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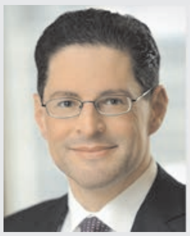
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In this report, the authors discuss Treasury's issuance of proposed regulations under section 385, arguing that there are parallels between the current approach to debt-equity and Treasury's initial approach to entity classification.

The views expressed herein are not necessarily those of Skadden Arps or any of its clients.

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Treasury dropped a bombshell on April 4 when it issued proposed regulations under section 385 that impose equity treatment on some debt instruments issued by a corporate borrower to a related lender.[1]

Although folks far more talented and influential than the three of us will undoubtedly write on weighty topics such as the regulations' validity, their arbitrary nature, and so on, we thought it might be interesting to explore one aspect of the proposed regulations not yet discussed: the parallels between Treasury's current approach on debt-equity classification and its initial approach (beginning in the 1920s) on entity classification. Although the questions may at first blush seem completely unrelated, whether a particular corporate financial instrument is classified for tax purposes as debt or equity and whether a particular business entity is classified for tax purposes as a corporation or a passthrough are, from the perspective of corporate tax policy, two sides of the same coin. And given that Treasury's initial pre-check-the-box approach to entity classification proved to be a seven-decade tax policy nightmare that inflicted as much pain on the government as it did on taxpayers, we thought it might be useful to highlight some of these parallels.

That the proposed regulations will be severely criticized by the tax bar seems certain but in all likelihood irrelevant; regardless of how persuasive those criticisms may be, Treasury unfortunately appears poised to relive past mistakes. Given the political climate around corporate tax issues, Treasury would appear to have gone all-in on its new approach to debt-equity classification, and the body language exhibited by folks at Treasury and the IRS certainly seems to suggest that the proposed regulations will be finalized in something resembling their current form before the inauguration of our next president.

We harbor no illusions about this report altering the government's behavior or changing in any way what the final regulations will say. We simply thought that before we all go down a path that our profession has already beaten, it might be helpful to explore our past so that we might better understand the present and prepare for the future. If the past really is prologue, this process will not be pretty.

The Corporate Tax and Debt-Equity

The proposed regulations would appear in large part to target earnings stripping by U.S. corporations. "Earnings stripping" is a loaded term used to describe the practice in which a foreign parent capitalizes a U.S. corporate subsidiary with debt

[1]Prop. reg. section 1.385-1 and -2; REG-108060-15.

and equity and relies on interest payments on the debt to reduce the subsidiary's income tax. The proposed regulations also focus on the use of intercompany indebtedness by U.S. multinational corporate groups to either repatriate the earnings of foreign subsidiaries or manage parent-level recognition of tax attributes of those subsidiaries.[2]

The proposed regulations' focus on these two issues implicates two bedrock principles of the tax law: the taxability of corporate earnings and the distinction between debt and equity. Although these principles are integrally related, the way in which they interact is not always evident. That interaction becomes clear, however, if one properly understands the historical underpinnings of each principle.

As we described in a recent paper,[3] the corporate tax was enacted in 1909 as an antitrust enforcement mechanism and developed in the late 1920s and early 1930s into an anti-deferral mechanism. The corporate tax was enacted to reduce the retained earnings of the large industrial concerns that by the late 19th century had come to dominate the U.S. economy.[4] Over the decades following 1909, individual income tax rates increased much more quickly than corporate tax rates,[5] and corporations began to retain larger and larger portions of their earnings to ensure their ability to finance their businesses.[6] These two developments resulted in a potential tax deferral opportunity for wealthy individual shareholders: As corporations retained more and more of their earnings, individual shareholders paid less and less annual income tax on their shares of the corporations' profits. High earners were enjoying accessions to wealth in the form of earnings locked inside corporate solution (which earnings could be expected to increase the value of shares held by those shareholders), while corporate managers were enjoying accessions to power in the form of control over larger piles of cash and larger businesses.[7]

During the interwar period in general and during the Great Depression in particular, the government became concerned about the ability of individual shareholders to defer taxation on their shares of corporate earnings, and it began pushing for corporations to distribute their earnings. Corporate managers, however, fought hard against any tax incentive or requirement to distribute earnings, because they generally valued the ability to fund business opportunities with retained earnings without having to go to the capital markets to validate their ideas.[8]

These opposing positions triggered a decades-long legislative struggle that ended when the government and corporate managers reached what could best be described as a political settlement: The government would increase the corporate tax rate as a proxy for taxing shareholders on their annual accessions to corporate wealth, and managers would keep their ability to retain earnings at the corporate level (albeit on an after-tax basis).[9]

Thus, once the dust settled in the late 1930s, the corporate tax was, from the government's perspective, a rough-justice anti-deferral regime. Under this regime, corporate shareholders would not pay tax on their shares of corporate profits until the corporation distributed the profits to shareholders; the corporation, in turn, would pay an entity-level tax every year for the privilege of retaining that year's earnings. From the perspective of the corporation and its shareholders, the corporate tax could be viewed as the amount of shareholder wealth that corporate managers were willing to surrender to

[2]*See*, *e.g.*, preamble to REG-108060-15, 81 F.R. 20912, 20917 (Apr. 8, 2016) (expressing concern over "inverted groups and other foreign-parented groups [using specific] transactions to create interest deductions that reduce U.S. source income without investing any new capital in the U.S. operations. In addition, U.S.-parented groups obtain distortive results by, for example, using these types of transactions to create interest deductions that reduce the earnings and profits of controlled foreign corporations (CFCs) and to facilitate the repatriation of untaxed earnings without recognizing dividend income").

[3]David F. Levy, Nickolas P. Gianou, and Kevin M. Jones, "Modern REITs and the Corporate Tax: Thoughts on the Scope of the Corporate Tax and Rationalizing Our System of Taxing Collective Investment Vehicles," 94 *Taxes* 217 (Mar. 1, 2016) (hereinafter Modern REITs).

[4]*See id.* at 226-227; *see generally* Reuven S. Avi-Yonah, "Corporations, Society, and the State: A Defense of the Corporate Tax," 90 *Va. L. Rev.* 1193 (2004); and Marjorie E. Kornhauser, "Corporate Regulation and the Origins of the Corporate Income Tax," 66 *Ind. L. J.* 53 (1990).

[5]For example, in 1913 the corporate rate was 1 percent while the top individual rate was 7 percent (including the individual surtax). By 1917 the corporate rate had risen to 6 percent, but the top individual rate (including the individual surtax) had been raised to 67 percent to fund the war effort. *See* Section I(2) of the War Revenue Act of 1917.

[6]*See* Modern REITs, *supra* note 3, at 227-229; *see generally* Steven A. Bank, "Tax, Corporate Governance, and Norms," 61 *Wash. & Lee L. Rev.* 1159, 1187-1190 (2004).

[7]*See* Avi-Yonah, *supra* note 4, at 1215-1225; and Modern REITs, *supra* note 3, at 224-229. In addition to laying out the historical case, Avi-Yonah locates a normative justification for the corporate tax in its facility in restraining the ability of corporate managers to wield power using other people's money, i.e., corporate retained earnings. *See generally* Avi-Yonah, *supra* note 4, at 1231.

[8]*See* Bank, "Corporate Managers, Agency Costs, and the Rise of Double Taxation," 44 *Wm. & Mary L. Rev.* 167, 199 (2002) (noting that corporations could avoid "expensive and intrusive external financing sources" by "simply . . . dip[ping] into retained earnings").

[9]*See* Bank, "A Capital Lock-In Theory of the Corporate Income Tax," 94 *Geo. L. J.* 889 (2006).

the government in order to have the power to deploy what was left.[10] From either perspective, as we argued in our paper, the corporate tax is all about retained earnings.[11]

In a post-1930s world, the role of the corporate tax as an anti-deferral regime that imposes a toll charge on increases in shareholder wealth (in the form of earnings retained at the corporate level) prompts two questions. First, in calculating its income tax liability, should the corporation be allowed to deduct interest payments made on indebtedness? Second, if an investor acts as both shareholder and creditor for the same corporation — that is, if the shareholder owns both debt and equity in the same corporation — is the corporation still allowed to deduct interest payments made to the shareholder-creditor? Put differently, in a world in which the corporate tax is designed to impose a toll charge on retained earnings (or on the flexibility to retain earnings), should the corporate tax base include earnings paid out to shareholders under a binding loan contract that requires that those earnings be paid out?

On the first question, Congress decided early on that corporations ought to be allowed to deduct interest payments made on corporate debt.[12] The political process that produced the interest deduction was complex;[13] nevertheless, we note that the interest deduction made sense in light of the policy objectives underlying the corporate tax, because interest payments inherently reduce corporate retained earnings and trigger immediate taxation to the recipient. Simply put, in a corporate tax regime that acts as a toll charge on earnings retained by the corporation, there is no policy justification for disallowing the deduction for interest actually paid to a creditor.

Further, if a corporation were not allowed a deduction for interest paid, the result would be an inappropriate increase in the incidence of federal tax imposed on shareholders. For example, suppose that a corporation is subject to tax at a rate of 35 percent, earns $100 of gross income, pays $100 to a creditor as interest, and has no other cash or noncash items of deduction to report. If the interest deduction were not allowable in computing taxable income, the corporation would owe $35 of tax and have no cash to pay it. Presumably, the corporation could raise the money through a borrowing or asset sale to pay the tax due to the government. Under either scenario, the shareholders of the corporation would have suffered a $35 reduction in the value of their shares as a result of corporate earnings having been paid out to a creditor as interest. That result could in no way advance the policy objectives underlying the corporate tax. Indeed, to the extent the corporate tax is aimed at shareholder-level tax deferral attributable to retained earnings, the corporate tax must, as a matter of policy and logic, be computed after taking into account cash payments that reduce those earnings.

On the second question, over time, Congress, the courts, and the executive branch settled on a sensible result: As long as a corporation had the ability to borrow a specific amount of money from a third-party lender on a particular set of terms, the corporation should be able to borrow that same amount of money from one or more of its shareholders on those same terms.[14] That position makes complete sense given the policy objectives underlying the corporate tax. All else being equal, interest payments made to shareholder-creditors reduce corporate retained earnings and accelerate taxation in precisely the same way as interest payments made to third-party creditors. Put differently, as a matter of policy and logic, in a corporate tax regime that acts as a toll charge on earnings retained by the corporation, there is no reason to include in the corporate tax base amounts that have been paid out to investors under binding loan contracts, regardless of whether those investors act in the dual capacities as shareholders and creditors. (Indeed, as discussed below, the policy objectives underlying the corporate tax weigh in favor of some type of dividends paid deduction.)

This brings us to the key question underlying the proposed regulations: When will a financial instrument denominated as debt be treated as debt for tax purposes? The code does not supply a definition of either debt or equity, and under current law the label given to an instrument does not control its tax classification. Instead, under a facts and circumstances analysis, an instrument denominated as debt will generally be classified as debt for tax purposes if the likelihood of its being repaid is

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[10]*See* Modern REITs, *supra* note 3, at 229; and Bank, "Capital Lock-In Theory," *supra* note 9, at 931.

[11]*See* Modern REITs, *supra* note 3, at 226-229.

[12]Interest was deductible in the 1894 income tax, which was struck down as unconstitutional in 1895, as well as in the 1909 tax that is the predecessor of our current regime. *See* the Tariff Act of 1909, ch. 6; and the Wilson-Gorman Tariff Act of 1894, ch. 349, section 32; s*ee also* Bank, "Historical Perspective on the Corporate Interest Deduction," 18 *Chapman L. Rev.* 29, 30 (2014).

[13]*See, e.g.*, Bank, "Historical Perspective," *supra* note 12, at 31-40.

[14]*See, e.g.*, *Fin Hay Realty Co. v. United States*, 398 F.2d 694, 697 (3d Cir. 1968); and *Kraft Foods Co. v. Commissioner*, 232 F.2d 118, 123 (2d Cir. 1956). *See generally* William T. Plumb Jr., "The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal," 26 *Tax L. Rev.* 369 (1971).

sufficiently high, while an instrument whose repayment is speculative will be treated as equity regardless of whether it is denominated as debt. Thus, under current law, it is the nature of the instrument's risk profile that governs the distinction between debt and equity. The nature of the creditor is generally irrelevant. A cat is a cat regardless of its owner.

The Proposed Regulations

While the proposed regulations contain several provisions, including those concerning recordkeeping requirements, the most pertinent provisions for purposes of this report are those dealing with the per se classification of some debt instruments as equity. Under the per se classification rules, some types of debt instruments will be treated as equity only in the hands of specific investors and regardless of whether they represent debt in substance under a traditional facts and circumstances analysis. Thus, even if an instrument is denominated as debt, fully secured, limited as to upside, and 100 percent certain to be repaid, it will nonetheless be classified as equity for tax purposes if it falls into one of the per se categories and is held by a party related to the borrower.[15] This per se equity rule applies even if a participation in the instrument is held by a third party in whose hands the instrument is classified as debt, meaning, for example, that two promissory notes bearing the same Committee on Uniform Securities Identification Procedures number can be subject to different tax classifications simply because one of the notes is held by a party related to the borrower.

Because the government wants to apply the per se equity rule only when a debt instrument is held by a person related to the borrower, the tax classification of the same instrument can change as it moves through the marketplace. Thus, if an instrument is classified as equity because it is held by a person related to the borrower, the instrument will morph from equity to debt if the related person sells the instrument to a third party; likewise, if a third party sells a debt instrument to a person related to the borrower, the instrument can morph from debt into equity once it lands in the hands of the related person.[16]

In other words, Treasury proposes to change the tax law such that a cat is a cat unless it is owned by an out-of-favor investor, in which case the cat becomes a dog unless and until it becomes owned by an in-favor investor, in which case the cat becomes a cat again. In Treasury's view, the nature of the animal depends on the nature of its owner, and the same animal can change its nature many times over.

We've Been Down This Path Before

When the corporate tax was enacted in 1909, the scope of the term ''corporation'' was not precisely defined.[17] As it does today, the law stated that the term ''corporation'' includes associations, but the term ''association'' was not defined either in the tax law or in the commercial laws of the states.[18] Instead, similar to today's debt-equity situation, Congress created a regime with profound ramifications for everyone involved and left it to Treasury and the courts to determine the scope of the tax.

It is in this sense that entity classification and the distinction between debt and equity are two sides of the same coin: The scope of the term ''association'' determines which entities are absorbed into the corporate tax system, while the terms ''debt'' and ''equity'' provide the key building blocks that define the scope of the corporate tax base.

After floundering on the definition of association for a decade or so, Treasury settled on a look-alike approach to corporate classification beginning in the 1920s, referred to in later years as the ''corporate resemblance test.''[19] Under the corporate resemblance test, if an entity possessed more corporate factors than noncorporate factors, the entity would be classified as a corporation, and if the entity possessed more noncorporate factors than corporate factors, it would be taxed as a passthrough.[20] In other words, under the corporate resemblance test, if an entity looked too much like a corporation and not enough like a passthrough, it would be taxed like a corporation. If this test sounds ridiculous, that's because it was. When Congress enacted the

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[15]*See, e.g.*, prop. reg. section 1.385-3(b)(3) (providing a per se rule under which a debt instrument is generally treated as equity if it is issued by a corporation to a related party to fund a distribution to a related party or the acquisition of the stock of a related party).

[16]*See* prop. reg. section 1.385-3(d)(2) (''When the holder and issuer of a debt instrument that is treated as stock under this section cease to be members of the same expanded group, either because the debt instrument is transferred to a person that is not a member of the expanded group that includes the issuer or because the holder or the issuer cease to be members of the same expanded group, the debt instrument ceases to be treated as stock under this section'').

(Footnote continued in next column.)

[17]Section 38 of the Tariff Act of 1909, ch. 6.

[18]*See* Modern REITs, *supra* note 3, at 231.

[19]*See generally id.* at 232-237. For an excellent summary of the corporate resemblance test saga, see Patrick E. Hobbs, ''Entity Classification: The One Hundred-Year Debate,'' 44 *Cath. U. L. Rev.* 437, 447-452 (1995).

[20]*See, e.g.*, reg. 69, art. 1504 under the Revenue Act of 1924; reg. 74, art. 1314 under the Revenue Act of 1928; reg. 77, art. 1314 under the Revenue Act of 1932; and reg. 86, section 801-2 of the Revenue Act of 1934.

corporate tax, it did not care so much about what an entity looked like; what it really cared about was whether the entity had the ability to retain its earnings. By enacting a regulation that was completely divorced from its statutory underpinnings, Treasury set us all up for a nightmare — and that's exactly what we got.

For example, right after the Supreme Court gave its approval to the corporate resemblance test,[21] the IRS noticed that doctors had begun to band together into small medical practices that were formed as state law trusts to limit liability. The IRS decided to subject those small medical practices to the corporate tax because the trusts looked like corporations, so it pursued a taxpayer named Ora Pelton. Doctor Pelton was naturally aghast at the thought that his tiny medical practice was a taxable corporation, and he fought the IRS as far as he could. In a cursory and unreasoned opinion, the judge hearing Pelton's case classified his medical practice as a corporation, relying on the corporate resemblance test.[22]

This result made no sense from a policy perspective. A small medical practice could never create an antitrust problem, nor could a medical practice that, like Pelton's, was required to distribute its net income annually retain earnings in a manner that allowed its owners to defer income.[23] Small medical practices of this sort simply did not implicate the policy objectives underlying the corporate tax and should never have been brought into the corporate tax regime.

The IRS's victory in *Pelton* quickly came back to haunt it when a clever doctor named Arthur Kintner structured his medical practice to achieve corporate status under the corporate resemblance test. Kintner's idea was simple: Because corporations could form tax-deductible pension plans while partnerships could not, it made sense for him to structure his medical practice to look like a corporation for tax purposes and to establish a pension plan, thereby achieving what many of us consider to be one of the holy grails of individual tax planning — a fully deductible, fully tax-deferred savings account.

The IRS's reaction to Kintner's planning gambit demonstrates what can happen to the administration of the tax law when the executive branch enacts a regulation that is completely divorced from the tax policy behind the underlying statute. Having created a look-alike test for corporate status, the IRS challenged its own regulation on the grounds that the corporate resemblance test was unfair to the government.[24] Unsurprisingly, the court hearing Kintner's case chose to apply the regulation as written by the IRS, and Kintner prevailed.[25]

At this point, the historic parallels between the corporate classification saga and today's debt-equity situation really start to emerge. In response to the *Kintner* decision, the IRS issued Rev. Rul. 56-23.[26] This remarkable piece of tax administration stated that a professional service entity would be classified for tax purposes as a corporation if it possessed a sufficient number of corporate factors, unless the entity tried to establish a pension plan, in which case it would be classified as a partnership, full stop. In other words, under Rev. Rul. 56-23, a cat was a cat unless it did something the government did not like, in which case the cat became a dog. The key point, in our view, is that the action the government found objectionable — establishing a pension plan — had nothing to do with whether the entity should be subject to the corporate tax in light of the tax's policy objectives.

After receiving some heat from tax practitioners, the IRS did a 360-degree turn on Rev. Rul. 56-23. That's not a misprint: The IRS did a flip-flop-flip, effectively reversing Rev. Rul. 56-23 in 1957[27] and then reviving it by issuing an updated version of the corporate resemblance test, affectionately nicknamed the *Kintner* regulations, in 1960.[28]

Under the 1960 version of the *Kintner* regulations, a state law general partnership could not be classified as a corporation for tax purposes even if it had a preponderance of the other corporate factors.[29]

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[21]*See Hecht v. Malley*, 265 U.S. 144 (1924); and *Morrissey v. Commissioner*, 296 U.S. 344 (1935).

[22]*Pelton v. Commissioner*, 82 F.2d 473 (7th Cir. 1936).

[23]*See id.* at 474 (noting that the terms of the trust required the trustees "to distribute the net income annually or oftener").

[24]Then-existing Treasury regulations gave the IRS latitude to determine whether an unincorporated association was taxable regardless of that association's legal form. The IRS argued that because doctors were prohibited by state law from organizing as corporations, Kintner's practice was not an association for tax purposes. The court rejected that argument, noting that the IRS had long ruled that an entity's classification under state law was irrelevant to its treatment under federal tax law. *See United States v. Kintner*, 216 F.2d 418, 423 (9th Cir. 1954) ("The Government's contention here goes counter . . . to the policy of the Internal Revenue Department, which, at all times, declines to be bound by State law"). *See also* Hobbs, *supra* note 19, at 484 ("The government's reliance on local law was ironic because, as Judge Yankwich writing for the three-judge panel noted, the Service always refuses to be 'bound by State law.' The court also declined to follow the government's reliance on state grounds because the government's regulations themselves undermined the government's argument").

[25]*Kintner*, 216 F.2d 418.

[26]1956-1 C.B. 598.

[27]Rev. Rul. 57-546, 1957-2 C.B. 886.

[28]Reg. section 301.7701-1 through -11 (1960); T.D. 6503.

[29]*See* former reg. section 301.7701-2(b)(3), -2(c)(4), and -2(d)(1) (providing that partnerships whose charters conform to the Uniform Partnership Act will generally lack continuity of

(Footnote continued on next page.)

That rule was aimed squarely at medical practices that desired to be classified as corporations for tax purposes. State laws at the time prohibited medical practices from being operated as state law corporations, meaning that for a medical practice to be classified as a corporation for tax purposes, it would have to be formed as a state law unincorporated entity that possessed more corporate characteristics than noncorporate characteristics.

As proof of the craftiness of the medical profession, doctors began successfully lobbying state governments to permit the formation of medical practices under state law "professional corporations."[30] Those entities were literally corporations formed under state law to carry on the practice of medicine. In a world in which corporate status was determined under a look-alike test, one would have thought that a state law corporation would look a lot like a corporation, or indeed, that it could not look like anything *other* than a corporation. The IRS, however, thought otherwise and adopted a number of amendments to the corporate resemblance test that, if upheld by the courts, would have made it impossible for state law professional corporations to be classified as corporations for tax purposes.[31]

Taxpayers were incredulous at this state of affairs, and one of them — Howard Kurzner — was brave enough to challenge the government. When the case came before a judge, the IRS, presumably with a straight face, asked the court to conclude that a narrow class of state law corporations did not resemble corporations under the corporate resemblance test. Not surprisingly, the court invalidated the amendments on the grounds that they were "arbitrary and discriminatory."[32]

Apparently none too happy at being knocked around by the medical profession, the IRS decided to move on to a different industry, this time real estate. During the 1960s, most of the real estate rental sector conducted business through limited partnerships that were intentionally structured to possess more noncorporate factors than corporate factors. Also, like medical practices, real estate development and rental partnerships did not implicate the policy objectives underlying the corporate tax. Real estate, by its nature, does not tend toward monopoly; passthrough entities, by their nature, do not allow for the deferral of owner-level income; and in any event, real estate rental partnerships were typically structured as "yield vehicles" that were required to regularly distribute available cash.[33]

Although real estate rental partnerships were properly classified as partnerships under the corporate resemblance test and did not implicate the policy objectives underlying the corporate tax, the IRS decided to challenge the status of real estate partnerships anyway. The result of this adventure was the Tax Court's decision in *Larson*,[34] in which it held that a state law limited partnership that possessed more noncorporate factors than corporate factors had to be classified as a partnership for tax purposes under the *Kintner* regulations.

Having turned its back on corporate tax policy by adopting the corporate resemblance test in the first place, the IRS turned its back on its own test by issuing proposed amendments to the *Kintner* regulations that would have classified real estate development and rental limited partnerships as corporations for tax purposes even if they otherwise possessed more noncorporate factors than corporate factors.[35] Having already received one black eye from the Tax Court, the IRS promptly received another one, this time (apparently) from the Department of Housing and Urban Development, which is reported to have been so upset with the IRS that it caused the proposed regulations to be scuttled and withdrawn in under 48 hours.[36] Apparently, HUD believed that the proposed regulations, if enacted and upheld, would have

life, centralization of management, and limited liability, which made it practically impossible for those partnerships to qualify as corporations).

[30]*See* Hobbs, *supra* note 19, at 489, citing Ala. Code sections 10-4-380 to 10-4-406 (1975) (legislation approved in 1961); Colo. Rev. Stat. section 12-36-134 (1969); Fla. Stat. Ann. sections 621.01 to 621.15 (1969); Idaho Code sections 30-1301 to 30-1315 (1963); Mass. Gen. Laws Ann. ch. 156A, sections 1-17 (1965); Minn. Stat. Ann. sections 319.01 to 319.961 (1963); Mo. Ann. Stat. sections 356.010 to 356.261 (1963); N.D. Cent. Code Ann. sections 10-31-01 to 10-31-14 (1963); Okla. Stat. Ann. tit. 18, sections 801 to 819 (1963); and Utah Code Ann. sections 16-11-1 to 16-11-15 (1963).

[31]*See* prop. reg. sections 301.7701-1(d) and 301.7701-2(g) and (h), 28 F.R. 13750, 13751 (1963) (approved by T.D. 6797).

[32]*See, e.g.*, *Kurzner v. United States*, 413 F.2d 97, 106 n.43 (5th Cir. 1969). *See* Rev. Rul. 70-101, 1970-1 C.B. 278, for list of court cases invalidating the 1965 proposed regulations.

[33]Moreover, even if a real estate partnership were to retain a portion of its earnings to fund expenses or capital expenditures, the practice would not implicate one of the main the policy objectives underlying the corporate tax, because the passthrough taxation accorded to partnerships eliminated the owner-level tax deferral problem at which the corporate tax was partially aimed.

[34]*Larson v. Commissioner*, 66 T.C. 159 (1976), *acq.*, 1979-2 C.B. 1.

[35]*See* prop. reg. section 301.7701-1 to -3, 42 F.R. 1038-1044 (1977).

[36]42 F.R. 1489.

crushed the agency's low-income housing program, which was for the most part carried on through limited partnerships.[37]

Those are just two examples of the problems caused by the corporate resemblance test, and entire law review articles have been dedicated to its pitfalls and the endless litigation it produced. It suffices to say that the process described above, in which the IRS attempted to amend a rule that never should have existed in order to address problems that could never have been imagined, continued until the IRS finally gave up on the corporate resemblance test altogether in 1997. At that point, the IRS replaced the corporate resemblance test with the elective entity classification regime that we know as the check-the-box regulations.[38]

By that time, however, the damage was done. Treasury and the IRS had been dedicating resources to the corporate resemblance test for over seven decades with little, if any, positive tax policy results to show for it. The IRS challenged the tax classification of closely held business entities that should never have had their tax status challenged; it received judicial rebukes that it need not have endured, and it had its legs pulled out from under it by another executive branch agency in an act of intrabranch humiliation. In the process, Treasury and the IRS undercut their collective reputation for tax policy and evenhanded tax administration and damaged their prestige and standing both inside and outside the tax profession. All of this was for naught in the end, since the corporate resemblance test was eventually tossed away as so much rubbish. That is what happens when an agency enacts a rule that is divorced from policy and tries doggedly to enforce it.

Why Is This Happening Again?

The various iterations of the corporate resemblance test are similar to the proposed regulations in some key respects.

For example, both authorities are designed to help define the corporate tax base, the former by deciding which entities are subject to tax as corporations and the latter by deciding when a transfer of money by a corporation to an investor is deductible from the corporation's gross income.

Also, similar to the amended regulations that followed the IRS's losses in *Larson* and *Kintner*, the proposed regulations adopt a disjointed two-step approach to debt-equity classification. The proposed regulations first accept the general propositions that an instrument is classified as debt or equity at the time of its issuance and that this classification applies regardless of who holds the instrument. But the proposed regulations then create a result-oriented exception to those two propositions when the government wants a different result. In other words, under both the proposed amendments to the corporate resemblance test discussed above and the proposed regulations, the government is happy to treat a cat as a cat for as long as it wants a cat, but when the government prefers that the cat be treated as a dog, Treasury simply enacts a special rule providing that the cat shall be treated as a dog.

These types of similarities lead us to two fundamental questions:

1. If the ability of a corporate borrower to deduct interest payments on its debt produces results that are consistent with the policy objectives underlying the corporate tax, why does Treasury want to impose different results?

2. To the extent the proposed regulations are intended to address a real tax policy problem, what else is the government supposed to do about it?

The answer to the first question is both simple and evocative of the history underlying the corporate resemblance test: When critical pieces of the code are fundamentally broken and Congress is unable to muster the political will to fix them, Treasury might take action on its own and, when the code does not provide the authority necessary for narrowly tailored regulations, the agency will resort to the use of blunt instruments.

This is exactly what happened in *Kintner* and *Larson*, and it is exactly what is happening now. For example, when Kintner set up his corporate pension plan, individuals were subject to income tax at a high rate on earned income,[39] individuals (unlike corporate employers) were not allowed a deduction for amounts contributed to a retirement savings account,[40] closely held corporations with significant passive income (for example, dividends, interest, and capital gains) were subject to the corporate tax and the personal holding company tax regime,[41] and pension plans were not treated as personal

[37]*See* Hobbs, *supra* note 19, at 500; *see also* Note, "Tax Classification of Limited Partnerships: The IRS Bombards the Tax Shelters," 52 *N.Y.U. L. Rev.* 408, 410-411 (1977).

[38]Reg. section 301.7701-1 to -7 (1996); T.D. 8697.

[39]The highest marginal rate on individuals in 1948, the tax year at issue in *Kintner*, was 91 percent.

[40]*See* sections 23(p) and 165(a) of the Revenue Act of 1939; *see also* Berrien C. Eaton Jr., "Professional Corporations and Associations in Perspective," 23 *Tax. L. Rev.* 1, 6-8 (1967).

[41]*See* section 502 of the Revenue Act of 1939.

holding companies.[42] Strictly from a tax policy perspective, the idea that an individual could use corporate classification to achieve a deduction for amounts contributed to a savings account holding passive investment assets while simultaneously avoiding the corporate tax and the personal holding company tax regime was outrageous, and Treasury was by no means wrong to react negatively to Kintner's tax planning gambit.

Similarly, the idea that a taxpayer such as Phillip Larson could acquire property using nonrecourse financing, obtain full tax basis for both the equity and debt-financed components of the property, and use tax depreciation deductions on the full purchase price of the property to offset income from other sources (including earned income)[43] was inappropriate from a tax policy perspective.

In both instances, the then-current statutory regime did not give Treasury the tools necessary to address the situation that created the inappropriate result. In the case of Kintner's corporation, the tax rules applicable to pension plans did not provide sufficient room for administrative maneuver, and Congress was unable or unwilling to correct the problem. In the case of Larson's partnership, two Supreme Court cases — *Tufts*[44] and *Crane*[45] — had enabled taxpayers to claim tax basis credit for property acquired with nonrecourse financing, and once again Congress was unable or unwilling to correct the problem.

In each of these cases, Treasury resorted to a blunt instrument — entity classification — to prevent taxpayers from creating the fact pattern that produced the inappropriate result. In other words, because Treasury could not modify either the rules applicable to closely held corporate pension plans or the rules applicable to nonrecourse borrowings, it decided to break the statutory link between the taxpayer who enjoyed the inappropriate benefit (Kintner or Larson) and the piece of the tax law that created that benefit by interposing either a partnership or a corporation between the two. In each of those cases, Treasury attempted to use the entity classification regime to insert a regarded entity — a partnership for Kintner and a corporation for Larson — between an individual taxpayer and the facts that created a potential tax benefit in order to prevent the individual from enjoying that benefit.

The current debt-equity situation is similar in many respects. Treasury has tailored the per se equity rule to address transactions in which a corporation either distributes a debt instrument to a shareholder or issues a promissory note to a shareholder in connection with specific types of internal restructurings. In both cases, while Treasury purports to be concerned with the treatment of the borrowing corporation, it would appear that Treasury's actual concern is the effect of the debt instrument on the related-party *lender*. Treasury is using the blunt instrument of debt-equity classification to address a perceived problem that arises in a completely different area of the code, regarding the treatment of the holder of the debt instrument that is subject to the per se equity rule, an area in which Treasury has less room for maneuver.[46]

For example, for a distribution of a promissory note from a U.S. corporation to its non-U.S. parent, the proposed regulations focus on the issuing corporation's ability to deduct interest payments on the debt. But as discussed above, allowing a corporation to deduct interest payments on indebtedness, even indebtedness held by persons who are also shareholders, is completely consistent with the policy objectives underlying the corporate tax.

If allowing a corporation to deduct interest paid to a shareholder-creditor is consistent with the policy objectives underlying the corporate tax, one is left to wonder why the proposed regulations classify the debt instrument as equity, thereby denying the deduction. The policy problem that the proposed regulations are attempting to remedy stems from two facts. First, to the extent the corporate tax is a rough justice, anti-deferral mechanism, the allowance of a deduction for interest paid to a shareholder-creditor is necessarily premised on the notion that the shareholder-creditor will immediately report and pay tax on the receipt of that interest. Second, many tax treaties between the United States and its key trading partners allow for reduced rates of withholding on, or sometimes even completely exempt from U.S. tax, interest payments made by a U.S. corporation to its foreign parent.[47] In other words, when a U.S. corporation distributes a promissory note to a related party, the tax policy

[42]*Id.* at section 165(a).

[43]*See* Hobbs, *supra* note 19, at 498-500.

[44]*Commissioner v. Tufts*, 461 U.S. 300 (1983).

[45]*Crane v. Commissioner*, 331 U.S. 1 (1947).

[46]Treasury Tax Legislative Counsel Thomas C. West Jr. has been candid that the proposed regulations are partially in response to congressional inaction. While noting that it is clear under section 385 that Treasury has the authority to issue regulations, West said that the proposed regulations follow "years of calling for legislative action. In the absence of a legislative overhaul or fix, we felt we needed to act." *See* Alison Bennett, "Pain of Earnings-Stripping Rules Might Ease: Treasury," *DTR* (May 10, 2016).

[47]In some treaties, such as the Canada-U.S. tax treaty, interest payments are often completely exempt from withholding. *See* art. 11, para. 1 of the Canada-U.S. treaty (Aug. 16, 1984). In fact, in the Canada-U.S. treaty, a foreign parent can enjoy reduced withholding rates on interest payments received from a U.S.

(Footnote continued on next page.)

problem lies not with the deduction of interest payments at the U.S. corporate level but rather with the potential non-inclusion of interest income at the shareholder level for foreign shareholders who are entitled to treaty benefits.[48]

To address this tax policy problem while at the same time remaining true to the policy objectives underlying the corporate tax, Treasury would have to override the exemptions provided in these treaties, but it has little or no ability to do that as a practical matter. Treasury, then, must have felt compelled to find a different way to ensure that the interest payment is taxed at least once before escaping the U.S. tax net forever. By using the blunt instrument of debt-equity characterization to deny a deduction by the borrower, Treasury apparently has chosen the proposed regulations as the (far from perfect) solution to the non-inclusion of income by the lender.[49]

This is very similar to both *Kintner* and *Larson*. In *Kintner*, the problem lay not in the corporate status of Kintner's medical practice but in the fact that the code allowed closely held corporations to establish pension plans for shareholder-owners. Likewise, in *Larson*, the problem lay not in the passthrough nature of the real estate rental partnership but in the fact that Larson was able to use a combination of nonrecourse financing and the resulting allocation of noncash depreciation deductions to shield income from other sources. In both of those situations, the strategy relied on by the government to address the problem — mandatory partnership classification for Kintner and mandatory corporate classification for Larson — had little to do with the tax policy problem that Treasury was trying to remedy and actually undercut the policy objectives underlying the corporate tax.

Treasury is doing the same thing in the debt-equity area. Thus, rather than acting under one of the code provisions dealing with the taxability of interest payments received by a creditor, Treasury is using a blunt instrument from a different area of the code, one that has little to do with the tax policy problem that Treasury is trying to remedy and actually undercuts the policy objectives underlying the corporate tax.

Similarly, in the context of cross-border restructuring transactions involving U.S. multinational groups, Treasury is worried that the issuance of a promissory note might enable the U.S. parent of a controlled foreign corporate subsidiary to repatriate earnings of the foreign subsidiary, recognize foreign tax credits, or achieve some other outcome (such as a reduction in the subpart F income recognized by the U.S. taxpayer as a result of owning stock in the foreign subsidiary) that Treasury views as inappropriate. Again, because the foreign subsidiary is by definition not a U.S. taxpayer,[50] the ability of the foreign corporate subsidiary to deduct interest payments is irrelevant to the U.S. federal income tax liability of the foreign subsidiary itself, which means that the ability of the corporate borrower to strip earnings is irrelevant.

As with the promissory note distribution situation, Treasury's problem lies not with the tax treatment of the borrower under the debt instrument but with the tax treatment of the holder of the debt instrument. Again, rather than proceeding under the rules that create the results that trouble Treasury — for example, the reorganization regime, the subpart F regime, or the FTC regime — Treasury is using a blunt instrument from a different area of the code, one that has little to do with the tax policy problem that Treasury is trying to remedy and actually undercuts the policy objectives underlying the corporate tax.

So, What Happens Next?

Treasury obviously does not like it when a U.S. corporation distributes a promissory note to a foreign parent, and it possesses no love whatsoever for internal restructurings involving the use of intercompany debt instruments. We get that. The real

corporation even when those payments are contingent on the revenue of the U.S. corporation. *See id.* at art. 11, para. 6(b), and art. 10, para. 2(b).

[48]One interesting aspect of the proposed regulations is that the per se equity rule applies to a distribution of a promissory note by a U.S. corporation to a foreign parent even if the foreign parent is subject to full 30 percent withholding on the interest payments. As discussed above, from a policy perspective, the current-law treatment of interest payments made in that situation — i.e., a corporate-level deduction for interest paid and a 30 percent withholding tax on the interest payment itself — actually works; the corporation is not subject to tax on earnings paid out as interest, and the recipient is subject to immediate taxation upon the receipt of interest. Thus, the per se equity rule is not only inconsistent with the policy objectives underlying the corporate tax, it harms capital structures that are consistent with those policy objectives at both the borrower and lender levels.

[49]We acknowledge that without viewing this through the lens of the original policy justifications of the corporate tax — as is likely the case with Treasury and not uncommon in our profession generally — one could reasonably view the borrower's deduction as the tax law equivalent of the lender's exemption. In other words, if U.S. tax must be paid once before the money leaves the U.S. system, there is no particular reason why the U.S. corporate level is not an appropriate place to pay the tax. This is thus another example, similar to those that we discuss in Modern REITs, *supra* note 3, of how forgetting the original justifications of the corporate tax can distort current policy and lead to rules inconsistent with policy.

[50]We assume here that the foreign subsidiary is not engaged in a U.S. trade or business.

questions are these: What will happen if the proposed regulations are finalized, and what should happen regardless of whether the proposed regulations are finalized?

It's impossible to predict how this will play out, but we can certainly describe a couple of plausible outcomes. If the proposed regulations are finalized (and found valid), we can expect taxpayers to change their behavior. Right now, taxpayers are engaging in the activities described in the proposed regulations (collectively, Activity X) and are satisfied with receiving Tax Outcome X. If the government creates a rule that changes Tax Outcome X so that it goes from being attractive to ugly, taxpayers will explore new ways of obtaining economic or business results that are similar to those obtained through Activity X. Let's call this Variation X-1. If the tax treatment of Variation X-1 (Tax Outcome X-1) is both acceptable to taxpayers and better than the ugly result now associated with Activity X, taxpayers can be expected to pursue Variation X-1. Variation X-1 is obviously a second-best solution, but when the rules change mid-game, what was a second-best solution may become taxpayers' new operating model.

If events were to play out along those lines, as chatter in the tax practitioner community seems to suggest they might,[51] Treasury would have a choice. First, it could turn a blind eye toward taxpayers' modified behavior in recognition of the inherent limitations of using a blunt instrument to solve a problem that requires finesse. Alternatively, Treasury could try to attack the new behavior through the issuance of new results-oriented regulations — perhaps using the entity classification regime, the conduit financing regime, the economic substance doctrine, or some new-fangled antiabuse rule similar to the partnership antiabuse rule — that make the tax treatment of Variation X-1 sufficiently painful that taxpayers need to rethink their behavior once more. At that point, the process would start anew, with taxpayers pursuing some other behavior (Variation X-2) to which Treasury would react. At that point, our future would probably start to look a whole lot like our past, and in all likelihood anyone reading this report in 2016 would not live long enough to see the end of this adventure.

Turning to our views on what should happen, we believe that aside from achieving a result desired by Treasury, the proposed regulations have nothing to do with the policy concerns that led to the disparate tax treatment of debt and equity in the corporate setting. The tax treatment of corporate debt goes to the heart of the corporate tax itself, and based on the policy objectives underlying that tax, there is no problem with a shareholder, even a controlling shareholder, owning corporate indebtedness. This means that a rule prohibiting some shareholders from owning debt of their corporations in specific situations cannot be expected to produce sound tax policy results or otherwise advance the policy objectives underlying the corporate tax. From a tax policy perspective, these regulations should not be finalized.

The real issues here concern the tax treatment of foreign holders of some types of corporate debt and the U.S. tax regime applicable to U.S.-based multinational corporations that own debt and equity interests in their foreign subsidiaries. Both issues require serious examination and create a strong case for some type of fundamental tax reform, perhaps a complete rewriting of significant parts of the code.[52]

First, the U.S. tax treatment of debt and equity instruments held by foreigners is completely broken. The fundamental problem here is that the system behaves as though corporate debt and corporate equity are different in kind when they are merely different in degree, at least economically speaking. Economically speaking, equity instruments and debt instruments both represent claims on the income and assets of the issuing corporation. The difference in degree between the instruments is that payments on debt are mandatory while those on equity are not, meaning that the debts must be serviced even if the borrower prefers to retain earnings, and claims of debt holders rank senior to the claims of equity holders, much the same as the claims of holders of preferred equity rank senior to the claims of holders of common equity. There is no real basis, economically speaking, for taxing debt and equity differently.[53]

This analysis presents a strong case for some type of fundamental corporate tax reform. For example, insofar as the corporate tax is a rough justice,

[51]*See* William R. Davis and Lee A. Sheppard, ''Debt-Equity Regs May Change Current Law,'' *Tax Notes*, May 16, 2016, p. 868 (''David Garlock of EY said that while he doesn't think the bifurcation requirements of the proposed regulations will change industry practices too much — mainly affecting the 'calculus of how aggressive planners are going to be' — the documentation requirements under -2 of the proposed regulations won't change the world that much, either'').

[52]*See* Mindy Herzfeld, ''A New Protectionism in U.S. Tax Policy?'' *Tax Notes Int'l*, May 9, 2016, p. 525 (describing a consensus at a recent international tax symposium that ''a greater focus on inbound taxation and the inbound tax base would be necessary as part of broader tax reform'').

[53]*See, e.g.*, John D. McDonald, ''A Taxing History — Why U.S. Corporate Tax Policy Needs to Come Full Circle and Once Again Reflect the Reality of the Individual as Taxpayer,'' 94 *Taxes* 93 (Mar. 1, 2016).

anti-deferral regime, a corporation should be allowed to issue current-pay debt instruments in unlimited amounts (that is, without regard to leverage limits, thin cap, etc.) to shareholders. As long as the corporation actually makes the required interest payments, the payments reduce retained earnings at the corporate level and trigger immediate taxation at the shareholder level, two results that are completely consistent with the policy objectives underlying the corporate tax. Another, purer proposal would permit all corporations to deduct dividends paid to shareholders out of current-year earnings, leaving retained earnings to be taxed at the corporate level as the price for shareholder-level tax deferral and the flexibility to retain earnings.[54]

If either of those approaches were adopted, the code and, when necessary, our tax treaty network, would have to be modified in several key respects. For example, rules applicable to foreign and tax-exempt investors would need to be modified so that any money transferred from a corporation to an investor, whether denominated as interest or as a dividend, would always be subject to U.S. tax if the corporation receives a deduction for that transfer. Mandatory investor-level taxation upon receipt of payments that are deductible by the corporation would apply regardless of whether the recipient is a U.S. tax-exempt organization or a foreigner.[55] The goal here is not to eliminate U.S. tax on business income but rather to treat all claims against business income equally regardless of the form of that claim.

More important, if the dividends paid deduction were extended to all corporations, the rules defining the corporate tax base would have to be modified to eliminate corporate tax preferences such as the modified accelerated cost recovery system, business tax credits, and quirky tax accounting rules that allow for the deferral of prepaid income and the acceleration of deductions for expenses that produce future income. The corporate tax base has been narrowed over the years through targeted tax preferences, often at the behest of corporate management and often as an alternative to attempts by Congress to eliminate the corporate double tax through some form of corporate-shareholder integration (such as the mark-to-market regime, passive foreign investment company-like regime, or dividends paid deduction).[56] Again, the idea is not to raid the fisc but to rationalize the corporate tax in a way that advances the anti-deferral policy objective underlying the corporate tax and produces logical results at the corporate and investor levels.

These types of all-encompassing solutions would resolve most of the inbound investment problems that the proposed regulations are concerned with. If, however, one desired to take incremental steps and focus solely on U.S. multinational corporations owning foreign corporations that are capitalized with debt and equity, one would find that several issues that bother Treasury can be addressed through the elimination of meaningless distinctions in the tax law.

For example, under current law, generally speaking, when a corporation distributes its own stock to one of its shareholders as a dividend or issues its own stock to an existing shareholder as part of an internal restructuring, the shareholder does not report income or gain upon receipt of the newly issued shares and simply spreads his preexisting tax basis among both his historic shares as well as the newly issued shares.[57] By contrast, if that same corporation distributes a promissory note or issues a promissory note to that same shareholder in connection with an internal reorganization, the code treats the receipt of a promissory note as the receipt of a taxable dividend or as boot in a reorganization.[58]

The current-law distinction between the receipt of a stock dividend and the receipt of a promissory note dividend and the related distinction between the receipt of stock in an internal reorganization and the receipt of debt in an internal reorganization lie at the heart of the remaining problems that Treasury seems to have had in mind when it adopted the per se equity rule. Thus, in the remaining contexts in which the per se equity rule applies, the recipient of

[54]In this type of system, one's view of the proper tax rate imposed on retained earnings will reflect one's views on issues such as the social impact of large amounts of retained earnings and corporate governance. *See, e.g.*, Avi-Yonah, *supra* note 4, at 1231; *see generally* Bank, ''Capital Lock-In Theory,'' *supra* note 9. These sorts of issues are well beyond the scope of this report.

[55]That approach would not extend to tax-exempt organizations such as U.S. pension funds if distributions made from those organizations are ultimately subject to tax in the hands of (for example) beneficiaries. Pension funds, 401(k) funds, and similar entities defer but do not eliminate taxation, and it would be inconsistent with Congress's approach toward retirement savings to subject corporate dividends and interest to tax in the hands of those entities, even if the distributing corporation receives a deduction because of the distribution. By contrast, we believe that corporate dividends and interest that are deductible from corporate taxable income *should* be subject to tax in the hands of tax-exempt entities that like Roth IRAs, can distribute amounts to beneficiaries without further beneficiary-level tax. Otherwise, money could leave corporate solution and eventually make its way to individuals without once being subject to tax.

[56]*See* Kornhauser, *supra* note 4, at 136; and Bank, ''Corporate Managers,'' *supra* note 8, at 260.

[57]*See* sections 305(a), 354(a)(1), and 358(b).

[58]*See* sections 301(c), 356(a), 1001, and 1012.

the debt instrument obtains a more favorable tax result under some other part of the code (for example, the FTC regime or the subpart F regime) if the instrument is classified as debt of the issuing corporation and a less favorable tax result under those provisions of the code if that same instrument is classified as equity.

This is what happens when two instruments that are the same in kind but different in degree are treated differently. Rather than adopting a rule, such as the per se equity rule, that is so easily attacked, we think it better to remove the distinction between shareholders who receive debt instruments in distributions and reorganizations and those who receive equity. Simply put, there is nothing conceptually wrong from a policy perspective with treating a promissory note distribution by a corporation to a shareholder as a tax-deferred distribution that results in the spreading of the shareholder's preexisting tax basis between the promissory note and the shares on which the promissory note was distributed. For example, assume that a shareholder owns 100 percent of the common stock of a corporation that has $1 million in assets and $100,000 of earnings and profits. In that case, the shareholder owns economic claims of $1 million against the assets and income of that corporation. If that corporation were to distribute a $100,000 promissory note to that shareholder, the shareholder still owns economic claims of $1 million against the assets and income of that corporation — common stock worth $900,000 and a promissory note worth $100,000. From an economic perspective, and we think from a conceptual perspective as well, there is no reason to treat the shareholder as having received income of $100,000, since the shareholder has not experienced an accession to wealth in the sense that before and after the distribution, the aggregate value of his economic claims against the assets and income of the corporation is $1 million.

This seems to us an appropriate case in which to apply either a principle of nonrealization or nonrecognition, whichever one prefers. The point is that unless the shareholder sells or collects on the promissory note, nothing has happened economically — he simply went from holding one piece of paper worth $1 million to holding two pieces of paper worth $1 million — and we would be better served if the code were to respect this result and defer taxation until the taxpayer sells one of the pieces of paper for cash, collects on the note, or exchanges the piece of paper for some asset (other than a claim against the same corporation).

In contrast, by treating the shareholder as having a potentially taxable section 301 distribution in this context (that is, by treating the receipt of debt as if it were different than the receipt of equity), the current structure of the code sets up the fact pattern that creates the problem that led Treasury to issue the per se equity rule. The same holds true if the shareholder were to receive the promissory note in an intercompany reorganization. These fact patterns would not exist — and the problems that bother Treasury would not exist — if, upon receipt of the $100,000 promissory note, the shareholder reported income and gain of zero and then spread a portion of that previously existing common stock basis to the promissory note, leaving the taxation of the receipt of the promissory note until collection on or sale of the note.

Further, in the multinational context, there is another, more (conceptually) simple approach: reconciliation of the corporate tax bases and rates of the major developed nations. In a world in which capital and goods can move freely across national borders and nations compete with one another for production and growth, it seems axiomatic that if one country's corporate tax rate is higher than every other country's corporate tax rate, corporations organized in the high-tax country will find themselves at a competitive disadvantage to competitors formed in other countries.[59] As several former Treasury officials recently indicated,[60] in the world we live in, the corporate tax rates, and indeed the corporate tax bases, of the major nations need to be the same. Personally, from a policy perspective, we're indifferent whether the United States lowers its rate to match the rate of the other major nations or, alternatively, the other major nations increase their rates to match ours. As long as the rates and the tax bases are the same, this would address most of the problems that seem to keep Treasury and IRS officials awake at night.

Conclusion

This report is about our collective professional history and the parallels between what our profession has been through and what it seems poised to go through once more. In that spirit, we return once again to the place where this all started: the enactment of the original, and short-lived, corporate tax in 1894.[61] It was during the 1894 legislative process

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[59]*See, e.g.*, Ken Brewer, "Endangered Species: The U.S.-Based Multinational," *Tax Notes*, May 16, 2016, p. 967 (noting in particular the discriminatory effects of the U.S. system of high taxation on the worldwide income of U.S. corporations, compared with the tax systems of other countries, which generally impose tax at a lower rate and on a merely territorial basis).

[60]*See* letter to Treasury Secretary Jacob Lew (Apr. 18, 2016).

[61]Section 73 of the Revenue Act of 1894, ch. 349. The corporate tax of the Revenue Act of 1894 was struck down by the Supreme Court as unconstitutional in *Pollock v. Farmers Loan & Trust Co.*, 157 U.S. 429, *reh'g granted*, 158 U.S. 601 (1895).

that Congress first decided to enact a corporate tax that applied to an amorphous set of entities that included associations. The 1909 and later versions of the corporate tax simply incorporated the 1894 approach.

One interesting and particularly relevant aspect of the 1894 legislative process was the amount of debate dedicated to the proper administration of our tax laws, particularly as it related to the term ''association'' and how the government was expected to apply that term. On that score, Sen. William Chandler of New Hampshire, speaking out of despair at a corporate taxing statute that left unresolved the very definition of the term ''corporation,'' made what might be one of the most prescient statements found in any tax legislative history:

> The clause [defining the scope of the tax] is a fearful bungle, and it ought to have, if it passes, a special title to it, and that is ''[a] clause to increase the fees of lawyers,'' because there will be more litigation and more large fees in connection with this wonderful discovery, invention, contrivance, and construction . . . than ever have been known before in connection with any tax law passed by this Government. [T]here never was a more loosely drawn, inaccurate, and, I was about to say, impotent taxation clause submitted to a legislative body.[62]

Chandler's quote would have been hilarious were it not so true. The situation Chandler warned about came to pass in the form of the corporate resemblance test debacle, which lasted for about seven decades and imposed significant costs on both taxpayers and the government.

The challenge here is that Chandler's quote could have applied with equal force to the entire debt-equity distinction because corporate classification and debt-equity classification are two sides of the same coin. Similar to the problems it faced in the days of the corporate resemblance test, Treasury is trying to use its regulatory authority in one area of the tax law — debt-equity classification — to address problems in other areas of the tax law: in this case, four decades of poor policymaking in the tax treaty space and about five decades of poor policymaking in several other spaces, including debt-equity, corporate reorganizations, subpart F, and FTCs. The use of a blunt instrument in this fashion did not work in the past and will not work in the future. Simply put, if the proposed regulations are finalized in anything like their current form, taxpayers are going to change their behavior, not to accede to Treasury's wishes, but to obtain results that are as close as possible to the results they are obtaining under current law. Unless we want to relive the Kintner days of regulatory whack-a-mole and results-oriented regulations that risk the reputation, prestige, and legitimacy of our Treasury Department, we need a better approach.

A better approach ought to start with policy and identify as problematic only those rules that produce results contrary to policy. From a policy perspective, there is nothing wrong with an investor acting in the dual capacities of shareholder and creditor, nor is there anything wrong with the corporate-level deduction for interest paid on indebtedness owed to creditors who are also shareholders. The real problems lie in the selective nontaxation of interest income paid by a corporation, in the code provisions that treat debt or the receipt of debt different from equity or the receipt of equity, and in a regulatory environment in which barriers to the movement of capital and goods among nations have been lowered even though the business tax regimes of those nations have not been reconciled with one another.

Until we can muster the political will to deal with those problems head on, taxpayers will adjust their behavior to take advantage of rules that treat similar activities differently, and Treasury can be expected to feel pressure to act. Without real reform, Treasury will most likely feel compelled to rely on a results-oriented approach to taxation, an approach that inevitably requires the use of blunt instruments from one area of the code to solve problems arising in another. If events play out along those lines, we are all likely to understand firsthand what it was like to deal with a ''know it when we see it'' approach to the application of our tax laws. ■

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[62] 26 *Cong. Rec.* 6880 (1894) (statement of Chandler).