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Sloan G. Speck

University of Colorado Law School

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THE SOCIAL BOUNDARIES OF CORPORATE TAXATION

*Sloan G. Speck**

INTRODUCTION

The United States employs a classical system of corporate taxation in which income earned through certain domestic business entities—"corporations" for tax purposes—is subject to taxation once at the entity level and again when distributed to the entity's owners. By contrast, income earned through other business entities—"conduits" for tax purposes—is taxable directly to the entity's owners and not taxable at the entity level.[1] The differential treatment of corporations and conduits places tremendous pressure on how corporations are defined under the Internal Revenue Code[2] ("the Code"). Not surprisingly, taxpayers and their advisors generally have taken an instrumental approach to the corporate/conduit distinction under the Code, seeking their preferred tax status while limiting adverse nontax consequences.[3]

Historically, the tax law distinction between corporate and conduit treatment drew primarily on doctrinal understandings, treating state-law

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1. *See, e.g.*, Michael J. Graetz & Alvin C. Warren, Jr., *Integration of Corporate and Individual Income Taxes: An Introduction*, 84 TAX NOTES 1767, 1767–68 (1999). Not all corporate income faces two distinct levels of tax; for example, corporate income paid to tax-exempt debtholders faces tax neither at the entity level nor when paid. *Id.* at 1768. In addition, entity-level taxes may function as withholding or anti-deferral mechanisms with respect to shareholders, rather than distinct levies. *See* STEVEN A. BANK, FROM SWORD TO SHIELD: THE TRANSFORMATION OF THE CORPORATE INCOME TAX, 1861 TO PRESENT 83–84 (2010) (describing the corporate tax between 1913 and World War I as "a complementary, rather than separate, tax"). Finally, neither corporate nor conduit treatment is systematically favored, and taxpayers may prefer different classifications depending on their specific circumstances. *See* BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 2.01[2], Westlaw (database updated May 2015). These qualifications do not detract from—and perhaps increase—the pressure on distinguishing corporations and conduits.

2. The basic statutory definitions are contained in I.R.C. § 7701(a)(1)–(3) (2012). A significant body of law—statutory, administrative, and judicial—elaborates these categories.

3. *See* 1 WILLIAM S. MCKEE ET AL., FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS ¶ 3.06[1], Westlaw (database updated May 2015).

corporations as corporate for tax purposes and classifying unincorporated legal entities based on their resemblance to conventional state-law corporations. More recently, commentators and the U.S. Department of Treasury ("Treasury") have abandoned these doctrinal touchstones in favor of efficiency, broadly construed, as the guiding principle in determining an entity's tax classification.[4] In part, this shift reflects conventional critiques of classical corporate taxation, which focus on the ways in which entity-level taxes burden taxpayers' choices, including the choice of entity under state corporate law, beyond the labor/leisure and saving/spending tradeoffs that underlie income taxation. Alleviating the tax system's pressure on these choices advances efficiency, the argument goes.[5] More broadly, this shift in perspectives on corporate tax classification mirrors a larger turn in academic and policy circles, rooted in the 1970s, toward efficiency as a controlling metric for evaluating legal rules.[6]

This Article argues that, while important, efficiency considerations should not function as the sole arbiter of the boundary between corporate and conduit tax treatment. First, classical corporate taxation is, in many ways, deeply embedded within a larger network of legal and social meanings.[7] Classical corporate taxation operates in concert with, rather than separately from, these legal and social meanings. For this reason, the rules governing entities' tax classification should take these interrelationships into account, if not as a primary norm, then as a secondary consideration when empirical or other uncertainties preclude a clear choice based on efficiency.[8] The social boundaries of corporate taxation refer to the extent to which these types of nontax considerations implicate the Code's structural distinction between corporations and conduits.[9] Second, efficiency is often conceptually tractable as a metric, but this intuitive appeal can mask significant empirical uncertainties about

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4. *See* David A. Weisbach, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, 84 CORNELL L. REV. 1627, 1627–28 (1999).

5. *See* DANIEL N. SHAVIRO, DECODING THE U.S. CORPORATE TAX 27–28 (2009). In a world that recognizes legal entities, some of these efficiency costs may be unavoidable. *See* David A. Weisbach, *The Irreducible Complexity of Firm-Level Income Taxes: Theory and Doctrine in the Corporate Tax*, 60 TAX L. REV. 215, 224–29 (2007).

6. *See* Boris I. Bittker, *Equity, Efficiency, and Income Tax Theory: Do Misallocations Drive Out Inequities?*, 16 SAN DIEGO L. REV. 735, 736–37 (1979).

7. The legal and social implications of taxation have long been acknowledged. *See, e.g.*, THOMAS PIKETTY, CAPITAL IN THE TWENTY-FIRST CENTURY 520 (Arthur Goldhammer trans., 2014) ("[A] tax is always more than just a tax: it is also a way of defining norms and categories and imposing a legal framework on economic activity.").

8. More typical are claims that tax law should operate independently from other areas of law. *See, e.g.*, Mitchell A. Kane & Edward B. Rock, *Corporate Taxation and International Charter Competition*, 106 MICH. L. REV. 1229, 1251–52 (2008) (arguing that tax and corporate law should be severed with respect to entities' country of residence).

9. Weisbach acknowledges that policymakers may consider "goals other than efficiency" in line drawing where the relevant law "attempts to change preferences." *See* Weisbach, *supra* note 4, at 1676 & n.177 (giving as examples the restrictions on the deductibility of bribes and lobbying expenses, as well as the disparate tax consequences for married and unmarried couples). Weisbach does not, however, contemplate that such other goals are relevant to structural aspects of the Code such as the corporate/conduit distinction.

behavioral responses, especially if policymakers possess limited information, have difficulty reversing inapposite decisions, or face other constraints.[10] In these situations, policymakers should take cues from the broader legal and social context in which tax law operates. Finally, by claiming that corporate tax law is situated in broader legal and social contexts, this Article does not attempt to validate or valorize the independent merit of these other contexts. Instead, this Article advocates consistency across policy areas—"fit" within the broader legal and social framework—rather than particular policy prescriptions.[11]

This Article proceeds in three parts. Part I discusses the evolution of the basic rules governing corporate tax classification and the turn from doctrine to efficiency in the evaluation of these rules. Part II brings historical understandings of corporations in the United States into conversation with current debates about corporate personhood and social responsibility. Part III examines the boundaries of corporate tax classification through three vignettes that explore special tax categories that complicate the corporate/conduit distinction, namely small business corporations ("S corporations"), real estate investment trusts (REITs), and domestic corporations that have engaged in inversion transactions to shift their corporate residence to a non-U.S. jurisdiction.

I. EFFICIENCY AND CORPORATE TAX CLASSIFICATION

The classification of legal entities for tax purposes presents a paradigmatic line-drawing problem, one intrinsic to the structural choice to impose a classical corporate tax. Under the reasonable assumption that fundamental reform is impossible or unavailable to the policymakers charged with drafting the legal rule,[12] the task is clear: the rule must

10. *See* Bittker, *supra* note 6, at 746–48; *see also* Herwig J. Schlunk, *Little Boxes: Can Optimal Commodity Tax Methodology Save the Debt-Equity Distinction?*, 80 TEX. L. REV. 859, 860–61 (2002) (outlining certain problems with applying "optimal commodity tax methodology" to income taxation); Weisbach, *supra* note 4, at 1666–71 (discussing informational and computational issues with determining the ex ante efficiency effects of line drawing).

11. *See* Steven A. Bank, *A Capital Lock-In Theory of the Corporate Income Tax*, 94 GEO. L.J. 889, 946–47 (2006) (describing corporate taxation as a "pragmatic compromise" that is not necessarily "the best or only means" to resolve the issue); *cf.* RONALD DWORKIN, LAW'S EMPIRE (1986) (arguing that interpretations of legal rules must both "fit" and "justify" a legitimate objective).

12. *See* David A. Weisbach, *Thinking Outside the Little Boxes: A Response to Professor Schlunk*, 80 TEX. L. REV. 893, 895–97 (2002). Congress generally has relied on Treasury and courts to give content to the statutory delineation between corporations and conduits. *See* BITTKER & EUSTICE, *supra* note 1, ¶ 2.01[3]; *see also* Yehonatan Givati, *Walking a Fine Line: A Theory of Line Drawing in Tax Law*, 34 VA. TAX REV. 469, 474–75 (2015) (describing how Treasury should choose among instruments for line drawing). Fundamental reform to eliminate the corporate/conduit distinction would face significant political hurdles in Congress. *See* Heather M. Field, *Checking in on "Check-the-Box"*, 42 LOY. L.A. L. REV. 451, 521–22 (2009) (arguing that, in the late 1990s, administrative rulemaking may have alleviated any pressure Congress felt to enact more sweeping corporate tax reforms); *see also* Schlunk, *supra* note 10, at 861–62 (advocating fundamental reform as a solution to line-drawing questions in the distinction between corporate debt and equity). While Treasury and

categorize each relevant legal entity as either a corporation or a conduit for tax purposes.[13] The collective pool of legal entities, however, is diverse and relatively continuous in its economic and legal characteristics. These entities vary in, among other things, their ownership, management, capital structure, and the transferability of their interests; their name, the powers they possess under their charter and the law of the jurisdiction of their organization, and the activities they actually conduct; and any limitations on liability for owners or fiduciary duties imposed on managers.[14] Policymakers must denote certain of these characteristics as legally salient in order to parse these entities as either corporations or conduits for tax purposes.

Changes in law, financial markets, and business practices have complicated, and likely will continue to complicate, the calculus for determining corporate classification under the Code. For example, the advent of limited liability companies (LLCs) in the late 1970s, and their widespread adoption by the mid-1990s, gave businesses an alternative to state incorporation laws that preserved limited liability protections for all owners while allowing significant flexibility in governance and ownership structures.[15] By the mid-2000s, this flexibility had been enhanced by a number of public and private legal innovations, including state statutes enabling "series" LLCs and automatic conversions among various entity types.[16] Series LLCs allow a single legal entity to designate multiple series that are treated as separate and distinct from each other for liability purposes.[17] State-law conversion statutes permit entities to change their type by filing a short certificate, enabling, for example, an LLC to convert to a corporation, or vice versa.[18] Both of these innovations challenge conventional understandings of entities as having discrete, durable legal personhood, and in each of these cases, Treasury issued guidance that was relatively favorable to taxpayers by permitting LLCs to elect either corporate or conduit treatment,[19] treating each series in a series LLC as a

courts generally lack the power to engage in fundamental reform, the congressional political process also substantially limits the practical availability of such reform through the legislative process. *See, e.g.*, Jeffrey H. Birnbaum, *Showdown at Gucci Gulch*, 40 NAT'L TAX J. 357 (1987) (describing the idiosyncratic politics that resulted in the Tax Reform Act of 1986). Even at the congressional level, policymakers face line-drawing problems much more frequently than fundamental reform.

13. As discussed *infra* Part III.A and III.B, tax conduits are subject to several different tax regimes.

14. *See, e.g.*, BANK, *supra* note 1, at xi; LARRY E. RIBSTEIN, THE RISE OF THE UNCORPORATION 67–75 (2010).

15. *See* RIBSTEIN, *supra* note 14, at 119–23.

16. *See id.* at 146–47.

17. *See* DEL. CODE ANN. tit. 6, § 18-215(a)–(b) (2016). The extent to which liabilities are "siloed" has not been tested extensively at state law. *See* RIBSTEIN, *supra* note 14, at 146–47.

18. *See, e.g.*, DEL. CODE ANN. tit. 6, § 18-214(a)–(b) (allowing conversions to Delaware LLCs).

19. *See* Rev. Rul. 88-76, 1988-2 C.B. 360; I.R.S. Priv. Ltr. Rul. 81-06-082 (Nov. 18, 1980). For more detail, see Field, *supra* note 12, at 460–63.

separate entity for tax purposes,[20] and allowing state-law conversions to qualify for tax-free treatment under conventional tax rules.[21] Finally, globalization has increased dramatically the number and variety of entities whose tax classifications are relevant for U.S. tax purposes; domestic and foreign multinationals may own subsidiary entities both inside and outside the United States.[22] Again, this change amplifies the number of variables in play when drawing lines between corporations and conduits in the tax system.

Before 1997, Treasury employed an approach to line drawing that looked to doctrinal distinctions drawn from state corporate law. For entities incorporated under state law, this fact was dispositive; such entities were treated as corporations for tax purposes.[23] In addition, after 1986, most entities listed on a public stock exchange were taxable as corporations.[24] By contrast, Treasury regulations classified unincorporated entities based on their resemblance to a "pure corporation," as measured by six "major characteristics." Drawn from *Morrissey v. Commissioner*,[25] these characteristics included the existence of "associates" (roughly, joint owners), the presence of an entity-level business objective, continuity of life, centralization of management, limited liability, and free transferability of ownership interests.[26] Because all business entities had associates and an entity-level business objective, the regulations deemed an unincorporated entity a corporation for tax purposes if it possessed at least three of the remaining four characteristics.[27]

Ultimately, Treasury's doctrinal approach to line drawing failed to delineate corporations from conduits in a meaningful way. Sophisticated taxpayers, in consultation with their advisors and in reliance on legal opinions, could manipulate the *Morrissey* factors to achieve their preferred tax classification with limited changes to the underlying economic

20. *See* I.R.S. Priv. Ltr. Rul. 2008-03-004 (Jan. 18, 2008).

21. *See* Treas. Reg. § 301.7701-3 (as amended in 2006); *see also* I.R.S. Priv. Ltr. Rul. 2005-48-021 (Dec. 2, 2005); I.R.S. Priv. Ltr. Rul. 2005-28-021 (July 15, 2005). Furthermore, these changes occurred alongside an expansion in the use of other conduits, such as S corporations. *See infra* Part III.A.

22. *See* BANK, *supra* note 1, at 261–64. In addition, that entities can be relevant in more than one jurisdiction creates difficult-to-police arbitrage opportunities. *See generally* Gregg D. Lemein & John D. McDonald, *Final Code Sec. 894 Regulations: Treaty Benefits for Hybrid Entity Payments*, TAXES, Sept. 2000, at 5, 5–6 (hybrid entities); Gregg D. Lemein & John D. McDonald, *Proposed Regulations Regarding Domestic Reverse Hybrid Entities*, TAXES, May 2001, at 5, 7–8 (reverse hybrid entities).

23. *See* BITTKER & EUSTICE, *supra* note 1, ¶ 2.02[1] (discussing Morrissey v. Commissioner, 296 U.S. 344 (1935)).

24. *See* I.R.C. § 7704 (2012).

25. 296 U.S. 344 (1935).

26. Treas. Reg. § 301.7701-2(a)(1) (1960) (revised 1997). The regulations were issued in 1960 in response to the Internal Revenue Service's loss in *United States v. Kintner*, 216 F.2d 418 (9th Cir. 1954), and typically are referred to as the "*Kintner* regulations."

27. Treas. Reg. § 301.7701-2(a)(2)–(3) (1960).

arrangement.[28] By the mid-1990s, Treasury acknowledged that the regulations' "formalistic rules" allowed taxpayers to "achieve partnership [that is, conduit] tax classification for a nonpublicly traded organization that, in all meaningful respects, [was] virtually indistinguishable from a [state-law] corporation."[29] For unincorporated entities, the choice between corporate taxation and conduit taxation had become "effectively elective."[30]

In late 1996, Treasury promulgated the "check-the-box" regulations, which replaced the effectively elective *Morrissey* factors with a regime that was explicitly elective with respect to unincorporated entities whose interests were not readily tradable (so-called "eligible entities").[31] By contrast, state-law corporations and similar enumerated entities ("per se corporations"), as well as most publicly traded entities, could not choose to be taxable as conduits.[32] In addition, the check-the-box regulations included complex default rules that Treasury claimed "generally would match taxpayers' expectations."[33] The check-the-box regulations were well received by taxpayers and their advisors, and Treasury trumpeted its approach as "much simpler" to implement by both public and private actors.[34]

Subsequent commentators have addressed the effectiveness of the check-the-box regulations by focusing on efficiency considerations, broadly construed.[35] For this Article, the core efficiency consideration is deadweight loss, which describes the costs associated with private actors' behavioral changes in response to a tax. These behavioral changes include the substitution of less-taxed activities for more-taxed (but otherwise preferred) activities, as well as the private costs of tax avoidance and evasion—that is, the costs to engage in preferred (but otherwise taxed) activities without paying the applicable tax.[36] Efficiency considerations also include public administrative costs, private compliance costs with regard to reporting, and simplicity (which presumably lowers both public

28. *See* I.R.S. Notice 95-14, 1995-1 C.B. 297 (noting that, under the pre-1997 regime, "small unincorporated organizations may not have sufficient resources and expertise to apply the current classification regulations to achieve the tax classification they desire").

29. Prop. Treas. Reg. § 301.7701-1 to -3, 61 Fed. Reg. 21,989, 21,990 (May 13, 1996).

30. *See* SHAVIRO, *supra* note 5, at 27–28, 52–54.

31. *See* Treas. Reg. § 301.7701-3 (as amended in 2006).

32. *See* I.R.C. § 7704 (2012); Treas. Reg. § 301.7701-2 (as amended in 2014).

33. T.D. 8697, 1997-1 C.B. 215, 218.

34. *Id.* at 216; *see also* I.R.S. Notice 95-14, 1995-1 C.B. 297.

35. *See* Joel Slemrod & Schlomo Yitzhaki, *Tax Avoidance, Evasion, and Administration*, *in* 3 HANDBOOK OF PUBLIC ECONOMICS 1423, 1447 (Alan J. Auerbach & Martin Feldstein eds., 2002) (adopting "a broader concept of efficiency cost").

36. One could exclude transfers among private actors, such as payments to lawyers and accountants, from the category of deadweight loss because such transfers do not involve real resource costs. *See* Raj Chetty, *Is the Taxable Income Elasticity Sufficient to Calculate Deadweight Loss?: The Implications of Evasion and Avoidance*, 1 AM. ECON. J.: ECON. POL'Y 31, 32 (2009).

and private administrative costs).[37] The common thread in these efficiency considerations is that they constitute the aggregate social cost of taxation.

Shortly after Treasury finalized the check-the-box regulations, David Weisbach argued in favor of the type of reform that these regulations represented. By "drop[ping] traditional doctrinal concerns and instead focus[ing] on efficiency," bad taxes could be replaced with better ones, and any revenue loss or distributional effects could be remediated through changes to the rate structure or transfer system.[38] Treasury could maximize efficiency by drawing the line between corporations and pass-through entities to treat close economic substitutes the same while keeping tax rates low for items with ready substitutes.[39] In Weisbach's analysis, the check-the-box regulations accomplished this by classifying publicly traded entities as corporations for tax purposes and allowing all other entities to migrate to a pass-through regime.[40] Although this statement is largely true, taxpayers use entities classified as corporations for tax purposes in a variety of well-established situations outside of public markets, including in certain small business arrangements and as leveraged blockers for investments in U.S. real property by non-U.S. persons.[41] In addition, the category of publicly traded entities requires regulators to draw a second line, with the consequence that some entities with highly liquid interests will fall outside the corporate tax base and into the elective regime.[42] For these reasons, the line drawn by the check-the-box regulations is not entirely coextensive with the efficient line Weisbach postulated.

Although subsequent commentators have taken a less-rosy view of the check-the-box regulations, their critiques also focus on efficiency considerations. Steven Dean, for example, argues that the simplicity-related

37. *See* Joel Slemrod & Shlomo Yitzhaki, *The Costs of Taxation and the Marginal Efficiency Cost of Funds*, 43 IMF STAFF PAPERS 172, 173, 179–82 (1996) (including all of these social costs when calculating the marginal efficiency cost of funds). For more on social costs and efficiency considerations, see Leigh Osofsky, *Who's Naughty and Who's Nice?: Frictions, Screening, and Tax Law Design*, 61 BUFF. L. REV. 1057, 1063 nn.15–16 (2013).

38. Weisbach, *supra* note 4, at 1628–31 ("[W]hat is important about the check-the-box regulations is that they drop traditional doctrinal concerns and instead focus on efficiency."). Weisbach also raises "traditional tax policy concerns," such as conformity to the Haig-Simons definition of economic income, as a possible (but flawed) basis for distinguishing corporate and noncorporate entities for tax purposes. *Id.*

39. *See id.* at 1663–64 (discussing "substitution costs" and "direct costs" and applying both concepts to entity classification).

40. *Id.* at 1628–31; *see also* David A. Weisbach, *An Efficiency Analysis of Line Drawing in the Tax Law*, 29 J. LEGAL. STUD. 71, 71–73 (2000).

41. *See* COOLEY LLP & PROBITAS PARTNERS, U.S. REAL ESTATE FUNDS AND FIRPTA: STRUCTURES TO MAXIMIZE NET RETURNS TO NON-U.S. INVESTORS 3–4, 5–7 (2014), https://www.cooley.com/files/probitas_partners_cooley_FIRPTA_2014.pdf [http://perma.cc/5UZE-MXVN]; Barbara Weltman, *5 Reasons to Be a C Corporation*, U.S. SMALL BUS. ADMIN. (May 23, 2012), https://www.sba.gov/blogs/5-reasons-be-c-corporation [http://perma.cc/2CVX-W9PU].

42. *See* Lee A. Sheppard, *What Is Public Trading?*, 67 TAX NOTES 443, 443 (1995) (describing the definition of "publicly traded" as "a new front in the entity classification wars").

benefits promised by Treasury in the 1990s never materialized. Instead, the check-the-box regulations "deliver[ed] pro-taxpayer deregulation that [caused] more of society's resources to be devoted to paying, minimizing, and collecting taxes"—all social costs that implicate efficiency considerations.[43] Similarly, Heather Field argues that, although the check-the-box regulations simplified the law in some respects, eased certain administrative and compliance burdens, and promoted neutrality with respect to choice-of-entity considerations, the regulations also introduced new areas of complexity and transaction costs.[44] Significantly, the check-the-box regulations facilitated increased planning and avoidance efforts by taxpayers, often to achieve tax effects not related directly to the corporate/conduit distinction.[45] Field concludes that the check-the-box regulations "represent an improvement over the [prior] regulations" but "are far from a panacea."[46] The common thread for Weisbach, Dean, and Field is that efficiency considerations drive the analysis and evaluation of entity classification schemes under the Code.

II. THEORIZING CORPORATIONS

In evaluating the rules for classifying entities for tax purposes, an orientation toward efficiency considerations obscures the broader legal and social implications of the choice of whether to subject a business entity to corporate taxation. Such an orientation treats the tax system as separate from other legal regimes governing entities' existence and activities, such as state corporate law, and as distinct from broader understandings about the role of business in society. This part first develops connections between tax and nontax understandings of corporations, then addresses two potential objections to deploying these understandings in tax policy.

A. Corporate Identity

Corporate law scholars have identified three principal theories of corporate identity, which over time have exchanged positions of prominence in academic, legal, and popular understandings of corporations.[47] First, the "artificial entity" theory holds that corporations,

43. *See* Steven A. Dean, *Attractive Complexity: Tax Deregulation, the Check-the-Box Election, and the Future of Tax Simplification*, 34 HOFSTRA L. REV. 405, 466–67 (2005) [hereinafter Dean, *Attractive Complexity*]; *see also* Steven A. Dean, *Tax Deregulation*, 86 N.Y.U. L. REV. 387, 390 (2011).

44. *See* Field, *supra* note 12, at 471–78, 490.

45. *See id.* at 486–87.

46. *See id.* at 522. One way of reading Field's argument is that the check-the-box regulations radically democratized the entity classification process, removing certain aspects of tax planning from social norms that previously constrained abuses. *See generally* TANINA ROSTAIN & MILTON C. REGAN, JR., CONFIDENCE GAMES: LAWYERS, ACCOUNTANTS, AND THE TAX SHELTER INDUSTRY (2014).

47. *See generally* Reuven S. Avi-Yonah, *The Cyclical Transformations of the Corporate Form: A Historical Perspective on Corporate Social Responsibility*, 30 DEL. J. CORP. L. 767, 772–813 (2005); Virginia Harper Ho, *Theories of Corporate Groups: Corporate Identity Reconceived*, 42 SETON HALL L. REV. 879, 891–97 (2012); Martin Petrin,

as creatures of the state, are subject to unlimited regulation by the state, including through taxation. Second, the "aggregate" theory views corporations as agglomerations of their owners or other stakeholders. In the 1970s, the law and economics movement drew on the aggregate theory to describe the corporation as a "nexus of contracts" that coordinates production using many independent actors. Similarly, the "lock-in" theory of corporate identity, developed in the 2000s, contends that corporations' distinguishing feature is their ability to credibly commit their owners' capital to long-term investments without claim by those owners.[48] Finally, the "real entity" theory treats corporations as distinct legal persons with specific rights and obligations not linked to those of their owners. Although each of these theories explains some aspects of corporate law, the aggregate and real entity theories have the most legal and social salience today.[49]

To some extent, these theories of corporate identity simply fail to map onto tax scholarship, and tax scholars often argue that these theories provide limited normative justification for the corporate tax. For example, Reuven Avi-Yonah claims that none of the artificial entity, aggregate, or real entity theories provides a clean justification for the corporate tax.[50] More generally, tax scholars describe popular understandings that corporations or other business entities bear the burden of, or ultimately pay, the corporate tax as a "fiscal illusion."[51] Instead, natural persons bear the burden of corporate taxes, and although some consensus exists that labor and holders of capital share this burden at equilibrium, the precise proportions of this allocation engender significant disagreement.[52] For tax scholars, corporations resemble neither "real" entities nor aggregates of their direct constituents, and the true measure of the corporate tax (and nearly all tax scholars take a dim view) requires understanding both its incidence and efficiency costs.[53] Corporate law and tax scholars diverge

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48. *See* Lynn A. Stout, *On the Nature of Corporations*, 2005 U. ILL. L. REV. 253, 254–55; *see also* Bank, *supra* note 11, at 892.

49. *See* Michael J. Phillips, *Reappraising the Real Entity Theory of the Corporation*, 21 FLA. ST. U. L. REV. 1061, 1061–63 (1994).

50. *See* Reuven S. Avi-Yonah, *Corporations, Society, and the State: A Defense of the Corporate Tax*, 90 VA. L. REV. 1193, 1197–212 (2004); *see also* Jennifer Arlen & Deborah M. Weiss, *A Political Theory of Corporate Taxation*, 105 YALE L.J. 325, 331–32 (1995) (discussing "populist" explanations of the durability of corporate taxation in the United States).

51. *See* Avi-Yonah, *supra* note 50, at 1208–11.

52. *See* SHAVIRO, *supra* note 5, at 61–62, 67–70 (discussing the "New Harberger" model). Economists have done general equilibrium modeling and empirical work on corporate tax incidence, and estimates of incidence vary significantly under both approaches. *See* WILLIAM M. GENTRY, OFFICE OF TAX ANALYSIS PAPER 101, A REVIEW OF THE EVIDENCE ON THE INCIDENCE OF THE CORPORATE INCOME TAX 4–6 (2007), https://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/ota101.pdf (analyzing the empirical data) [http://perma.cc/UKB7-DNQQ]; Jennifer Gravelle, *Corporate Tax Incidence: Review of General Equilibrium Estimates and Analysis*, 66 NAT'L TAX J. 185, 204–05, 211 (2013).

53. *See* Bank, *supra* note 11, at 896–97.

fundamentally in how they debate the role of legal entities, and especially corporations, in their respective fields.

The artificial entity, aggregate, and real entity theories of corporate identity matter, however, in the sense that they have positive, and potentially normative, value in state corporate and entity law. In turn, this state law has significant historical linkages to the design of the corporate tax. For example, Steven Bank argues that, in the early twentieth century, the managers of state-law corporations accepted entity-level taxation as a price to maintain corporations' ability to retain earnings and credibly commit capital, consistent with the lock-in theory of corporate identity.[54] Although Bank acknowledges the (efficiency) costs of such a compromise (and is agnostic about the (efficiency) value of lock-in for corporate law purposes), his analysis illustrates that choices about the scope of corporate taxation can interact, positively or negatively, with core principles in corporate law.[55] These interactions indicate that an approach to entity classification based exclusively on line drawing and efficiency considerations may fail to account for the broader legal context in which corporate taxation operates.

B. Corporate Personhood and Social Responsibility

Not only is corporate taxation enmeshed with state laws governing corporations and other entities, but it also is situated within broader social understandings of corporate personhood, rights, and responsibilities. In the tax academic literature, these social understandings suffer because they tend to be diffuse, perhaps intrinsically so, and often stand at odds with a rational, economically informed perspective on public policy.[56] The recent renaissance in judicial, academic, and popular engagement with the nature of corporate personality indicates, however, that these social understandings should not be dismissed as irrelevant to tax law and policy.[57]

At the heart of this recent renaissance lie two well-known Supreme Court decisions—*Citizens United v. FEC*[58] and *Burwell v. Hobby Lobby Stores,*

54. *See id.* at 917–31; *see also* Arlen & Weiss, *supra* note 50, at 348–62 (discussing the "retained earnings trap").

55. *See* Bank, *supra* note 11, at 947.

56. *See, e.g.*, Daniel Shaviro, *Beyond Public Choice and Public Interest: A Study of the Legislative Process As Illustrated by Tax Legislation in the 1980s*, 139 U. PA. L. REV. 1, 57–61 (1990) (arguing that, in terms of public opinion, "[r]ational ignorance is mixed with just plain ignorance").

57. *See, e.g.*, Richard Briffault, *Nonprofits and Disclosure in the Wake of* Citizens United, 10 ELECTION L.J. 337, 337 (2011) ("Few campaign finance cases have drawn more public attention than [*Citizens United*]."); Paul Horwitz, *The* Hobby Lobby *Moment*, 128 HARV. L. REV. 154, 154–57 (2014) (describing public opinions about *Hobby Lobby* as "divided" and "inflamed"); Stefan J. Padfield, *The Silent Role of Corporate Theory in the Supreme Court's Campaign Finance Cases*, 15 U. PA. J. CONST. L. 831, 863 (2013) ("Much of the public backlash against *Citizens United* can be seen as a populist rejection of the idea that corporations are merely associations of citizens.").

58. 558 U.S. 310 (2010).

Inc.[59]—both of which implicate policy choices about which types of entities should be subject to corporate taxation. *Citizens United* invalidated portions of the McCain-Feingold Act, as well as certain state laws, that restricted corporate spending on "electioneering communications" in advance of elections.[60] Citizens United, a not-for-profit state-law corporation, paid for advertising and distribution of a film criticizing Hillary Clinton, who was running for the Democratic presidential nomination in 2008.[61] The Court held that, while such spending violated the McCain-Feingold Act, the Act itself contravened Citizens United's First Amendment rights to free speech.[62]

Although Citizens United's tax-exempt status did not figure prominently into the Court's opinion, taxation proved critical to the decision's subsequent effects.[63] Citizens United was exempt from tax under section 501(c)(4) of the Code,[64] one of several provisions under section 501(c) that exempt entities from corporate taxation based on their organization and purposes.[65] In the wake of *Citizens United*, contributions to section 501(c)(4)-qualified groups increased dramatically.[66] The decision had the effect of linking tax status to a mode of political expression, both under the law and in the popular imagination. In addition, an internal Treasury review confirmed congressional suspicions that, after *Citizens United*, the Internal Revenue Service (IRS) had applied additional scrutiny to certain conservative groups, among others, applying for tax-exempt status under section 501(c)(4).[67] Following these revelations, some viewed the tax system as a partisan mechanism for contesting the Court's extension of First Amendment rights to state-law corporations.[68] In these ways, *Citizens*

59. 134 S. Ct. 2751 (2014).

60. *Citizens United*, 558 U.S. 310 *passim*. Justice Kennedy wrote for a divided Court.

61. *Id.* at 319–20, 404–05.

62. *Id.* at 371–72.

63. Theories of corporate identity, however, played a role in the opinions, although scholars debate the nature of that role. *See* Reuven S. Avi-Yonah, Citizens United *and the Corporate Form*, 2010 WIS. L. REV. 999, 1033; Alan Meese & Nathan B. Oman, Hobby Lobby, *Corporate Law, and the Theory of the Firm: Why For-Profit Corporations Are RFRA Persons*, 127 HARV. L. REV. F. 273, 280–81 (2014); Padfield, *supra* note 57, at 843–48; David G. Yosifon, *The Public Choice Problem in Corporate Law: Corporate Social Responsibility After* Citizens United, 89 N.C. L. REV. 1197, 1217–18 (2011). For a brief overview of historical understandings of corporate rights and identity, see Naomi Lamoreaux & William Novak, *Getting the History Right: Tracking the Real History of Corporate Rights in American Constitutional Thought*, SLATE (Mar. 24, 2014), http://www.slate.com/articles/news_and_politics/jurisprudence/2014/03/hobby_lobby_and_corporate_personhood_here_s_the_real_history_of_corporate.html [http://perma.cc/9NVV-R2CW].

64. *Citizens United*, 558 U.S. at 404.

65. *See* I.R.C. § 501(c) (2012).

66. *See* Briffault, *supra* note 57, at 337–38.

67. *See* TREAS. INSPECTOR GEN. FOR TAX ADMIN., INAPPROPRIATE CRITERIA WERE USED TO IDENTIFY TAX-EXEMPT APPLICATIONS FOR REVIEW 5–6 (2013), https://www.treasury.gov/tigta/auditreports/2013reports/201310053fr.pdf [http://perma.cc/P3WE-RQ4S].

68. For an overview of these events, see Frances R. Hill, Citizens United *and Social Welfare Organizations: The Tangled Relationships Among Guidance, Compliance, and Enforcement*, 43 STETSON L. REV. 539, 539–42 (2014).

United highlights how tax law interplays with nontax questions about the social role of corporate actors.

The Court's decision in *Hobby Lobby* also had significant connections to taxation. At stake were certain provisions of the Affordable Care Act of 2010 that required employers either to provide health care coverage to employees that included costless access to contraceptives or to pay a nondeductible "penalty" administered through the Code.[69] The two employers before the Court were corporations, each substantially owned by a single family who objected, based on religious beliefs, to providing access to contraceptives.[70] Both employers also qualified as S corporations under the Code, a conduit tax status available to certain closely held corporations.[71] Justice Alito, writing for the majority, held for these employers, finding that the contraceptive mandate violated the Religious Freedom Restoration Act of 1993. Material to Justice Alito's opinion was the fact that the actions of these employers substantially aligned with the beliefs of their owners.[72] Indeed, this alignment of interests extends to taxation, where the nondeductible penalty directly affected these owners' tax liabilities.[73] Like *Citizens United*, *Hobby Lobby* illustrates how tax and substantive corporate powers are intertwined.

Citizens United and *Hobby Lobby* address the rights of corporations; the obverse of these holdings involves understandings of corporations' social responsibilities. After (and notwithstanding) Milton Friedman's famous admonition that corporate managers have no duty other than to generate profits for their shareholders,[74] ideas of corporate social responsibility have become prominent in business, academic, and popular discourses.[75] Indeed, in *Hobby Lobby*, Justice Alito noted that "modern corporate law does not require for-profit corporations to pursue profit at the expense of everything else, and many do not do so."[76] Writing in the wake of the social movements of the 1950s and 1960s, Friedman explicitly juxtaposed managerial spending on social causes with taxation, arguing that such

69. Burwell v. Hobby Lobby Stores, Inc., 134 S. Ct. 2751, 2762 (2014).

70. *Id.* at 2763–67.

71. *See* I.R.C. §§ 1363(a), 1366(a) (2012).

72. *Hobby Lobby*, 134 S. Ct. at 2774–75, 2785. For more discussion, see Brandon L. Garrett, *The Constitutional Standing of Corporations*, 163 U. PA. L. REV. 95, 145–46 (2014).

73. *See, e.g.*, Steven J. Willis, *Corporations, Taxes, and Religion: The* Hobby Lobby *and* Conestoga *Contraceptive Cases*, 65 S.C. L. REV. 1, 72–73 (2013).

74. *See generally* Milton Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, N.Y. TIMES MAG., Sept. 13, 1970, at 32.

75. Although the relationship between business and society has changed over time, the postwar period ushered a new focus on the responsibilities of business to other stakeholders. *See, e.g.*, ELIZABETH A. FONES-WOLF, SELLING FREE ENTERPRISE: THE BUSINESS ASSAULT ON LABOR AND LIBERALISM, 1945–60, at 5 (1994) ("[C]orporate leaders constructed and sold a specific vision of the reciprocal relationship of businesses and citizens that stressed mutual rights and responsibilities."). Friedman wrote in the context of this new focus.

76. *Hobby Lobby*, 134 S. Ct. at 2771. For a discussion of how theories of corporate identity inform debates about corporate social responsibility, see Petrin, *supra* note 47, at 22–26; Michael J. Philips, *Corporate Moral Personhood and Three Conceptions of the Corporation*, 2 BUS. ETHICS Q. 435, 435–36 (1992).

managers usurp the role of government by "in effect imposing taxes, on the one hand, and deciding how the tax proceeds shall be spent, on the other."[77] Justice Stevens mobilized similar concepts in his minority opinion in *Citizens United*, writing that corporate political speech "can impose a kind of implicit tax" on shareholders by "effectively forc[ing] corporations to use their shareholders' money both to maintain access to, and to avoid retribution from, elected officials."[78] Under this view, certain manager-driven corporate actions replicate the spending and taxing functions of representative government.

If these types of corporate actions substitute for democratic decision making on social issues, a corollary question is how such actions affect corporations' then-existing fiscal obligations to the state. As Mihir Desai writes,

> [I]ronically, managers have come to embrace corporate social responsibility. Companies routinely tout their constructive role in society and pour resources into social programs even as they pursue aggressive tax strategies. Instead they should show their commitment to their communities by treating their tax obligations as a responsibility commensurate with, say, abiding by environmental regulations.[79]

Although corporations may have adopted corporate social responsibility rhetoric and activities to advance their business interests rather than pursuant to an altruistic motive, social understandings about corporations' responsibilities to the state and the polity are necessarily linked to questions about which entities should, or should not, be subject to corporate-level tax.

C. Two Objections

This section addresses two potential objections to using nontax legal or social understandings in setting rules that determine the scope of the corporate tax base, such as the check-the-box regulations. First, these nontax legal or social understandings may introduce tax-expenditure features into the Code, in that these understandings may justify deviations from a normative or ideal corporate income tax base, taking the existence of such a tax as a given.[80] To the extent that tax expenditures obscure or entrench social policy in ways that do not align with the polity's preferences, these types of deviations imply a breakdown in political

77. Friedman, *supra* note 74, at 33, 122. Friedman also believed that government's role in society should be relatively limited. *See id.*

78. Citizens United v. FEC, 558 U.S. 310, 468 (2010) (Stevens, J., concurring in part and dissenting in part).

79. Mihir A. Desai, *A Better Way to Tax U.S. Businesses*, HARV. BUS. REV., July–Aug. 2012, at 134, 139.

80. *See* Stanley S. Surrey, *Tax Incentives As a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures*, 83 HARV. L. REV. 705, 705–06 (1970).

economy and should be resisted.[81] Resolving this objection, however, would require the tax system to operate independently of corporate law and social understandings about corporations, and implementing this degree of separation would require fundamental reform, an option generally assumed to be unavailable in the line-drawing literature.[82] For example, policymakers would need to abandon the longstanding norm that state-law corporations are classified as corporations for tax purposes.[83] To the extent that corporate law and social understandings are embedded in the structural distinction in tax law between corporations and conduits, these nontax legal and social understandings should inform the construction of the corporate tax base.

A second objection is that these nontax legal and social understandings are simply misguided, and as such, policymakers should ignore them. For example, theories of corporate identity, such as the real entity theory, may be unjustifiable, and adhering to these flawed theories when defining the corporate tax base may perpetuate the fiscal illusion that corporate entities, rather than human beings, bear the burden of taxation.[84] In this case, aligning tax law with inapposite corporate-law values could have deleterious effects by essentially compounding one mistake in corporate law with a second error in taxation. For social understandings, individuals' subjective beliefs about the tax system also may be wrong.[85] Although individuals may not comply with a tax system that either fails to meet their expectations or appears unfair to them, it is not clear that policymakers should defer to these incorrect beliefs when making decisions, rather than simply enacting the objectively best policy.[86] These types of incongruities, however, can indicate places where tax law is misaligned with other areas of law or social norms and may signal opportunities for incremental improvements in outcomes, assuming that fundamental reform is unavailable. In addition, social understandings may offer a way to resolve policy questions in situations where economic factors, such as incidence or net efficiency consequences, are uncertain or unclear. Finally, democratic

81. *See id.* at 722, 731–32. For a critical analysis of this perspective, see Boris I. Bittker, *A "Comprehensive Tax Base" As a Goal of Income Tax Reform*, 80 HARV. L. REV. 925, 926–28 (1967).

82. *See* Weisbach, *supra* note 12, at 895. Outside of relatively extraordinary circumstances, fundamental reform may not be available even to Congress. *See supra* note 12.

83. *See* Field, *supra* note 12, at 505–08 ("[A]ttempts to justify mandatory corporate taxation for incorporated entities have been largely unsuccessful."); *cf.* Bittker, *supra* note 81, at 980–81 ("[A]chiev[ing] a truly 'comprehensive' base would require many more fundamental changes in existing law than are usually acknowledged.").

84. *See supra* Part II.A.

85. *See supra* Part II.A.

86. *See* Dean, *Attractive Complexity*, *supra* note 43, at 418 (discussing "the confidence of the 'common man' in the fairness of the tax law"); *see also* Noël B. Cunningham & Deborah H. Schenk, *The Case for a Capital Gains Preference*, 48 TAX L. REV. 319, 368–70 (1993) (discussing "perceptional equity").

values or other primary norms may support relying on such social understandings, even if they are misguided.

III. THREE VIGNETTES

The contours of corporate taxation have implications beyond current debates about corporate personhood. This part presents three vignettes of specific features of corporate tax law that engage normative questions about which business operations should be subject to corporate tax. In each of these vignettes, an efficiency-type analysis, where close substitutes are taxed the same, produces ambiguous or potentially undesirable results. All three vignettes implicate questions of which entities should be included in the corporate tax base—that is, they engage the Code's entity classification system beyond the boundaries of the check-the-box regulations and the scholarship on those regulations. These vignettes are intended to challenge the primacy of efficiency in setting entity classification rules for tax purposes and to illustrate the relevance of nontax legal considerations and social understandings in resolving these rules.

A. Small Businesses and S Corporations

In 1958, Congress enacted subchapter S of the Code, which permits certain closely held state-law corporations to elect out of federal corporate taxation and into a conduit regime.[87] The stated purpose of subchapter S was to "permit[] businesses to select the form of business organization desired, without the necessity of taking into account major differences in tax consequence."[88] Originally intended to complement rules that permitted sole proprietorships to be taxed as corporations, only the election out of the corporate tax base survived the Technical Amendments Act of 1958.[89] An election under subchapter S favored individuals who owned closely held corporations (at the time, limited to ten shareholders) and who, for example, faced marginal tax rates close to or below the corporate tax rate (generally, not the highest earners).[90]

Although the S corporation rules ostensibly decoupled corporate law considerations from tax effects, the S corporation regime arguably functioned less to ameliorate choice-of-entity distortions and more to

87. The S corporation conduit regime is not the same as the partnership conduit regime. *See* I.R.C. §§ 1361–1379 (2012).

88. *See* S. REP. NO. 85-1983, at 87 (1958).

89. In 1954, the Senate passed rules similar to subchapter S, which the House rejected. *See id.* (discussing a proposed subchapter R). Congress did pass the complementary provision that allowed elections into the corporate tax base, apparently to provide specific relief to a small number of taxpayers who desired the provision. This second provision was repealed in 1958. *See* Mirit Eyal-Cohen, *When American Small Business Hit the Jackpot: Taxes, Politics and the History of Organizational Choice in the 1950s*, 6 PITT. TAX. REV. 1, 33 n.211 (2008).

90. *See* S. REP. NO. 85-1983, at 87 (citing a corporate rate of 52 percent). At the time, individual rates ranged from 20 to 91 percent. *See* Eyal-Cohen, *supra* note 89, at 10.

subsidize small businesses.[91] In the 1950s, clear corporate and noncorporate sectors existed. Agriculture, real estate, and miscellaneous repair services operated through state-law partnerships, while all other industries almost uniformly employed state-law corporations to do business.[92] Under these facts, choice-of-entity considerations were substantially inelastic with respect to tax rates, and corporate taxation had limited effect on whether particular businesses organized as state-law corporations or partnerships.[93] Furthermore, Congress enacted subchapter S in the context of broader federal efforts to aid small businesses in acquiring financing and competing with larger concerns.[94] From this perspective, subchapter S initially operated as a targeted subsidy to certain small businesses owned by certain middle-income individuals. In effect, subchapter S permitted an elective rate reduction for these small businesses that purportedly would reduce the number of small business failures and increase the tax system's overall progressivity.[95]

In 1982, Congress overhauled the S corporation provisions.[96] This overhaul relaxed the eligibility requirements for S corporation status and aligned the S corporation conduit regime more closely with the partnership conduit rules under subchapter K.[97] The effect was significant: the number of S corporation returns filed increased eightfold between 1982 and 2012, and the share of corporate tax returns that belonged to S corporations increased from 20 percent to more than 70 percent.[98] This period also spanned the height of effective electivity for entity classification, as well as the advent of the check-the-box rules.[99] After 1982, the S corporation rules

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91. *See* Eyal-Cohen, *supra* note 89, at 3.

92. *See* Arnold C. Harberger, *The Incidence of the Corporation Income Tax*, 70 J. POL. ECON. 215, 216–17, 230–31 (1962) (noting, however, "a fringe of unincorporated enterprises" in some industries). This analysis sets aside personal service corporations, the treatment of which was unsettled when Congress enacted subchapter S. *See* J. Timothy Philipps et al., *Origins of Tax Law: The History of the Personal Service Corporation*, 40 WASH. & LEE L. REV. 433, 441–42 (1983).

93. This proposition is central to the Old Harberger model of corporate tax incidence and arises out of empirical observations of the period. *See* SHAVIRO, *supra* note 5, at 62–65.

94. *See* Eyal-Cohen, *supra* note 89, at 18 (discussing the Small Business Administration and government contracts); Mirit Eyal-Cohen, *Why Is Small Business the Chief Business of Congress?*, 43 RUTGERS L.J. 1, 4–5 (2011) (discussing the Small Business Investment Company, a financing entity).

95. *See* Eyal-Cohen, *supra* note 89, at 52–53.

96. Subchapter S Revision Act of 1982, Pub. L. No. 97-354, 96 Stat. 1669 (codified as amended in scattered sections of 26 U.S.C.).

97. *See* SAMUEL P. STARR ET AL., S CORPORATIONS: FORMATION AND TERMINATION, pt. I.B.2, BNA (Tax Management Portfolio 730-3d, database updated 2016).

98. Although the share of corporate gross receipts earned by S corporations also increased over this time period, such receipts are less than one-third as large as the receipts attributable to C corporations (22 percent compared to 76 percent). *See SOI Tax Stats—Integrated Business Data*, IRS, https://www.irs.gov/uac/SOI-Tax-Stats-Integrated-Business-Data (last updated Apr. 15, 2015) (providing selected financial data on businesses from 1980 to 2012 in Table 1) [http://perma.cc/C9RQ-6UJP].

99. *See supra* Part I.

functioned less as a targeted subsidy and more as part of a larger trend that favored decoupling state-law entities and their tax classifications.

This history complicates understandings of the S corporation rules under a line-drawing analysis. If partnerships and closely held corporations are close substitutes, then homogenizing their tax treatment makes sense from an efficiency perspective. This rationale, however, is inconsistent with the subsidy function of the original S corporation rules, which attempted to lower average rates on small businesses and supported increased progressivity. In addition, the administrative costs and arbitrage opportunities inherent in maintaining parallel conduit regimes undercut a line-drawing analysis based on efficiency considerations.[100] Underlying social understandings about the value of small businesses, whether correct or misguided, may tip the balance in favor of maintaining a dual regime.

B. Real Estate Ownership and REITs

A second vignette, which again challenges a strict efficiency approach to the corporate/conduit divide, analyzes the rules governing REITs. The REIT rules allow state-law entities with passive real estate activities and diffuse ownership to elect into a special conduit regime.[101] Congress enacted the REIT provisions in 1960, at a time when owners typically formed state-law limited partnerships to conduct real estate activities.[102] Generally, only wealthy or well-connected investors could access these real estate partnerships.[103] In creating the REIT regime, Congress addressed several concerns, including the lack of parity between large investors and small investors with respect to real estate, the disparate tax treatment of regulated investments companies (RICs) such as mutual funds compared to similar vehicles for real estate, and the availability of capital to the real estate sector.[104] At the same time, policymakers worked to preserve classical corporate taxation for so-called "active" businesses, even if those businesses involved significant real estate.[105]

Since Congress created REITs as an exception to corporate tax treatment, REITs have grown significantly in scope and importance within the financial system, a change fueled by legislative and administrative actions

100. *See* STAFF OF THE JOINT COMM. ON TAX'N, REVIEW OF SELECTED ENTITY CLASSIFICATION AND PARTNERSHIP TAX ISSUES 23–25 (1997), http://www.jct.gov/s-6-97.pdf [http://perma.cc/8LMD-LS3M].

101. *See* I.R.C. §§ 856–860 (2012); *see also* Bradley T. Borden, *Reforming REIT Taxation (or Not)*, 53 HOUS. L. REV. 1, 47–48 (2015) (comparing the REIT conduit regime to partnership taxation).

102. *See* Harberger, *supra* note 92, at 216 (noting that, of the total return of taxes to capital in the private sector in the 1950s, two industries accounted for 80 percent of the noncorporate profits—agriculture and real estate, in which corporate profits were negligible).

103. *See* PETER M. FASS ET AL., REAL ESTATE INVESTMENT TRUSTS HANDBOOK: A PASS-THROUGH ENTITY TO MAKE MORTGAGE LOANS AND OPERATE REAL ESTATE § 1:7, Westlaw (database updated 2015).

104. *See* Borden, *supra* note 101, at 13–21.

105. *See id.* at 19–20, 60.

as well as market-driven legal innovations.[106] Justifications for (or rationalizations of) these changes generally have looked to the original purposes of the REIT regime. For example, commentators defend the rules relaxing the types of services that REITs could provide (that is, how "active" they could be) because the new rules "appropriately made REITs more similar to limited partnerships."[107] In addition, less restrictive rules to facilitate REIT ownership by pension plans have been characterized as consistent with efforts to democratize and encourage investment in real estate.[108] From this perspective, expansions of the REIT regime advance the social goals of the original legislation.

Critics of these changes argue that expanded REIT rules vitiate the corporate tax base by allowing largely active businesses to divert earnings to the REIT conduit regime.[109] Recent concerns have crystalized around two issues: the definition of "real property" for REIT purposes and tax-free spin-offs involving an existing active business and a newly formed REIT. Starting in the late 1960s, the IRS issued a series of increasingly permissive rulings that allowed REITs to apply nontraditional real estate assets—from railroad tracks to mobile homes to certain on-site energy generation systems—toward certain REIT qualification requirements. This practice accelerated in the 2000s, as the IRS issued rulings that gave favorable treatment under the REIT rules to distribution systems and pipelines, communication towers, data centers, and billboards; simultaneously, critics lamented these rulings' effects on the corporate tax base.[110] Similarly, critics have highlighted the negative effects on the corporate tax base of tax-free spin-offs in which one of the resulting companies elects REIT status and leases its real estate assets back to the other resulting company.[111] These spin-offs effectively permit integrated operating companies to separate their real estate assets into a tax-advantaged vehicle. Congress essentially foreclosed these types of spinoffs by legislation in December 2015.[112]

An efficiency analysis does little to clarify debates over the REIT regime's expansion. REITs can be publicly traded or privately held.[113] Under an approach analogous to the current check-the-box regulations, public trading represents a possible line by which to classify REITs as

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106. *See id.* at 21. *See generally* Peter E. Boos, *Runaway REIT Train?: Impact of Recent IRS Rulings*, 144 TAX NOTES 1289, 1290–92 (2014) (discussing the history of REITs); Borden, *supra* note 101, at 32–55 (summarizing changes since 1986).

107. *See* Borden, *supra* note 101, at 37.

108. *See id.* at 42–45.

109. *See id.* at 3–4 (discussing news coverage and the 2014 Camp Plan). *But see id.* at 57 (arguing that "bad optics, more than bad policy," led to these criticisms).

110. *See* Boos, *supra* note 106, at 1294–98; Borden, *supra* note 101, at 52–53.

111. *See* Borden, *supra* note 101, at 52.

112. *See* LATHAM & WATKINS LLP, CONGRESS ENACTS SIGNIFICANT CHANGES TO THE REIT AND FIRPTA RULES 1 (2015), https://www.lw.com/thoughtLeadership/lw-congress-reit-firpta-rules [http://perma.cc/B4QV-2CH8].

113. *See* FASS ET AL., *supra* note 103, § 1:81 (describing various ways to satisfy the REIT ownership tests).

corporations or conduits. Also relevant to the REIT rules, however, are two other close substitutes: real estate partnerships, which are conventional vehicles for investment in real estate, and RICs, which facilitate passive, diversified investments by small holders of capital. Indeed, the tensions between these two substitutes better explain current debates about the REIT regime's scope, which generally focus on parity between REITs and either real estate partnerships or RICs.[114] The choice between these two substitutes—and corporate or conduit taxation—depends on the social goals at stake. In this way, a broader look at the social understandings and critiques of REITs, rather than a pure efficiency analysis, may help inform the appropriate framework for REIT taxation.

C. Corporate Residence and Inversions

The final vignette explores line drawing in the taxation of international business activities through the lens of corporate residence and inversions. The United States, which taxes domestic corporations on their worldwide income, defines corporate residence as the jurisdiction where a corporation is "created or organized."[115] By contrast, many non-U.S. legal systems impose tax on resident corporations only with respect to their business income arising in that jurisdiction (known as "territorial" taxation), with residence determined under a multifactor test that examines, for example, a corporation's management or operations.[116] Together, these disparate tax rules produce an incentive for corporations incorporated in the United States to migrate to or be acquired by an entity organized in a non-U.S. jurisdiction—a type of transaction known colloquially as a corporate expatriation or corporate inversion.[117]

A central benefit of inversions is that they enable U.S.-incorporated multinationals to achieve a sort of "self-help" territorial taxation, in which the expatriating entity faces U.S. tax only on income from its U.S. operations.[118] Multinationals can amplify this effect through "earnings

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114. *See* Borden, *supra* note 101, at 62–67 (describing this issue as an "inequity conundrum").

115. *See* I.R.C. §§ 11, 7701(a)(4) (2012). The United States credits certain foreign income taxes paid against corporations' domestic tax liabilities. *See id.* §§ 901, 902.

116. These rules mean that a corporation may be incorporated in a high-tax non-U.S. country but be "resident" for non-U.S. tax purposes in a low-tax country (a "tax haven"). *See* DANIEL N. SHAVIRO, FIXING U.S. INTERNATIONAL TAXATION 32–33 (2014); Cathy Hwang, *The New Corporate Migration: Tax Diversion Through Inversion*, 80 BROOK. L. REV. 807, 813–14, 833 (2015).

117. In their ideal form, these transactions involve minimal effects on operations and ownership. *See* OFFICE OF TAX POLICY, DEP'T OF THE TREASURY, CORPORATE INVERSION TRANSACTIONS: TAX POLICY IMPLICATIONS 1–2 (2002), https://web.law.columbia.edu/sites/default/files/microsites/millstein-center/panel_1_001_office_to_tax_policy.pdf [http://perma.cc/KHJ2-Z3RC]. For reasons discussed below, current law generally precludes inversions in their ideal form.

118. *See id.* at 29; *see also* N.Y. STATE BAR ASS'N TAX SECTION, REPORT ON OUTBOUND INVERSION TRANSACTIONS 22 (2002), http://old.nysba.org/Content/ContentFolders20/TaxLawSection/TaxReports/1014report.pdf (describing post-inversion taxation as on "a de facto 'territorial' basis") [http://perma.cc/9CQP-NH3Z].

stripping" payments from U.S. entities to non-U.S. entities, aggressive intercompany pricing, and careful allocations of the multinational group's interest expense, all of which can shift additional taxable income outside the U.S. corporate tax base.[119] In practice, however, multinationals can attain virtual territoriality through tax planning without undertaking an inversion. This alternative type of self-help territoriality relies on the fact that U.S.-incorporated multinationals generally are not taxed on income earned by non-U.S. corporate subsidiaries until that income is repatriated to the United States as a dividend or similar payment, a concept sometimes referred to simply as "deferral."[120] These multinationals either never repatriate this non-U.S. income or gain access to the non-U.S. income in ways that do not trigger U.S. tax inclusions. According to Michael Graetz, "[I]n the case of corporations, we should probably stop talking as if our policy is worldwide taxation of corporate residents and as if any departure from such policy, such as taxing active business income of foreign corporations only when repatriated, is an aberration."[121] As applied, U.S. tax law occupies a space between worldwide and territorial taxation.

Various provisions in the Code and Treasury regulations attempt to deter inversions.[122] Among these provisions is section 7874, which qualifies the general rules governing corporate residence.[123] If a U.S.-incorporated multinational undertakes an inversion, and the multinational's pre-inversion shareholders own 80 percent or more of the post-inversion foreign parent company, then section 7874 effectively disregards the inversion, and the multinational's post-inversion parent company is treated as a domestic corporation for U.S. income tax purposes unless the multinational has "substantial business activities" in the relevant foreign jurisdiction.[124] Currently, inversions typically avoid the 80 percent threshold by partnering with an existing foreign corporation that is organized in a low-tax

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119. Interest stripping is policed, in part, by I.R.C. § 163(j) (2012), and earnings stripping using rents, royalties, or service fees is scrutinized under I.R.C. § 482. The extent to which inversions' tax benefits stem from these strategies is contested. *Compare* Michael S. Kirsch, *The Congressional Response to Corporate Expatriations: The Tension Between Symbols and Substance in the Taxation of Multinational Corporations*, 24 VA. TAX REV. 475, 502–03 (2005) (very important), *with* Andrew Velarde, *Treasury Sees Tougher Inversion Problems than Interest Stripping*, TAX NOTES TODAY (Feb. 16, 2016), http://www.taxnotes.com/tax-notes-today/cross-border-mergers-and-acquisitions/treasury-sees-tougher-inversion-problems-interest-stripping/2016/02/16/18239596 (less important) [http://perma.cc/K4LG-DN5N].

120. Subpart F of the Code sets limitations on this type of deferral. *See* I.R.C. §§ 951–965.

121. Michael J. Graetz, *Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 54 TAX L. REV. 261, 323 (2001).

122. *See* I.R.C. §§ 1248(i), 4985; Treas. Reg. § 1.367(a)-3(c) (as amended in 2015) (the "Helen of Troy" regulations).

123. For another anti-inversion provision that addresses corporate residence, see I.R.C. § 269B (treating a foreign corporation and a U.S. corporation whose stock are "stapled"—unable to be traded independently—as a single U.S. corporation).

124. I.R.C. § 7874(a)(2), (b). The threshold for "substantial business activities" is relatively high. *See* I.R.S. Notice 2015-79, 2015-49 I.R.B. 775 (stating Treasury's intent to issue regulations tightening the "substantial business activities" exception).

jurisdiction such as Ireland or Switzerland.[125] This type of "inversion 'lite'" mimics an economically motivated "real" acquisition.[126]

Fundamentally, the policy question raised by inversions involves the scope of the U.S. corporate tax base. The law must distinguish domestic entities subject to U.S. corporate taxation on their worldwide income from foreign entities that do not face this regime.[127] The decision about where to incorporate, the touchstone of the U.S. corporate residence rules under the Code, is relatively (and increasingly) elastic, at least for some taxpayers.[128] For example, multinationals may be able to draw on contract law, innovations in local corporate law, or increasingly complete financial markets to "replicate the benefits of Delaware incorporation without actually selecting it."[129] This flexibility indicates that, from an efficiency perspective, inversions present a line-drawing problem for which policymakers should group close substitutes, assuming the unavailability of fundamental reform.[130]

Identifying the relevant close substitutes, however, is challenging because inversions implicate multiple axes of comparison. Incorporation outside the United States may be a close substitute for U.S. incorporation,[131] self-help territoriality through deferral may be a close substitute for self-help territoriality through inversions,[132] and "real" cross-border acquisitions may be close substitutes for inversions.[133] Furthermore, the availability of these substitutes may vary across industries or sectors in

125. *See* Hwang, *supra* note 116, at 831–37; *see also* I.R.S. Notice 2014-52, 2014-52 I.R.B. 712, § 2 (stating Treasury's intent to issue regulations addressing transactions to tailor companies' size to avoid I.R.C. § 7874).

126. *See generally* Lewis J. Greenwald & David H. Kaplan, *Inversions "Lite": Finding "Substantial Business Activity" Under the New U.S. Regs*, 43 TAX NOTES INT'L 515 (2006); Lee A. Sheppard, *Challenging Unwritten Inversion Regulations*, TAX NOTES TODAY (Feb. 17, 2016), http://www.taxnotes.com/tax-notes-today/cross-border-mergers-and-acquisitions/news-analysis-challenging-unwritten-inversion-regulations/2016/02/17/18242816 (describing I.R.C. § 7874 as "a weak statute") [http://perma.cc/ZJ3J-LRWX].

127. Entities incorporated outside the United States remain subject to tax, including a substitute entity-level tax (the "branch profits tax"), on income that arises in, or is effectively connected to, the United States. For the relevant Code provisions, see I.R.C. §§ 881, 882, 884; tax treaties follow a similar framework.

128. *See* Eric J. Talley, *Corporate Inversions and the Unbundling of Regulatory Competition*, 101 VA. L. REV. 1649, 1652 (2015) ("America's traditional market power in regulatory competition has begun to slip."); *see also* SHAVIRO, *supra* note 116, at 67–70 (elaborating on factors that influence the elasticity of tax residence).

129. SHAVIRO, *supra* note 5, at 143; *see also* Kane & Rock, *supra* note 8, at 1265–69 (arguing that, although U.S. corporations "los[t] some value simply because they became subject to a different regime of [non-U.S.] corporate law," this loss was mitigated by the quasi-regulatory listing requirements of the New York Stock Exchange).

130. In addition to grouping close substitutes, policymakers generally should disfavor corporate taxation. *See supra* Part I.

131. For discussions of various differences in U.S. and non-U.S. corporate law, see Hwang, *supra* note 116, at 838–42; Talley, *supra* note 128, at 1690–700.

132. Inversions and deferral probably are not perfect substitutes because inversions may facilitate more earnings stripping than deferral.

133. These types of combinations, however, may have costs. *See* Hwang, *supra* note 116, at 844–45.

the economy, complicating an efficiency analysis.[134] Although each of these three axes likely favors a rule less stringent than current law, the precise contours of a rule that maximizes efficiency across all three axes depends on how these axes interact in producing overall efficiency, as well as the relative normative weights given to each axis.[135] The answer to the former question may be difficult or impossible for policymakers to determine, and the answer to the latter question may fall outside of particular policymakers' expertise.[136]

Nontax legal regimes and social understandings about inversions may illuminate these policy decisions in a different way. Implicit in efficiency-oriented reforms such as the check-the-box regulations is that policymakers should separately consider tax policy and corporate law, but doing so may have deleterious systemic effects. For example, Eric Talley argues that "severing the link completely" between corporate and tax law may cause "the variety and quality of corporate governance regimes worldwide [to] atrophy."[137] In addition, to the extent that U.S. public policy is intertwined with the success and failure of companies with substantial ties to the United States, inversions may result in nontax harms.[138]

Finally, the public and political rhetoric surrounding inversions means that these transactions—and their policing—have significant social meaning. For example, in response to the proposed inversion of Stanley Works in 2002, Senator Chuck Grassley, at the time the ranking Republican on the Senate Finance Committee, said: "These expatriations aren't illegal. But they're sure immoral. During a war on terrorism, coming out of a recession, everyone ought to be pulling together. If companies don't have their hearts in America, they ought to get out."[139] Stanley Works's shareholders approved the reincorporation shortly after Grassley's comments, but the company's board "threw out the results the next day" in response to public and governmental pressure.[140] These social understandings not only influence multinationals' behavior and the

134. *See id.* at 846–48, 850–51.

135. For example, if multiple lines lead to identical efficiency results, policymakers should consider other normative factors in setting policy. *But see* Weisbach, *supra* note 4, at 1675–76 (arguing that local improvements in efficiency should control where policymakers' ability to draw lines is constrained).

136. *See supra* Part I.

137. *See* Talley, *supra* note 128, at 1653–54.

138. *See* Hwang, *supra* note 116, at 842–44.

139. Press Release, Chuck Grassley, Grassley Announces Bill to Rein in Corporate Expatriation (Apr. 11, 2002), http://www.finance.senate.gov/ranking-members-news/grassley-announces-bill-to-rein-in-corporate-expatriation [http://perma.cc/XN5D-82SR].

140. *See* David Cay Johnston, *Stanley Works Backs Away from a Move to Avoid Taxes*, N.Y. TIMES (Aug. 2, 2002), http://www.nytimes.com/2002/08/02/business/stanley-works-backs-away-from-a-move-to-avoid-taxes.html [http://perma.cc/KX5G-VSYM]. On the day after the shareholder vote, two state officials sued Stanley Works, and investigators from the Securities and Exchange Commission contacted the company. Union leaders also accused Stanley Works's CEO of "stealing the election"—that is, the shareholder referendum. In August 2002, Stanley Works abandoned its inversion attempt entirely. *Id.*

elasticity of corporate residence, but they also indicate ways in which tax policy can be aligned with democratic or popular sentiment.[141]

CONCLUSION

In addressing which entities should face the corporate tax, commentators generally have looked to efficiency considerations as the principal metric by which to gauge the success or failure of the law. This is particularly true with respect to the check-the-box regulations. This turn to efficiency, however, downplays the fact that corporate taxation—a structural feature of the Code—intersects with other, nontax legal regimes, as well as social understandings about corporations' personhood, rights, and responsibilities. For this reason, this Article contends that the appropriate line between corporate and conduit entities for tax purposes depends not only on whether such distinctions are efficient but also on the valence of each category in nontax legal and social contexts. More generally, even structural aspects of the Code must be understood within larger legal and social contexts, and the precise ways in which these legal and social contexts implicate the boundaries of corporate taxation warrant further exploration.

This contention has two broader implications. First, non-tax legal and social understandings are interwoven with the tax system, and this fact provides a possible answer for why policymakers, including Congress, rarely implement tax reforms that advance efficiency by eliminating line-drawing problems.[142] For example, among tax scholars, a substantial consensus opposes "meaningless distinctions" such as classical corporate taxation, which requires delineation of corporate and conduit entities for tax purposes, and the debt/equity distinction, which entails the differentiation of equity investors from lenders to a business.[143] Such lines may be inconvenient from a tax perspective but critically important from a nontax legal perspective; alternatively, the social meaning of these distinctions may be important.[144]

In addition, the heterogeneity of nontax legal and social understandings suggests that the strict binary choices characteristic of line-drawing questions may be incomplete. Indeed, while the check-the-box regulations typically address a choice between corporate (subchapter C) and partnership (subchapter K) tax treatment, a fuller picture of the corporate tax base includes conduits such as S corporations (subchapter S) and REITs (subchapter M), as well as nonprofits and foreign corporations not subject

141. For a discussion of the potential value of such sentiment, see *supra* Part II.C.

142. *See supra* note 12.

143. Many of these "meaningless distinctions" are best characterized as structural. *See* Weisbach, *supra* note 4, at 1637–43; *see also* SHAVIRO, *supra* note 5, at 48–52 (discussing "pillars of sand"); Schlunk, *supra* note 10, at 861 ("[T]he most robust approach is simply to eliminate the inconsistent tax treatment of the existing items.").

144. For example, the social implications of debt may differ from those of equity, and these social implications may change over time. *See generally* BRUCE H. MANN, REPUBLIC OF DEBTORS: BANKRUPTCY IN THE AGE OF AMERICAN INDEPENDENCE (2002).

to U.S. tax at the entity level.[145] Each of these regimes operates according to different rules and with varying effects. Taken together, these regimes imply that future policy choices involving entity classification for tax purposes need not reside within the narrow constraints of the current check-the-box rules.[146]

145. *See* Treas. Reg. § 301.7701-3 (as amended in 2006); *see also supra* Part III.

146. For a similar rejection of all-or-nothing approaches in the international tax context, see SHAVIRO, *supra* note 116, at 187–90.