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AVOIDING TAX AVOIDANCE: A RATIONAL PROPOSAL TO CLOSE EXISTING LOOPHOLES IN THE U.S. CORPORATE TAX SYSTEM

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I like to pay taxes. With them, I buy civilization. —Oliver Wendell Holmes Jr.

INTRODUCTION

Today, few people share Justice Holmes' feelings about taxes. April 15 is a date when the feelings, needs, and desires of different citizens clash. It is a dreaded deadline for most taxpayers, especially those with a large taxable income (wealthy individuals and large corporations); other taxpayers wait at the edge of their seats for a refund; accountants rejoice as old and new clients knock at their doors to prepare the due filings; and the IRS oversees this frantic activity ensuring compliance with the law, proper reporting, and emanating an aura of holy terror. However, there is one motive common to all taxpayers; whether in the form of maximizing a refund or minimizing a tax liability, everyone wants to keep as much money in his or her own pockets as the law permits. But what exactly does the law permit?

The Internal Revenue Code ("I.R.C.") is long and complex, it contains many exemptions, exclusions, and exceptions, which are typically not within the understanding of the general public. The "income defense industry,"[1] a class of highly specialized lawyers and accountants, dispenses its knowledge on tax-minimization and tax-avoidance to the few chosen ones who can afford it, such as wealthy individuals and, most often, large corporations. Why are corporations the most frequent clients of the income defense industry, and why is that a problem?

Corporations in the United States are "persons" in the legal sense: entities that the law treats as individuals for purposes of doing business, assessing liability and, obviously, for tax purposes.[2] Certain corporations

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1 Jeffrey Winters, *America's Income Defense Industry*, HUFFINGTON POST (Oct. 22, 2010, 6:21 PM), http://www.huffingtonpost.com/jeffrey-winters/americas-income-defense-i_b_772723.html.

2 *See generally* 14a C.J. *Corporations* § 2864 (1921) (describing the limitation of liability of

today reach titanic dimensions; hiring hundreds of thousands of employees, managing thousands of subsidiaries, and booking multi-billion dollar income statements. The scale of operation of these corporate giants is exemplified by companies like Wal-Mart, which recorded sales of $476 billion in 2014; and Exxon Mobil, whose sales were just shy of $400 billion.[3] Wal-Mart and Exxon Mobil's tax expenses, as reported in their income statements, were approximately $8 billion for Wal-Mart, and $18 billion for Exxon Mobil.[4] These corporate behemoths have a tri-fold advantage in employing the services of the income defense industry. First, they have the economic resources to access the best and brightest minds in the industry. Second, they have the pressing need to reduce their gigantic tax liabilities. Third, they have a world-wide presence that allows these large multinationals to exploit complex schemes of profit shifting, tax deferrals, transfer pricing, and other techniques described in more detail in later sections of this article.

This explains why corporations have a particularly strong incentive to take advantage of the income defense industry; but why is that a problem? Is it not a legitimate interest of every citizen, whether a corporation or an individual, to reduce its tax burden within the limits of the law?[5] Certainly; but, just like any other right, it should be punishable when abused. The think tank Citizens for Tax Justice published a report in February 2014, which examined the tax reporting practices of the top tax-dodgers of corporate America.[6] The report analyzed the 2008–12 period and showed that the average tax rate for 288 profitable, large, U.S. corporations was approximately 19.4% over the five years of the study.[7] Further, twenty-six corporations, including giants like General Electric, Boeing, Verizon, and Yahoo!, paid no federal income tax for the period analyzed in the report.[8]

It is objective and undeniable (even from a cursory reading of the statistics provided in the previous paragraph) that there are imperfections and contradictions in the I.R.C. that need to be addressed.[9] This article

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corporate entities and their attributes of standing and "legal persona" separate from its owners and/or administrators).

3 Wal-Mart Stores Inc., Annual Report (Form 10K) (Mar. 21, 2014); Exxon Mobil Corp., Annual Report (Form 10K) (Feb. 25, 2015).

4 Wal-Mart Stores Inc., Annual Report (Form 10K) (Mar. 21, 2014); Exxon Mobil Corp., Annual Report (Form 10K) (Feb. 25, 2015).

5 Gregory v. Helvering, 293 U.S. 465, 469 (1935).

6 *See generally* ROBERT S. MCINTYRE ET AL., THE SORRY STATE OF CORPORATE TAXES (2014), http://www.ctj.org/corporatetaxdodgers/sorrystateofcorptaxes.pdf.

7 *Id.* at 3.

8 *Id.* at 4.

9 Specifically, this article will discuss 26 C.F.R. Sections 1.482, 1.83-7 (2016), and I.R.C. Section 83 (West 2016).

neither seeks to develop a utopian socialism, nor does it aim at impinging on the free market tradition of the United States. The purpose of this article is to underline the intrinsic contradictions and inefficiencies of the I.R.C., particularly regarding those provisions that allow corporate entities to substantially reduce their effective tax rate to a rate comparable to small and middle enterprises.

This article will further propose statutory language designed to close existing tax "loopholes" and to improve the equality of the tax system, thus improving the current state of affairs. In the next section, this article will analyze why and how excessive corporate tax avoidance creates inequality throughout the tax system. Then, this article will focus on the current state of affairs, discussing first the different tax statuses among business entities, and then the specific methods employed by corporations to reduce their income tax. Lastly, this article will suggest proposed reforms to be applied to the existing tax provisions with the objective of mitigating or eliminating the unfairness described in the earlier paragraphs.

WHAT IS FAIR AND WHAT IS NOT

For most, the fact that multi-billion dollar corporations do not pay income taxes is startling and produces strong feelings of inequity and unfairness. However, equity and fairness are more than just a general "gut" feeling; they comprise several dimensions. Given the complexity of the tax system, it is almost an impossible task to properly balance all of the different layers of the multi-faceted idea of "fairness" in order to produce a perfect tax code.

While an in-depth discussion on the ideals of fairness and justice is beyond the scope of this article, it is certainly important to mention that the American Institute of Certified Public Accountants has identified seven different "dimensions" of equity and fairness with respect to tax policy, which provide a useful framework of analysis to determine when and how specific tax provisions affect the fairness of the overall tax system.

1. *Exchange Equity and Fairness* – Over the long run taxpayers receive appropriate value for the taxes they pay.
2. *Process Equity and Fairness* – Taxpayers have a voice in the tax system, are given due process, and are treated with respect by tax administrators.
3. *Horizontal Equity and Fairness* – Similarly situated taxpayers are taxed similarly.
4. *Vertical Equity and Fairness* – Taxes are based on the ability to pay.

5. *Time-Related Equity and Fairness* – Taxes are not unduly distorted when income or wealth levels fluctuate over time.
6. *Inter-Group Equity and Fairness* – No group of taxpayers is favored to the detriment of another without good cause.
7. *Compliance Equity and Fairness* – All taxpayers pay what they owe on a timely basis.[10]

Excessive tax avoidance is problematic because it hinders the fairness and administrability of the tax system at different levels.

First, certain tax provisions encourage the movement of money towards less socially-desirable investments, thus creating a problem of exchange equity and fairness.[11] The tax consequences of business decisions play an important role in the decision-making process itself, from both a management and investment perspective. The tax implications of business decisions have created three major distortions in the U.S. economy: (1) a preference towards non-corporate business entities; (2) a preference towards debt financing of corporations and excessive leverage; and (3) a preference towards earnings retention, rather than distribution, to avoid the double taxation of corporate income.[12] Further, the current nominal corporate tax rate in the United States, which is one of the highest among Organisation for Economic Co-operation and Development ("OECD") countries,[13] creates an incentive to shift capital towards different, less tax-burdened investments, such as unproductive real estate[14] and investment abroad.[15]

Second, excessive tax avoidance creates differences among taxpayers with a similar taxable income but different access to professionals in the income defense industry, which is a problem of horizontal equity and fairness as well as inter-group equity and fairness.[16] For example, let us

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10 AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS ("AICPA"), GUIDING PRINCIPLES FOR TAX EQUITY AND FAIRNESS 3 (4th ed. 2007).

11 *Id.*

12 DEP'T OF THE TREASURY, INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS: TAXING BUSINESS INCOME ONCE vii (1992).

13 *Corporate Income Tax Rate*, ORG. FOR ECON. CO-OPERATION & DEV., http://stats.oecd.org//Index.aspx?QueryId=58204# (last visited Nov. 21, 2015).

14 Real Estate Investment Trusts, for example, are not subject to corporate income tax, provided that they comply with certain ownership, operational, and distribution requirements. I.R.C. § 857 (West 2016).

15 Countries like Bermuda, Jersey, the Isle of Man, the Cayman Islands, the Bahamas, and the British Virgin Islands have a statutory 0% corporate income tax. Kyle Pomerleau, *Corporate Income Tax Rates Around the World, 2014*, TAX FOUND. (Aug. 20, 2014), http://taxfoundation.org/article/corporate-income-tax-rates-around-world-2014.

16 AICPA, *supra* note 10.

assume that two corporations have exactly the same income. One corporation may end up with a larger tax bill than the other because it allocated more resources towards tax avoidance, electing to use more skilled tax attorneys and accountants.

One may argue that this is not a problem at all, but rather the mere result of free will. A corporation chooses a better accountant to reduce its tax liability like an individual may choose a better doctor to treat an illness. However, this argument is not entirely correct because not everybody may need to treat an illness every year, but every corporation does need to pay taxes every year. The incidence of illnesses, which creates a market for doctors, is random; whereas the incidence of taxes is defined by law, and imposed by the government on the entity. Because the government imposes a duty upon the taxpayers, the government also has the responsibility of ensuring the fairness of the tax reporting process of similarly-situated taxpayers.

Third, excessive tax avoidance defeats the purpose of a progressive tax system—vertical equity[17]—because it concentrates the highest effective tax rates on the "middle" earners. This concentration of the tax burden can be easily visualized by analyzing historical corporate tax return data. The IRS periodically publishes statistical data summaries for the tax receipts of previous years.[18] The year 2012 was analyzed to show how tax avoidance affects vertical equity. The table selected for the analysis shows income tax receipts of corporations by size of taxable income.[19] Using data from the table, the effective tax rate by taxable income was calculated, dividing the total income tax after credits, by the income subject to tax, for each of the taxable income brackets reported in the dataset. The results are summarized in Table 1 below.

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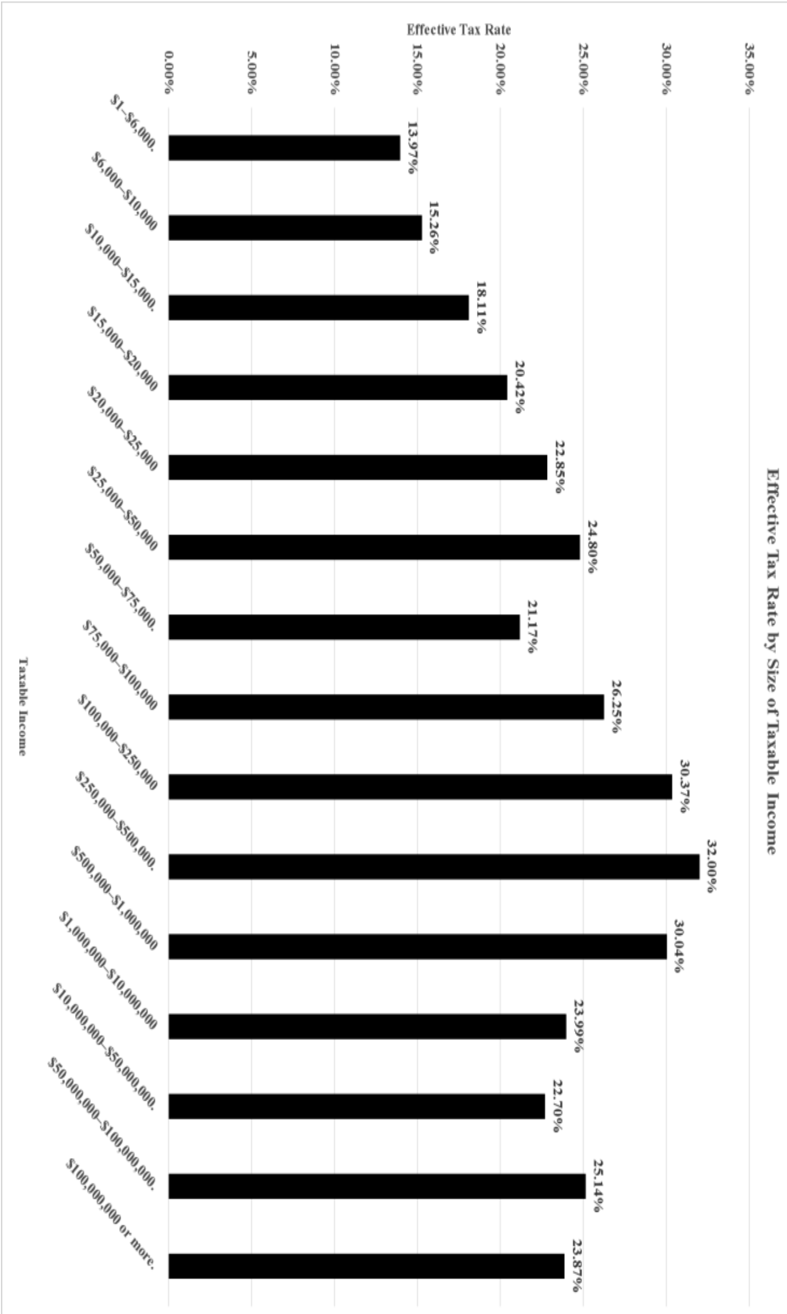
[17] *Id.*

[18] *SOI Tax Stats - Corporation Data by Size*, INTERNAL REVENUE SERV., http://www.irs.gov/uac/SOI-Tax-Stats-Corporation-Data-by-Size#_bm2# (last updated Jan. 6, 2015).

[19] *SOI Tax Stats - Returns of Active Corporations, Other Than Forms 1120S, 1120-REIT, and 1120-RIC*, INTERNAL REVENUE SERV., https://www.irs.gov/uac/SOI-Tax-Stats-Table-22-Returns-of-Active-Corporations,-Other-Than-Forms-1120S,-1120-REIT,-and-1120-RIC (last updated May 25, 2016).

Table 1


Effective Tax Rate by Size of Taxable Income
Effective Tax Rate
0.00%
5.00%
10.00%
15.00%
20.00%
25.00%
30.00%
35.00%
Taxable Income
$1–$6,000.
$6,000–$10,000
$10,000–$15,000.
$15,000–$20,000
$20,000–$25,000
$25,000–$50,000
$50,000–$75,000.
$75,000–$100,000
$100,000–$250,000
$250,000–$500,000.
$500,000–$1,000,000
$1,000,000–$10,000,000
$10,000,000–$50,000,000.
$50,000,000–$100,000,000.
$100,000,000 or more.
13.97%
15.26%
18.11%
20.42%
22.85%
24.80%
21.17%
26.25%
30.37%
32.00%
30.04%
23.99%
22.70%
25.14%
23.87%

From Table 1, it is easy to identify that the effective tax rate across the various classes of taxable income follows a shape closer to a bell curve, rather than an ideal positive-slope line. The highest effective tax rate falls on corporations with a taxable income between $100,000 and $500,000. On the other hand, corporations with over $100 million in taxable income have a lower effective tax rate than corporations with $25,000 to $50,000 in taxable income.

Lastly, from an administrative standpoint, excessive tax-avoidance creates inefficiencies within the tax system, both for the taxpayer and for the IRS, which is a problem of compliance equity and fairness.[20] The taxpayer has an interest in allocating resources towards tax-avoidance, therefore reducing the amount of resources available for otherwise productive investments, while the IRS collects less taxes than it should (because of the effective tax-dodging) and faces rising costs of enforcement due to the complexity of the regulations.

CURRENT TAX SCHEME – BUSINESS ENTITIES

As a general distinction, the I.R.C. recognizes three types of business entities, each subject to a different tax scheme: corporations, partnerships, and "disregarded" entities.[21] These tax categories may or may not coincide with the actual organizational status of the entity; a corporation may be treated as a partnership for tax purposes, or vice versa, so it is convenient to compartmentalize the different "purposes" of the same entity because they may not necessarily overlap. Disregarded entities, as the name suggests in a somewhat confusing manner, are not really entities. In simpler terms, the existence of the entity for tax purposes is "disregarded" and the tax is applied directly to the owner.[22] This generally applies to sole proprietorships where, also in terms of liability, formation, and financing, the existence of the entity is disregarded such that the owner and the entity are one and the same.[23] Disregarded entities will not be further analyzed as their tax treatment falls beyond the scope of this article. On the other hand, partnerships and corporations have a greater significance in terms of popularity, capitalization, and contradictory legislation.

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20 AICPA, *supra* note 10.

21 26 C.F.R. § 301.7701-2(a) (2016). There are other entities with special tax treatment, such as non-profit corporations, trusts, foreign corporations, etc. The analysis of these "special entities" is beyond the scope of this article.

22 *Id*.

23 *Sole Proprietorship*, U.S. SMALL BUS. ADMIN., http://www.sba.gov/content/sole-proprietorship-0 (last visited Nov. 21, 2015).

1. Partnerships

Partnerships are possibly the oldest form of business entity recognized in history.[24] As early as the 6th century, the laws of the Roman Empire started recognizing certain business, trade, and religious associations known as *societas* (literally "societies"), which had the ability to enter into contracts and assume liability independently from their owners.[25] Under the common law, the legal concept of partnership, and the resulting joint and several liability of the partners, was developed as early as the 18th century.[26] For tax purposes, partnerships are a type of "pass-through" entity, that is, the entity itself does not pay income tax, but the owners do at the individual level (so the tax "passes through" the entity to its owners).[27] So, while there is a separation between the legal entity and its owners in terms of contractual capacity and title to the assets, there is no such separation in terms of assessing tax liability.[28]

2. Corporations

Corporations, like partnerships, have a millenary history.[29] The oldest known corporation was the Japanese temple construction company Kongo Gumi, which was incorporated in the year 578 and terminated its independent operations in 2006—an impressive record of 1,428 years in business.[30] This clearly highlights one of the main differences between a corporation and a partnership; a corporation has an indefinite lifespan, whereas the life of a partnership is tied to the life of its owners, unless expressly provided otherwise in the partnership documents.[31]

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24 MAX WEBER, THE HISTORY OF COMMERCIAL PARTNERSHIPS IN THE MIDDLE AGES 120, (Lutz Kaelber trans., Rowman & Littlefield Publishers, Inc., 2003) (1889).

25 HAROLD JOSEPH BERMAN, LAW AND REVOLUTION: THE FORMATION OF THE WESTERN LEGAL TRADITION 215–16, (Harvard Univ. Press 1983) (1918).

26 Waugh v. Carver, (1793) 126 Eng. Rep. 525 (C.P.).

27 *Partnerships*, INTERNAL REVENUE SERV., https://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Partnerships (last updated Oct. 24, 2016). Even though a tax is not assessed against the partnership itself, partnerships still have to report their income to the IRS using Form 1065. The owners must then include their portion of the partnership income in their own personal tax returns.

28 *Id.*

29 James Olan Hutcheson, *The End of a 1,400-Year-Old Business*, BLOOMBERG BUS. (Apr. 16, 2007, 7:22 PM), http://www.bloomberg.com/bw/stories/2007-04-16/the-end-of-a-1-400-year-old-businessbusinessweek-business-news-stock-market-and-financial-advice.

30 *Id.*

31 As a default provision, a partnership terminates 90 days after one of the partners dies or decides to leave the partnership. UNIF. P'SHIP ACT § 801(2)(i) (1997). However, partnership agreements generally contain specific provisions to avoid involuntary dissolution. The partnership agreement governs over the default statutory rules. "In the absence of prohibitory provisions of the

Another record holding corporation is the Dutch East India Company (chartered in 1602), recognized as the first multinational corporation, and the first corporate entity to ever issue stock to the public.[32] This highlights another major feature of corporations—the ability to issue stock to the public to raise capital, which is not a feature of partnerships. The third major difference between corporations and partnerships, and the last one relevant for this article,[33] is the tax regime applied to each entity. As previously discussed, partnerships are "pass-through" entities for tax purposes; corporations are not. In terms of liability, contracting capacity, *and* tax purposes, a corporation "occupies the same position as a natural person *sui juris*."[34] This means that the income of a corporation is taxed first at the corporate level—the corporation files Form 1120 and pays its corporate income tax[35]—and then at the individual level, when the shareholders receive a dividend.[36] Generally speaking, the three types of dividends are the ordinary dividend, qualified dividend, and capital gain distribution.[37] The three dividends are taxed at different rates: an ordinary dividend is taxed at the receiving individual's personal tax rate; a qualified dividend is taxed at either 0%, 15%, or 20%; and a capital gain distribution is taxed similarly to a qualified dividend.[38] At the source, corporate income is taxed in brackets ranging from 15% to 35%.[39]

3. A Hybrid Statutory Creation: LLCs

Historically, the difference between partnerships and corporations makes sense. A corporation provides a shield to liability for its owners who, in exchange for this liability protection, are subject to a double tax

statutes or of rules of the common law relating to partnerships, or considerations of public policy, the partners . . . may include in the partnership articles any agreement they wish." Lanier v. Bowdoin, 24 N.E. 2d 732, 735 (1939).

32 Clem Chambers, *Who Needs Stock Exchanges?*, MONDO VISIONE (July 14, 2006), http://www.mondovisione.com/exchanges/handbook-articles/who-needs-stock-exchanges/.

33 The first full list of criteria that identifies an entity as a corporation is discussed in Morrissey v. Commissioner, 296 U.S. 344 (1935). Four criteria have been recognized as making a corporation different from other business forms, and will be hereinafter referred to as "corporate characteristics."

34 *See* 14a C.J. *Corporations* § 2864, *supra* note 2 (addressing the extent of capacity of a corporation) (citing Johnson v. Butte & Superior Copper Co., Ltd., 41 Mont. 158, 165 (1910).

35 *Corporations*, INTERNAL REVENUE SERV., https://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Corporations (last updated July 8, 2016).

36 INTERNAL REVENUE SERV., Cat. No. 15093R, PUBLICATION 550: INVESTMENT INCOME AND EXPENSES 20 (2014).

37 *Id.*

38 Capital gains distributions have a separate tax schedule. *See id.* at 70. However, for purposes of this article, the tax schedule of capital gains distributions and qualified dividends overlap.

39 I.R.C. § 11 (West 2016).

regime. In a very pragmatic way, the government charges a price for a service. The "sovereign" collects a double tax in exchange for the grant of an indefinite life span, limited liability, and the possibility of raising capital on the public markets.[40] Then, everything changed when Wyoming first started to recognize the Limited Liability Company ("LLC") as a business form.[41] During the 1970s, other states followed Wyoming's steps by enacting limited liability statutes. In 1988, Revenue Ruling 88-76 determined that certain entities that met some, but not all, of the "corporate characteristics"[42] would be treated as partnerships for tax purposes.[43] LLCs were recognized as "pass-through" entities for tax purposes, but they also had limited liability by statute.[44] With the objective of stopping the surge of tax cases crowding the federal courts after the enactment of the LLC state statutes, the IRS adopted the so-called "check-the-box" tax regulations in 1997, affording taxpayers the ability to elect their preferred tax status.[45] LLCs enjoy the broadest choice because, by literally checking a box in Form 8832, an LLC could elect to be treated (for tax purposes) as either a pass-through entity (which is the default provision in case no election is made),[46] or as a corporation taxed under either Subchapter C, or Subchapter S of the corporate tax code.[47]

LLCs are interesting statutory creatures because they represent a change from the old dichotomist universe of partnerships vis-à-vis corporations. LLCs are, essentially, corporations, except they cannot raise capital by issuing shares on the public market and they do not have to pay corporate taxes.[48] This highlights the first controversy of the current corporate tax system. Does it make sense to have a corporate tax at all? The assessment of a corporate tax may have been a tradeoff for a corporation to obtain several benefits over a partnership. Today, most of these benefits are available without any tradeoff by forming an LLC. In terms of a cost-benefit analysis, corporate taxes appear to be the price corporations have to pay to sell shares on the public market—the only effective difference between today's corporations and LLCs. This idea is corroborated by the existence of another "hybrid" business form, the "S-Corporation."[49] The S-

40 Morrissey v. Commissioner, 296 U.S. 344 (1935).

41 WYO. STAT. ANN. § 17-15-101 *et seq., repealed by* 2010 Wyo. Sess. Laws 94.

42 *See Morrissey,* 296 U.S. 344; *see also* Larson v. Commissioner, 66 T.C. 159 (1976).

43 Rev. Rul. 88-76, 1988-2 C.B. 360.

44 *Id.*

45 I.R.C. § 7701 (West 2016).

46 *Id.*

47 I.R.C. § 1361 (West 2016).

48 Rev. Rule 88-76, 1988-2 C.B. 350.

49 *S-Corporations*, INTERNAL REVENUE SERV., https://www.irs.gov/Businesses/Small-businesses-&-Self-Employed/S-Corporations (last updated Aug. 1, 2016). Other restrictions apply, but they are

Corporation is a special statutory variant of a "traditional" corporation. Once formed, a corporation can, somewhat similarly to an LLC, "check the box" and elect to be taxed under Chapter I, Subchapter S of the I.R.C., instead of the default taxation under Subchapter C.[50] S-Corporations are another type of pass-through entity, which, similarly to LLCs, have restrictions on share ownership.[51] For example, S-Corporations cannot have more than one hundred shareholders,[52] making it impossible to trade S-Corporations' shares on a public stock exchange.

For the small business owner, this is all nonsense. John Doe, our sample small business owner, does not care whether his company is called "J.D. Inc.," "J.D. LLC," or "J.D. and partners." All John Doe cares about is, laconically, limited liability and having to pay the lowest amount of taxes possible. A mom-and-pop shop owner has no short-term aspiration of getting a ticker symbol and starting to trade its shares on a stock exchange. So, the benefit of trading shares on a public market is reserved to larger corporations, those which meet the capital requirements to be listed on a stock exchange, but the double taxation of corporations affects all corporate entities, big or small, publicly traded or not. This creates, in a way, a windfall to larger corporate entities because they are essentially the ones reaping the only remaining benefit of the corporate form. But, do large corporations actually pay for this benefit? The answer is "sometimes," and this takes us to the next section of this article, tax avoidance.

TAX AVOIDANCE

This section will focus on the most well-known schemes employed by large multinational corporations to reduce their overall tax burden. Not to be confused with underreporting or tax evasion, these practices are completely legal (except when they result in tax evasion) and they are herein exposed to highlight some additional contradictions created by the existing provisions of the I.R.C. This section will address, in order, the practices of transfer pricing (with profit shifting to tax-havens) and stock option deductions.

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not relevant for the purposes of this article as they relate to the nationality of the shareholders, allowable business purpose, etc.

50 *Id.*

51 *Id.*

52 *Id.*

TRANSFER PRICING – GOODS

Transfer pricing, simply put, is the practice of altering the price of a good sold in a transaction between controlled subsidiaries to keep profits where the corporate income taxes are lowest.[53] Transfer pricing is best described with an example. CC Corp. ("CC") is a United States-based manufacturer of cola drinks sold everywhere in the world. CC buys its aluminum cans from one of its subsidiaries, A Inc., ("A"), which is incorporated in the Bahamas where there is no corporate tax. The market price for an aluminum can is $1, and CC sells its cola cans on the market for $2. Instead of purchasing the cans at the market price of $1, CC directs A to sell its cans above the market price, at $2 each. CC keeps purchasing the overpriced cans, and it keeps selling its cola products at $2 each, thus making no profits at all. On the other hand, A is capturing all the profits that would have been made by CC, which would have been subject to the 35% corporate tax rate in the United States. With this simple "trick," CC is now making no profits at all from its United States activities. All the profits are being kept in A, in the Bahamas, where they are not subject to any corporate tax.

What is the economic impact of this type of tax avoidance? The problem can be analyzed from three different perspectives. First, CC is effectively avoiding corporate tax altogether, saving $0.35 for each can of cola sold during the tax year. At the other end of the spectrum, the IRS is losing precious revenue, that is, those very same $0.35 per can. Lastly, there is the perspective of subsidiary A. Do these famous $0.35 per can at least go towards developing the economy of the Bahamas, expanding the local aluminum production industry, and creating jobs on the island? No. In most cases, corporations like our subsidiary A are just empty "shells" consisting of only a name and a P.O. Box without any real activity. A does not produce anything, it just takes title to some aluminum cans bought on the market and sold to its parent company at an artificially inflated price.

For obvious reasons, the I.R.C. prohibits the activities described in the example above.[54] Transactions involving controlled entities must be reported to the IRS and are subject to strict supervision and reporting requirements.[55] I.R.C. provisions require that the transactions between

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53 *Transfer Price – Definition*, BUS. DICTIONARY, http://www.businessdictionary.com/definition/transfer-price.html (last visited Nov. 21, 2015).

54 26 C.F.R. § 1.482 (2016).

55 *See* INTERNAL REVENUE SERV., Form 5471: Information Return of U.S. Persons with Respect to Certain Foreign Corporations (2016); INTERNAL REVENUE SERV., Form 5472: Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business (2016).

controlled entities be at arm's-length, that is, the controlled entity must behave as if it was uncontrolled.[56] Applying the rule to the example above, subsidiary A would have been forced to sell the aluminum cans at the going market price of $1 each, instead of the marked-up price of $2 each. However, real-world transactions are never so clear-cut, and this creates room for argument. The I.R.C. recognizes that different transactions in different contexts may have different results, and therefore it introduces the so-called "standard of comparability."[57] The standard of comparability, and related provisions, can be summarized as follows: because no two transactions are identical, the reporting corporation should do its best to reproduce, in a transaction involving a controlled subsidiary, the context of a transaction involving an uncontrolled third party corporation.[58]

There are various methods used to determine how an arm's-length transaction between the two controlled entities would be structured.[59] The I.R.C. requires that the "best method"—the one that better simulates an arm's-length transaction—is employed for proper reporting.[60] So, back to our example, executives from CC and subsidiary A will sit at the negotiation table and will start looking at various factors when determining the price A should charge to CC. These factors include, for example, the price A charges to other companies for the same product, the economic conditions of the country where A is located, the volume of the trade between the two corporations, quality of the products, currency risk, etc.[61]

After a thorough examination of all the relevant factors, the executives prepare an extensive report describing how A is selling special aluminum cans to CC, which are 100% recyclable and made only with high-quality aluminum coming from "responsible" mines where there is no exploitation of the workers. To sweeten the deal, A will offer an extended 4-year warranty on the cans and, given the long-standing commercial relationship between the two firms, A will extend a credit line to CC at a mere 5% interest rate. CC will purchase the aluminum cans from A, who will take care of the shipping, at an all-inclusive price of $1.80 per can; a true bargain given all the perks CC is getting with the deal. With these added facts, CC buys the cans for $1.89 (the purchase price plus the interest on the credit line) from A, and sells the cola products for the same $2.00 each. CC then

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56 26 C.F.R. § 1.482-1(b) (2016).

57 26 C.F.R. § 1.482(d)(1)–(2) (2016).

58 *Id.*

59 A full list of acceptable accounting methods can be found in DELOITTE, 2015 GLOBAL TRANSFER PRICING COUNTRY GUIDE (2015). However, a discussion of the difference between the various methods is beyond the scope of this article.

60 26 C.F.R. § 1.482-1(c) (2016).

61 *See id.*

reports the transaction to the IRS, files its taxes, and pays the 35% tax rate on its $0.11 of domestic profit. CC then writes a check to the IRS for approximately $0.03 per can. CC has respected all the current laws, and its management has effectively reduced the income tax expense of the corporation by 89%, from the initial $0.35 per can, to the current $0.03 per can.

TRANSFER PRICING – INTELLECTUAL PROPERTY

The concept of transfer pricing does not apply only to goods. As a matter of fact, goods are fairly easy to price because they are tangible, can be classified, subjected to international standards for quality, etc. Pricing becomes a lot more complex when the object of the trade is intellectual property ("I.P."). In many cases, corporations develop new products, which are then licensed for use to subsidiaries. The accurate selection of corporate structure and licensing agreements between various tiers of subsidiaries can relieve multinational corporations of large amounts of tax liability.

A typical example of an I.P. transfer pricing is the famous profit-shifting scheme known as "double Irish with a Dutch sandwich," pioneered by Apple, Inc., and soon followed by other technology and pharmaceutical corporations.[62] This strategy is centered on the possibility of an Ireland-incorporated entity to be taxed under a different country's tax regime.[63] Irish law, in fact, determines the residency of a corporate entity based on where the corporation's management is located.[64]

Here is how it all works. A U.S. corporation enters into a cost-sharing agreement with a wholly owned subsidiary in a tax-haven, such as Bermuda. This tax-haven subsidiary is incorporated in Ireland, but is subject to Bermuda corporate tax because the main office and management of the corporation are in Bermuda.[65] This corporation is the "First Irish." The cost-sharing agreement provides that the U.S. corporation and the First Irish will split, 50-50, the development cost of a new technology and patent. The First Irish will retain the patent and license it for use to the U.S. corporation, this way the U.S. corporation can recognize an initial tax saving by reducing its taxable income by its 50% contribution to the new

62 Martin A. Sullivan, *Apple Reports High Rate but Saves Billions on Taxes*, TAX ANALYSTS, Feb. 13, 2012, at 777, http://taxprof.typepad.com/files/134tn0777.pdf.

63 PRICEWATERHOUSE COOPERS, *Tax Facts 2015: The Essential Guide to Irish Tax* (2015), http://download.pwc.com/ie/pubs/2015-pwc-ireland-tax-facts.pdf.

64 *[2.2.3] Company Residence in the State* 4–5, IRISH TAX & CUSTOMS, http://www.revenue.ie/en/about/foi/s16/income-tax-capital-gains-tax-corporation-tax/part-02/02-02-03.pdf (last updated July 2015).

65 *Id.*

technology, and by the amount of the royalties paid to the First Irish for the I.P. license. This initial licensing agreement is regulated by the transfer pricing requirements of an arm's-length transaction imposed by U.S. law.[66]

Then, the First Irish sub-licenses the same I.P. received from the U.S. corporation to a wholly owned Dutch subsidiary. Lastly, the Dutch subsidiary sub-sub-licenses the very same I.P. to a second Irish corporation, this time doing business in the EU (the "Second Irish"). The Second Irish books all the sales of products and services outside of the United States. Then, the Second Irish pays a large royalty to the Dutch corporation for the I.P. it licensed, maintaining the profits in the Second Irish at a minimum, and, in any case, subject to the lower Irish tax rate of 12.5%.[67] This first royalty is not subject to withholding tax,[68] so the money flows untaxed from Ireland to the Netherlands. The Dutch corporation then pays a large royalty to the First Irish in Bermuda, maintaining the profits of the Dutch corporation to a minimum and, in any case, subject to the lower Dutch tax rate of 25%.[69] This second transfer is not subject to withholding tax either because of the many bilateral tax treaties signed by the Netherlands, of which Bermuda is a party.[70] The corporation in Bermuda books the vast majority the profits and pays no corporate tax. How does the money get back to the United States? The corporation in Bermuda could transfer money back to the United States at any time by paying a dividend to its parent company, obviously subject to taxes for the repatriation of income.[71]

Since this arrangement relies heavily on the use of I.P. and licensing agreements, it is mostly used by technology and pharmaceutical corporations, and the more unique and profitable the I.P. is, the larger the tax savings.[72] It is estimated that the "double Irish with a Dutch sandwich" arrangement saved Apple between $2.4 and $4.8 billion on its tax bills in 2011 alone.[73]

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66 *See* 14a C.J. *Corporations* § 2864, *supra* note 2.

67 *Corporation Tax*, IRISH TAX AND CUSTOMS, http://www.revenue.ie/en/tax/ct/ (last visited Nov. 11, 2016).

68 *See* Council Directive 03/49, art. 1, 2003 O.J. (L 157/49) (EC), http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32003L0049:en:HTML.

69 PRICEWATERHOUSE COOPERS, DOING BUSINESS IN THE NETHERLANDS (2014).

70 For a complete list of the tax treaties of the Netherlands, see *Overview of Treaty Countries*, DUTCH TAX ADMINISTRATION, http://www.belastingdienst.nl/wps/wcm/connect/bldcontenten/belastingdienst/individuals/tax_arrangements/tax_treaties/overview_of_treaty_countries/.

71 *See* I.R.C. § 884(a) (West 2016). Branch profits tax, subjecting dividends from U.S. controlled foreign corporations to a 30% withholding tax.

72 *See* Sullivan, *supra* note 62, at 777–78.

73 *Id.* Note that the Irish legislature has changed the provisions allowing this transfer pricing scheme with the enactment of the Finance Act 2014 (Act No. 26/2014) (Ir.), http://www.legislation.gov.uk/ukpga/2014/26/pdfs/ukpga_20140026_en.pdf, which more strictly enforces taxation of Irish corporations and more narrowly defines the corporate residency requirements.

TRANSFER PRICING – CAPITAL, A/K/A "LIQUIDITY TRANSFER PRICING"

Another interesting way to shape transfer pricing is the so-called "liquidity transfer pricing."[74] This technique is relied upon mostly by banks or financial institutions with large amounts of cash.[75] Liquidity transfer pricing is not necessarily a tool for tax avoidance, but rather a system of adequate performance reporting.[76] The importance of liquidity transfer pricing as a risk management tool was stressed by the Basel Committee on Bank Supervision with the introduction of the Basel III capital requirements in December 2010.[77] While the regulatory and risk management aspects of liquidity transfer pricing are beyond the scope of this article,[78] liquidity transfer pricing may also be another useful tool to lower the overall tax liability of large multinational corporations.

The way liquidity transfer pricing works is similar to the other forms of transfer pricing, except that the "price" in this case is the interest charged on a loan. Let us go back to the "double Irish with a Dutch sandwich" example above. Our U.S. multinational corporation has effectively avoided the U.S. corporate income tax, but is now facing a difficult decision. The corporation could repatriate the cash accumulated in Bermuda, and pay a hefty profit repatriation tax,[79] which in some cases can be as high as 30% of the amount repatriated in the form of dividends.[80] Alternatively, the corporation could keep the money in Bermuda, tax-free until repatriated, and enjoy the benefits of tax-deferral.[81] Often, corporations prefer to accumulate cash in tax-havens, enjoying the benefits of tax-deferral

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However, all those entities incorporated before January 1, 2015, will have a "grace period" until 2020 before they will be affected by the new provisions of the Finance Act 2014. Based on the estimates in Dr. Sullivan's article for the past fiscal performance of Apple, the U.S. multinational alone should be able to save another $10–20 billion before the new measures enter into force in 2020.

74 Steve Culp, *Liquidity Transfer Pricing is Now a Key Element in Banks' Success*, FORBES (Sept. 12, 2013, 3:39 PM), http://www.forbes.com/sites/steveculp/2013/09/12/liquidity-transfer-pricing-is-now-a-key-element-in-banks-success/.

75 *Id.*

76 *Id.*

77 *See id; see also* BANK FOR INTERNATIONAL SETTLEMENTS, LIQUIDITY TRANSFER PRICING: A GUIDE TO BETTER PRACTICE (2011), http://www.bis.org/fsi/fsipapers10.htm.

78 For a proper account of the regulatory impact of Basel III regulations on liquidity and capital requirements, see generally José Gabilondo, Bank Funding: A Post-Crisis View (Oct. 22, 2015) (unpublished manuscript) (on file with author).

79 *See* I.R.C. § 884(a) (West 2016).

80 *Id.*

81 David Alexander, *Big U.S. Firms Hold $2.1 Trillion Overseas to Avoid Taxes: Study*, REUTERS (Oct. 6, 2015, 6:37 PM), http://www.reuters.com/article/2015/10/06/us-usa-tax-offshore-idUSKCN0S008U20151006#FqYgQUDfAc1X9Yzg.97 (describing how most Fortune 500 companies operate subsidiaries in tax-havens, and hold an approximate total of $2.1 trillion therein).

similarly to individuals with 401(k) plans.[82] However, profits may need to be repatriated for a variety of reasons, ranging from capital needs, to downturns in the economy.

In order to deal with these temporary cash shortages, the foreign subsidiary may use liquidity transfer pricing to avoid the profit repatriation tax. Instead of paying a dividend to its U.S. parent company, the subsidiary can offer it a loan. Obviously, the loan will have to be structured as an arm's-length transaction, in line with the going market rate, etc.[83] This practice offers a threefold advantage. First, it avoids the profit repatriation tax. Second, it gives the multinational yet another opportunity to shift profits towards the foreign subsidiary as the U.S. parent company makes payments of interest and principal on its loans. Third, the interest paid by the parent company to the subsidiary is tax-deductible for U.S. tax purposes.[84]

STOCK OPTION DEDUCTIONS

The last tool for corporate tax avoidance discussed in this article is the deduction of stock options from taxable income. Similar to accelerated depreciation, the stock option deduction is a tax "fiction," that is, a deductible non-cash expense, which can be used to reduce the taxable corporate income.[85] Executives and directors in larger corporations receive the majority of their remuneration through stock options,[86] rather than in cash as a salary. The stock option grants the holder a right to purchase a definite amount of the corporation's stock, at a definite price (the issue price), independent of market fluctuations.[87] Common practice for the recipient of the stock option is to exercise the purchase right only when the market value of the stock is higher than the issue price of the option, in order to immediately profit from the difference in prices. This type of compensation is highly desirable for the executive and the corporation because of the substantial tax benefits it offers, as will be discussed in more

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82 *Id.*

83 *See* 14a C.J. *Corporations* § 2864, *supra* note 2.

84 I.R.C. § 163 (West 2016).

85 I.R.C. § 162 (West 2016).

86 There are two types of stock options: qualified and nonqualified. The options referred to in this article–those issued as compensation to highly remunerated executives–are the nonqualified type, subject to the provisions of I.R.C. Section 83. *See generally* JAMES M. BICKLEY, CONG. RESEARCH SERV., RL31458, EMPLOYEE STOCK OPTIONS: TAX TREATMENT AND TAX ISSUES (2012) (discussing the current statutory scheme governing stock options, as well as the advantages and disadvantages of qualified and nonqualified stock options), http://digitalcommons.ilr.cornell.edu/cgi/viewcontent/cgi?article=1935&context=key_workplace.

87 *Id.*

detail below.

The transaction can be analyzed from both the perspective of the corporation and the perspective of the executive. The executive receives the regular salary in cash, and a bonus stock option. The issue price of the option does not have to be anywhere near the market price of the stock, it can be set arbitrarily, as long as the option cannot be actively traded.[88] While the executive pays income tax on the cash salary as it is earned, the stock option is not taxable until it is exercised, because its value cannot be "readily ascertained" until it is traded.[89] The executive enjoys tax-deferral on the stock option until the day it is exercised.[90]

From the corporation's perspective, the deal is even sweeter. First, the corporation provides an alternative form of compensation to its highest paid executives, therefore reducing what would otherwise be a direct cash outflow. Second, the corporation can deduct the full exercise price of the option.[91] While the deduction is used only in the year when the executive decides to exercise (so it may not produce an immediate tax benefit for the corporation), the amount of the deduction is substantial because these options represent the bulk of the employee compensation expenses for most corporations. Third, when the option is exercised and the corporation books the deduction, there is still no cash outflow on the part of the corporation. The "expense" deducted is only an opportunity cost to the corporation, that is, what the corporation would have registered as a cash inflow if it had sold its stock to the market, instead of giving it as an option to the executive.[92] After understanding the mechanisms of the existing I.R.C. provisions with respect to transfer pricing and stock option deductions, the next section will focus on possible solutions to address the problem of excessive tax avoidance.

A PROPOSAL

Since the Tax Reform Act, signed in 1986 by former-president Reagan, multiple studies and proposals have been analyzed to determine a

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88 26 C.F.R. § 1.83-7(b)(2) (2016); Cramer v. Commissioner, 64 F. 3d 1406, 1414 (9th Cir. 1995) (holding that a stock option that cannot be freely alienable does not have a "readily ascertainable fair market value."). Note that, as described in the sources, it is the option itself which cannot be freely traded rather than the stock of the corporation. Therefore, a publicly traded company can issue a non-transferrable traded stock option to one specific executive, and still be able to set the issue price of the option at will.

89 I.R.C. § 83(e)(3) (West 2016) (exempting property of unascertainable value from the inclusion into the taxpayer's gross income).

90 *Id.*

91 I.R.C. § 162 (West 2016).

92 The effects of share dilution are assumed to be minimal.

relatively simple, administrable, fair, and effective tax system.[93] Yet, no major tax reform has taken place in the last thirty years.[94] Out of the different studies already performed by private and public entities, perhaps the most detailed and inclusive is the 1992 *Report on Tax Integration* redacted by the Department of the Treasury.[95] The most important distinction between the *Report on Tax Integration* and other studies is that it analyzes tax reform not only from the perspective of the taxpayer, but also from the standpoint of the Government.[96]

This different perspective adds a layer of complexity to the analysis of a proposed tax reform because, in addition to the ideals of equity and fairness in the tax system exposed in the earlier sections of this article, an effective tax reform must be easy to implement and grant an equal or increased revenue stream for the Government (tax-neutrality).[97] While this article will focus only on the problems of transfer pricing and stock option deductions, rather than on the corporate tax system at large, the same principles of efficient and effective tax reform expressed in the Department of the Treasury's *Report on Tax Integration* will be taken into consideration. The next sections will analyze the problem of tax avoidance and propose a solution based on a model of international competitiveness.

A PROPOSED SOLUTION TO TRANSFER PRICING TAX AVOIDANCE

Transfer pricing is a complex problem to resolve because it does not derive from the tax code (and relative loopholes) of a single country, but rather it is the result of the existing gaps and discrepancies between the tax systems of different countries. Although "[n]o consensus exists about the proper norms for capital taxation in economies with international capital and labor mobility,"[98] the OECD has developed a set of actions to be taken by member countries in order to address the problem of transfer pricing on a global scale.[99] The suggested solution of the OECD Base Erosion and Profit Shifting ("BEPS") Project, however, does not deviate substantially

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93 Andrew Lundeen, *A Lot Has Changed in the 27 Years Since the Last Major Tax Reform*, TAX FOUND. (Oct. 22, 2013), http://taxfoundation.org/blog/lot-has-changed-27-years-last-major-tax-reform; *see also* DEP'T OF THE TREASURY, *supra* note 12.

94 Lundeen, *supra* note 93.

95 DEP'T OF THE TREASURY, *supra note* 12.

96 *Id.*

97 *Id.*

98 *Id.* at 75.

99 OECD, OECD/G20 BASE EROSION AND PROFIT SHARING PROJECT: ACTION 13: GUIDANCE ON THE IMPLEMENTATION OF TRANSFER PRICING DOCUMENTATION AND COUNTRY-BY-COUNTRY REPORTING (2015), http://www.oecd.org/tax/aggressive/beps-2015-final-reports.htm.

from what appears to be the present practice of corporate America.[100] The OECD BEPS best practices would require large multinational corporations to maintain a three-tiered system of documentation in order to ensure that the principle of arm's-length dealing is respected among the controlled subsidiaries of the Multi National Enterprise ("MNE").[101] However, just like it happens today under the IRS directives,[102] it is possible to structure a transaction in a way that satisfies the requirements of the arm's-length principle while still shifting a portion of the profits of the MNE to a low-tax jurisdiction.[103] Although the more in-depth reporting required under the OECD BEPS guidelines will make transfer pricing more difficult, it will not solve the problem; a group of skilled accountants and lawyers can still manipulate the form of a transaction so as to maintain the substance of profit shifting. Because added reporting requirements simply will not do, perhaps the most effective remedy to transfer pricing practices is the creation of an incentive not to engage in the practice; namely, reducing the statutory corporate tax rate. This may seem to have been a long read for such an "easy fix," but there is more to the matter than it seems.

Transfer pricing is a technique to transfer profits from a high-tax jurisdiction to a low-tax jurisdiction.[104] A MNE acting as a rational decision-maker tries to maximize its utility, and engages in transfer pricing. Clearly, in a fictitious scenario where every country in the world had the exact same tax rate, transfer pricing would not provide any meaningful financial advantage because our rational decision-making entity would be indifferent between the available alternatives. The reality is more complex, however, because the statutory tax rate by itself does not reflect the full extent of the "utility" derived from the choice of a tax jurisdiction over another. Countries have widely different tax systems, reporting requirements and standards, penalties for underreporting, enforcement systems, etc. All of these factors, together with the statutory tax rate, are taken into account by the rational decision-making MNE when determining the utility derived from the allocation of profits in one specific jurisdiction rather than another. The bureaucracy associated with tax reporting and

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100 INTERNAL REVENUE SERV., *supra* note 35, at 20.

101 OECD guidelines essentially increase the reporting requirements to ensure that every transaction between controlled subsidiaries is at arm's-length. The proposed three-tier increased reporting requirement includes: "(i) a master file containing standardised information relevant for all MNE group members; (ii) a local file referring specifically to material transactions of the local taxpayer; and (iii) a Country-by-Country Report containing certain information relating to the global allocation of the MNE group's income and taxes paid together with certain indicators of the location of economic activity within the MNE group." OECD, *supra* note 99.

102 INTERNAL REVENUE SERV., *supra* note 35, at 20.

103 See Transfer Pricing – Goods section above.

104 *Transfer Price – Definition*, *supra* note 53.

compliance has a cost, and this cost is taken into account in determining the overall utility of shifting profits to a specific country.

Further, the MNE needs to take into account the cost of tax-avoidance and potential non-compliance. Stated differently, before shifting any profits around the world, the MNE will make sure that for every dollar spent on tax-avoidance (the bills of some professionals in the income defense industry can be very expensive), there is at least an equal or greater saving on the corporate tax bill, plus an allowance for any penalties in case the tax-avoidance crosses the line of underreporting.[105]

The decision of choosing which jurisdiction has the best tax regime is not an easy one as it requires the balancing of many disparate factors. The mechanics of a similar decision-making process are interestingly modeled in a quantitative study conducted at the Leibniz Information Centre for Economics,[106] which will help us understand the importance of the statutory tax rate in the context of the other factors. The study aims at creating a dimensionless number–the Tax Attractiveness Index–which quantifies the desirability of a specific tax jurisdiction.[107] For our purposes, the Tax Attractiveness Index can be equated to the utility received by the MNE when choosing a certain tax jurisdiction. In the study, the U.S. tax system ranks among the countries with the lowest Tax Attractiveness Index.[108] One of the factors that most heavily influences such a low score is the negative effect of a very high statutory tax rate.[109] What this study reveals, in simpler words, is that if a MNE was evaluating where to shift its profits, the United States would be at the bottom of the list.[110] Further, the study finds that one of the main reasons for such a low score is the very high statutory tax rate in the United States.[111] Therefore, a reduction of the statutory corporate tax rate alone may greatly increase the Tax Attractiveness Index of the United States, without the need for a complete restructuring of the corporate tax system.

While a reduction of the corporate statutory tax rate alone will not completely resolve the problems of equity and fairness of the tax system at

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105 *See* Myles Udland, *The IRS Says Coke Owes 3.3 Billion,* BUS. INSIDER (Sep. 18, 2015, 1:45 PM), http://www.businessinsider.com/irs-coca-cola-tax-bill-2015-9 (describing how Coca-Cola is under investigation by the IRS for shifting profits abroad through transfer pricing.) It is striking that Coca-Cola seemed to be following reporting guidelines suggested by the IRS itself.

106 SARA KELLER & DEBORAH SCHANZ, *Measuring Tax Attractiveness Across Countries*, THE OPEN ACCESS PUBLICATION SERVER OF THE ZBW – LEIBNIZ INFORMATION CENTR. FOR ECONOMICS (June 9, 2013) (manuscript), http://hdl.handle.net/10419/75220.

107 *Id.* at 43, Table 1.

108 *Id.* at 45, Table 3.

109 *Id.* at 29.

110 *Id.*

111 *Id.*

large, a relatively small statutory modification may have a substantial impact in terms of reducing the existing inefficiencies of the current tax scheme. First of all, a reduction in the statutory corporate tax rate will reduce the inequality between corporate and unincorporated entities. Currently, real estate investment trusts and certain limited liability entities in the oil drilling and exploration industry enjoy a tax advantage over publicly traded corporations as they are not subject to double taxation.[112] A reduction in the statutory corporate tax rate will consequently reduce the bias towards non-corporate entities, therefore increasing inter-group equity and fairness, which was one of the problems described in Section I, Part A of this article.[113] Similarly, a reduction in the statutory corporate tax rate will reduce the bias towards earning retention vis-à-vis dividend distribution precisely because of a reduced burden in the double taxation of corporate profits. A lesser impact of the tax consequences in corporate decision-making processes will hopefully lead to less biased, and more efficient, decisions with a consequent improvement in corporate performance.

A reduction in the statutory corporate tax rate will most likely translate into an immediate reduction of tax revenue for the government, creating a problem of tax-neutrality.[114] However, the decrease in tax revenue, if any, will be only marginal. The Tax Policy Center reports that in 2014 corporate tax receipts accounted for only 10.6% of the total receipts, compared to the 46.2% of the personal income tax.[115] Therefore, a reduction in the corporate tax rate will affect the total tax receipts much less than a proposed change to the personal income tax rate. Further, although the literature on the matter is not conclusive, a 2011 study published in the INTERNATIONAL REVIEW OF ECONOMICS AND FINANCE suggests that a weak, negative causality exists between corporate tax rate and per capita GDP growth.[116] The study does not provide us with a correlation indicator, which would be useful in determining how the changes in one variable (corporate tax rate) affect the other (per capita GDP growth).[117] However, the study qualitatively concludes that a reduction in corporate tax rates will moderately stimulate GDP growth.[118] For our purposes, this could

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112 *See* AICPA, *supra* note 10.

113 *Id.*

114 DEP'T OF THE TREASURY, *supra* note 12, at 5.

115 *Historical Tables: Table 2.1 Receipts by Source: 1934–2020*, OFFICE OF MGMT. & BUDGET, https://www.whitehouse.gov/sites/default/files/omb/budget/fy2017/assets/hist02z1.xls (last visited Nov. 2, 2016).

116 Stella Karagianni et al., *Tax Burden Distribution and GDP Growth: Non-linear Causality Considerations in the USA*, 21 INT'L REV. OF ECON. & FIN. 186, 192 (2012).

117 *Id.*

118 *Id.* at 193.

potentially translate into an offset of the tax receipts reduction mentioned earlier in this paragraph. However, more precise quantitative studies need to be conducted on the matter before the problem of tax-neutrality can be considered resolved.

One last aspect of tax neutrality needs to be considered under this model. The increase in the overall competitiveness of the U.S. business environment will likely stimulate investment in the country. As discussed in earlier sections, the Tax Attractiveness of the United States is among the lowest in the study mainly because of the high statutory corporate tax rate.[119] Nonetheless, the United States houses a vast majority of the largest and most profitable corporations in the world.[120] This is because, notwithstanding its high corporate tax rates, the United States offers a fertile land for businesses, with relatively limited regulations on entrepreneurs and start-up businesses; an efficient justice system, which enforces the protection of property and the collection of debts; multiple large stock exchanges and securities markets; and a relatively efficient and transparent administration of the government.[121] While all of these benefits to businesses attract investments, high taxation discourages them, reducing the competitiveness of the system as a whole on the international investment market.[122] In terms of transfer pricing, as mentioned earlier, this creates an incentive to shift profits abroad. However, as the tax differential with other countries is reduced, this "incentive" to shift money abroad is also reduced, up to a point of equilibrium, where the push to move money out of the country is nonexistent. By setting a corporate tax rate just below this "equilibrium" point, there would be a small incentive for MNEs to move or maintain profits inside of the United States rather than outside. Unfortunately, again, an exact quantitative measure of what this new, lower tax rate should be is extremely difficult to estimate with precision.[123]

A PROPOSED SOLUTION TO STOCK OPTION DEDUCTIONS TAX AVOIDANCE

The problem of non-statutory stock options lies in the wording of one provision of the I.R.C. and its related Section in the C.F.R., I.R.C. Section 83(h) and C.F.R. Section 1.83-7(a)–(b). These sections provide for the

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119 *See* KELLER & SCHANZ, *supra* note 106.

120 *See generally Fortune 500*, FORTUNE, http://fortune.com/fortune500/ (last visited Nov. 2, 2016) (providing general background information on the largest 500 corporations in the world).

121 *See Ease of Doing Business in the United States*, WORLD BANK DOING BUSINESS PROJECT, http://www.doingbusiness.org/data/exploreeconomies/united-states (last visited Jan. 24, 2016).

122 DEP'T OF THE TREASURY, *supra* note 12, at 4.

123 Karagianni et al., *supra* note 116.

taxation of nonqualified (or non-statutory) stock options, and for the standard used to determine whether the option has a readily ascertainable market value.[124] As explained earlier in the paragraph, these types of options allow both the receiving executive and the issuing corporation to realize substantial savings in tax liability. The taxable income is recognized by the individual when the option is exercised,[125] while at the same time the corporation books a deductible non-cash expense.[126]

In order to provide a solution to the tax avoidance problem presented by stock option deductions, it is necessary to identify how stock options should be taxed and how to assess the tax liability. To determine how to tax stock options, we perform an analysis of the transaction under the "business purpose" and "substance over form" doctrines. To determine how to assess the tax liability, we will propose an amendment to the statutory language in the relevant Sections of the I.R.C.

1. How to Tax Stock Options

A non-statutory stock option is a form of compensation, just like a salary.[127] The I.R.C. considers certain stock option plans (qualified stock options) as compensation, and those stock options are subject to withholding taxes like FICA (Federal Insurance Contributions Act) and FUTA (Federal Unemployment Tax Act), which are calculated based on the cash value of the stock compensation under the plan.[128] Nonqualified stock options should be no different, and should therefore be taxed as regular cash salary. The U.S. tax administration and courts recognize the legal doctrines of "substance over form" and "business purpose."[129] Both doctrines derive from the Supreme Court ruling in *Gregory v. Helvering*, a case decided in 1935.[130] These same doctrines should be applied when analyzing the issue of stock option deductions.

Seven years before the case was decided by the Supreme Court, petitioner Evelyn Gregory was the sole stockholder of United Mortgage Corporation ("United"), which, in turn, owned stock of another corporation,

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124 26 C.F.R. § 1.83-7(a)–(b) (2016).

125 I.R.C. § 83(b) (West 2016).

126 I.R.C. § 83(h) (West 2016).

127 *See* Janet Novack, *Stock Options Meant Big Tax Savings for Apple and JPMorgan, as Well as Facebook.,* FORBES (Apr. 24, 2013, 12:12 PM), http://www.forbes.com/sites/jaetnovack/2013/04/24/stock-options-meant-big-tax-savings-for-apple-and-jp-morgan-as-well-as-facebook/#82f9fd225036.

128 I.R.C. § 3121(a)(22)(A) (West 2016) (FICA applied to certain stock compensation plans); I.R.C. § 3301 (West 2016) (assessing FUTA tax on all "wages," as defined in I.R.C. § 3306(b)(19)(A) (West 2016), to include the cash value of certain stock compensation plans).

129 Gregory v. Helvering, 293 U.S. 465, 468 (1935).

130 *Id.*

Monitor Securities Corporation ("Monitor").[131] Gregory intended to transfer the Monitor shares owned by United to herself, without having to pay taxes on the distribution.[132] Gregory devised the following strategy to dodge her tax bill. First, she incorporated a new company in Delaware, called Averill Corporation ("Averill"), of which she was the sole shareholder. Three days later, she transferred all of the Monitor shares to Averill in a transaction that complied with the tax exemption requirements of a reorganization under Section 112(g) of the Revenue Act of 1928. Lastly, she dissolved Averill and distributed the Monitor shares, the only asset owned by Averill, to herself.[133]

Helvering, the Commissioner of Internal Revenue, sued Gregory on the basis that the transaction had no purpose other than tax avoidance.[134] However, the Board of Tax Appeals rejected the Commissioner's view because the transaction fell squarely within the boundaries of the law at the time.[135] The Commissioner appealed to the Second Circuit Court of Appeals, which reversed the lower court, and certified the question to the Supreme Court.[136] The Supreme Court decision is a milestone in tax law; however, it is somewhat controversial.

The opinion stated, in one of the opening paragraphs, that "[t]he legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted."[137] The Court cited relevant authority, and the opinion should have stopped there, reversing the Circuit Court of Appeals and upholding the right of a taxpayer to minimize its tax burden. After all, what Gregory did was perfectly legal, as held by the Court itself.

However, the opinion did not stop there and went beyond the plain language of the law, although unambiguous, creating two doctrines of judicial invention: the business purpose doctrine, which states that if a transaction has no other business purpose but to reduce the amount of taxes payable, the transaction will be disregarded; and the substance over form doctrine, which states that the underlying substance of a transaction, and not its form, should be taken into account when determining tax liability.[138]

The case set forth language, which suggested a bright line test to

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131 *Id.* at 467.

132 *Id.*

133 *Id.*

134 *Id.*

135 *Gregory*, 293 U.S. at 468.

136 *Id.*

137 *Id.* at 469.

138 *Id.* at 469–70.

determine whether the business purpose doctrine applies.[139] The Court stated, in relevant part, that a transaction should be disregarded if it has "no business or corporate purpose;" but the transaction is in fact "a mere device."[140] This implies that a transaction with *any* corporate or business purpose should *not* be disregarded. However, a corporation never has the sole purpose of tax avoidance. Most corporations are created with the purpose, as stated in their bylaws, of conducting "any and all lawful business." Even Averill, the "device" corporation created by Gregory, performed lawful business until it was closed, as recognized by the Court.[141] Therefore, the test set out by the Court is less of a bright-line rule than the language in the opinion seemed to suggest. Rather, the test conforms more closely to a balancing test, where the Court will disregard a transaction if its purpose of tax avoidance greatly outweighs any other business purpose.

Although controversial, and maybe even a bit contradictory, *Gregory v. Helvering* is still good law. We therefore proceed with the analysis of stock option deductions under the business purpose doctrine and the substance over form doctrine. Under the business purpose doctrine, we look at whether there is any other underlying business purpose to the transaction and, therefore, whether it should be disregarded.[142] The arguments that can be made as to the business purpose of stock options are (1) stock option compensation increases employee performance because the employees are now shareholders as well, thus having a direct monetary reward from the positive performance of the corporation; and (2) stock options are a form of non-cash compensation, which alleviates the corporation of large cash outflows for payroll.

Both arguments can be easily defeated by the existence of statutory (or qualified) stock options distributed under an incentive plan. Unlike nonqualified stock options, qualified stock options cannot be exercised before one year from vesting and have a minimum exercise price, thus reducing excessive speculation and tying compensation even more closely to performance and employee retention than any nonqualified stock option.[143] Therefore, issuing nonqualified stock options serves no real business purpose that could not otherwise be equally or better served by a different type of taxable compensation. The business purpose of nonqualified stock options should therefore be disregarded. Conversely, if a business purpose for these options exists, other than mere tax avoidance, then such business purpose has a negligible extent when compared to the

139 *Id.* at 468.

140 *Id.*

141 *Id.*

142 *Id.*

143 I.R.C. § 422 (West 2016).

tax avoidance benefits provided by the nonqualified stock option compensation.

The analysis of stock options under the substance over form doctrine is simpler. The substance over form doctrine is applied particularly to cases where the transacting entities are closely related.[144] In this case, the highly compensated executives have a very strong connection with the entity issuing their stock options, although indirectly. Generally, a compensation committee is employed in determining executive pay. The committee is composed of, at least in part, corporate insiders. Therefore, the compensation committee has a close relationship to the corporation, since corporate employees are on the committee. Further, the compensation committee also has a close relationship to the executives whose pay it is assessing because those executives have the authority to fire the insiders on the committee. Stock option compensation, as the name suggests, is compensation. As previously stated, stock options are subject to FICA and FUTA, and they become part of the ordinary income of the taxpayer when they are exercised, just like any other form of compensation. Therefore, stock options should be treated as any other compensation and taxed when earned.

2. How to Assess Tax Liability

The problem with taxing stock options like a salary is that, unlike a salary, the value of the option cannot always be readily ascertained.[145] Specific provisions in the C.F.R. detail that, unless the option is actively traded, it is difficult to ascertain the value of the option and, therefore, the tax owed.[146] The option has a value beyond the difference between the exercise price and the market value of the underlying asset. The option's value must also include a premium for the right of the holder to exercise the option when it is preferred.[147] The reason nonqualified stock options have a special tax regime is because they do not have a readily ascertainable

144 "The substance-over-form doctrine is invoked by the government with greatest success with respect to transactions between related persons, since, in these circumstances, form often has minimal, if any, nontax consequences and particular forms are often chosen solely to reduce taxes." BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS: ¶ 4.3 PERVASIVE JUDICIAL DOCTRINES 9 (2016).

145 26 C.F.R. § 1.83-7 (2016).

146 26 C.F.R. § 1.83-7(b)(2) (2016) sets out a presumption, whereas, if the stock option is not actively traded on a public market, its value is determined to be "not readily ascertainable." If the taxpayer wished to rebut the presumption, instead of taking advantage of this statutorily granted tax-deferral tool, he would have to prove that the option meets the four criteria described in the statute.

147 26 C.F.R. § 1.83-7(b)(3) (2016).

market value.[148]

However, a possible solution to the problem would be making an estimated tax payment when the option is issued. The estimated tax payment would be based on the market price minus the exercise price. When the option is actually exercised the taxpayer can make an adjustment to his tax: (1) if the spread between exercise price and market price has increased, the taxpayer will make an additional tax payment; and (2) if the spread between exercise price and market price has lowered since the date of issue of the option, the taxpayer will receive a refund. This system would eliminate the benefit of tax deferral to the individual because the income from the option is taxed as the option is issued.

In order to obtain this result, relevant language in the C.F.R. must be amended. The relevant C.F.R. sections are lengthy and therefore not reported in this article, which will include only the proposed amendments, with modifications to the original language in **bold** and a comment.

Proposed Amendment to 26 C.F.R. Section 1.83-7(a) and (b).

> (a) *In general.* If there is granted to an employee or independent contractor (or beneficiary thereof) in connection with the performance of services, an option to which section 421 (relating generally to certain qualified and other options) does not apply, section 83(a) shall apply to such grant if the option has a readily ascertainable fair market value (determined in accordance with paragraph (b) of this section) at the time the option is granted. **[If the option does not have a readily ascertainable market value at the time the option is granted, the person who performed such services realizes compensation in the year the option is granted in the amount equal to the value of the option (determined in accordance with paragraph (b) of this section)].** ~~If section 83(a) does not apply to the grant of such an option because the option does not have a readily ascertainable fair market value at the time of grant, sections 83(a) and 83(b) shall apply at the time the option is exercised or otherwise disposed of, even though the fair market value of such option may have become readily ascertainable before such time.~~ If the option is exercised, sections 83(a) and 83(b) apply to the transfer of property pursuant to such exercise, and the

148 26 C.F.R. § 1.83-7 (2016).

employee or independent contractor realizes compensation upon such transfer at the time and in the amount determined under section 83(a) or 83(b). If the option is sold or otherwise disposed of in an arm's-length transaction, sections 83(a) and 83(b) apply to the transfer of money or other property received in the same manner as sections 83(a) and 83(b) would have applied to the transfer of property pursuant to an exercise of the option. The preceding sentence does not apply to a sale or other disposition of the option to a person related to the service provider that occurs on or after July 2, 2003. For this purpose, a person is related to the service provider if—

> (1) The person and the service provider bear a relationship to each other that is specified in section 267(b) or 707(b)(1), subject to the modifications that the language "20 percent" is used instead of "50 percent" each place it appears in sections 267(b) and 707(b)(1), and section 267(c)(4) is applied as if the family of an individual includes the spouse of any member of the family; or
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> (2) The person and the service provider are engaged in trades or businesses under common control (within the meaning of section 52(a) and (b)); provided that a person is not related to the service provider if the person is the service recipient with respect to the option or the grantor of the option.
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> **[If the person who performed services realizes a gain (or loss) from the exercise, sale, or disposal of the option, and such gain (or loss) has not been accounted for in the year the option was granted, then such gain (or loss) shall become part of the person's income in the year the gain (or loss) is realized.]**

(b) ***Value of the option***

> (1) *Actively traded on an established market.* Options have a value at the time they are granted, but that value is ordinarily not readily ascertainable unless the option is actively traded on an established market. If an

option is actively traded on an established market, the fair market value of such option is readily ascertainable for purposes of this section by applying the rules of valuation set forth in § 20.2031-2.

(2) *Not actively traded on an established market.* When an option is not actively traded on an established market, **its fair market value for purposes of this section shall be equal to the excess of**

(i) the fair market value of the asset underlying the option, over

(ii) the exercise price of the option.

The value of the asset underlying the option shall be ascertained for purposes of this section by applying the rules of valuation set forth in § 20.2031-2.

(3) Option Privilege. [. . .] *Repealed.*[149]

Comment to Proposed Amendment to 26 C.F.R. Section 1.83-7(a) and (b).

This proposed amendment to 26 C.F.R. Section 1.83-7(a) and (b) introduces the proposed taxation methodology to reduce the impact of tax deferral on stock option compensation. The new language in subsection (a) provides a definite scenario for the cases in which the option does not have a readily ascertainable market value; the very same scenario that created the problem of tax-deferral in the original statute. The proposed amendment provides explicitly that in such cases the person receiving the option in lieu of cash compensation has to include the value of the option in its taxable income for that year.

The proposed new language in this section imposes a duty on the taxpayer to report the income derived from the stock option immediately, regardless of whether the option is exercised. This measure imposes a rather burdensome requirement on the taxpayer, who has to make a tax payment on unearned income in the majority of cases where the stock option is not exercised in the same year it is granted; if the option was, in fact, exercised when granted, there would be no tax-deferral benefit. Although burdensome, this measure is necessary to eliminate the tax saving derived from deferral of taxation on stock options, which is substantial at the highest income brackets. Further, it is an established practice of

[149] *Id.*

corporate-America to highly inflate the equity portion in executive compensation packages, leaving the immediately taxable cash portion to a minimum.[150] The proposed amendment, which introduces an immediate tax liability for the option-holder, will likely have the collateral benefit of discouraging excess equity compensation.

The last sentence in amended subsection (a) provides for the adjustment in the year of exercise or disposal of the option. This language is a catch-all safety net, which provides for any other possible scenario in which the option-holder disposes of the option, realizing either a gain or a loss. Although it is still possible to obtain a tax-deferral benefit in case the value of the asset underlying the option increases in value over time, such effect is reduced from the tax deferral resulting from the previous version of the statute.

Subsection (b) has undergone more substantial changes. The subsection heading has been changed to "value of the option" to mirror the language in amended subsection (a). The language of (b)(1) is substantially the same, as it does not affect stock options granted to individual executives. These options, as discussed in the relevant sections above, have certain restrictions on alienability and cannot be publicly traded on an established market.

The language of (b)(2) is radically different. The proposed language now provides an explicit valuation formula in the cases where the option is not publicly traded. The proposed valuation is simply the difference between exercise price and the value of the asset underlying the option. In the case at bar, one share of stock of the corporation, which is granting the option. This formula presents another problem, however, which is the determination of the value of the asset underlying the option. The problem is solved by the immediately subsequent sentence providing for valuation in accordance with 26 C.F.R. Section 20.2031-2.

26 C.F.R. Section 20.2031-2 could potentially be applied to two different scenarios. First, a scenario where the option is not traded on an established market, but the underlying asset is. Second, a scenario where neither the option nor the underlying asset are traded on an established market. If the option is not traded on an established market, but the underlying asset is, the valuation of the option with the proposed formula is

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150 From a cursory review of the literature and quantitative data on the matter, it appears that the CEO's of large U.S. corporations have a compensation package that highly favors equity compensation. Data extrapolated from S.E.C. filings reveal the equity-to-cash ratio for these executives can be anywhere from 2:1 to almost 50:1. *See generally Browse Executive Salaries, Bonuses, Stock Grants, Stock Options and Other Compensation*, SALARY.COM, http://www.salary.com/Executive-Salaries/ (last visited Feb. 21, 2016) (analyzing data from selected S.E.C. filings to graphically represent the compensation breakdown of executives of large publicly traded corporations). The corporations selected by the author were Oracle, Wal-Mart, and Bank of America.

extremely simple. The fair market price of the underlying asset is given by the average of the highest and lowest selling price on the valuation date,[151] and the exercise price of the option is determined by the option contract itself. This scenario is by far the most common because, generally, only larger corporations issue stock options. The corporate entities with the need of employing complex compensation arrangements involving stock options usually meet the capitalization threshold required to be publicly listed on an established market. However, smaller corporations, not publicly listed, may issue stock options; which takes us to the second scenario where neither the option nor the underlying asset are publicly traded.

In this case, 26 C.F.R. Section 20.2031-2 provides a series of acceptable calculation methods, which can be used to estimate the value of the asset in question. If bid and ask prices for the underlying stock are not available, the calculation will be based on a series of factors, which include the net worth of the corporation, its predicted earning power, dividend-paying capacity, and other factors, such as market outlook, etc.[152] It will appear to the reader, at first glance, that these calculation techniques are not exact, but rather aim at providing a best-guess estimate of the value of the stock. The valuation of a company that is not publicly traded is part science and part dogmatic mystery, even for the connoisseurs.[153] Nonetheless, the value of the proposed amendment lies in its inverse proportionality between error and transaction size.

When a corporation begins its activities, it is hardest to value it because there is no historical data to base the predictions on. However, a corporation in its infancy is the least likely to grant stock options to its executives. Even in the extremely unlikely case in which a stock option was granted at this early stage, and the calculations of value of the underlying asset were far from its real value, the overall size of the transaction would probably be negligible. In sum, even if the formula provides for approximate results in small-business type transactions, the error in valuation would have only a minimal impact on the taxpayer. This is because of at least two factors. First, the value of the option is likely to be small. Second, the executives of such a small business are more likely to be in lower tax brackets, thus reducing the effect of tax deferral offered by the

151 26 C.F.R. § 20.2031-2(b)(1) (2016).

152 26 C.F.R. § 20.2031-2(f) (2016).

153 The problem of valuation of not-yet publicly traded corporations is well-known even to large financial conglomerates. As a vivid example of this problem, Facebook's stock valuation was off by almost 30% when compared to the market's actual perception of the value of the stock. Corporate banking giant Morgan Stanley was behind the valuation, and, despite its history and expertise on the matter, it made a multi-billion-dollar mistake in valuation. David Weidner, *Facebook IPO, Facts, Fiction, and Flops*, WALL ST. J. (May 30, 2012, 7:29 PM), http://wsj.com/articles/SB100014240527023 04821304577436873952633672.

stock option. As the corporation grows, so does the historic data on which the value predictions can be made. As the likelihood of granting stock options increases, their value increases, and so does the potential for tax deferral. However, the precision of calculation of the value of the underlying asset also increases, making the model more reliable. As the potential for tax deferral increases, so does the robustness of this valuation model.

Proposed Amendment to I.R.C. Section 83(h).

> (h) Deduction by employer. In the case of a transfer of property to which this section applies or a cancellation of a restriction described in subsection (d), there shall be allowed as a deduction under section 162, to the person for whom were performed the services in connection with which such property was transferred, an amount equal to the amount included under subsection (a), (b), or (d)(2) in the gross income of the person who performed such services. Such deduction shall be allowed for the taxable year of such person in which or with which ends the taxable year in which such amount is included in the gross income of the person who performed such services.
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> **[In the case of a transfer of property governed by 26 C.F.R. § 1.83-7, the employer granting the option shall be allowed a deduction under § 162 in the year when the option is exercised, sold, or disposed of, by the recipient of the option. Such deduction under § 162 shall be equal to the total income realized by the recipient of the option with the exercise, sale, or disposal thereof.]**[154]

Comment to Proposed Amendment to I.R.C. § 83 (h).

The proposed amendment to Section 83 seeks to modify the existing language of the statute to better reflect the changes proposed in the earlier sections. The aim of this amendment is to allow the employer of the recipient of the stock option to make appropriate business expense deductions; both in the year when the option is granted, as well as in the year when the option is exercised by the employee.

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154 I.R.C. § 83(h) (West 2016).

However, this proposed amendment does not fix one of the main problems of stock option deductions; the fact that the corporate entity gets to make a business deduction for a non-cash expense. As mentioned in the earlier sections of the article, this is a sort of a "freebie" to the corporation, which deducts as a business expense something that is not really an expense, but rather only an opportunity cost. However, the deduction of non-cash items is an issue that is somewhat accepted in accounting with Generally Accepted Accounting Principles. Another common example of a non-cash expense that can be deducted under current tax law is depreciation.[155] The I.R.C. even provides for accelerated depreciation schedules, which allow the taxpayer to effectively defer income tax.[156] Interestingly enough, the depreciation schedule provided for by the I.R.C. are so fictional, and so clearly geared towards tax avoidance, that in most cases they have absolutely no reference to the actual useful life of the assets. For example, long-lived assets like heavy-duty oil drilling equipment, or airplanes, have a book life of five years.[157] But, a discussion of non-cash deductions is beyond the scope of this article, and it will not be addressed here.

CONCLUSION

The I.R.C. is an incredibly complex body of law, and the discussion of any tax issue or reform, even if successful, is just a drop in the ocean. However, the ocean is made of little drops of water, and tax reform needs to start somewhere. This article discusses two of the problems affecting corporate taxation in the United States, with a particular focus on excessive corporate tax avoidance.

Corporate tax avoidance is unfair and inequitable under multiple points of view. First, excessive tax avoidance affects the quality of the investments; "poisons" the corporate decision-making process; and biases corporate decisions towards tax-exempt investments, investments abroad, earnings retention, and excessive debt levels. Second, excessive tax avoidance creates differences between similarly-situated taxpayers with different access to the income defense industry. Third, because tax avoidance is more effective as the size of the enterprise increases, it defeats the purpose of a progressive tax system by leaving most of the tax burden on the "middle" earners. Lastly, excessive tax avoidance directly reduces the effectiveness of the tax system, and of the economy at large, because

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155 I.R.C. § 168 (West 2016).

156 *Id.*

157 *Id.*

more resources are allocated towards tax avoidance, and the authorities have a high cost of enforcement to ensure compliance with overly complex regulations.

The article focused on corporations, and on the most common practices of tax-avoidance employed by corporate giants like Apple, Inc. and Yahoo!, transfer pricing and stock option deductions. Transfer pricing is a three-headed beast. It is generally employed as a base-erosion and profit shifting mechanism using goods, I.P., or capital. The article discussed possible solutions to the problem of transfer pricing, and suggested international regulation that addresses the principle of arm's-length dealing. However, transfer pricing is the result of different tax regimes in the different countries of the world, the direct and inevitable result of sovereignty. While detailed accounting may make it more difficult for a corporation to deliberately engage in transfer pricing, heightened reporting requirements alone are not likely to resolve the problem. Although utopian, the true solution to transfer pricing is the complete harmonization of the tax systems of the world. Until that day, the only real solution for the U.S. economy is becoming a more competitive tax jurisdiction in a global market arena where tax-havens and black-listed nations provide an overly friendly environment to tax-avoiding MNEs.

On the other hand, stock option deductions are a tax-deferral instrument created by a loophole in the legislation. A nonqualified stock option allows the individual to book substantial savings on tax deferral, and it allows the corporation to deduct a non-cash expense similar to depreciation. This article seeks to close this tax loophole by applying known doctrines of judicial interpretation, as well as proposing amended statutory language. The aim of this article is to strike a balance and treat nonqualified stock options like other regular cash compensation in order to eliminate the benefits the stock options confer to the holder through tax deferral. This article is far from being the definitive panacea to the ailments of the U.S. tax system. However, this article does illustrate how relatively small changes to the wording of relevant I.R.C. and C.F.R. provisions can, consistently with legal precedent, resolve or mitigate the problem of excessive tax avoidance.