Tax L. Rev. 1 (1992), at 12. Further, in the US, the property exchanged must be substantially different for realization to occur. In principle, this requirement is satisfied so long as the two items "embody legally distinct entitlements", and thus is satisfied even where as an economic matter, or to the taxpayer, they are "substantially identical". Id. *See also* IRC Treas. Section Reg. Section 1.1001-1(a) and *Sav. Ass'n v. Commissioner, 111 S. Ct. 1503, 1508-09 (1991).* The UK CIT system also focuses on "disposal" as the principal test of realization for its capital gain tax. Several of the various income schedules have their own concepts of realization, using either a receipts basis or an earnings (accrual) basis. The term "disposal" is not defined for capital gain tax purposes but has been held to cover any transfer of beneficial ownership. *See* HUGH J. AULT, *et al.*, Comparative Income Taxation: A Structural Analysis, *supra* note 7, at 237.

[10] This central principle is subject to certain exceptions under the US CIT system, as well as under many CIT systems. These exceptions tend to be couched in terms of anti-abuse or tax incentive considerations. For instance, certain events are often treated as "deemed" realization events although no consideration is received by the transferor (*e.g.*, exit of a corporate group member of a tax consolidated group). Further, many CIT systems, including the Portuguese and the British, also contain rules that allow for the rollover of realized gain, partially or on its entirety, in certain circumstances. These provisions typically involve the reinvestment of realization proceeds and other similar situations. *See* HUGH J. AULT, *et al.*, Comparative Income Taxation: A Structural Analysis, *supra* note 7, at 233. *See also* in Portugal, CIRC Article 48.

[11] *See* DAVID A. WEISBACH, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, 84 Cornell L. Rev. 1627 (1998), at 1634.

[12] Id.

to situations where, although a formal transfer occurs, the transferor maintains a substantial economic interest in the property transferred. From a policy perspective, this *continuity of interest* principle fulfils a double purpose. First, it allows the corporate sector a greater flexibility to move assets to where they provide a highest economic return [13]. Second, it avoids abusive manipulations of the realization rule. Under the realization rule, similarly to gains, losses on property are triggered upon a transfer. Thus, allowing for tax consequences to arise upon mere formal property transfers could result in a substantial revenue loss for the state due the corporate taxpayer's ability to selectively realize losses [14].

From a design perspective, this continuity of interest principle materializes in the addition of the so-called *recognition* requirement to the realization yardstick. Specifically, when faced with a property transfer, the CIT system must incorporate rules to determine whether the transfer will be classified as a taxable event (or, under the American taxonomy, *recognition* event), or, conversely, afforded deferral (or *non-recognition*) treatment. The problem is that to give regulatory expression to this recognition requirement, and thereby materialize the continuity of interest principle, is an extremely thorny affair.

Once we add in the recognition requirement to the realization yardstick, the classification for tax purposes of a transfer of corporate assets as a sale or the mere holding of property requires economic criteria (*i.e.*, need to inquire into the actual changes in the underlying economic relationship to assets) [15], and mechanic rules to ensure a proper functioning of the CIT system. These necessarily complex rules are made even more intricate by the fact that the problem of the "uncommon becoming common" is particularly strong in the tax law [16].

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[13] *See infra* notes 45 and 88.

[14] Since the realization principle gives selectivity to the taxpayer of when to include income in its taxable income, absent the limitation of recognition on formal transfers, capital losses could be selectively triggered to reduce ordinary income, especially on transactions between related parties. The state further protects itself against this type of cherrypicking behavior by creating a divide, either formal or practical, between ordinary and capital income, and not allowing one type of income to offset the other. *See* discussion *infra* at note 68.

[15] *See* DANIEL SHAVIRO, *Disclosure and Civil Penalty Rules in the U.S. Legal Response to Corporate Tax Shelters, in* Tax and Corporate Governance (Wolfgang Schon ed. 2008), at 234.

[16] Weisbach contends that the problem of uncommon transactions becoming common is worse in the tax law than in other areas since "[t]he tax law relies on form more than most areas of the law, and one can easily manipulate form without changing the economics

Thus, the legislator must devise these rules taking into consideration the propensity of the corporate taxpayer for substitution [17]. The need to take into account certain practical aspects associated with efficiency and equity in the operation of the tax law [18], such as the need for expediency and the desire to give "fair notice" to taxpayers [19], adds a further layer of complexity to this policy determination.

Consider the treatment of the formal changes in corporate-shareholder relationships that involve a substantial continuity of interest in the firm. These formal transfers are typically disregarded for tax purposes [20]. That is, they typically constitute non-recognition events. However, the actual verification of whether a substantial economic interest in the firm exists and the definition of the tax consequences associated with non-recognition require a multitude of intricate rules to define continuity of interest [21], as well as rules to put into

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of a transaction. In addition, taxpayers often feel entitled to structure transactions to avoid taxes…This type of entitlement may encourage taxpayers to push the boundaries [.]". DAVID A. WEISBACH, *Formalism in the Tax Law*, 66 Univ. Chicago Law Rev. 860 (1999), at 885. *See also* PETER C. CANELLOS, *A Tax Practitioner's Perspective on Substance, Form and Business Purpose in Structuring Business Transactions and in Tax Shelters*, 54 S.M.U.L. Rev. 47 (2001), at 55 ("Tax practitioners involved in real transactions are called upon to cast a desired business transaction in a form that is most beneficial from a tax perspective").

[17] *See* discussion *infra* at Section A.3 for the concept of substitution in corporate tax law adopted in this article.

[18] *See* MARTIN FELDSTEIN, *On the Theory of Tax Reform*, 6 J. Pub. Econ. 77 (1976), at 90-94.

[19] *See* LEWIS R. STEINBERG, *Form, Substance and Directionality in Subchapter C*, 52 Tax Law. 457 (1999), at 497 (arguing that this 'fair notice' principle is "premised not only on notions of fairness, but also on a desire not to discourage taxpayers from consummating economically beneficial transactions because of uncertainty about how such transactions will ultimately be taxed". That is, the "fair notice" principle responds to concerns associated with both equity and efficiency in the tax laws).

[20] This includes certain corporate mergers and divisions, certain capital contributions, etc.

[21] As Clark notes, "[e]xactly which test will give specific content in specific contexts to the underlying concept of continuity of interest which is at the heart of all nonrecognition transactions? The task is truly enormous, given the multiplicity of ways in which businesses can operate and the manifold objectives they may serve"). *See* ROBERT J. CLARK, *The Morphogenesis of Subchapter C: An Essay in Statutory Evolution and Reform*, 87 Yale Law J. 90 (1977), at 118. In the US, the complexities associated with defining continuity-of-interest are considerable. As Bittker explains, "the continuity-of-interest doctrine has a multifaceted

practice the non-taxability of the transaction, despite the transfer of assets, income and, in certain cases, tax attributes, to a different taxpayer.

For instance, a primary criterion adopted to define continuity of interest is "control" [22]. Control, however, may be implemented through a multiplicity of legal and economic mechanisms [23]. It is a complex phenomenon that extends far beyond simple *de jure* definitions, difficult to define and quite prone to manipulation [24]. The legislator faces therefore a dilemma. While

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nature, depending on the context in which it arises. At the corporate level, the major focus is on the business enterprise and its continuation, under modified forms, following the corporate readjustment. At the investor level, the relevant factors are the nature and extent of investors' continued participation in the corporation's control, earnings, and assets as well as the relationship of their interests to those of other shareholders and security holders after the transaction has been consummated. Thus, the nature of the consideration received in the transaction (stock, debt or other property), the remoteness of the ownership interests from the underlying assets of the business, the proportion of old owners who continue their participation after the transaction, the length of time the investor interests continue (holding period aspects), and the special features and problems of debt securities all form important aspects of the continuity-of-interest concept". BORIS BITTKER & JAMES EUSTICE, Federal Income Taxation of Corporations and Shareholders (WGL. 2005), Section 12.21[1] at 12-26, 27.

[22] *See, e.g.,* in the US, definition of control required to access the tax benefits granted to certain corporate restructurings under IRC Section 368 at BITTKER & EUSTICE, Federal Income Taxation of Corporations and Shareholders, *supra* note 21, Section 3.07. *See* generally, in the UK, JOHN TILEY, Revenue Law (Hart Publishing 5th ed. 2005), at 827 and 844. *See also* HUGH J. AULT, *et al.*, Comparative Income Taxation: A Structural Analysis, *supra* note 7, for analysis of several jurisdictions.

[23] The legal mechanisms to implement control include mechanisms of a financial nature (such as intercorporate stock ownership), mechanisms of a contractual nature (such as profit pools or business transfer contracts), mechanisms of a personal nature (such as the device of interlocking board directorates), mechanisms of an organizational nature (such as special stipulations in the by-laws of companies that derogate the general principle of "one share one vote") and mechanisms of a factual nature (such as supply agreements or exclusivity contracts). In turn, the economic mechanisms of control gravitate between the two poles of direct control (with the parent corporation intervening in the everyday operational management of the affiliate) and indirect control (generally exercised via general long-term planning or via supervision of the affiliate's economic performance). *See* JOSÉ ENGRÁCIA ANTUNES, Liability of Corporate Groups: Autonomy and Control in Parent-Subsidiary Relationships in US, German and EU Law (Kluwer Law. 1994), at 144-155.

[24] Scott, for instance, defines control as a "structural relation through which a particular category of owners have *de facto* capacity to mobilize the powers vested in the company itself". *See* JOHN SCOTT, *Corporate Groups and Network Structure, in* Corporate Control and

the adoption of administratively more adequate *de jure* definitions makes the tax system easily subject to manipulation, the adoption of more encompassing, or *de facto* standards, may not always be adequate to the need for expediency required in the tax world due to the high number of transactions involved, and to the desire to give "fair notice" to taxpayers. The solution of legislators to this dilemma is varied. While, in certain cases, a definition of control based on percentage of vote and/or value of stock suffices, in other cases additional substantive requirements are imposed [25].

Once the benefits of non-recognition are accessed, an additional set of rather intricate rules comes into play. This set of rules aims at providing a solution to the mechanic problems associated with non-recognition, such as the carryover of the tax cost in the property transferred, and the carryover of other tax attributes [26]. All these rules are backed up by anti-abuse measures

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Accountability (Sol Picciotto ed. 1993), at 294. A symptom of the difficulty to define control is the inconsistency in the definitions available. In general, inconsistencies may be found at three levels within the technical definition of the control requirement, namely, jurisdiction versus jurisdiction, specific tax legislation versus non-tax legislation and specific tax legislation versus other tax legislation. *See, e.g.,* MARGARET LAMB, *When is a Group a Group? Convergence of Concepts of Group in European Union Corporate Tax*, 4 European Accounting Review 33 (1995).

[25] As Bittker notes, in the US certain provisions define "control" by reference to objective circumstances, such as percentages of stock ownership (*see, e.g.,* IRC Sections 1563 and 267), while others use more unclear concepts. A paradigmatic case is IRC Section 482 (*i.e.,* US transfer pricing regime), which refers to organizations that are "owned or controlled directly or indirectly by the same interests". This provision, through its regulations, adopts a broad interpretation of what amounts to a relationship between related parties. It states that the term "controlled" includes any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised' and adding that "it is the reality of the control which is decisive, not its form or the mode of its exercise". *See* IRC Treas. Reg. 1.482-1(i)(4). Further, certain rules prescribe attribution rules for determining stock ownership (*see, e.g.,* IRC Sections 1563 and 267), while others do not (*see, e.g.,* IRC Sections 482 and 269). *See* BITTKER & EUSTICE, Federal Income Taxation of Corporations and Shareholders, *supra* note 21, Section 13.01[3][a], at 13-10. For similar difficulties to define control for tax purposes in the UK *see* generally UK, TILEY, Revenue Law, *supra* note 22, at 827 and 844.

[26] The aim of these rules is to ensure that no tax attributes effectively drop out of the CIT system or are used to achieve purposes that would not be at the reach of the transferor corporation. With several anti-abuse limitations, the general policy is to allow the transferee corporation to step into the shoes of the transferor corporation. In general, this applies to the tax value of the property transferred (*i.e.,* the transferee gets the asset with a substituted tax cost, which, depending on the transaction at stake, may be either transferred

that aim at ensuring that the entities that qualify for the benefits of non-recognition do not abusively use or transfer their tax attributes [27].

Thus, in face of the adoption of the realization principle and of the need to give material expression to the continuity of interest principle, the CIT system must incorporate a set of rules to define when it considers that there has been a change in the underlying economic relationship to property, introduce anti-abuse rules to ensure that such criteria are not manipulated, and establish the mechanic rules, and their anti-abuse counterparts, that make non-taxability possible despite the transfer. All this taking into consideration the efficiency and equity considerations associated with the operation of the tax laws.

— determined by reference to the asset's tax cost in the hands of the transferor from whom the taxpayer acquired the property — or exchanged — determined by reference to other property held at any time by the taxpayer); and other tax attributes, such as tax losses and depreciation schedules. *But see infra* note 27 on the anti-abuse limitations to the carryover of tax attributes between different taxpayers.

[27] For instance, in the US, in the context of business combinations and reorganizations the availability of loss carryovers to other entities is restricted by several, fairly complex, provisions including IRC Section 269 (prohibits a carryover if the principal purpose of the acquisition was to avoid federal income taxes); IRC Section 381 (restricts carryovers to only certain forms of tax-free corporate reorganizations and liquidations); IRC Section 382 (limits use of carryover in certain stock acquisitions); IRC Section 383 (similar restrictions to those imposed by IRC Section 382, but applicable, among other attributes, to carryovers of capital losses) and IRC Section 384 (limits the use of carryovers on certain asset acquisitions). *See also* IRC Section 311 (a) (denies a loss deduction upon a corporation's distribution of depreciated property to shareholders). Similar entity limitations exist in the UK. For instance, where a "trading" loss has been incurred in relation to one trade and that trade is subsequently merged with another trade, the income of the merged trade must be streamed and the carried forward losses can only be set off against that part of the income of the merged trade which relates to the trade where the loss was incurred. Further, a body of anti-avoidance provisions applies to prevent the purchase of shares in a company to obtain the benefit of accumulated trading losses and to prevent the carryback of losses following a change of ownership. The provisions apply where, in any period of three years, there is a change in the ownership of a company and a major change in the nature of the conduct of the company's trade, or if at any time after the scale of the company's has become small or negligible and before any considerable revival there is a change in the ownership of the company. *See* JON FURSDON, British Tax Guide: Corporation Tax (CCH. 2009), at 87 and 91. Because of these different limitations on the use of losses, most often losses cannot be fully deducted, which in turn means that losses are taxed at a different rate than gains. *See* DAVID A. WEISBACH, *The (Non) Taxation of Risk*, 58 Tax L. Rev. 1 (2004), at 33. *See also* discussion *infra* at Section B.3.

In the final analysis, the connection between taxation and property that stems from the adoption of the realization principle as a yardstick for taxability induces rule complexity. The use of complex statutory terminology often aggravates this complexity problem [28]. Last but not least, it leads to compliance complexity. Compliance complexity refers to the problems taxpayers face in ensuring their ongoing compliance with the tax rules [29]. It includes the administrative hurdles faced by taxpayers, such as keeping records, choosing forms and making the requisite calculations [30]. The need to provide adequate proof of the fulfillment of the formal and substantive requirements commonly associated with the tax rules discussed above, and their anti-abuse counterparts, considerably increases the compliance complexity associated with the CIT system [31].

[28] *See* GRAEME S. COOPER, *Themes and Issues in Tax Simplification, in* Critical Perspectives on the World Economy, Vol. 2 (Simon R. James ed. 2002), at 255. For a good discussion on the theme *see* MENAHEM PASTERNAK & CHRISTOPHE RICO, *Tax Interpretation, Planning, and Avoidance: Some Linguistic Analysis* 23 Akron Tax Journal 33 (2008). *See also* the UK's Tax Law Rewrite Project at www.hmrc.gov.uk/rewrite/ (the aim of the Tax Law Rewrite Project is to rewrite the UK's primary direct tax legislation to make it clearer and easier to use, without changing the law). In Portugal, *see* the recently approved guidelines for legislative drafting (Council of Ministers Resolution n.º 77/2010, of October 11, implementing the legislative program SIMPLEGIS, in *Diário da República*, S. 1 N. 197 (11 Out. 10), p. 4421-4433)). It is, however, unclear how the application of these broad legislative guidelines will work out in practice. We note that the revision of the UK Corporate Tax Code required several years of work to be properly performed.

[29] *See* WEISBACH, *Formalism in the Tax Law*, *supra* note 16, at 860.

[30] *See* DAVID F. BRADFORD, Untangling the Income Tax (Harvard Univ. Press. 1999), at 266-267. The obligation imposed on the taxpayer may require the taxpayer to perform substantial tasks and incur significant costs beyond the amount of tax to be collected. *See, e.g.*, CEDRIC SANDFORD, Tax Compliance Costs Measurement and Policy (Fiscal Publications. 1995). For an in-depth analysis of this phenomenon in Portugal *see* CIDÁLIA LOPES, Quanto Custa Pagar Impostos em Portugal? Os Custos de Cumprimento da Tributação do Rendimento (Almedina. 2008).

[31] *See, e.g.*, in the US, IRC Treas. Reg. Section 1.368-3 (requiring the participants in a tax-free reorganization to keep detailed records of the reorganization proceedings and to file with their returns for the year of the reorganization a statement setting out the information prescribed by the regulations); IRC Section 482 and associated Treasury Regulations (extensive transfer pricing compliance requirements); and IRC Sections 6111 and 6112 (compliance with complex anti-shelter regulations). On the intricate and burdensome anti-corporate tax shelter provisions and their legislative background *see* BITTKER & EUSTICE, Federal Income

3. The Behavioral Impact: Realization, Discontinuity and Substitution

Besides fostering rule and compliance complexity, the connection between taxation and property induces transactional complexity. As a consequence of the adoption of the realization principle, artificial legal categories strongly determine line-drawing in CIT [(32)]. This phenomenon, in turn, results in discontinuities in the CIT system, in that due to artificial line-drawing a transaction or item may often be taxed differently from its closest economic substitutes [(33)]. The problem with this discontinuity of the CIT system is that it allows taxpayers, without changing the economics of a transaction, merely by altering its legal characteristics, to obtain a different tax result for a property transfer [(34)].

Taxation of Corporations and Shareholders, *supra* note 21, at Section 5.10. *See also* discussion infra at Section B.1 for the economic consequences associated with the complexity of the CIT system.

[(32)] *See* discussion *supra* at Section A.2. The emphasis of CIT law on legal form is further strengthened by CIT's historical evolution. In the US, CIT was originally built upon certain basic concepts developed in corporate law, bankruptcy law and accounting. Due to the essentially cumulative process of development of corporate tax law, imported legal concepts such as "stock," "debt," "control," or "reorganization," have significantly contributed to the formalism of the CIT system. *See* STEINBERG, *Form, Substance and Directionality in Subchapter C, supra* note 19, at 496; and CLARK, *The Morphogenesis of Subchapter C: An Essay in Statutory Evolution and Reform, supra* note 21, at 13. Interestingly, Steinberg argues that this emphasis on form may also be related to certain practical aspects associated with the operation of a CIT system. Specifically, an emphasis on form may respond to a need for expediency in the tax law; to a belief that the tax law should give "fair notice" to taxpayers of how their transactions will be taxed prior to their entering into such transactions; of a desire to avoid whipsaw; or simply of ensuring a notion of transactional finality, such that later transactions or events do not affect the tax characterization of earlier transactions. *See* STEINBERG, *Form, Substance and Directionality in Subchapter C, supra* note 19, at 496-497.

[(33)] From an efficiency point of view, lines should be continuous, that is, they should be drawn so that a transaction or item is taxed like its closest economic substitutes. *See* DAVID A. WEISBACH, *An Efficiency Analysis of Line Drawing in the Tax Law*, 29 Journal of Legal Studies 71 (2000), at 71. *See also* discussion *infra* at Section D for the definition of efficiency in tax law adopted in this article.

[(34)] Id. *See, e.g.,* describing the common practice of substitution in corporate transactions, CANELLOS, *A Tax Practitioner's Perspective on Substance, Form and Business Purpose in Structuring Business Transactions and in Tax Shelters, supra* note 16, at 50 ("To the tax adviser

In terms of behavioral impact, when there is a discontinuity in the tax rules, taxpayers sufficiently close to the discontinuity may be expected to move to the lower tax regime, if transaction costs are inferior to the tax savings and associated risk [(35)]. Based on current research, the desire to find substitutes for a transaction to reduce the tax bill should be presumed a normal behavioral pattern of the corporate taxpayer [(36)]. When a taxpayer substitutes a transaction, instead of implementing the transaction that it would in principle implement

in true business transactions, the existence of substance is a given and form is usually a friend to the extent it permits the tax planner to control the tax results of a given substantial transaction by employing one form rather than another"). *See also* WEISBACH, *Formalism in the Tax Law, supra* note 16, at 885 ("The tax law relies on form more than most areas of the law, and one can easily manipulate form without changing the economics of a transaction").

[(35)] *See* WEISBACH, *Formalism in the Tax Law, supra* note 16, at 874. As Weisbach further notes, the drafting of the particular tax provision may itself alter the degree of continuity of the tax laws. Specifically, when tax provisions are enacted in the form of rules, minor changes in transactional form often create substantial changes in tax liability. That is, rules tend to create discontinuities, in that they create a bright line between two types of transactions. Thus, a minor change in the transaction often causes a significant change in tax consequences (*e.g.,* characterization of an instrument as debt or equity). Standards are "fuzzy at the borders", reducing this problem (*i.e.,* rules are more uniform and standards less uniform). Id. at 871. *See also infra* note 40 discussing the variables associated with substitution.

[(36)] *See, e.g.,* MYRON S. SCHOLES, *et al.,* Taxes and Business Strategy: A Planning Approach (Pearson Prentice Hall 3rd ed. 2005), at 4 ("Most taxpayers around the world pay no more tax than they believe they must and they spend nontrivial resources to arrange their affairs to keep the tax bite as painless as possible"); SHAVIRO, *An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax, supra* note 9, at 5 ("[A]mong well-informed informed and conventionally self-interested taxpayers, only those with sufficiently important competing nontax goals will fail to follow the tax-preferred course of action"); NOEL B. CUNNINGHAM & DEBORAH H. SCHENK, *The Case for a Capital Gains Preference*, 48 Tax L. Rev. 319 (1993), at 351-353 ("Any tax, except a head tax, imposed on any item or activity, prompts taxpayers to investigate alternatives or substitutes to avoid the tax"); CANELLOS, *A Tax Practitioner's Perspective on Substance, Form and Business Purpose in Structuring Business Transactions and in Tax Shelters, supra* note 16, at 47 ("Corporations are increasingly willing to treat taxes as a cost to be avoided, with the efficacy of avoidance increasingly being measured purely in monetary, probabilistic terms with only passing attention to ethical and public perception concerns"). *But see* WOLFGANG SCHON, Tax and Corporate Governance (Wolfgang Schon ed., Springer 2008). (arguing that certain corporations are increasingly aware of ethical and public perception concerns regarding tax avoidance). *See also* discussion *infra* at note 40 regarding the impact of frictions on this propensity of the corporate taxpayer to substitute transactions.

based on its regular business considerations, the taxpayer implements an alternative transaction. As a rule, the alternative transaction should lead to a similar economic result, but with a differing, more advantageous tax treatment.

Directionality provides a case in point. Under a CIT system, a property transfer may, in certain cases, be afforded a different legal characterization depending on its transactional direction, *i.e.*, depending on whether a person is viewed as initiating an action or, instead, as being the person against whom an action is initiated [37]. By the same token, when parties are related, by choosing direct or indirect transactional paths for the transfer of property the taxpayer may often alter the type of formal characterization available to implement the transaction [38]. The problem is that the selection of acquired versus acquiring status, or direct versus indirect transactional routes, is mostly a matter of form and often indifferent to related parties [39]. By manipulating the transactional direction, related parties may, thus, easily control the formal characterization of the transfer transaction and, consequently, realization.

As a rule, the least the effort (in terms of transaction costs) and risk involved, and the stronger the benefit obtained, the higher should be the degree of transactional substitution. In principle, directionality should be an area with propensity for a high degree of substitution [40]. As will be further discussed, the root of the economic problems associated with substitution is that, apart from the fostering of the complexity of the CIT system and the erosion of the tax base [41], in a world of costly contracting and information asymmetries,

[37] *See* STEINBERG, *Form, Substance and Directionality in Subchapter C*, *supra* note 19, at 458. *See also* id. at 472 (Steinberg notes that "[b]ecause so many of the requirements for reorganization status apply only to the acquired corporation and its shareholders, and not to the acquirer, the parties have considerable flexibility in shaping the tax consequences to the parties of the transaction").

[38] For example, instead of a direct distribution to a shareholder, a corporation may implement an indirect transfer of cash using back-to-back loans with other related or unrelated entities.

[39] *See* STEINBERG, *Form, Substance and Directionality in Subchapter C*, *supra* note 19, at 458. *See also* CHARLES I. KINGSON, *The Deep Structure of Taxation: Dividend Distributions*, 85 Yale Law J. 861 (1976), at 905.

[40] Note that the assessment of the degree of substitution of the tax rules depends on several interrelated factors, and may only be assessed for each specific taxpayer at a particular moment in time. Specifically, besides the degree of continuity of the tax rules here discussed, the degree of substitution of the tax rules may vary depending on the direct costs of the substitution; the presence of tax law restrictions; the existence and relative strength of tax law restrictions and non-tax law frictions; the risk-taking profile of the firm; the firm's organizational design; and the corporate tax rate. *See* DEBORAH H. SCHENK, *An Efficiency Approach to Reforming a Realization-Based Tax*, 57 Tax L. Rev. 503 (2004), 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 36, at 351-353; SCHOLES, *et al.*, Taxes and Business Strategy: A Planning Approach, *supra* note 36, 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*, *in* Critical Perspectives on the World Economy, Vol. 4 (Simon R. James ed. 2002), at 150. Although the discussion in detail of each of these variables of substitution is outside the scope of this article, it is worth noting them here briefly for clarity purposes. Broadly, the direct costs of the substitution include the legal fees to restructure a transaction, accounting fees, filing costs and similar costs. In turn, tax law restrictions encompass the constraints to taxpayer behavior imposed by the tax law. As for non-tax law frictions, these include a set of transaction costs and other negative consequences that may result from the implementation of the substitute transaction. Several types of external frictions to the tax law exist. In general, the strongest are the taxpayer's business preferences and legal and accounting constraints. The taxpayer's business preferences include factors such as risk, timing, complexity, preferences about capital structure, or organizational design. Legal and accounting constraints may also provide an effective deterrent to substitution. Specifically, legal restraints external to the tax law may render certain tax advantageous transactions more costly, risky or simply forbidden. By the same token, the desire of corporations to keep earnings high may provide an important friction, in that transactions that lower taxes tend to decrease earnings. In the US research studies have demonstrated that, when having to choose between lower taxes or higher earnings, many firms choose to give up the tax benefit for the privilege of higher earnings. Even when substitution decreases taxes but does not result in a change to earnings, the accounting friction may deter, in that many managers fear that the lack of book-tax conformity may prompt special scrutiny from the tax authorities. Further, how the specific firm perceives the odds of an audit may impact its willingness to substitute a transaction, especially when substantial tax risk is involved. Also, a firm's organizational design may impact the way it reacts to the tax rules. This phenomenon is especially acute with corporate groups, in that the ability to use the corporate veil of its affiliates and the possibility to more easily structure complex internal transactional flows gives them wide flexibility for substitution. Finally, as the corporate tax rate increases, the incentive to substitute should also tend to increase. Id.

[41] In the US, as well as in many other jurisdictions, this phenomenon has led to the development of a complex arsenal of substance-over-form rules and principles. This body of rules and principles essentially aims at determining whether the taxpayer's chosen transactional form should or should not be respected. This includes a number of different doctrines, such as "substance-over-form," step transaction, agency, conduit and tax ownership. For a discus-

the search and adoption of substitute transactions has associated costs and potential operational inefficiencies for the firm [42].

In sum, the discontinuity of the tax rules induces transactional substitution. Such substitution fosters the complexity of the CIT system, erodes the tax base, and has associated costs and potential operational inefficiencies for the firm. Overall, the connection between taxation and property that stems from the adoption of the realization principle induces rule, compliance and transactional complexity. All these different forms of complexity, as will be discussed below, have significant consequences for the firm and for the state.

B) Taxation and Market

The tax rules are implemented in an imperfect economy, *i.e.*, an economy with information asymmetries and transaction costs [43]. In this imperfect

sion of these different doctrines in the US *see, e.g.*, CANELLOS, *A Tax Practitioner's Perspective on Substance, Form and Business Purpose in Structuring Business Transactions and in Tax Shelters*, *supra* note 16, at 49; SAUL LEVMORE, *Recharacterizations and the Nature of Theory in Corporate Tax Law*, 136 Uni. Pa. L. Rev. 1019 (1988); CHIRELSTEIN, *Learned Hand's Contribution to the Law of Tax Avoidance*, 77 Yale. L. J. (1968); BOWEN, *The End Result Test*, 72 Taxes 722 (1994); STEINBERG, *Form, Substance and Directionality in Subchapter C*, *supra* note 19.

[42] *See* discussion *infra* at section B.4.

[43] For purposes of this article, transaction costs are defined as "conditions impeding the carrying out of mutually beneficial exchanges…such [as]… information costs, costs of negotiating and contracting, and costs imposed by… regulations". *See* ROBIN PAUL MALLOY, Law and Economics: A Comparative Approach to Theory and Practice (West Publishing Co. 1990) glossary at 163. *See also* RICHARD A. POSNER, Economic Analysis of Law (Aspen Publishers 5th ed. 1998), 3.1, at 39. Note that the definition of transaction costs in the literature is not consensual. The literature uses inconsistent and widely varying definitions of transaction costs. *See, e.g.*, OLIVER E. WILLIAMSON, *Transaction Cost Economics: The Governance of Contractual Relations*, 22 J. L. & Econ. 233 (1979) at 233 (the concept of transaction costs "wants for definition"); GIDEON PARCHOMOVSKY & PETER SIEGELMAN, *Selling Mayberry: Communities and Individuals in Law and Economics*, 92 Cal. L. Rev. 75 (2004), at 94 (transaction costs are "notoriously difficult to define"). *See also* CAROL ROSE, *The Shadow of the Cathedral*, 106 Yale Law J. 2175 (1997), at 2184-89 (distinguishing between Type I transaction costs that are incurred prior to bargaining and Type II transaction costs that arise after bargaining has begun); DOUGLAS W. ALLEN, *Transaction Costs, in* Encyclopedia of Law and Economics (Volume One: The History and Methodology of Law and Economics) (Boudewijn Bouckaert & Gerrit De Geest eds., 2000), at 913 (stating that two definitions prevail in the literatures: one that defines transaction costs as only occurring when a market transaction

economy, valuation of assets, knowledge of the tax rules, compliance, administration, and tax planning have associated costs. This section will discuss the impact of these costs on the design, operation and behavioral impact of the CIT system.

First, the section will consider the economic impact of rule, compliance and transactional complexity. Then, it will examine the impact of the market on the definition of the operational structure of the CIT system. Subsequently, the section will consider the distortions introduced to the behavior of corporations that may arise as a side effect of the adoption of the realization principle as the basis for corporate taxation in a market-based economy and the potential inferences of the CIT system on the firm's organizational arrangements. The section will conclude by analyzing the potential impact of the CIT system on the firm's agency problems.

1. Complexity and Transaction Costs

Consider the economic impact of rule and compliance complexity. To start with, due to rule and compliance complexity, it is more expensive for corporations to determine what rules and regulations apply to a specific transaction, to determine the ensuing tax consequences and to comply with them. In certain cases, the transaction costs become so prohibitive that the firm may not undertake the planned action, because the "expected benefits of the action are less than the sum of the costs of implementing the action plus the transactions costs of determining its legal outcome" [44]. That is, when these tax-related costs come into the calculus, the economic efficiency gain of a transaction may not be sufficient to offset its associated tax costs and, thus, the transaction may not be implemented or may be implemented outside its optimal timing [45].

takes place; the other defining transaction costs as occurring whenever any property right is established or requires protection).

[44] JAMES A. FELLOWS, *Nonrecourse Debt and Real Estate: The Issues of Tax Basis*, 26 Real Est. L.J. 270 (1998), at 271.

[45] *See* YOSEPH M. EDREY, *What are Capital Gains and Losses Anyway?*, 24 Va. Tax Rev.141 (2004), at 170-174 ("[F]irms might choose not to replace an asset producing a lower rate of return if they take tax into account when calculating the cost of the new asset, which reduces its rate of return"); GEORGE R. ZODROW, *Economic Analyses of Capital Gains Taxa-*

Further, besides the additional transaction costs, rule complexity may lend to uncertainty as to tax results, which may deter corporations from entering into certain transactions [46]. If the firm does not undertake the planned action, society's wealth lowers, as the firm thrusts aside an otherwise productive activity [47]. This problem should be especially acute with regard to new and small firms [48]. Significantly, the transaction costs incurred by the government in writing and enacting the laws and regulations upon which the tax system is built, and in enforcing the laws and regulations when it perceives a lack of compliance, should also substantially increase in light of the complexity of the tax law [49]. Lastly, the increased transactional complexity that arises due to the implementation of substitute transactions aiming to manipulate the CIT system, breeds additional rule and compliance complexity from tax reformers and legislators who respond with measures designed to circumvent the latest tax maneuvers [50].

In sum, the complexity of the corporate tax system that transpires, among other causes, from the relationship between taxation and property, has considerable economic repercussions. Specifically, the increased transaction costs

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tion: Realizations, Revenues, Efficiency and Equity 48 Tax Law Rev. 419 (1993) at 467 ("[T]he taxation of capital gains on sales of business assets might discourage asset sales that otherwise would occur, thus reducing firm operating efficiency"). *See also* SHAVIRO, *An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax, supra* note 9, at 24 ("Taxing gain or loss upon sale…cannot help but change some taxpayers' decisions regarding the retention of particular assets").

[46] *See* R. M. BIRD, *Why Tax Corporations?*, International Centre for Tax Studies. University of Toronto. WP 96-2 (1996), at 1 ("[U]ncertainty as to the precise tax implications of various corporate decisions may act as a general deterrent to investment"). *See also* COOPER, *Themes and Issues in Tax Simplification, supra* note 28, at 423 ("[W]hen faced with complexity (in the sense of an uncertain outcome), all taxpayers are risk-avoiders and will try to eliminate the risk arising from uncertain tax outcomes, even if it means abandoning the transaction altogether").

[47] *See* JAMES A. FELLOWS, *Nonrecourse Debt and Real Estate: The Issues of Tax Basis, supra* note 44, at 271.

[48] *See* BIRD, *Why Tax Corporations?, supra* note 46, at 1.

[49] Together, these costs can be a very substantial burden on the economy. See KNEAVE RIGGALL, *Comprehensive Tax Base Theory, Transactions Costs, and Economic Efficiency: How to Tax Our Way to Efficiency*, 17 Va. Tax Rev. 295 (1997), at 320.

[50] *See* BRADFORD, Untangling the Income Tax, *supra* note 30, at 266-67. *See also* discussion *supra* on compliance complexity at Section A.2.

required for the taxpayer to determine what rules and regulations are applicable to a specific transaction, to determine the ensuing tax consequences and to comply with them, may deter taxpayers from entering into certain transactions, or from implementing them at the optimal business timing. This problem should be especially acute with regard to new and small firms. By the same token, complexity should result in a significant increase of the costs incurred by the government to supervise the operation of the CIT system. Overall, the complexity of the CIT system should result in significant deadweight loss for businesses and government.

2. The Market and the Structure of the CIT System

In an imperfect economy, the valuation of assets, the knowledge of the tax rules, compliance and administration have associated costs. These costs fundamentally determine the structure and operation of a CIT system. To a certain extent, they may also contribute to the current worldwide preference for the CIT model as basis for corporate taxation [51].

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[51] Other justifications include international considerations (*i.e.*, the pressure to adopt a corporate tax system compatible with the tax systems of other jurisdictions as well as with the existing international framework of tax treaties) and the political advantages associated with this type of corporate tax system. Broadly, neurological and psychological research has demonstrated that requiring a realization event to measure taxable income is consistent with how individuals perceive income, *i.e.*, the receipt of gains and anticipation of gains activate different areas of the brain and are very likely perceived differently by the taxpayers *See* TERRENCE R. CHORVAT, *Perception and Income: The Behavioral Economics of the Realization* 36 Conn. L. Rev. 75 (2003), at 110-111. The intuitive acceptability of the tax system that naturally follows from its alignment with the taxpayer's psychological reality should aid taxpayer compliance. *See* ZELINSKY, *supra* note 6, at 893. In addition, at a more practical level, a realization-based CIT system should be easier to approve politically by avoiding the hardships imposed on the taxpayer by a pure accretion system, which most often forces the taxpayers to borrow in order to pay such taxes. *See* CHORVAT, *supra* note 51. Lastly, the political appeal of a realization-based CIT system is enhanced by the lack of clarity that surrounds the question of incidence on this type of tax, which makes its burden difficult to trace to individual taxpayers. *See* ALAN J. AUERBACH, *et al.*, *Taxing Corporate Income, supra* note 5, at 867. In particular, in economic terms, it is unclear whether the corporate tax actually falls on shareholders. In certain cases, it may be shifted to consumers or labour. *See, e.g.*, MARTIN FELDSTEIN, *Incidence of a Capital Income Tax in a Growing Economy with Variable Saving Rates*, 41 Rev. Econ. Stud. 505 (1974), at 510-11; DON FULLERTON & GILBERT E. METCALF, *Tax*

To start with, when parties are unrelated, a CIT system is able to provide a costless and reliable valuation of the assets transferred and services provided in the corporate sector. The reliability of the valuation process is ensured by the economic dynamics that exist between buyer and seller in their effort to optimize their own individual profit on the transfer transaction. Specifically, while the seller is interested in selling for the highest possible price, but is averse to disclosing it to the tax authorities in order to avoid high tax payments [52], the buyer is interested in making the acquisition for the lowest possible value, but in disclosing it to the tax authorities by the highest possible amount in order to minimize its tax bill [53]. The end result is a sale or exchange for the highest possible value, due to the pressure exerted by the seller, with a disclosure of the highest possible amount, as a result of the pressure made by the buyer. Therefore, realization benefits the interests of the tax authorities, in that the regular economic dynamics that operate between the parties on the transfer transaction ensure a proper tax result without the need for direct supervision of the transaction. By relying on the natural dynamics of the

Incidence, NBER, Working Chapter No. w8829 (2002), at 20-23. *See also* ALAN J. AUERBACH, *Who Bears the Corporate Tax? A Review of What We Know*, NBER, Working Paper No. W11686 (2005) at 3 ("[T]he ultimate incidence of the [corporate income] tax remains somewhat unresolved"). For a recent work on the theme questioning the classic assumptions *see* WIJI ARULAMPALAM, *et al.*, *The Direct Incidence of Corporate Income Tax on Wages*, Oxford University Centre for Business Taxation, Working Paper 09/17 (2009). For the classic work on the issue *see* ARNOLD HARBERGER, *The Incidence of the Corporation Income Tax*, 70 J. Pol. Econ. 215 (1962). For a recent survey on the theme *see* DANIEL L. SHAVIRO, Decoding the U.S. Corporate Tax (The Urban Institute Press. 2009)(Shaviro concludes that "[w]hile the debate about the incidence of the corporate tax is ongoing and unlikely to be resolved definitely any time soon, it does appear to be trending strongly toward the view that labor rather than capital bears the largest share of the burden"). Id. at 70.

[52] On the interest of corporations to reduce tax payments *see supra* note 36.

[53] This alignment of the buyer and tax authorities interests, vital to the proper working of the tax system, occurs because by reporting a higher acquisition amount the buyer is able to obtain a higher tax basis in the asset acquired or tax deductible expense on the services purchased, and, thus, a reduction in future tax payments. In agency terms, "the buyer's interest in maximizing his basis and deductions is aligned with the IRS's interest in the disclosure to it of the correct price paid to the seller". *See* ZELINSKY, *supra* note 6, at 902. *See also* id. at 881 ("[T]he moment of realization is the only time when the taxpayer and the tax collector have perfectly-aligned interests in maximizing the recognized value of the taxpayer's property").

market, the tax system avoids the potentially significant transaction costs that would otherwise be required to adequately control the transaction [54].

Further, its hybrid income tax characteristics allow the CIT system to finance itself in a relatively cost-efficient way [55]. Since the tax system fails,

[54] *See* id. at 880. In addition, the taxpayer, on top of the tax authorities' supervision, often has the surveillance of other governmental authorities (*e.g.*, real estate transfers). That is, tax benefits also from frictions from other regulatory fields on certain transfers. Finally, the amount transferred is automatically calculated based on the fungibility of the property surrendered by the buyer, thereby avoiding additional transaction costs to value the property. *See* id. at 889 ("[F]rom the vantage of minimizing the transactions costs of valuation, the rule of realization, which costlessly uses the valuations automatically produced as incidents of cash and cash equivalent transactions, is superior to accretionism which requires expensive appraisals for many common forms of property"). The problem, however, is that when both parties have an identical economic interest, such as when two corporations are subject to common control, the natural behavioral dynamics that sustain the system collapse. This occurs because the differing economic interests that ensure adequate valuation, independent of government supervision, of the transferred property or rendered services are absent. Absent supervision, the valuation provided by related parties will likely be the one that provides a more advantageous result to the superior common interest of both parties, which is often contrary to the government interests. This, in turn, requires governmental supervision of the value of the transactions that the parties declare, most significantly, transfer pricing rules. In general, these rules aim at ensuring that related parties pay arm's length prices, *i.e.*, that the traded goods are correctly valued. This issue is outside the scope of our analysis. For a good background on the US transfer pricing regime *see, e.g.*, J. KUNTZ & R. PERONI, US International Taxation (Warren, Gorham & Lamont. 1992).

[55] As Shaviro notes, a realization-based tax system is a hybrid income tax system, which blends elements of a transfer tax with an accretion tax and a consumption tax. Broadly, in light of the prominent role played by realization, the CIT system is partly a transfer tax in that it works as a tax on the act of engaging in transactions such as sales and exchanges. While transfer determines the moment when tax is due, accretion concepts, in turn, determine how much is levied at that moment. That is, while the timing of the tax liability is determined based on transfer tax concepts, its nominal amount is established based on accretion. Further, the system blends accretion tax with consumption tax concepts, in that although it reaches income arising from capital, such as interest, just as an accretion tax would do, it fails, like a consumption tax, to currently tax unrealized appreciation in the value of assets. SHAVIRO, *An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax*, *supra* note 9, at 11. *But see* id. at 2 (The actual relative importance of the transaction tax and accretion tax elements may vary between sectors of the economy and over time. Further, despite the usefulness of these conceptual distinctions, certain rules in the corporate income tax may have nothing to do with any of these basic models). *See also* WILLIAM D. ANDREWS & DAVID F. BRADFORD, *Savings Incentives in a Hybrid Income Tax*, *in* Uneasy Compro-

just as a consumption tax would, to tax unrealized appreciation in assets, the onus to find the necessary sources of funds to finance the tax system until realization occurs is placed on the government [56]. Since the government is able to secure loans more consistently and at a better rate than the majority of taxpayers, the tax system may be financed with lower interest and transactional costs [57]. In addition, the government, as a single, centralized borrower, benefits from substantial economies of scale, in that to obtain the same funds through countless separate loans would result in much higher overall transaction costs [58]. In the context of today's capital markets, which are generally not willing to accept unrealized capital gains as collateral for borrowing, an alternative system based on pure accretion concepts should result in much higher transaction costs to ensure the overall liquidity of the tax system [59].

To a considerable extent, market-related considerations also justify the corporate-level nature of the CIT system. In a tax system with personal income taxation, a corporate-level income tax is a rather convenient and effective device

mise: Problems of a Hybrid Income-Consumption Tax (Henry J. Aaron, *et al.* eds., 1988), at 270.

[56] *See* ZELINSKY, *supra* note 6, at 890.

[57] *See* id. at 891 ("[T]he Treasury is our society's most economical borrower; the rate at which the Treasury obtains funds is the accepted benchmark for risk-free interest. A relative handful of taxpayers can borrow at the Treasury rate; virtually none can borrow below it; most taxpayers obtain funds at considerably higher rates").

[58] *See* id. at 891 ("An accretionist tax system would necessitate millions of separate loan transactions as taxpayers acquire the funds to discharge their tax obligations. We can only guess at the resulting costs — legal and appraisal fees, recording and other closing expenses, bank fees, and the taxpayers' time. We can, however, confidently predict that these costs will be considerable").

[59] *See* CHORVAT, *supra* note 51, at 91-94 ("If taxpayers could accurately ascertain the value of an asset, banks and others with liquid assets would be willing to lend to them a sufficient amount to pay the taxes assessed due to the increased value, thus eliminating the liquidity problem. However, because such lending generally does not occur, this form of tax could cause substantial hardship"). *See also* WOLFGANG SCHON, *Tax and Corporate Governance: A Legal Approach, in* Tax and Corporate Governance (Wolfgang Schon ed. 2008), at 44. *But see* ZELINSKY, *supra* note 6, at 890 ("[U]nder an accretionist system, taxpayers can borrow to pay their tax or can use cash from other sources to satisfy their obligations to the fisc. Once taxpayers understand their liabilities under an accretionist regime, the argument runs, they will arrange their affairs to generate the cash necessary to pay their taxes").

to collect income tax on shareholders [60]. This occurs due to the reduced number of corporations, when compared to the number of shareholders, and because corporations offer an easier way of collecting relevant financial information [61]. Further, although the CIT system is not completely non-distortionary in that, in addition to economic rent, it taxes the normal return to capital; it does tax economic rents in a more efficient way than some other alternative tax regimes [62]. There are considerable efficiency advantages in taxing such rents at the corporate level, since taxes imposed on economic rents levy income from the private sector without distorting private economic decisions [63].

[60] *See* ALAN J. AUERBACH, *et al., Taxing Corporate Income, supra* note 5, at 867.

[61] *See* R. M. BIRD, *Why Tax Corporations?, supra* note 46, at 10 ("The key to effective taxation is information, and the key to information in the modern economy is the corporation"). In addition, certain shareholders, namely those foreign and tax exempt, may often be hard to reach otherwise. Also, without a corporate-level tax, individuals could avoid taxation by earning their income through corporations. That is, absent some type of accrual or anti-avoidance mechanism, tax could be deferred until a dividend was distributed or stock was sold. This, in turn, would provide a strong incentive for the indefinite retaining of non-taxed earnings at the corporate level. *See* R. M. BIRD, *Why Tax Corporations?, supra* note 46, at 1 ("[S]o long as the main form of personal taxation is a personal income tax, some form of corporation income tax will be a necessary part of the tax system").

[62] To tax only economic rent requires all expenses to be deducted from taxable income when incurred. A CIT system, therefore, has distortionary elements that should in principle affect the cost of capital and corporate finance decisions. *See* ALAN J. AUERBACH, *et al., Taxing Corporate Income, supra* note 5, at 842. For this reason, recent proposals for reform of the corporate tax systems, such as the proposal recently suggested by the Mirrlees report, aim to tax only the economic rent element of corporate profits. Id. *See also* R. M. BIRD, *Why Tax Corporations?, supra* note 46, at 5.

[63] *See* R. M. BIRD, *Why Tax Corporations?, supra* note 46, at 5. *See also* ALAN J. AUERBACH, *et al., Taxing Corporate Income, supra* note 5, at 842 ("Taxing only economic rent can be considered desirable since it is non-distortionary, leaving the (normal) return earned by the marginal investment free of tax"). Other traditional defenses of the current corporate-level CIT system include the arguments that corporate tax is a reasonable user fee for services provided by the government to corporations, that the tax allows the government a partial return on its implicit partnership investment in risk taking, or that the corporate tax offers a way of offsetting the social costs imposed by corporations because of their limited liability. Although none of these traditional arguments are particularly strong, in total they do provide an additional defense for the existence of a separate corporate-level income tax system. *See* REUVEN S. AVI-YONAH, *Corporations, Society, and the State: A Defense of the Cor-*

The adoption of the CIT model as basis for corporate taxation may be partially justified by these market-related considerations. Significantly, by inducing the selection of these core structural elements (*i.e.*, the realization principle and the separate tax personality of corporate entities), the market indirectly determines the structure of the whole CIT system. That is, the logic of these fundamental postulates strongly determines the design of a CIT system [64]. Based on the US experience, the development of a CIT system tends to occur in a cumulative way, with new concepts building upon these fundamental postulates [65].

Specifically, once certain core decisions are made, such as whether to tax the corporate sector through an accretion, a consumption or a realization-based tax, or whether to impose a tax directly on corporations or tax solely its shareholders, there is a subsidiary set of rules and corporate tax attributes that must come into play in order for the corporate tax system to operate properly. In the case of a CIT (a realization-based, corporate-level tax), which

porate Tax, 90 Virginia Law Review 1193 (2004), at 1206-1207. *See also* R.M. Bird, *Why Tax Corporations?*, *supra* note 46, at 1.

[64] *See* Clark, *supra* note 21, at 92 ("The corporate tax culture is…of endogenous origin. The pressures created by its own basic postulates have controlled its development"); Weisbach, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, *supra* note 11, at 1633 ("Many doctrines, such as the realization requirement, are fundamental building blocks of our tax system"); Shaviro, *An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax*, *supra* note 9, at 23 ("[C]orporate taxation is in many respects a closed, internally logical system, working out relentlessly the consequences of initial premises, above all the treatment of corporations as separate from their owners and corporate stock as distinct from corporate assets").

[65] *See* Clark, *supra* note 21, at 92 ("The present highly developed law of the taxation of corporations and shareholders is the product of a few basic decisions…"); id. ("[T]he corporate tax culture has developed from these principles in a cumulative, evolutionary way rather in a cyclical or random manner [.]"). Historically, such evolution, however, tends not to be regular, in that it is also constrained by the historical materialism process and external world constraints. *See* id. at 95 ("By themselves, abstract principles cannot develop into a culture. In this obvious sense, corporate tax law has not been a mere unfolding of the logic of its postulates"). *See also* Ajay Mehrotra, *Mergers, Taxes, and Historical Materialism*, 83 Indiana Law Journal 881 (2008) at 955 ("[Tax] rules are a product not solely of economic ideas or legal logic, but also of changing social, political and economic conditions and interests — a product, that is, of *historical sequence* and *material context*"). Emphasis added. *See also* Ajay Mehrotra, *et al.*, The New Fiscal Sociology: Taxation in Comparative and Historical Perspective (Cambridge University Press. 2009).

is payable on a yearly basis [66], these elements include the recognition requirement [67], the distinction — either formal (as usual in common law jurisdictions), or practical, and usually more limited (as more frequent in continental Europe) — between capital and ordinary income [68], loss limita-

[66] *See, e.g.*, in the US, IRC Section 441 (a corporation, like any other taxpayer, must report its income on a taxable-year basis) and, in Portugal, CIRC Article 8. Note that, in both jurisdictions, the yearly-tax assessment rule is subject to certain exceptions. The yearly tax assessment rule is imposed by practicality. Defining a moment on which all expenses and profits of a certain period are determined and offset against each other is administratively much simpler. Further, it allows the government to receive income on a periodic basis to face its expenses. However, it requires the existence of additional tax rules to allocate receipts and expenses to their correct years as well as rules to minimize the unfair effects that strict-year-by-year accounting has on corporations, such as year loss carryover rules (*i.e.*, possibility to carryforward and carryback tax losses) and the mechanism of basis (*i.e.*, since the tax cost of property transcends taxable years, basis ensures consistency from taxable year to taxable year. 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* Glen Arlen Kohl, *The Identification Theory of Basis*, 40 Tax L. Rev. 623 (1985)). *See* John Prebble, *Why is Tax Law Incomprehensible?*, 4 British Tax Review 380 (1994), at 385. *See also* M. Campisano & R. Romano, *Recouping Losses: The Case for Full Loss Offsets*, 76 Northwestern University Law Review 709 (1981) at 710, and *infra* note 66.

[67] *See* discussion *supra* at Section A.2.

[68] Since the realization principle gives selectivity to the taxpayer of when to include income in its taxable income, the divide ensures that capital losses, which can be selectively triggered, do not reduce ordinary income. *See*, in the US, IRC Section 1211 (disallowing the use of capital losses to offset ordinary income). Similarly, in the UK, capital losses cannot be set-off against "trading" gains of the relevant accounting period. Interestingly, the inverse, *i.e.*, the set-off of "trading" losses against capital gains of the relevant accounting period, is allowed. *See* Fursdon, British Tax Guide: Corporation Tax, *supra* note 27, at 79-80. Certain countries, such as Portugal, although not formally implementing this divide, have several limitations on the use of losses accrued on the transfer of capital assets, which pursue a similar policy rationale. *See, e.g.*, CIRC Articles 45, n.º 3 (capital losses arising on a stock transfer are only recognized in half of their value) and 48 n.º 4, c) 2)(limiting the use of rollover benefits in certain cases involving related entities). *See also* Article 23 n.º 3 (limiting the deductibility of expenses associated with certain transfers of stock between related entities). For a defense of the "cherrypicking" rationale to justify the capital/ordinary income divide *see* 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 681 ("It is widely agreed that the principal justification for limiting capital losses is to prevent selective realization, or "cherrypicking," of losses by taxpayers who have unrealized gains"). *See* id. at ft 12 for extensive bibliography on the subject. *See also* Zelinsky, *supra* note 6, at 908 ("[T]he limitation on

capital loss deductions is a reasonable response to the possible manipulation of the realization regime, precluding taxpayers from accelerating the realization of loss while they postpone the realization of gain"). There are also commentators who justify the distinction between capital and ordinary income based on an economic and practical distinction between types of income. From an economic perspective, it is argued that while certain income derives from the realized proceeds generated by an asset during the taxable period it is held (*i.e.*, the income is a result of events that have already occurred and, thus, it is certain), other income derives from the sale of the asset itself, which is actually a realization of the increase in the anticipated income the asset is expected to yield in future years (*i.e.*, this gain has an uncertain nature, since it is based on *ex ante* anticipations and thus, it is a capital gain). Therefore, from a theoretical point of view, capital gains should be taxed only to the extent that there has been a change, during the holding period, of the anticipated flow of income that the asset may generate in future years. If no such change has occurred, such gain should not be subject to tax. This clear cut distinction has, however, not been implemented in US tax law. *See* EDREY, *What are Capital Gains and Losses Anyway?*, *supra* note 45, at 146. *See also* STANLEY S. SURREY, *Definitional Problems in Capital Gains Taxation* 69 Harvard Law Rev. 985 (1956) at 990 (defending the capital/ordinary income divide based on the division between "business" and "investment" income). *But see* CUNNINGHAM & SCHENK, *The Case for a Capital Gains Preference*, supra note 36, at 326 ("[N]othing inheres in the nature of a capital gain that warrants treating it differently from other sources of income"). In addition, there is also a practical distinction between both types of income under a realization-based tax system. In particular, while certain assets require the offset of realized gain against tax basis, other income is taxed in its entirety without the need for any offset against tax basis (*i.e.*, this type of income does not require the operation of the mechanism of basis because there is no need to record pre-taxed amounts). *See* WEISBACH, *The (Non) Taxation of Risk*, *supra* note 27, at 33. Note, however, that some commentators in the US criticize this capital/ordinary income divide in tax law. A first line of argument criticizes the cherrypicking rationale. In particular, it is claimed that the cherrypicking argument is based on the assumption that all taxpayers have both unrealized gains and losses, what may often not be the case. Further, it is claimed that it is farfetched to assume that taxpayers, absent such divide, would rush to sell loss assets, what in many cases implies taking the tax element too far when compared with business motives. Finally, it is argued that the cherrypicking rationale assumes that taxpayers would be able to constantly generate new loss assets, what may not always be the case. *See* 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 1118. *See also* ZELINSKY, *supra* note 6, at 908; JEFF STRNAD, *Periodicity and Accretion Taxation: Norms and Implementation*, 99 Yale Law J. 1817 (1990), at 1888, fn.10. A different line of argument against the existence of this divide is that disallowing deductibility of capital losses (*i.e.*, true economic losses) to taxpayers with no capital gains may discourage investment. *See* SCARBOROUGH, *Risk, Diversification and the Design of the Loss Limitations Under a Realization-Based Income Tax*, at 681 ("[T]he problem of unusable losses is a problem of behavior distortion; the

tions [69], a dual tax basis for each corporation [70], rules to define the tax tre-

limitation may discourage certain investments and risk management techniques"); ZELINSKY, *supra* note 6, at 908 ("[T]he limitation may…distort the economic behavior of such taxpayers as they seek capital gains to release otherwise nondeductible capital losses"). *See also* WEISBACH, *The (Non) Taxation of Risk*, supra note 27, at 33. For this reason, several commentators have defended a special capital gains rate (and it has indeed been implemented in certain periods in the US) or a more effective taxation of undistributed corporate earnings. The problem with the special capital gains rate is that, although it may arguably reduce lock-in, it provides a very strong incentive to tax planning in order to change the character of income. Alternatively, other commentators defend that in order to reduce the problem of cherrypicking tax rules should strongly penalize retained earnings. The argument is based on the fact that a very high proportion of all capital gains and losses derives from the sale of stock or other securities. That is, without accumulated earnings, there would be no significant capital gains to be taxed, and thus, the lock-in effect would be substantially reduced. *See* CECIL, *supra* note 68, at 1118. However, apart from the fact that these types of measures are not easy to implement (*see, e.g.*, the current anti-abuse rules to combat retained earnings in the US, *i.e.*, IRC Section 531 (Accumulated Earnings Tax) and IRC Section 541 (Personal Holding Company regime)), as well as of its potential corporate governance side-effects, there could be an increase in lock-out behavior, since this measure could increase the amount of capital losses on stock dispositions. This should depend on the type of anti-abuse arsenal applying to the taxation of stock dispositions.

[69] Under a CIT, which is payable on a yearly basis, character, entity and year loss limitations are necessary to avoid the manipulation of the realization rule by taxpayers and to cope with administrative concerns. To begin with, character loss limitations enforce the capital/ordinary income divide. That is, loss limitations avoid capital losses from being selectively characterized by the taxpayer as ordinary losses and, thereby, reduce ordinary income. *See, e.g.*, in the US, rules applicable to limit "bootstrap acquisitions" at BITTKER & EUSTICE, Federal Income Taxation of Corporations and Shareholders, *supra* note 21, Sections 8.07[2] and 9.06. Further, in order to enforce the separate tax personality of individual corporations, entity loss limitations are required so that taxpayers may not transfer losses to entities other than those that originated the loss. *See supra* note 27. Lastly, year loss limitations are required. That is, in order to counteract the negative effects of the yearly tax assessment rule, there is a need to average income and, thus, permit carryover of losses to tax years other than the one when the loss was incurred. However, due mostly to administrative concerns, such possibility is limited either by restricting the carryover of losses to prior tax years or by limiting the time allowed for their use in future tax years. *See, e.g.*, in the US, IRC Section 172 (business operating losses may be carried back two years before the year of the loss and forward twenty years) and IRC Section 1212 (for capital losses there is a carryback of three years and a carryforward period of five years).

[70] Due to its nature as a separate tax levied on corporations, shareholder dispositions of stock need to be taxed independently of corporate-level events. Accordingly, the need to

atment of corporate distributions [71], and capitalization and depreciation rules [72]. Since the remainder of the tax system is built cumulatively on these principles and the associated body of subsidiary rules, their selection ends, thus, by strongly determining legislative evolution [73].

In sum, the adoption of the CIT model as basis for corporate taxation may be partially justified by market-related considerations. Due to the essentially cumulative process of development of the CIT laws, market-related

create a dual set of tax attributes, namely, a separate tax cost for assets and stock, so that dispositions of stock may be treated purely as dispositions of capital assets, follows.

(71) In particular, an issue arises regarding which distributions classify as dividends and how to treat those dividends. All CIT systems must have rules that characterize for tax purposes payments to shareholders with respect to their stock and determine the consequences of that characterization. The payments can potentially be treated as a distribution of corporate profits, a distribution of the corporation's stated capital or capital surplus, or a return of the capital of the shareholder invested in the stock, all with differing tax results. *See* HUGH J. AULT, *et al.*, Comparative Income Taxation: A Structural Analysis, *supra* note 7, at 352. *See, e.g.*, in the US, IRC Section 316 (defines the term "dividend" as a distribution of property by a corporation to its shareholders from its current or accumulated earnings and profits). On the complexities associated with such definition *see* BITTKER & EUSTICE, Federal Income Taxation of Corporations and Shareholders, *supra* note 21, at Chapter 8. *See also* on the mechanics of the distribution, Section 301 (providing whether property distributions by corporations to their shareholders are treated as dividends or as a return of stock basis). For an in-depth coverage of corporate/shareholder integration issues, an issue outside the scope of this article, *see* PETER A. HARRIS, Corporate/Shareholder Income Taxation and Allocating Taxing Rights Between Countries: A Comparison of Imputation Systems (IBFD Publications. 1996). *See also* BITTKER & EUSTICE, Federal Income Taxation of Corporations and Shareholders, *supra* note 21, at Section 1.08; for an exhaustive list of references on the topic *see* ALI, Integration of the Individual and Corporate Taxes (Alvin C. Warren. 1993) at 223.

(72) Since in order to measure income, expenses must be recovered over time to match the realization of income from an investment, a CIT system requires capitalization and depreciation rules. *See* WEISBACH, *The (Non) Taxation of Risk*, supra note 27, at 34. *See, e.g.*, in the US, IRC Section 168. *See also* HUGH J. AULT, *et al.*, Comparative Income Taxation: A Structural Analysis, *supra* note 7, at 269-270 (discussing these rules in several jurisdictions).

(73) *See supra* note 64. This evolutionary process of development of the CIT law sheds a light on the importance of historical studies for the development of our understanding of the tax laws. For recent, and enlightening, studies adopting an historical approach to income tax law, *see, e.g.* STEVEN A. BANK, From Sword to Shield: The Transformation of the Corporate Income Tax, 1861 to Present (Oxford University Press. 2010); PETER HARRIS, Income Tax in Common Law Jurisdictions (2 Vols.) (Cambridge University Press. 2006 and 2010).

considerations play also an important role on the definition of the whole structure of the CIT system.

3. The "Structural Distortions"

Another noteworthy aspect of the relationship between taxation and market are the distortions introduced to the behavior of corporations that may arise as a side effect of the adoption of the realization principle as basis for corporate taxation in a market-based economy. For purposes of this article, they will be referred to as "Structural Distortions" A CIT system may introduce distortions at the following levels:

1. The timing of transactions;
2. The level of after-tax return on assets;
3. The level of risk-taking; and
4. The level of transaction costs incurred by firms.

As discussed, under the CIT system, a potential built-in gain or loss on an asset is only includable in taxable income once a qualifying transfer occurs. Accordingly, by anticipating or postponing an asset transfer, the taxpayer may effectively control when to include such asset's built-in gain or loss on its taxable income. Thus, the CIT system may distort the timing of transfer transactions, in that it may encourage corporations to retain assets beyond the optimal period ("lock-in" effect) or to sell assets before the optimal period ("lock-out" effect) [74]. In principle, the type and magnitude of the behavioral distortion should vary depending on the tax attributes of the corporation in question and the type of asset transferred [75].

(74) *See* SHAVIRO, *An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax*, *supra* note 9, at 5 ("Taxes triggered by the act of transfer…are inherently distortive…they straightforwardly influence taxpayers to avoid transfers that yield taxable gain, and to engage as soon as possible in transfers that yield deductible loss"). *See also* CHORVAT, *supra* note 51, at 89.

(75) In particular, whether the taxpayer expects to be at a taxable gain or loss position at year end, and whether it possesses or not accumulated tax attributes, such as tax loss carryovers, especially when close to expiry, may impact the timing of implementation of a transaction. For instance, the incentive to adopt a certain conduct provided by the deduct-

Further, since the taxation of gains from certain assets may be deferred indefinitely, such assets should be subject to a lower rate of tax even if they are subject to the same nominal rate [76]. That is, not all income is taxed at the same rate under a realization-based tax system. The longer an asset is held, the longer the tax on any gain or loss is deferred. This, in turn, lowers the effective rate of tax on income from that asset [77]. Assets with an identical before-tax return may, therefore, be favored differently by investors due to the different after-tax return that results from deferral. In particular, deferral may alter taxpayer preferences between investments that generate current or deferred compensation, and between appreciating assets and assets which generate current cash returns [78].

In addition, the CIT system may impact the level of corporate risk taking [79]. In principle, 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

ibility of a payment, or the non-recognition of a specific transaction involving built-in gain assets, may be made totally irrelevant to a taxpayer who is in a loss position with a substantial amount of tax losses to be expired. By the same token, the nature and tax attributes of the asset transferred may alter such decision. That is, while the tax value of cash always equals its market value, the tax value of assets and stock may differ from their market value, *i.e.*, assets or stock may have a built-in gain or loss. For that reason, they raise different tax issues, which may affect the willingness of the taxpayer to transfer an asset at its optimal business timing *See, e.g.*, in the US, imposing limits on the transfer of assets with built-in losses, IRC Section 269 and IRC Section 382. *See also* discussion *supra* at note 40 on the impact of tax and non-tax law frictions to substitution.

[76] *See* CHORVAT, *supra* note 51, at 80.

[77] *See* CHORVAT, *supra* note 51, at 80.

[78] *See* ZELINSKY, *supra* note 6, at 914.

[79] For a definition of risk *see* EVSEY D. DOMAR & RICHARD A. MUSGRAVE, *Proportional Income Taxation and Risk-Taking*, 58 The Quarterly Journal of Economics 388 (1944), at 396 ("Of all possible questions which the investor may ask, the most important one, it appears to us, is concerned with the probability of the actual yield being less than zero, that is, with the probability of a loss. This is the essence of risk"). In general, the risk literature distinguishes between systematic risk — the risk of the market — and unsystematic risk — the risk of a particular asset. Unsystematic risks can be managed by diversifying into different types of investments, while systematic risk is unavoidable and inherent in the nature of the system. For a more comprehensive definition of risk *see, e.g.*, REBECCA S. RUDNICK, *Enforcing the Fundamental Premises of Partnership Taxation* 22 Hofstra L. Rev. 229 (1993), at 267-270.

a portion of the losses [80]. In principle, pure neutrality towards risk should not be possible under a CIT system [81]. The characteristics of the loss relief system should dictate whether a CIT system enhances or reduces the risk-taking capabilities of corporations [82].

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 [83]. 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 [84].

[80] *See* RUDNICK, *Enforcing the Fundamental Premises of Partnership Taxation, supra* note 79, at 273-278. *See also* MARTIN H. DAVID, Alternative Approaches to Capital Gains Taxation (Brookings Institution. 1968) at 140; CECIL, *Toward Adding Further Complexity to the Internal Revenue Code: A New Paradigm for the Deductibility of Capital Losses, supra* note 68, at 1107.

[81] *See* SCARBOROUGH, *Risk, Diversification and the Design of the Loss Limitations Under a Realization-Based Income Tax, supra* note 68, at 685. *See also* id. at 717 ("If losses were allowable without limit, taxpayers would be encouraged to make risky investments so that they could selectively realize losses. If losses were limited, however, risky investments could give rise to unusable losses and thus would be discouraged. No treatment of losses eliminates both of these biases").

[82] *See* DOMAR & MUSGRAVE, *Proportional Income Taxation and Risk-Taking, supra* note 79, at 391ff (In general, whether an income tax system with a realization requirement encourages or discourages risk depends on how the system treats losses). *See also* M. DONNELLY & A. YOUNG, *Policy Options for Tax Loss Treatment: How Does Canada Compare?*, 50 Canadian Tax Journal 429 (2002), at 439.

[83] Specifically, the spectrum ranges from relief being granted only to losses from the same tax year, incurred by the same entity, and respecting to the same source of income, to carryover being allowed both to prior and subsequent tax years, to all types of related and unrelated entities, and to offset income from whatever source (*i.e.*, independently of the character of the income, or the activity or country where it was generated). *See generally*, for a description of different technical solutions and their policy implications, DONNELLY & YOUNG, *Policy Options for Tax Loss Treatment: How Does Canada Compare, supra* note 82, at 439.

[84] Due to the different types of restrictions introduced to the loss offset mechanism and to its interaction with other elements of the CIT system, the assessment of CIT's impact

Finally, due to its realization-based nature, the CIT system affects the level of transaction costs incurred by firms. In particular, by making the taxpayer's decisions regarding what to sell or to retain more complex, and by creating additional legal issues for taxpayers to consider, CIT increases regular business transaction costs by adding a further element that must be taken into consideration whenever two parties decide to contract [85]. This includes information costs to determine applicable rules (including lawyer's fees and financial professional advice), compliance costs and tax planning costs.

These Structural Distortions may affect the investment and financing preferences of corporations. First, since the CIT system allows taxpayers to strategically time their realizations to minimize taxes due, it may make investors less responsive to changes in the prospects of their investments, thereby reducing the ability of the market to shift capital to its most efficient use at

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on risk taking is far more complex than may at first be envisaged. *See* generally DOMAR & MUSGRAVE, *Proportional Income Taxation and Risk-Taking, supra* note 79; ANDREW WEISS, *The Fair Tax: A Tax Reform To Alleviate Recessions and Reduce Biases in the Tax Code*, Boston University Working Paper, available at SSRN: http://ssrn.com/abstract=258853 (1999); DONNELLY & YOUNG, *Policy Options for Tax Loss Treatment: How Does Canada Compare, supra* note 82; CAMPISANO & ROMANO, *Recouping Losses: The Case for Full Loss Offsets, supra* note 66; MICHAEL L. SCHULTZ, *Section 382 and the Pursuit of Neutrality in the Treatment of Net Operating Loss Carryovers*, 39 U. Kan. L. Rev. 59 (1990); CANADA DEPARTMENT OF FINANCE, Report of the Technical Committee on Business Taxation (Department of Finance. 1998); 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); JACK M. MINTZ, *Corporation Tax: A Survey*, 16 Fiscal Studies 23 (1996); SATYA PODDAR, *Refunding the Tax Value of Unutilized Losses, in* Policy Options for the Treatment of Tax Losses (Clarkson Gordon Foundation ed. 1991). Note that there is a fair amount of controversy in the literature regarding theoretical assumptions. *See, e.g.*, MARTIN S. FELDSTEIN, *The Effects of Taxation on Risk Taking*, 77 The Journal of Political Economy 755 (1969), at 763 ("The widely accepted proposition that proportional taxation with full loss offsets causes increased risk taking has been shown to rest on weak theoretical foundations"). *See also* JEREMY I. BULOW & LAWRENCE H. SUMMERS, *The Taxation of Risky Assets*, 92 The Journal of Political Economy 20 (1984), at 22 ("The paradoxical conclusions obtained in much of the literature suggesting that taxes on risky assets may actually encourage investment in them are shown to depend on implausible assumptions").

[85] *See* SHAVIRO, *An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax, supra* note 9, at 24.

the most optimal time [86]. Further, it may provide significant encouragement for taxpayers to engage in tax planning. Both of these aspects may result in deadweight loss for the economic system. Second, since deferral may alter taxpayer preferences between investments that generate current or deferred compensation, and between appreciating assets and assets which generate current cash returns, it may alter regular investor preferences regarding investments and may yield negative economic consequences. Third, the potential impact of a CIT system on corporate risk-taking may affect the optimal level of risk-taking in an economy [87]. Finally, the increase in business transaction costs may reduce the ordinary frequency of transactions and, thus, the ability of an economy to allocate capital to its most efficient uses, generating deadweight loss [88].

In short, there are certain distortions that occur as a necessary side-effect of the adoption of the realization principle as a basis for corporate income taxation. Accordingly, corporate tax policy should depart from the premise that the "playing field" for CIT reform is already distorted, not only due to natural market imperfections, but also due to the Structural Distortions that necessarily result from the adoption of CIT as the basis for corporate taxation in a market-based economy.

4. The CIT System and the Firm's Organizational Arrangements

As discussed above, artificial line-drawing provides an inducement to transactional substitution. The root of the economic problems associated with

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[86] *See* CECIL, *Toward Adding Further Complexity to the Internal Revenue Code: A New Paradigm for the Deductibility of Capital Losses, supra* note 68, at 1104 ("[T]he lock-in effect prevents the flow of capital to its best economical use").

[87] Note that although risk-taking is generally assumed as a positive good, there is a substantial controversy on whether risk-taking is or not beneficial. Even assuming risk-taking is beneficial, as defended by several authors, there is a substantial controversy on whether tax is the ideal mean to foster it. This issue is beyond the scope of this work. For a good introduction *see* RUDNICK, *Enforcing the Fundamental Premises of Partnership Taxation, supra* note 79. *See also* AVI FIEGENBAUM & HOWARD THOMAS, *Attitudes Toward Risk and the Risk-Return Paradox: Prospect Theory Explanations*, 31 Acad. Mgmt. J. 85 (1988).

[88] *See* R. H. COASE, *The Nature of the Firm*, 4 Economica 386 (1937). *See also* OLIVER E. WILLIAMSON & SIDNEY G. WINTER, The Nature of the Firm: Origins, Evolution, and Development (Oxford University Press. 1993).

substitution is that, apart from the fostering of the complexity of the CIT system and the erosion of the tax base, in a world of costly contracting and information asymmetries, the search and adoption of substitute transactions has associated costs and potential operational inefficiencies for the firm. These costs include, first, the fees paid to professionals to locate these alternatives and to evaluate how cost effective it is to bear the potential frictions associated with the new tax position [89]. Second, the costs associated with implementing the substitute transaction [90]. Apart from these costs, substitution may also result in additional inefficiencies. This will depend on whether the substitute transaction is a perfect, or imperfect, substitute for the substituted transaction [91].

In the case of perfect substitutes, the taxpayer should substitute without any associated inefficiencies [92]. However, in the case of imperfect substitutes, the implementation of the substitute transaction may have associated inefficiencies [93]. For instance, in certain cases, substitution may be conducive to the adoption of a corporate functional structure with a greater degree of centralization of management than would otherwise be optimal [94]. Similarly,

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(89) This assessment may include both a monetary and reputational analysis. *See* SCHENK, *An Efficiency Approach to Reforming a Realization-Based Tax*, *supra* note 40, at 516.

(90) Restructuring costs, etc. *See* id. at 516.

(91) *See* WEISBACH, *Formalism in the Tax Law,* supra note 16, at 875 ("Tax arbitrage is inefficient. If the forms used in the arbitrage are perfect substitutes, there is no economic cost to the arbitrage; the social costs are the transaction costs, which can be large — as large as the tax avoided. If the forms are not perfect substitutes, taxpayers can change their economic position to obtain a tax advantage, creating inefficiencies").

(92) The state, however, suffers a revenue loss.

(93) *See* SCHOLES, *et al.*, Taxes and Business Strategy: A Planning Approach, *supra* note 36, at 3 ("In a world of costly contracting, implementation of tax minimization strategies may introduce significant costs along nontax dimensions"); THORNTON., *Managerial Tax Planning Principles and Applications*, *supra* note 40, at 142 ("Agency costs, generally the costs of people not trusting each other, often get in the way of tax planning. Indeed, in seeking tax savings, taxpayers often spawn new mutations of agency costs").

(94) That is, information asymmetries may require more decentralized organizational structures. *See* SCHOLES, *et al.*, Taxes and Business Strategy: A Planning Approach, *supra* note 36, at 168 ("When a complex organization is composed of distinct legal entities…shifting income from one pocket to the next may require considerable coordination, and tax rules often induce a greater degree of centralization of management than would otherwise be optimal"); id. at 156 ("[T]ax considerations and information-related transaction cost considerations

the substitute transaction may involve the adoption of a sub-optimal corporate legal structure [95], or the implementation of a transaction that is more complex and expensive than otherwise required. This, in turn, may yield negative economic and corporate governance effects [96].

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often have conflicting implications for efficient organizational design. Sometimes tax considerations dominate in importance and sometimes information considerations dominate. But frequently, both factors are important and trade-offs must be made"); MYRON S. SCHOLES & MARK A. WOLFSON, *The Effects of Changes in Tax Laws in Corporate Reorganization Activity*, 63 Journal of Business Finance S141 (1990), at 144 ("[I]n designing an organization, tax considerations and information-related transaction cost considerations are often in conflict with one another").

(95) Specifically, certain tax planning strategies may require manipulation of the corporate veil, including the amalgamation of several group businesses in a sole corporate member or the wind up of certain corporate members. This is prejudicial in that, from an efficient management perspective, in certain cases it may be preferable to maintain the corporate veil of a certain line of business. For instance, research conducted by the Canadian government showed that the use of amalgamations or windups to obtain tax advantages could collide with the following business considerations: profit centre management controls may not operate as well if the separate corporate status is eliminated; minority shareholders may block or delay reorganizations; the cost of the reorganization in money and management time may be considerable; corporate groups with high-risk projects or startup situations may conduct activities through separate corporations in order to limit liability to the equity directly related to individual projects; and corporations operating in regulated industries are either directly limited in how they must conduct their activities or indirectly encouraged by the existence of regulations to operate non-regulated business in separate corporations. *See* DEPARTMENT OF FINANCE CANADA, A Corporate Loss Transfer System for Canada (Budget Papers. 1985). Further, it may be desirable to maintain the separate operational independence, track records and corporate marketing identities achieved by the segregation of businesses in distinct but related companies. There may also be labor and management issues arising when corporations with distinct cultures and unions merge into one conglomerate, or financial considerations when subsidiaries within a corporate group have different costs of capital. Also, corporate investors setting up new uncertain ventures may find it desirable to co-invest with minority shareholders who may contribute their own expertise and networking to the success of innovative projects. *See* ALEXANDRE LAURIN, *Cleaning Up the Books: A Proposal for Revamping Corporate Group Taxation in Canada,* 284 C. D. Howe Institute's Fiscal Policy 1 (2009), at 5-6.

(96) Consider, for instance, the impact of transactional substitution on corporate governance. In principle, substitution induces more convoluted organizational structures and less transparent corporate flows. This internal complexity should make the firm more opaque from an informational perspective. Notably, it should become more difficult for top management and other stakeholders to continue to be accurately informed about the firm's operations. As a result, a shift of power from the board to inside managers and an increase of the poten-

Thus, the firm may adopt organizational arrangements that are sub-optimal from a transaction cost or agency perspective in order to obtain tax advantages [97]. The problem is especially acute due to the rigidity that CIT

tial for managerial opportunism may transpire. *See* ARNE FRIESE, *et al.*, *Taxation and Corporate Governance — The State of the Art*, *in* Tax and Corporate Governance (Wolfgang Schon ed. 2008) at 380; M. DESAI & D. DHARMAPALA, *Tax and Corporate Governance: An Economic Approach*, *in* Tax and Corporate Governance (Wolfgang Schon ed. 2008), at 14; STEFAN MAYER, *The Link Between Taxation and Corporate Governance: Report on the Discussion*, *in* Tax and Corporate Governance (Wolfgang Schon ed. 2008) at 67. On the relationship between tax rules and corporate governance *see* generally JEFFREY OWENS, *The Interface of Tax and Good Corporate Governance* 37 Tax Notes Int'l 767 (2005), at 768; SCHON, Tax and Corporate Governance, *supra* note 36. FRIESE, *et al.*, *Taxation and Corporate Governance — The State of the Art*, *supra* note 96, at 393-395; STEVEN A. BANK, *Dividends and Tax Policy in the Long Run*, 2007 University of Ilinois Law Review 533 (2007), at 572.

[97] There is a substantial amount of research demonstrating that taxes influence corporate behavior. Existing research demonstrates that tax rules may often impact the decisions of corporations regarding their financial structure, organizational form and ownership, general investment decisions, and corporate governance. On the interaction of tax and corporate financial structure *see, e.g.*, ALAN J. AUERBACH, *et al.*, *Taxing Corporate Income*, *supra* note 5, 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); BRADFORD, Untangling the Income Tax, *supra* note 30, 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 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 sur-

brings to corporate structures. That is, besides potentially giving rise to the implementation of sub-optimal functional and legal structures, the tax minimization strategies to explore the asymmetries of the CIT System may effectively lock the taxpayer into these structures for an extended period of time.

This rigidity follows from two main reasons. First, 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 or to avoid a specific anti-abuse rule, it should remain in operation for a certain time [98]. Second, due to the application of anti-abuse rules, the corpo-

rounding the choice of organizational form). On the interaction between tax and general investment decisions *see, e.g.*, BRADFORD, Untangling the Income Tax, *supra* note 30, at 108 and 112 (author notes that the corporation tax system creates strong pressures on the composition of corporate investment); THORNTON, *Managerial Tax Planning Principles and Applications*, *supra* note 40, at 119 (arguing that business decisions affect taxes and taxes affect business decisions); GRAHAM, *supra* note 94, 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* SCHOLES & WOLFSON, *The Effects of Changes in Tax Laws in Corporate Reorganization Activity*, *supra* note 97 (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 supra* note 96. Note, however, that most existing research has not concluded indisputably on CIT's impact on corporate behavior. Fundamentally, while most of the research concluded that CIT impacts several areas of corporate behavior, research has not been able to determine whether such effects are due mostly, or exclusively, to CIT provisions. That is, CIT generally has an impact on corporate behavior, but the precise determination of the extent of such impact is clouded with doubt in most cases. *See, e.g* GRAHAM, *supra* note 97, at 1075 "(Many issues remain unresolved…including understanding whether tax effects are of first-order importance…"); BRADFORD, Untangling the Income Tax, *supra* note 30, at 201 ("[W]e do not have a full understanding of the way tax rules affect corporate behavior"). *See also* GOOLSBEE, *Taxes, Organizational Form and the Deadweight Loss of the Corporate Income Tax*, *supra* note 97, and ALAN J. AUERBACH, *et al.*, *Taxing Corporate Income*, *supra* note 5. The difficulty incumbent to arriving at definitive conclusions on the behavioral impact of the CIT system may be attributed to three different types of factors. First, the possibility of the taxpayer to substitute transactions and the different variables to substitution that exist for each individual taxpayer. Second, the intertemporal difficulty to measure the effects of the tax rules. Finally, the problems associated with predicting the interaction of the tax rules with the dynamics of the market.

[98] These costs include fees paid to external consultants (*i.e.*, lawyers' fees, accountants, management consultants, etc) as well as the internal costs required to implement new opera-

rate 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 [99]. Although flexibility may be possible in certain cases, it usually comes at a higher cost [100]. Thus, in certain cases, a corporation may be effectively stuck with a sub-optimal corporate structure due to tax considerations.

In sum, in a world of costly contracting and information asymmetries, the search and adoption of substitute transactions has associated costs and potential operational inefficiencies for the firm. In certain cases, the firm may adopt organizational arrangements that are sub-optimal from a transaction cost or agency perspective in order to obtain tax advantages. The problem is especially acute due to the rigidity that CIT brings to corporate structures, which may effectively lock the firm into these structures for an extended period of time.

5. The CIT System and the Firm's Agency Problems

A final aspect of the utmost relevance regarding the relationship between CIT and the market is that taxing business income by levying a separate tax

tional guidelines throughout the organization. *See, e.g.* MARTINA BAUMGARTEL, *Taxation, Accounting and Transparency: The Interaction of Financial and Tax Accounting, in* Tax and Corporate Governance (Wolfgang Schon ed. 2008), at 99 ("'Over-optimization' very often leads to inflexible and complicated structures and downsides in case the tax legislation changes"); *See also* SCHOLES, *et al.*, Taxes and Business Strategy: A Planning Approach, *supra* note 36, ("[F]irms make incremental investment and financing decisions that depend, in part, on past investment and financing decisions. New strategies depend on past strategies because it is costly to adjust investment and financing decisions once they have been made").

[99] *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).

[100] *See* SCHOLES, *et al.*, Taxes and Business Strategy: A Planning Approach, *supra* note 36, at 185 ("In the presence of uncertainty regarding…the tax rules…, a premium is placed on contracts that offer flexibility in tax planning to respond to unexpected changes in tax status. But building flexibility, however, into contracts does not come free…flexibility typically requires greater contracting costs").

on corporations, as occurs under a CIT system, rather than exclusively through shareholder level taxes, gives rise to significant regulatory consequences. For purpose of this article, they will be classified as the *Reliability Effect*, the *Deterrent Effect*, the *Reversal of Clientele Effect* and the *Control Effect*. 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.

i) 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 [101]. 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 [102]. The level of detail of tax information [103], coupled with the strength of the state's supervision and enforcement mechanisms [104], turn the state into an important and differentiated inspector of the reliability of the firm's disclosed information regarding its operations[105]. Significantly, the state has an incentive

[101] *See* 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) 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").

[102] Id. at 5 ("[E]ffective tax enforcement makes hiding and diverting profits more difficult"). *See also* SCHON, *Tax and Corporate Governance: A Legal Approach*, *supra* note 59, 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").

[103] 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).

[104] 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.

[105] *See* SCHON, *Tax and Corporate Governance: A Legal Approach*, *supra* note 59, at 60 ("As tax inspectors do not face the same collective action problems which shareholders encoun-

to verify the reliability of the disclosed information and to enforce its rights even when the cost of doing so is higher than the recompense it can derive. In other words, the state does not face a "free rider problem" in monitoring and enforcing its rights [(106)]. By auditing accounts or taking legal action against a corporation, the state sets forth a case that induces other firms to behave [(107)]. This supervision activity of the government is of especial relevance for the protection of minority shareholders interests [(108)] and for the accuracy of small companies' books, which are often not legally obliged to have their accounts audited [(109)].

ii) The Deterrent Effect

The firm's financial results often determine the amount of control shareholders exercise over, and payments made to, corporate managers [(110)]. Further, the financial results of the firm generally dictate its stock value and the willingness of investors to invest in it [(111)]. 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 [(112)]. 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 [(113)]. That is, the higher the conformity between financial accounting and tax accounting [(114)], the easier it should be for discrepancies between book income and taxable income to attract the scrutiny of the tax authorities [(115)]. Due to the penalties

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ter 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").

(106) *See* M. DESAI, *et al.*, *Corporate Governance and Taxation*, *supra* note 101, at 38.

(107) Id. (authors refer to this phenomenon as the "spillover" effect).

(108) *See* SCHON, *Tax and Corporate Governance: A Legal Approach*, *supra* note 59, at 60 ("[T]he tax authorities are a major player when it comes to the protection of minority interests").

(109) *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).

(110) *See* SCHOLES, *et al.*, Taxes and Business Strategy: A Planning Approach, *supra* note 36, at 169 (arguing that compensation contracts for top managers are often based on accounting earnings).

(111) 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).

(112) *See* OWENS, *The Interface of Tax and Good Corporate Governance*, *supra* note 96, 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").

(113) *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).

(114) 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 CRIC (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 96, 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").

(115) *See* SCHOLES, *et al.*, Taxes and Business Strategy: A Planning Approach, *supra* note 36, 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.*,

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 [116].

iii) 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 [117]. As a result of this adjustment, the stock price changes [118]. 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 [119]. This could result in additional agency problems. Further, 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 [120].

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 is especially true in the US after the introduction of Schedule M-3 to the CIT return.

[116] *See* DESAI & DHARMAPALA, *Tax and Corporate Governance: An Economic Approach, supra* note 96, 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").

[117] *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).

[118] Id.

[119] *See* SAUL LEVMORE & HIDEKI KANDA, *Taxes, Agency Costs, and the Price of Incorporation*, 77 Virginia Law Review 211 (1991), at 213 ("[T]he separate tax on corporations 'equalizes' shareholders preferences for corporate transactions even though shareholders are in diverse individual tax circumstances").

[120] 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

iv) The Control Effect

Lastly, a separate corporate-level tax allows society to limit and, to a certain degree, to control managerial power [121]. 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 [122]. In addition, through the different incentives and disincentives it introduces to corporate activity [123], 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 [124].

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.

All in all, there is a profound interaction between the CIT system and the market. This interaction has a multifaceted nature, including the impact of the market on the definition of the operational structure of the CIT system; the distortions introduced to the behavior of corporations that may arise as a side effect of the adoption of the realization principle as the basis for corporate taxation; the impact of rule, compliance and transactional complexity on taxpayer and government activity; the potential inferences of the CIT system

CIT. *See* AVI-YONAH, *Corporations, Society, and the State: A Defense of the Corporate Tax, supra* note 63, at 1208.

[121] *See* AVI-YONAH, *Corporations, Society, and the State: A Defense of the Corporate Tax, supra* note 63, 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").

[122] *See* id. 1247.

[123] 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.

[124] *See* AVI-YONAH, *Corporations, Society, and the State: A Defense of the Corporate Tax, supra* note 63, at 1255 ("Corporate taxation is an important regulatory tool and an important element in managing the delicate balance between corporations, society, and the state").

on the firm's organizational arrangements; and the impact of the CIT system on the firm's agency problems and on managerial power.

C) Property and Market

The relationship between property and market has been widely studied and demonstrated. An analysis of such extensive literature is well beyond the scope of this article [125]. For purposes of our analysis, it suffices to bring to light certain central conclusions reached in this literature. To begin with, consider the origin of property rights from an economic perspective. A primary premise is that resources are scarce [126]. In face of such scarcity, resources need to be allocated between users and uses. This, in turn, requires some formal or informal recognition of who owns the resources, and, most significantly, the rights and constraints that attach to ownership [127]. As Veljanovski notes, "[w]here ownership rights are non-exclusive, or are difficult to define and enforce, a resource will be overexploited if already in existence and underprovided if it must be produced. Individuals and organisations will fail to take account of the economic value of such commonly owned resources and they will be used inefficiently, or a market in otherwise valuable activity may fail to develop" [128]. Thus, it is argued, the absence of recognition of enforceable ownership rights results in substantial economic waste, inefficiency and stagnancy. Overall, the existence of enforceable property rights increase wealth by reducing transaction costs and unlocking wealth-creating opportunities [129].

[125] For a comprehensive treatment of the theme *see, e.g.*, Y. BARZEL, Economic Analysis of Property Rights (Cambridge University Press 2nd ed. 1997); E. FURUBOTN, *et al.*, The Economics of Property Rights (Ballinger. 1974); H. DEMSETZ, *Toward a Theory of Property Rights*, 59 American Economic Review 347 (1969); A. A. ALCHIAN & H. DEMSETZ, *The Property Rights Paradigm*, 33 Journal of Economic History 17 (1973); STEVEN SHAVELL, Foundations of Economic Analysis of Law (Harvard University Press. 2004).

[126] *See* CENTO VELJANOVSKI, Economic Principles of Law (Cambridge University Press. 2007), at 58.

[127] Id. at 58.

[128] Id. at 60.

[129] Id. at 59. As Veljanovski notes "Clearly defined private property rights combined with competition are more likely to allocate resources to their most efficient or highest-valued uses". Id. at 60.

Consider now the impact of taxation on this fundamental relationship. As Veljanovski astutely notes, "[i]n modern capitalist economies income, goods and services, capital, wealth and property are all taxed, and their use and transfer restricted by laws and governments. Thus while these may still be characterised as 'private property', these legal restrictions affect *efficiency, value, the nature of exchange* and *the actions of their owners and users*" [130] (emphasis added). The impact of CIT on efficiency, value, nature of exchange and actions of owners and users of property has been discussed above.

Take the case, for instance, of efficiency. Since the CIT system allows taxpayers to strategically time their realizations to minimize taxes due, it may make investors less responsive to changes in the prospects of their investments, thereby reducing the ability of the market to shift property to its most efficient use at the most optimal time. By the same token, due to its realization-based nature, the CIT system affects the level of transaction costs incurred by firms. This increase in business transaction costs may reduce the ordinary frequency of transactions and, thus, the ability of an economy to allocate property to its most efficient uses.

Consider now the impact of the CIT system on the value of property. Since the taxation of gains from certain assets may be deferred indefinitely, such assets should be subject to a lower rate of tax even if they are subject to the same nominal rate. Assets with an identical before-tax return may, therefore, be favored differently by investors due to the different after-tax return that results from deferral. In particular, deferral may alter taxpayer preferences between investments that generate current or deferred compensation, and between appreciating assets and assets which generate current cash returns. This distortion, in turn, may result in changes to the value of assets. Specifically, when two assets give rise to identical before-tax cash flows, but, as a result of the tax system, the cash flows from one of such assets is taxed more favorably, taxpayers will generally prefer to hold such tax-favored asset. As a result, the price of the tax-favored asset tends to increase relative to the price of the tax disfavored asset. As Scholes explains, "given differences in tax treatment, if after-tax returns are to be equalized, then before-tax rates of return must differ across the assets" [131]. This

[130] Id. at 62, 63.

[131] *See* SCHOLES, *et al.*, Taxes and Business Strategy: A Planning Approach, *supra* note 36, at 119.

may alter regular investor preferences regarding investments and may yield negative economic consequences.

Lastly, CIT was shown to impact the nature of exchanges and the actions of owners and users. In particular, the nature of exchanges in the corporate sector may be considerably altered due to the desire of the corporate taxpayer to recast the form of transactions in order to manipulate the realization rule. Similarly, CIT may affect the actions of owners and users of property, by inducing substitution, promoting changes of organizational arrangements and operational structures, and bringing about lock-in and lock-out behavior.

In short, CIT may potentially affect the efficiency, value, nature of exchange and actions of owners and users with respect to private property. Significantly for our purposes, the recognition of CIT's impact on the dynamics of property use and transfer sheds a light on the political significance of the CIT legislative process and on the interest of social actors in controlling such process. In practice, different actors with distinct behavioral tendencies and aims become deeply involved in the CIT legislative process. The legislator, the tax authorities, political parties, corporate lobbies and interest groups act in constant tension regarding the definition of CIT's objectives and particular legislative shape [132]. Due to its important societal role [133], CIT's legislative process is particularly competitive, with these different internal cultural forces constantly trying to shape it according to their particular interests. The internal tension of these forces in the definition of the corporate tax laws is a central element in the definition of the corporate tax culture [134]. Historically, it has significantly contributed to turning the process of CIT reform into a controversial and piecemeal endeavor that has often generated genetically asymmetric and logically incoherent tax rules and principles [135].

In sum, CIT intrudes in the profound interrelationship between property and market. Significantly, the recognition of the impact of CIT on such interrelationship sheds a light on the political significance of the CIT legislative process and on the interest of social actors in controlling such process. Historically, the tension between these different interests in the definition of the corporate tax laws has significantly contributed to turning the process of CIT reform into a controversial and piecemeal endeavor that has often generated genetically asymmetric and logically incoherent tax rules and principles.

D) Corporate Tax Policy and the Interrelationship Between Taxation, Property and Market

As Professor Saldanha Sanches judiciously noted, there is a profound interrelationship between taxation, property and market. In face of these interactions, as the analysis has demonstrated, the design and operation of a CIT system remains subject to several constraints and distortions. Accordingly, to simply look at how far a certain policy is from optimality in order to determine whether an incremental improvement occurs may be insufficient. As explained under the theory of the second-best, the introduction of an improvement towards optimality will not necessarily result in an overall improvement if the underlying context is itself imperfect [136]. Therefore, to deter-

[132] *See* CLARK, *The Morphogenesis of Subchapter C: An Essay in Statutory Evolution and Reform*, *supra* note 21, at 95.

[133] As Mehrotra, *et al.*, note "In the modern world, taxation is the social contract". *See* MEHROTRA, *et al.*, The New Fiscal Sociology, *supra* note 65, at 1.

[134] *See* id. at 95 ("The principal internal forces that have shaped the corporate tax culture derive from the motivations and aspirations of its different groups of participants. Each group — taxpayers, the Service, courts, and legislators — displays characteristic behavioral tendencies that are themselves cultural activities and part of the corporate tax culture as defined"). *See also* MEHROTRA, *et al.*, The New Fiscal Sociology, *supra* note 65, at 3,4 ("[T]axation establishes a dynamic relationship between the taxpayer and the state, in which there always exists a potential conflict of interest…the form of tax obligations is constantly changing as different taxpayers and different rulers seek to renegotiate the relationship to their advantage"); MEHROTRA, *Mergers, Taxes, and Historical Materialism*, *supra* note 65, at 955 ("[Tax] rules are a product not solely of economic ideas or legal logic, but also of changing social, political and economic conditions and interests — a product, that is, of historical sequence and material context").

[135] *See* FELDSTEIN, *On the Theory of Tax Reform*, *supra* note 18, at 90-94 (noting how changes in tax systems are often slow, piecemeal and laced with political compromises); SIDNEY I. ROBERTS, *et al.*, *A Report on Complexity and the Income Tax*, 27 Tax L. Rev. 325 (1972), at 339 ("[T]he tax law has not evolved gradually through the implementation of the lessons of history, but has evolved by a series of amendments superimposed upon each other, reflecting an immediate need for revenue, the popular demand for tax relief, the pressure of interested special groups or an effort to prevent some type of abuse"). *See also* SHAVIRO, *An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax*, *supra* note 9, at 11.

[136] 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).

mine whether a proposed reform moves us closer to the Haig-Simons ideal, or, by that matter, any other normative tax policy ideal, may not be sufficient to ensure a successful incremental change to a CIT system [137]. By the same token, the application of optimal tax research may be insufficient to ensure a successful incremental change [138]. In sum, in face of the interactions between taxation, property and market, to simply look at how far we are from optimality may be insufficient to ensure an incremental improvement.

For that reason, the path this article proposes to determine whether incremental improvements are indeed improvements consists in *looking for more efficient tax solutions and, then, go further by identifying the distortions and their interactions associated with the operation of a CIT system, and factor them into corporate tax policy analysis* [139]. For this purpose, this article defines efficiency as the minimization of transaction costs and other sources of deadweight loss. This includes the minimization of substitution effects (*i.e.*, changes in taxpayer decisions or behavior due to the tax system) and tax overhead costs (*i.e.*, the amount of resources, including the value of time or labor, consumed in applying the tax system, through taxpayer or government activities such as tax planning, compliance, litigation, administration, and law-making) [140].

Further, in order to adequately factor into corporate tax policy analysis the different distortions and their interactions associated with the operation of the CIT system, this article proposes that corporate tax policy should take into consideration, first, the pre-existing distortions of the "playing field" for CIT reform, including market imperfections, the Structural Distortions,

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[137] *See* DEBORAH H. SCHENK, *An Efficiency Approach to Reforming a Realization-Based Tax*; *supra* note 40, 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"). *See also* WEISBACH, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, *supra* note 11, 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"); LEVMORE, *Recharacterizations and the Nature of Theory in Corporate Tax Law*, *supra* note 41, at 1061 ("The nature of corporate tax law defies normative argumentation").

[138] This is because of the limitations of its theoretical models, which usually depart from the assumption of perfect markets and no externalities. Further, the application of the existing optimal tax research has not yet focused appropriately on CIT issues. In particular, 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").

[139] On the defense of efficiency as the most appropriate way to deal with tax issues *see, e.g.*, CUNNINGHAM & SCHENK, *The Case for a Capital Gains Preference*, supra note 36, 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*, *supra* note 33, 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 40, 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"). This article defends that CIT should not be concerned with equity issues. Equity issues may be better dealt with at the shareholder's level, *i.e.*, with personal income taxation rules or, alternatively, with simple 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 33, at 74 (defending that decisions regarding redistribution should be left for adjustments to the rate structure).

[140] *See* SHAVIRO, *An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax*, *supra* note 9, at 4 ("The efficiency norm that I use is that of minimizing excess burden, or the deadweight loss generated by the tax system"); id. at 24 ("The standard tax efficiency norm of minimizing excess burden implies two principal objectives. The first is minimizing substitution effects, or changes in taxpayer decisions or behavior due to the tax system. The second is minimizing …the amount of resources …consumed in applying the tax system"). *See also* WEISBACH, *Formalism in the Tax Law*, *supra* note 16, at 870 ("Efficiency in the tax law is measured by whether the law raises revenue without creating adverse incentives"); HARVEY S. ROSEN, Public Finance (McGraw-Hill/Irwin 6th ed. 2001) at 284-303 (noting that a tax is efficient if it raises revenue with a minimum of behavioral distortions and other sources of deadweight loss). As may be noted, tax scholars often use efficiency in a manner different from that used by law and economics scholars, who generally refer to Pareto efficiency or Kaldor-Hicks efficiency. *See* DEBORAH H. SCHENK, *An Efficiency Approach to Reforming a Realization-Based Tax*; *supra* note 40, at 507.

the regulatory effects of the CIT system, and its political significance. Second, the impact of the CIT system on corporate behavior, corporate governance, and its relationship with related regulatory fields. This, in turn, forcefully demands the adoption of an interdisciplinary approach to tax research whereby these elements are brought into the corporate tax policy process [141].

[141] *See, e.g.,* also recommending an interdisciplinary approach to tax research, M. LAMB & A. LYMER, Interdisciplinary Research in Taxation: Research Approaches and Bibliographic Survey (The Institute of Chartered Accountants in England and Wales. 1999); S. JAMES, *Taxation Research as Economic Research*, University of Exeter Research Discussion Paper No. 01/07 (2001); C. NOBES & S. JAMES, The Economics of Taxation (Prentice Hall 7th ed. 2005); MEHROTRA, *et al.*, The New Fiscal Sociology, *supra* note 65.

O DIREITO FISCAL PERANTE AS NORMAS CONTABILÍSTICAS: UMA ABORDAGEM METODOLÓGICA

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Resumo: Durante muito tempo, o direito confiou as questões emergentes da mensuração financeira à *praxis* contabilística ("método indutivo"). Esta concepção indutivista foi posta em causa e começou a ser abandonada entre o início e os meados do séc. XX, sendo substituída pela concepção dedutivista, segundo a qual as normas jurídicas sobre a mensuração financeira devem ser deduzidas a partir dos fins da obrigação jurídica de prestação de contas. O presente estudo começa por demonstrar a invalidade metodológica insanável da concepção indutivista. Uma tal crítica, aparentemente anacrónica, a uma concepção que começou a ser abandonada há cem anos, é justificada pelo facto de a concepção indutivista se manter presente na mente do legislador de muitos países e estar na origem de remissões legais "em branco" que persistem em muitos sistemas. Uma segunda parte deste ensaio ocupa-se em explicar que a base da concepção dedutivista reside necessariamente nos fins jurídicos da obrigação de manter contabilidade e de prestação de contas. As duas questões enunciadas são indissociáveis de uma terceira questão, de grande actualidade. Volta a ser hoje amplamente defendido que os fins da determinação do lucro tributável não coincidem com os fins da contabilidade "financeira", *vide* comercial, e que por isso as normas para um e outro caso devem divergir amplamente. Embora não possamos entrar aqui no fundo desta terceira questão, resulta óbvio que não pode ser-lhe dada uma resposta sem previamente se ter respondido às duas anteriores e, concretamente, se terem identificado os fins do instituto jurídico da prestação de contas.

SUMÁRIO: I — Introdução. II — A *praxis* mercantil como fonte dos "princípios contabilísticos correctos"; *a)* A evolução do conceito; *b)* A postura "agnosticista" do direito; *c)* A concepção da necessária tutela jurídica dos interesses conexos com a prestação de contas das empresas; *d)* A remissão para os "usos comerciais". III — A superação da concepção

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