Evaluating the Consumption Tax Proposals: Changes in the Taxation of Interspousal Transactions, Use of Trusts, and Revising the Meaning of "Tax Planning"

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I. INTRODUCTION

This Article will focus on two proposals to revise our federal income tax system, the Armey flat tax[1] and the USA tax.[2] Our goal is to compare these tax reform measures with our current Internal Revenue Code (Code) for income tax in three areas: (1) corporate stock

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1. H.R. 2060, 104th Cong., 1st Sess. (1995); S. 1050, 104th Cong., 1st Sess. (1995) (introduced by Rep. Armey and Sen. Shelby).

2. S. 722, 104th Cong., 1st Sess. (1995), (introduced by Sen. Nunn and Sen. Domenici). Other consumption-tax type proposals made in the past few sessions of Congress include (1) a National Retail Sales Tax, H.R. 3039, 104th Cong., 2nd Sess. (1996); and (2) The Revenue Restructuring Act of 1996, H.R. 4050, 104th Cong., 2nd Sess., 142 CONG. REC. E1572 (No. 124, daily ed. Sept. 11, 1996) (introduced by Rep. Gibbons, would replace the income and social security taxes with a modified Value Added Tax/ Income Tax combination). Rep. Gephardt has proposed a 10% tax (but not a consumption tax), eliminating virtually all deductions, except mortgage interest. Recent studies of these proposals include: JOINT COMM. ON TAXATION, DESCRIPTION AND ANALYSIS OF PROPOSALS TO REPLACE THE FED. INCOME TAX, *reprinted in* 37 TAX ANALYSTS' DAILY TAX HIGHLIGHTS & DOCUMENTS 3587 (1995), *and in* 67 TAX NOTES 1491 (1995) [hereinafter JCT REPORT]; AM. INST. OF CERTIFIED PUB. ACCOUNTANTS & MARTIN A. SULLIVAN, PH.D., FLAT TAXES AND CONSUMPTION TAXES: A GUIDE TO THE DEBATE (1995) [hereinafter THE DEBATE]; TREASURY DEP'T OFFICE OF TAX ANALYSIS, AN ANALYSIS OF THE NEW ARMEY-SHELBY FLAT TAX PROPOSAL, *reprinted in* 96 TAX NOTES TODAY 5-84, Jan. 8, 1996, *available in* Westlaw, TNT database, 96 TNT 5-84 [hereinafter ARMEY-SHELBY]; KEMP COMM'N, REPORT OF THE NAT. COMM'N ON ECONOMIC GROWTH AND TAX REFORM (Jan. 17, 1996), *reprinted in* 96 TAX NOTES TODAY 12-46, Jan. 17, 1996, *available in* Westlaw, TNT database, 96 TNT 12-46.

redemptions and divorce; (2) the use of alimony trusts; and (3) nonqualified deferred compensation (so-called "rabbi") trusts.

While many economists and tax lawyers say it will never happen, we may well be only a few years away from a fundamental change in our tax system. Political leaders are all quietly dancing around with it. Sadly, they don't seem to really understand what it is, and the general public is very much in the dark.

Both the flat tax and USA tax proposals create a novel approach to moving from an income tax to a consumption tax. They fold consumption tax concepts into both the taxation of business and individuals. The business side is a modified value-added tax (VAT), taxing all active business, but not investment profit. They would eliminate the present double tax on corporate profits, one of the long-standing criticisms of the current income tax, treating all businesses (including partnerships, limited liability companies, limited liability partnerships, S corporations, and self-employed persons) in the same manner. This would eliminate the artificially created tax differences among business entities, and would be a major reform of an area laden with unnecessary complexity—moving taxation of business to a higher plane of tax policy.

The individual side of the proposals adopts a personal consumption tax, albeit by two different timing methods, where the emphasis is on tax incentives to save. The flat tax would include in an individual's gross income *only* cash wages, pension, and certain fringe benefits. Amounts invested would not be deducted from current income, and the income from these investments (dividends, interest, royalties, capital gains) would not be taxed on later receipt. The USA tax, by contrast, would include in gross income the items we currently include, and would allow a full deduction for the amounts invested or saved,[3] resulting in a tax only on what is consumed. Some economists claim that the two approaches produce the same result, assuming the tax rates stay constant over the years. Stated another way, the theory is that allowing a full deduction for investments or savings in the year made (the USA tax) is the equivalent of allowing no deduction against income in the year the investment is made, but not taxing the income or gain therefrom when

3. For discussion of the special (unfavorable) treatment of certain non-productive real estate, under both proposals, see Lester B. Snyder & Marianne Gallegos, *Redefining the Role of the Federal Income Tax Law: Taking the Tax Law "Private" Through the Flat Tax and Other Consumption Taxes*, 13 AM. J. TAX POL'Y 1, 23 (1996).

it is realized in subsequent years (the flat tax). The USA tax method is sometimes referred to as a "cash-flow" type consumption tax, where savings are deducted from current income and taxed when consumed in a later tax period. The flat tax adopts what is sometimes referred to as a "tax prepayment" method. But this applies only to wages, which are taxed in the year received, with any yield or return from that portion of wages invested or saved not taxed again when received in subsequent years.[4] It is thus necessary to understand this so-called tax equivalency theory to understand the differences between the flat tax and USA tax. A more detailed analysis of the tax equivalency issue is covered in Part II.C below.

The basic goal of these proposals is to create a tax base which includes only business income (which may, as in VAT countries, be passed on to the individual consumer), wages, and personal consumption.[5] In summary, the underlying rationale of these proposals appears to be the notion of taxing business profit only once by: (1) eliminating the potential double tax on corporate earnings, which under the current system, taxes profit and gains realized at the corporate level and taxes dividends received by shareholders at the individual level; (2) allowing businesses to fully expense capital purchases; and (3) eliminating the related double tax on an individual's savings.

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4. The two methods may be illustrated by an example based on the JOINT COMM. ON TAXATION, REPORT ON FLAT TAX PROPS. *reprinted in* 95 TAX NOTES TODAY 65-11, Apr. 4, 1995, available in Westlaw, TNT database, 95 TNT 65-11:

> The USA Tax Method: If T earns $25,000 and saves $1,000, which is deducted from his salary, then at a 20% tax rate he saves $200 in taxes in year one. If the amount saved earns 5% and he collects $1,050 in year two, his tax is on the full $1,050 at 20% or $210, leaving T with a net of $840. Under the USA Tax, if T reinvests the $1,050 in another investment in year two, he can again postpone a tax on the $1,050 until a later period when he stops saving, or withdraws the investment and consumes it. The Flat Tax, "tax prepayment method" allows no deduction in year one for the $1,000 savings by T (in effect T prepays his tax on the amount saved), but excludes the yield or return on the $1,000. This leaves T with $800 to save. In year two, he has $840 ($800 x 5% = $40) with no tax on his investment return of $40, leaving him with the same $840 as under the USA Tax. This assumes, however, that the same effective tax rate applies throughout the investment period. Since the Flat Tax statute provides for an annual inflation adjustment for the standard deduction, H.R. 2060, *supra* note 1, § 63(e), one can question the validity of the tax equivalency theory where the effective tax rate is likely to change annually. For other problems with the tax equivalency theory, particularly the treatment of losses, see Snyder & Gallegos, *supra* note 3, at 68-69 & n.271.

5. The likely tax incidence of these proposals (*i.e.,* who ultimately bears the tax, the consumer or capital investor), is discussed in a recent study by MICHAEL J. MCINTYRE & C. EUGENE STEUERLE, FEDERAL TAX REFORM, FAMILY PERSPECTIVE 20-25 (1996) (prepared for the Finance Project, Washington, D.C. 20005).

There is no assurance that these proposals would increase our rate of savings. But they are clearly compatible with a more pervasive aim of "downsizing" the federal government and returning (by Treasury estimates) over $130 billion each year in foregone tax revenue to the private investment sector.[6] Such a transfer to the private sector would increase the amount of private savings.

Much of what has been written to date on these proposals presumes Congress will be writing on a clean slate. However, many of the concepts referred to in the consumption tax bills borrow heavily from current income tax law. For example, the long-time troublesome distinctions between "earned income" (salaries and wages) and "investment income," between "trade or business" and "passive" investments, and between "ordinary" and "capital" gain are retained in the USA tax, but in a different format. The flat tax also sails between Scylla and Charybdis since it too amends the current Code and uses income tax terms, despite the aspersions cast on it.[7]

The three limited test sites we have selected for evaluation historically have raised the type of broad-based policy issues and controversies that permeate the present system: Redemptions of corporate stock in a family business as part of a divorce raise conflicting tax results between the tax-free interspousal transfer provision and the corporate stock redemption and dividend rules; alimony trusts raise issues of assignment or shifting of capital and its income in satisfaction of a spousal support divorce agreement; and "non-qualified" deferred compensation trusts (including so-called "rabbi trusts") raise the postponement of tax liability and related timing problems. All three topics involve double-tax, constructive receipt, and drawing the line between "services" and "capital" issues.

In assessing the pros and cons of the proposed changes in our tax structure, we will collaterally address four related questions: (1) How much simplification would be achieved?; (2) Have the proponents of these tax reforms, in their goal of encouraging savings and eliminating "double taxation" of business profits,[8] paved the way for undertaxation of some recipients of these profits?; (3) To what extent do these

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6. ARMEY-SHELBY, *supra* note 2.
7. Some material in this Article is taken from the senior author's article, co-authored with Marianne Gallegos. *See* Snyder & Gallegos, *supra* note 3.
8. For a discussion of the double tax issue, see *id.* at 14-15, 54-56, 61-68, 70-81.

"consumption" tax proposals require us to reassess our traditional "income" tax views on tax avoidance?; (4) Are there appropriate safeguards against abusive techniques in converting "consumption" into disguised "savings"?; and (5) To what extent would we be required to cast aside conventional tax planning and tax policy concepts in the new tax regime?

Part II of the Article will address the stock redemption/divorce issues using the facts in the *Arnes* case.[9] Part III will discuss the use of trusts in two hypothetical cases: alimony and deferred compensation.

II. DIVORCE AND REDEMPTION (OF STOCK, THAT IS)

A. Fact Pattern

John and Joann Arnes owned and operated a McDonald's Corporation (McDonald's) franchise in the state of Washington, a community property state.[10] The franchise was held by a corporation called Moriah Valley Enterprises, Inc. (Moriah).[11] The articles of incorporation included a right of first refusal on the part of the corporation to purchase the shares of any stockholder wishing to sell. The other shareholders had a right of second refusal.[12]

After several years of marriage and operating the franchise together, John and Joann separated and ultimately obtained a divorce. Pursuant to their divorce, McDonald's informed John and Joann of their policy concerning dissolution of marriages of owner-operators. Essentially, only one of them could end up owning the business. To accommodate McDonald's,[13] Moriah redeemed Joann's shares in return for an installment note as part of the property settlement, with John as the note's guarantor. Joann reported and paid the tax to the IRS (Service) on the gain realized on the redemption of her shares in Moriah. She subsequently filed a refund suit in the U.S. District Court, claiming that the redemption of her stock should not be deemed a taxable sale of her stock back to the corporation under section 302(a) of the Code,[14] but should instead be treated as a non-taxable transfer of her Moriah stock directly to John under another section of the Code,[15] which permits a tax-free interspousal transfer of property. She obtained a summary

9. Arnes v. Commissioner (John Arnes), 102 T.C. 522 (1994).
10. *Id.* at 523.
11. *Id.*
12. *Id.*
13. And, presumably, John Arnes, since he ended up as the sole stockholder.
14. I.R.C. §§ 301, 302 (1996).
15. I.R.C. § 1041 (1996).

judgment in her favor, with the court deciding that the transfer of stock to the corporation was really for the benefit of John.[16] The IRS also lost on appeal in the Ninth Circuit.[17]

In a separate case in the Tax Court, the IRS then proposed to tax John as the recipient of a "constructive dividend" from the corporation on the theory that the corporation in effect paid his debt to Joann on his behalf. A divided Tax Court ruled against the IRS, however, holding that the redemption of Joann's stock by the corporation could not be deemed a dividend to John under case and IRS ruling precedents.[18]

B. *Results Under Current Law*

Under the current Code, the fundamental issue in these two cases is which section of the Code prevails in a redemption of a shareholder's interest brought about incident to a marital property settlement in a divorce. Because of this statutory conflict, and because the IRS failed to combine the two *Arnes* cases, Joann received $450,000 for her stock interest in Moriah without any tax to her or to John, who remained the sole shareholder of the corporation, and on whose behalf the corporate funds were paid. Transfers between spouses or former spouses are not taxed, with certain limitations for those transfers incident to divorce.[19] The payee spouse pays a price for that nonrecognition treatment by taking a carryover basis on the transferred property,[20] which effectively defers but does not forgive the tax due on any appreciation.

By contrast, in the more general area of redemptions of a shareholder's interest by a corporation, section 302(b)(3) (and the safe harbor provisions of section 302(c)(2)[21] that disable the constructive

16. Arnes v. United States (Joann Arnes), 91-1 USTC ¶ 50,207 (W.D. Wash. 1991).

17. Arnes v. United States (Joann Arnes), 981 F.2d 456, 457 (9th Cir. 1992).

18. Arnes v. Commissioner (John Arnes), 102 T.C. 522, 526 (1994).

19. I.R.C. § 1041(a). Transfers between former spouses that are incident to their divorce may be accomplished up to a year after the end of the marriage, *id.* §1041(c)(1), or is related to the cessation of the marriage, *id.* § 1041(c)(2). The regulations spell out a rebuttable presumption that such a transfer must occur within six years of the end of the marriage. Treas. Reg. § 1.1041-1T(b) (1984).

20. I.R.C. § 1041(b).

21. *Id.* § 302(c)(2).

ownership rules contained in section 318)[22] govern redemptions of a family member's interest.

Thus, if a family member completely redeems her interest in a close corporation where the remaining shareholder is another family member, then, even though the remaining shareholder(s) may be related within the meaning of section 318(a),[23] the redeeming shareholder normally is taxable on her gain, albeit at the lower capital gain rate.[24] The "sale" of her stock is not treated as a dividend to the redeeming shareholder in this context.[25] As for the non-redeeming (or continuing) shareholder (John, in our case), the Tax Court noted the "well established" test that the non-redeeming shareholder normally "realizes no gain or loss or dividend income solely because all or a portion of the stock of another shareholder was redeemed, even though the effect of the redemption is to increase his percentage ownership in the corporation."[26] The application of these rules assumes that the standard redemption does not confer a sufficient benefit to the remaining family member/shareholder. But there is a potential trap for the ill-advised under the current tax law. When "the remaining shareholder blundered into incurring a direct and primary obligation to purchase the stock, which he belatedly attempts to shift to the corporation,"[27] the cases are far less clear.[28] However, the Service seemingly ended the controversy by issuing Revenue Ruling 69-608, setting forth examples illustrating when a nonredeeming shareholder's promise to purchase the redeemer's stock was "primary

22. *Id.* § 318(a).

23. *Id.* Parents, spouses, children, and grandchildren, not to mention related entities such as partnerships, trusts and other corporations can have their shares attributed to the redeeming shareholder under § 318(a), often with the consequence of changing the characterization of the corporate distribution.

24. The current maximum rate on long term capital gains, for individuals, is 28%. I.R.C. § 1(h) (1996).

25. *Id.* § 301(c). Distributions defined as dividends (which are made from the corporation's earnings and profits under § 316) are treated as ordinary income. The remaining amount in excess of basis is given capital gains treatment. *Id.* § 301(c)(3)(A).

26. Arnes v. Commisioner (John Arnes), 102 T.C. 522, 534 (1994) (citing Wall v. United States, 164 F.2d 462 (4th Cir.1947), and Holsey v. Commissioner, 258 F.2d 865 (3d Cir., 1958)); *see also* Edler v. Commissioner, 727 F.2d 857 (9th Cir., 1984), *aff'g* 43 T.C.M. (CCH) 508 (1982).

27. *Arnes* (John), 102 T.C. at 535-536.

28. Alan L. Feld, *Divorce and Redemption*, 64 TAX NOTES 651, 652 (1994).

and unconditional."[29] In other words, whose obligation is it—the corporation's or the remaining shareholder's?

Thus, the key technical question, as Alan Feld reminds us, as to which of these two mechanisms (section 302 redemptions, or section 1041 transfers between spouses) should govern a redemption of a spouse's interest in the family corporation that is incident to her divorce from the remaining shareholder, centers on whether the latter, in this case John Arnes, had an unconditional obligation to redeem Joann's stock based upon the deferral of division of the marital assets under section 1041.[30] IRS temporary regulations also allow section 1041 to govern transactions between Joann and Moriah on John's behalf by providing coverage of transactions involving third parties.[31] In the *Arnes* case, the critical question was whether or not Joann's redemption of her shares was "on behalf of" John, making the redemption of Joann's shares a "primary and unconditional obligation" of John's,[32] or whether it was a transaction between Joann and the corporation where John was not a primary party. The Ninth Circuit and Tax Court came out on opposite sides of the issue. The entire experience, which to date has not been further pursued by any of the parties, indicates the complexity of the current system and the importance of observing certain forms in order to achieve certain tax results.

In contrast to the contradictory results that the Ninth Circuit and the Tax Court reached in the Arnes cases, another recent Tax Court case, *Hayes v. Commissioner*,[33] illustrates a situation where the husband clearly did incur a primary obligation and thus liability for a constructive dividend. In *Hayes*, the divorce decree initially ordered the husband to pay his wife for her interest in the family corporation. A later *nunc pro*

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29. Rev. Rul. 69-608, 1969-2 C.B. 42; *see also* Feld, *supra* note 28, at 652. "The Service said it would continue to assert constructive dividend treatment against [the remaining shareholder] if his obligation to acquire the stock from the [redeeming shareholder] was primary and unconditional. However, when [the remaining shareholder] was only secondarily liable" there would be no constructive dividend treatment. *Id.*

30. Feld, *supra* note 28, at 652.

31. Temp. Treas. Reg. § 1.1041-1T(c) (1984). This temporary regulation, which takes the form of questions and answers, asks in Q-9 "[m]ay transfers of property to third parties *on behalf of a spouse (or former spouse)* qualify under section 1041?" *Id.* (Emphasis added). The answer is yes, "provided all other requirements of the section are satisfied." *Id.*

32. Rev. Rul. 69-608, 1969-2 C.B. 43.

33. 101 T.C. 593 (1993).

tunc order modified the decree ordering the corporation to discharge the note. This follows another case, *Sullivan v. United States*,[34] where the Eighth Circuit held that if a buyer who is under a primary obligation to buy the shares from a second party has the corporation redeem them instead, he will be deemed as having received a constructive dividend by this discharge of his obligation.[35] The situation in *Sullivan* was so clear that Rev. Rul. 69-608, mentioned above as seemingly ending litigation over primary obligations, uses it as "situation 1" in describing how a primary obligation will result in a constructive dividend.[36]

1. Ninth Circuit

The Ninth Circuit affirmed the district court finding that Joann's redemption fell under the aegis of section 1041.[37] The court based its decision on the trial court having found that Joann's redemption was made "on behalf of" John because he had a "primary and unconditional" obligation to Joann, which the transfer relieved him of.[38] The court found that John's obligation to Joann was based upon the divorce property settlement and that Joann's right to sue John did not involve the corporation.[39] In the Ninth Circuit's eyes, then, John fell afoul of Rev. Rul. 69-608, and (though not a party in that case) should incur the tax liability as a constructive dividend when Moriah redeemed Joann's shares.[40] Joann was entitled to her refund.[41] This analysis pointed to the ascendancy of section 1041 over section 302 in areas where they clashed, which the Ninth Circuit justified by pointing to legislative history behind section 1041 as intending the section to "defer the tax consequences of transfers between spouses or former spouses."[42]

2. Tax Court

The Tax Court rejected the Ninth Circuit's analysis, relying instead upon the Service's previous pronouncements describing an agreement

34. 363 F.2d 724 (8th Cir. 1966), *cert. denied*, 387 U.S. 905 (1967).

35. BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 9.06[6], at 9-45 (6th ed. 1994 & Supp. 1995).

36. Rev. Rul. 69-608, 1969-2 C.B. 42; *see also* Thomas Monaghan, *Corporate Redemption in the Context of Marital Dissolutions: I.R.C. § 1041 and* Arnes v. United States, 68 WASH. L. REV. 923, 931 (1993).

37. Arnes v. United States (Joann Arnes), 981 F.2d 456, 457 (9th Cir. 1992).

38. *Id.* at 458-59.

39. *Id.* at 459.

40. *Id.* (citing Schroeder v. Commissioner, 831 F.2d 856, 859 (9th Cir. 1987)).

41. *Id.* at 460.

42. *Id.* at 458 (citing H. R. REP. No. 98-432, pt. 2, 98th Cong., 2d Sess. 1491, *reprinted in* 1984 U.S.C.C.A.N. 697, 1134).

between two shareholders that the corporation would redeem the stock of either in the event of his or her death.[43] The court held that the marital property settlement, like the shareholder agreement, did not create a primary and unconditional obligation on John's part,[44] thus upholding the redemption treatment that John and Joann originally envisioned in their property settlement negotiations, in which Joann was to bear the tax burden as capital gain upon recognition of cash received under the terms of the note.

3. *Assessing the Argument*

The net effect of the two cases was a "whipsaw result . . . of [the Service's] own making."[45] The Service got caught between two interpretations of which section of the Code should govern in the area of closely held, family corporations incident to divorce. In his concurring opinion, Judge Beghe pointed to the legislative purpose behind section 302, which was "to bear lightly on withdrawals from incorporated partnerships,"[46] and the reliance that John, Joann, and their counsel placed upon this background to the bright line rules of section 302.[47] This section governs how to characterize income as either ordinary or capital gain.

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43. Arnes v. Commissioner (John Arnes), 102 T.C. 522, 528 (1994) (citing Rev. Rul. 69-608, 1969-2 C.B. 42, 44). The Tax Court directly used situation 5 to support its position:

> *A* and *B* owned all of the outstanding stock of *X* corporation. An agreement between *A* and *B* provided that upon the death of either, *X* will redeem all of the *X* stock owned by the decedent at the time of his death. In the event that *X* does not redeem the shares from the estate, the agreement provided that the surviving shareholder would purchase the unredeemed shares from the decedent's estate. *B* died and, in accordance with the agreement, *X* redeemed all of the shares owned by his estate.
>
> In this case *A* was only secondarily liable under the agreement between *A* and *B*. Since *A* was not primarily obligated to purchase the *X* stock from the estate of *B*, he received no constructive distribution when *X* redeemed the stock.

Id. (citing Rev. Rul. 69-608, 1969-2 C.B. 43.)

44. *Id.* at 530 (citing WASH. REV. CODE ANN. § 62A.3-416(1) (West 1979)).

45. *Id.* at 541-42 (Beghe, J., concurring).

46. *Id.* at 540 (quoting Marvin A. Chirelstein, *Optional Redemptions and Optional Dividends: Taxing the Repurchase of Common Shares*, 78 YALE L.J. 739, 749 (1969)).

47. *Id.*

With section 1041, Congress sought to use bright line rules to define who shall bear the tax burden in transfers between spouses and thus decrease the litigation and uncertainty that "relentlessly whipsawed" the government in the wake of the landmark case of *United States v. Davis*.[48] In that case, the husband transferred some appreciated stock to his wife pursuant to a property settlement agreement. The Court held that this transfer was not a gift and that he had realized a taxable gain.[49] The worst part of this outcome was that "it frequently imposed a heavy tax burden at the worst possible time—when a couple's finances were in disarray and every available dollar was needed to finance the transition from one household into two."[50] Section 1041 relieves the spouses of the burden of paying taxes for a recognition event that often generates little or no cash. Congress specifically designed section 1041 "[t]o correct these problems, and make the tax laws as unintrusive as possible with respect to relations between spouses."[51]

This purpose is entirely congruent with section 302 in the sense that both seek to minimize the tax burden in the changing of close, often family, relationships making the transition easier, and indeed, even possible. For instance, section 302 has specific rules to allow for generational changes in ownership of family held businesses at the lower capital gain rate. That is precisely the point behind section 302(c)(2), which de-triggers the family stock attribution rules where the redeeming shareholder severs her entire interest in the corporation. Section 1041 accomplishes a similar goal by deferring recognition of gain in a marital context, shifting any future gain, nonetheless, to the spouse remaining as the sole shareholder of the corporation. Both sections recognize that the taxpayers need cash to pay their taxes. Very often, these transactions produce very little cash. Therefore, it is preferable to defer recognition until such time that cash is realized. The best way to achieve that goal, as well as maximize certainty of treatment for the divorcing couple, as Judge Beghe said in his concurring opinion, is to observe the bright line rules of Rev. Rul. 69-608, which will both minimize the tax burden[52] and place it on the spouse who has the cash.[53]

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48. 370 U.S. 65 (1962).

49. *Id.* at 66-7; *see also* MARVIN A. CHIRELSTEIN, FEDERAL INCOME TAXATION 85 (7th ed. 1994).

50. Michael Asimow, *The Assault on Tax-Free Divorce: Carryover Basis and Assignment of Income*, 44 TAX L. REV. 65, 67 (1988).

51. *Id.* at 69 (citing H. R. REP. NO. 98-432, 98th Cong., 2d Sess. 1491 (1984)).

52. Arnes v. Commissioner (John Arnes), 102 T.C. 522, 541 (1994).

53. While approximately $290,000 of the consideration was actually in the form of a corporate note (carrying 9% interest), no issue was raised in these cases as to the potential applicability of the installment method of reporting any gain under I.R.C.

Yet, this position appears to have something of a "form over substance" flavor. The taxpayers have to be technically careful to ensure that any agreements to buy out one shareholder do not create this primary and unconditional obligation on the remaining shareholder. Insensitivity of the parties to the nuances of Rev. Rul. 69-608, such as when their divorce agreement requires one spouse to purchase the other's stock, which is later modified by a court order allowing the corporation to pay the note after the "purchasing" spouse had already agreed to assume primary obligation on it, will subject the purchasing spouse, as the remaining shareholder, to a constructive dividend. This unhappy consequence befell the unfortunate husband in *Hayes v. Commissioner*.[54] Tax reform proponents could point to this seeming anomaly as

§ 453. If the transaction was deemed a stock redemption under § 302, then Joann's realized capital gain would be the difference between the fair market value of the note and her basis in the stock. If the transaction was a tax-free interspousal transfer under § 1041, then no gain would attach to the note received, thus eliminating the relevance of § 453. Interest on the note, however, should be taxable to Joann. The chief disadvantage of the installment method, where it is relevant, is that the size of the obligation, which is in excess of $150,000, could run afoul of the interest charge rules of § 453A(b)(1). But, this section imposes interest only if the aggregate face value of all such obligations exceeds $5 million, only a remote possibility for this transaction. I.R.C. § 453A(b)(2)(B); *see also* BORIS I. BITTKER & MARTIN J. MCMAHON, JR., FEDERAL INCOME TAXATION OF INDIVIDUALS ¶ 41.3[3] (2d. ed. 1995). However, if Joann were to sell or otherwise dispose of the note before the expiration of the ten-year expiration date, the general rule of I.R.C. § 453B(a) provides for an acceleration of any unreported gain, by subtracting the "basis" of the note from the amount realized. But it would be inconsistent with the non-recognition of gain structure under § 1041 to tax the transferor spouse (Joann) on any later disposition of the note. Section 453B(b) could be argued to resolve this problem by defining the "basis of the obligation" as "amount equal to the income which *would be returnable were the obligation satisfied in full.*" I.R.C. § 453B(b) (emphasis added). Since no income, other than interest, should be taxed, perhaps the realized, but non-recognized gain, should be deemed part of her basis. The reference to § 1041 transfers in § 453B(g) seems to refer only to the case where the property transferred to a spouse under § 1041 is itself a pre-existing installment note, which is not our case.

54. 101 T.C. 593 (1993); *see also supra* text accompanying notes 21-29; BITTKER & EUSTICE, *supra* note 35, ¶ 9.06[6], at 9-46 n. 216; Feld, *supra* note 28, at 654.

The underlying principle was memorialized by the Supreme Court in Old Colony Trust Co. v. Commissioner, 279 U.S. 716 (1929), where the corporation attempted to pay the income tax obligations of its president above and beyond the nearly $1 million compensation paid directly to him. The Court held that the corporation's payment of tax was income imputed to him.

This theory of imputing income to a shareholder by assessing a constructive dividend is codified in a different context in I.R.C. § 7872, where foregone interest on loans between related persons (including corporations and their shareholders) is imputed and a prime example of the current system's arbitrary nature. It does not treat substantively similar transactions in a similar way, violating a basic premise of tax equality. But, in Rev. Rul. 69-608, "form" is the "substance."[55] Lines have to be drawn and definitions made in order to administer the system. Indeed, this issue goes to the very heart of any discussion of tax reform. It arises in both of the consumption tax systems under examination in this Article.[56]

To illustrate the importance of achieving the correct form, consider the couple above who, unlike the Arneses, arrange for one spouse to buy the other out directly. While the transaction appears to be equivalent to *Arnes*, it differs in that, contractually, they have distributed the tax burden differently. If John, for instance, were to have bought Joann's stock directly for a note payable to her, section 1041 would defer any tax on him until he sold that stock.[57] However, John would not only be using his own after-tax dollars (instead of corporate pre-tax dollars), but his stock basis would not reflect the amount he actually paid for the stock. Instead, under section 1041(b), John would be required to carry over Joann's lower stock basis, similar to a donee of a gift.[58] Joann would escape tax entirely, since she received cash or a note.[59] This would, theoretically, reduce the amount he would be willing to pay her to the amount she would have realized, after tax, had the corporation redeemed her stock (by issuing a note similar to John's) in a taxable non-spousal transfer, outside of section 1041. The inequality of bargaining power between the two spouses in particular cases, however, makes the section 1041 result less laudable than has been assumed by those who embrace that section's rationale.[60]

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then treated as a constructive dividend. Another example, and even more directly on point in this case, is found in the regulations: "The cancellation of indebtedness of a shareholder by a corporation shall be treated as a distribution of property." Treas. Reg. § 1.301-1(m) (as amended in 1995); *see also*, BITTKER & EUSTICE, *supra* note 35, ¶ 8.05[6], at 8-46.

55. BITTKER & EUSTICE, *supra* note 35, ¶ 9.06[6], at 9-45 n.214.

56. Snyder & Gallegos, *supra* note 3, at 69.

57. I.R.C. § 1041(b)(1) (1996).

58. *Id.* § 1015.

59. Joann could be liable for a deferred tax, as in John's case, had she received some of John's low basis property in addition to the cash or note, and later sold that property. *Id.* § 1041(b)(2). A potential for a double tax exists if the corporation is deemed to have been the real purchaser of her stock where the consideration consists of appreciated corporate assets. Section 311(b), as part of the 1986 Congressional repeal of most of the *General Utilities* doctrine, now taxes the corporation on the built-in gain on the appreciated property distributed in redemption of stock. This coupled with either a capital gain or dividend to the distributee-shareholder results in double taxation.

60. *See, e.g.*, Asimow, *supra* note 50, at 73-84.

A court order for John to pay Joann would have the same effect as a direct stock purchase by John: a primary and unconditional obligation. However, if a court were to order the corporation to redeem Joann's stock, Rev. Rul. 69-608, at least as interpreted by the majority of the Tax Court, seems to assure that John would not receive constructive dividend treatment, even though John's benefit arguably exceeds that of the corporation—all because the corporation has the court ordered obligation—and not John.[61]

Up to this point, analysis has focused only on the individual and how interactions with a close corporation can produce—or not produce—taxable events and their ultimate characterization as either ordinary income or capital gains. In the sections that follow, the same issues will be highlighted in the context of how the various consumption tax proposals will treat them. These sections will also focus, to a certain extent, on the corporation and how certain events can shift or defer the corporate tax burden in ways that are quite alien to the current system, but presumably consistent with the flat tax and USA tax proposals.

C. *Results Under the Flat Tax, H.R. 2060*

1. *Simplification*

The entire controversy that arose in the *Arnes* cases over who should bear the tax burden, and for what reason, would seem to vanish under the flat tax. When John and Joann divorced, John caused Moriah to redeem Joann's stock in return for a note. The note, as a redemption of corporate interest, would seemingly make the section 302/section 1041 controversy moot. Because the gain on the investment has theoretically been taxed at the corporate level, it does not get taxed again upon distribution to the investor. The flat tax avoids double taxation by only

61. Feld, *supra* note 28, at 652. Feld writes that the effect is to give practitioners a "clear line" with which to plan. *Id.* at 653; *see also* Asimow, *supra* note 50, at 73-84. Asimow refutes the charge that carryover basis, which is consistent with § 1041(b)'s gift treatment of inter-spousal transfers, somehow is biased against the nonworking spouse. He shows the importance of negotiating the property settlements to account for the tax burden that will eventually come due. *But, the disparity of bargaining power between the spouses may, in some cases, minimize the advantages of negotiation for one of the spouses.*

taxing wages at the individual level. The distribution, since it is not a wage, falls outside the tax base.[62]

Changing the form of the transaction to that of John paying Joann directly with an equivalent note—essentially the *Hayes* case—effectively shifted the tax burden from the wife to the husband as a constructive dividend under the current Code even though the corporation actually paid the note. Under the flat tax, the outcome is exactly the same as having Moriah redeem Joann's interest: Both transactions fall outside the tax base.[63] The involved controversies described in the previous section simply become irrelevant. That irrelevance ensures that both transactions, similar substantively, are treated similarly by the tax system. The flat tax also protects taxpayers, like the unfortunate husband in *Hayes,* from double taxation, once at the corporate level and then a second time at the individual level. The only price paid is a drastic narrowing of the tax base, just as Hall and Rabushka envisioned when they first proposed the flat tax in the 1980s.[64] However, this simplification raises another issue: What is a wage?

2. *Wages Versus Investment Income*

This issue is definitional, just as it is under the current law. However, the fault line runs not between ordinary income and capital gain as in the current system, but between wages and investment income because the former is taxed to the individual and the latter is not.[65] But, an argument can be made that a component of Joann's stock redemption can be structured as deferred—and disguised—wages on which neither she nor the corporation may pay tax. Even if the corporation were to pay a tax, it represents a major shifting of the incidence and timing of the tax.

62. H.R. 2060, *supra* note 1, § 63(a).

63. We are assuming, throughout this article, that the corporation is not distributing appreciated property (a so-called "in-kind" distribution) to the shareholder in redemption of her stock. A distribution of appreciated property, without a tax at the corporate level, would eliminate all taxation of business profit at both the business and individual levels, even after the business had fully expensed the purchase of this type of property. (Under the USA tax, however, the shareholder would include the fair market value of the property received in her income, with a deduction for certain reinvestments of this property.) While the flat tax does not, as currently drafted, address the problem of corporate distributions of "in-kind" property, presumably it would follow the USA tax provision (§ 211) which adopts current law by treating the distribution as a taxable sale of the property at its fair market value.

64. ROBERT E. HALL & ALVIN RABUSHKA, THE FLAT TAX (2d ed. 1995).

65. H.R. 2060, *supra* note 1, § 63.

Varying the *Arnes* scenario will illustrate this issue in a fairly stark manner. Suppose that the Arnes, when they formed Moriah,[66] only paid themselves a relatively small wage, say $50,000 per annum each as owner-operators, for their services. If they had to pay two executives $100,000 per annum to operate Moriah so that they could do something else, they would have paid $200,000 in total compensation, instead of just $100,000 in any given year. The flat tax would tax wages paid for services rendered during the tax year.[67] But since the proposed flat tax rate of seventeen percent is the same at both business and individual levels, aside from payroll taxes, the same total tax would be paid whether or not the owners receive salary or dividends.[68] For example, if the business paid only $100,000 in compensation instead of the $200,000 wages that would have been paid in an arms length employment relationship, the $100,000 lower business level deduction for wages would increase the business tax by $17,000. However, if the lower salary were distributed instead to the owners as a dividend (not taxable under the flat tax), the owners would have $17,000 less tax to pay. Thus, either way the owner-operator chooses to withdraw profits from her business, the same total tax is paid.[69]

However, the flat tax biases their investment decision by encouraging John and Joann to leave their profits in the corporation. A major new incentive allows businesses a full write-off in the year of purchase of "property used in business,"[70] such as equipment and other assets bought for expansion. These business level deductions thus reduce its tax by seventeen percent of the amount of business purchases. On the other hand, since owners such as John and Joann are not given a deduction for their individual financial investments under the flat tax,[71]

66. Our discussion assumes all transaction take place after the effective operative date of these tax proposals, disregarding, for this purpose, any special basis adjustment and other transition rules that might be in force.

67. H.R. 2060, *supra* note 1, § 63.

68. In fact, any distribution to the owners, even in redemption of their stock, would be non-taxable to the business and to the owners.

69. There is a built-in assumption in this example (and in the flat tax proposal, itself) that the IRS would not try to recharacterize the dividend as a constructive wage for payroll or other tax purposes. However, the proponents of this tax reform have expressly disavowed any attempt to coordinate the flat tax with our current payroll tax system. *See* HALL & RABUSHKA, *supra* note 64, at 77.

70. H.R. 2060, *supra* note 1, § 11(d)(2)(A)(i).

71. *Cf.* the unlimited savings deduction under the USA tax, discussed below.

an investment of wages received from the business starts at an after-tax amount which is seventeen percent smaller. In other words, an individual level financial investment must outperform business asset purchases to a considerable degree, although the margin of difference will become less the longer the holding period for the two types of assets.[72] Deferring the corporate tax (by a full 100 percent deduction for business assets purchased) will thus produce a higher yield on those types of investments made through the corporation.[73]

3. *Business Expenses and Borrowing*

Next, let us assume that at the time of the divorce, the business had a large operating loss carryforward (generated by fully deducted business asset purchases which exceeded the gross income of the business). The loss carryforward could be large enough to ensure that, although profitable from a cash flow standpoint, the corporation was paying little or no tax. As discussed above, both the flat tax and the USA tax allow for immediate expensing of all business asset purchases, regardless of whether or not they are capitalized or currently deductible under present law. To use current tax jargon, one way to regard this full expensing mechanism is that it postpones recognition of any gain. In this context, there is no real matching of revenues and expenses to a particular period. It allows deferral of any payment of tax until some later period. This forms the very heart of the bias for keeping business profits in corporate solution.

Moreover, borrowing by the business, as others have recognized, can potentially provide even more of a deferral—to the point of allowing withdrawal of dividends/profits in a period earlier than that in which the business tax would otherwise come due. Some observers have argued that not taxing borrowed money when first received by the borrower is the economic equivalent of denying a deduction for the repayment of the

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72. While businesses are not taxed on investment income (such as interest, dividends and capital gains), in keeping with the value-added tax philosophy, they are also not allowed a deduction for financial assets, including stock in other corporations. Business operating losses are carried forward, however, under rules similar to current net operating loss rules, but with the addition of an interest refund component. H.R. 2060, *supra* note 1, §§ 11(d)(2)(A)(i), d11(g). The USA tax has similar provisions. S. 722, *supra* note 2, §§ 203, 205(a)(3)C), 212, 207.

73. One example of this point: If John and Joann were to leave $100 with the business which buys an asset with a 5% rate of return (exclusive of the tax effect), then in five years, the business should be worth $127.63 more than without the business investment. A financial asset purchased by John and Joann, with after-tax wage dollars ($83), to achieve the same result, must produce a return of 8.99% return ($127.63) on the original investment.

interest and principal on the theory that the value of the loan at its inception equals the present discounted value of the future interest and principal payments.[74] However, when a business uses those loan proceeds to purchase business assets, which are fully deducted in the year of purchase, it is likely to generate loss carryforwards (excess of deductions over current income) that defer taxes for several tax years. This carryover of excess deductions against future years' income also yields the equivalent of an additional deduction computed by using the interest refund component.[75] The use of tax-free borrowed money in this fashion adds up to much more than the "net present value" of the cash stream of loan repayments.[76]

4. *The Divorce and Beyond: New Tax Planning Opportunities*

If John and Joann decide to end their marriage and redeem her share of the corporate ownership utilizing the above-described process of having the corporation apply her foregone salary to fully deductible business asset investments, thus generating loss carryforwards, both the corporation and Joann are accorded substantial tax benefits. Joann receives a note from the corporation, secured by John, just as in the *Arnes* case, payable over a ten year period.[77] Under the flat tax, she would not be taxable on any of it because it is nominally a return on her investment. But, as can be seen from our previous discussion, part of her investment might be more properly deemed deferred compensation that was reinvested in the corporation.

For the purposes of our scenario, we can quantify the size of each yearly investment as the difference between the wages Joann was paid and the wages that would have been paid in an arms-length employment relationship—$50,000 per annum for the period of time she and John operated the business together, say ten years.[78] Thus, $500,000 ($50,000 foregone salary x ten years) of Joann's note received for selling

74. THE DEBATE, *supra* note 2, at 188.
75. *See supra* note 72.
76. *See* Appendix at end of this Article (for a sample illustration of the effect of borrowing to purchase business assets and the resulting tax deferral benefits).
77. Although the form of the transaction has no tax significance under the flat tax, both John and Joann escape individual taxes regardless of whether John or the corporation bears the primary and unconditional obligation on the note.
78. This assumes a return in corporate growth in earnings of 10%, which is much less than the previous examples.

her stock back to the corporation is presumably transformed, under the flat tax, into a form of "savings." Joann is not taxed on this "principal" of her note nor the interest earned on it, since they are not "wages." The corporation is also likely to escape, or greatly minimize, the business tax if John keeps investing on behalf of the corporation during this period, making judicious use of borrowing and any loss carryforwards on its business asset investments (for example, expansion of its operations). The planning would become more complex if we take into account John's future tax burdens, resurrecting the current concepts of time value of money and net present value. Through the use of proper planning, John can defer a good deal of tax, thus reducing his burden as well.

If John were to sell out eventually, in years to come, he also would not pay any tax. However, the corporation will have to pay taxes on its profits during those years in which its expenses did not exceed revenues. Because of the nature of the expensing, a corporation's tax burden may vary quite significantly, depending upon what capital investments have been made and when—all of which lend to a considerable amount of tax planning.

If John were to perform a "sale and seller redemption,"[79] the buyer could purchase the business for very little cash out if John were willing to take a note. In another alternative, the corporation could also borrow the funds necessary to redeem John out of the business. John would not be taxed on the amount received since it was not wages. Assuming that Moriah could borrow that much, John would be better off since he would not face the risk of Moriah's continued viability under new ownership. Moreover, he could also borrow funds himself and then assign the note to the corporation in return for his stock. He could also just assign the note to the corporation and have it pay it off. Under the flat tax, all of these are exactly the same—transactions that fall outside the tax base. By tax planning as described above, John could defer any tax that would come due on the corporation's part for a significant number of years. The amount for which he could sell the corporation would be decreased by the net present value of the expected tax burden. This would, in fact, shift John's tax burden to the business's new owner.

79. So named in BITTKER & EUSTICE, *supra* note 35, ¶ 9.06[2], from a two-step transaction where the stockholder first sold a portion of his stock to the buyer and then had the corporation redeem the remainder under I.R.C. § 302(b)(3). The Service attempted to recharacterize this using the step transaction doctrine so as to obtain dividend treatment of the redemption, when the redemption preceded the sale but ultimately failed. *See* Zenz v. Quinlivan, 213 F.2d 914, 917 (1954); *see also*, BITTKER & EUSTICE, *supra* note 35, ¶ 9.06[2], at 9-39 to 9-40.

Perhaps the best way that the two parties could value the potential tax burden would be by using the tax value of the expense carryforwards at the point of sale. This would represent the amount of deferral that the buyer would inherit from John's investment activities.

Compare any of these alternatives to the tax burden that John and Joann would have borne had they been paid a salary—taxable at seventeen percent in the year in which it was received. In Joann's case, she would have received substantially less than if she had left the wealth in corporate solution and, in effect, reinvested in the business. John, in later years, would face much the same choice: take it now and pay seventeen percent, or leave it in corporate solution until the point of sale.

D. *Results Under The USA Tax, S. 722*

1. *Simplification*

It has been observed that "[t]he Nunn-Domenici [USA tax] proposal is not as simple as the flat tax, nor is it as sweeping in its elimination of tax preferences."[80] The American Institute of Certified Public Accountants attributes this to "realistic accommodations that may be necessary to ensure sufficient political support for enactment."[81] But, the USA tax's treatment of income and discharge of indebtedness raise some complications and revive the "form over substance" debate.[82] The "form over substance" debate also vitiates the notion that the flat tax and cash flow, or classic type consumption taxes, are equivalent. The decisions made about how to structure a particular transaction may change the tax treatment quite radically, thus influencing the decision-making process when structuring that transaction.[83] The influence of a tax system's design on such decision-making and differing outcomes between the flat and cash flow taxes also manifests itself in other ways.

80. THE DEBATE, *supra* note 2, at 124.
81. *Id.*
82. *See supra* notes 53-64 and accompanying text.
83. *Id.*

2. *The Definitional Problem in the USA Tax and the Fallacy of Tax Equivalency*

To return to the scenario discussed in the flat tax section, let us assume that John and Joann are married, owner-operators of Moriah, running a McDonald's as their primary business. If they paid themselves $50,000 each when the value of the services they render to Moriah would be $100,000 each in an arms-length employment relationship, they would be taxed in each year on the $50,000 with a deduction for whatever they saved and did not consume.[84] If they paid themselves $100,000 a year and then saved $50,000 in investments other than Moriah, then they would only be taxed on the $50,000 each that they consumed.[85] The remaining $50,000 would not be taxed as long as it remained invested. The definitional fault line that appears between different types of income in the current system (ordinary versus capital gain income) and the flat tax (wages versus investment income) recedes in the conventional consumption system, since it taxes only that wealth which is consumed.[86]

Conventional analysis assumes tax equivalency between the flat tax and the cash flow type consumption tax embodied in the USA tax.[87] As described in the Introduction of this Article,[88] the theory of tax equivalency is that allowing a full deduction for investments or savings in the year made (the USA tax) is the equivalent of allowing no deduction against income in the year the investment is made, but not taxing the income or gain therefrom when it is realized in subsequent years (the flat tax). The flat tax adopts what is sometimes referred to as a "tax prepayment" method. But this applies only to wages, which are taxed in the year received, with any yield or return from the portion of wages invested or saved not taxed again when received in subsequent

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84. S. 722, *supra* note 2, § 201.
85. *Id.*
86. For a complete theoretical discussion of a consumption tax, see William Andrews' seminal piece that appeared in the *Harvard Law Review* over twenty years ago. William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113 (1974). Andrews describes the consumption system as "a cash flow income tax [which] would correspond very closely to another ideal, that of a tax whose burdens are apportioned to current personal consumption expenditures rather than to total accretion." *Id.* at 1116.

In this issue, Alan Schenk describes the current rationales for adopting a consumption tax/VAT business tax. *See* Alan Schenk, *The Plethora of Consumption Tax Proposals: Putting the Value Added Tax, Flat Tax, Retail Sales Tax, and USA Tax into Perspective*, 33 SAN DIEGO L. REV. 1281 (1997).

87. *See* HALL & RABUSHKA, *supra* note 64; *see also* JCT REPORT, *supra* note 2.
88. *See supra* notes 3-4 and accompanying text.

years. The equivalency theory is only valid if the same effective tax rate applies throughout the investment period.[89] For instance, if rates rose over time, then the "tax prepayment method" (the flat tax) would both effectively tax at a lower rate than the "cash flow method" (the USA tax) and be less effective at raising actual tax receipts in the future.[90] It would also change behaviors by either subsidizing saving, if rates decreased over time, or subsidizing future consumption.

On the surface, the effect of the business taxes in the flat tax and the USA tax appear to be quite similar. Assuming that Moriah has the same expenses under the USA tax as under the flat tax scenario, where it pays little or no business tax, John and Joann would receive roughly equivalent treatment during the period prior to getting divorced.[91] This assumes, however, that the business expenses are high enough that the lack of salary deduction under the USA tax does not change the result. Under the flat tax, wages are deductible on the theory that they will be taxed in the same period on the individual side. Under the USA tax, wages and salary are not deductible beyond the payroll tax credit.[92] Thus, even at tax equivalent rates, John and Joann would pay a much

89. The flat tax statute provides for an annual inflation adjustment for the standard deduction, thereby automatically changing the effective tax rate annually. H.R. 2060, *supra* note 1, § 63(e). Tax rates, historically, have changed quite frequently, and there is no reason to believe that this would not occur under the proposals discussed.

90. This is because the wages in the tax base in period one are taxed at, say, 17%, and the investment income in subsequent periods, when the tax rates are higher, are outside the tax base, regardless of whether it is consumed or rolled over into savings.

91. This assumes equivalent tax rates for both regimes on both individuals and businesses. However, the USA tax has a lower tax rate on businesses (11%) and an eventual graduated tax rate on individuals from 8% to 40%. S. 722, *supra* note 2, § 13.

92. The USA tax provides for a 7.65% payroll tax credit to both businesses and individual taxpayers. (Payroll taxes refer to the 6.2% OASDI tax on both employer and employee—up to the taxable wage base, which is $62,700 for 1996—and 1.45% Medicare tax on both employer and employee, for a total of 15.3%. I.R.C. §§ 3101-3128 (1996).) The combination of the savings deduction from personal income and the payroll tax credit potentially will allow John and Joann to defer nearly indefinitely any tax burden, with their funds successfully extracted from the corporate solution and diversified. However, this is true only to the extent that the payroll tax credit offsets actual payroll taxes and the tax on wages paid. If the payroll tax credit is lower than the employer and employee regular tax rates, then the recharacterization of dividends as wages is less attractive to both parties. The nondeductibility of salaries at the business level, which is taxed at a rate of 11%, will not, as presently proposed, be sufficiently mitigated by the 7.65% payroll tax credit. Likewise, the taxability of wages to the employee at rates higher than the payroll tax credit only partially minimizes the tax burden.

For further analysis, see Snyder & Gallegos, *supra* note 3, at 49-51 & nn.193-202.

higher marginal rate on their consumption under the USA tax than they would under the flat tax. But both systems bias investment decisions in favor of John and Joann leaving their profits in corporate solution. Under the flat tax, John and Joann gained an immediate return on investment by leaving their profits in corporate solution. The motivation is not as great under the USA tax as under the flat tax, because the business tax rate is eleven percent (USA) versus seventeen percent (flat). However, if the rates were equivalent, then the motivation would be no different. The variations in treatment could potentially lead to some very different decisions about consumption versus savings, depending upon which system they were taxed under.[93]

The motivation for the business to borrow may even be greater under the USA tax,[94] to the extent that the payroll tax credit provision does not provide an equivalent effect to the wage deduction available under the flat tax.

3. *Divorce and the Return of "Form is Substance"*

When John and Joann do divorce, matters start to vary under the USA tax depending on how the parties structure their transaction. Let us assume that Joann has her shares redeemed for the same note from the corporation as it was under the flat tax.[95] Joann is separately liable for a tax on her realized gain as she receives it from Moriah.[96] However, if she invests it, she will receive a deduction,[97] but, to the extent that she consumes it, she will have to pay a tax. Her tax burden is entirely up to her, as is the timing of when she pays the tax.

On the other side of the transaction, other things remaining equal, Moriah will make payments on its note to Joann directly from corporate profits, thus ensuring that the transaction bears a business level tax in the appropriate period because it cannot take a deduction for this payment. Thus, John, as the sole shareholder of the corporation after the purchase of Joann's stock, will be encouraged to negotiate with Joann to obtain a decrease in the redemption amount that reflects a more equal distribution of the tax burden between them. But, if John were to continue to invest in Moriah by either leaving the excess cash flow with the business, or by borrowing so as to expand more rapidly, the

93. Any variation in decision—making finishes whatever tax equivalence there may have been to start with.

94. *See supra* note 74 and accompanying text (for further discussion of borrowing).

95. *See supra* note 63 (when appreciated property is distributed to shareholder instead of cash).

96. S. 722, *supra* note 2, § 15.

97. *Id.* §§ 50-58.

aggregate tax burden might be deferred well into the future, thus reducing the burden substantially.

However, the tax consequences might vary if John were to buy Joann's stock directly from her for a note payable to her over ten years and then assign the note to Moriah. The USA tax defines income in much the same way as the current system.[98] But the statute then creates a dichotomy between gratuitous discharge of indebtedness and discharge in return for "services, property or other valuable right."[99] If the corporation's assumption of the note were gratuitous, the consequence would be the same as if the original agreement had required the corporation to pay the note: John would not have any tax at the individual level. This is because the USA tax specifically excludes gifts from the individual tax base,[100] just like the current system[101] and the flat tax.[102] But this note potentially, at least, is taking the form of an employer gift to an employee.

In order to prevent the potential for tax avoidance attendant to characterizing a commercial payment or compensation as a gift, the current Code does not extend its general exclusion-of-gift to employer gifts to employees.[103] The USA tax would seem to require the same exception, otherwise taxpayers could potentially exploit the gaping hole: Employers could disguise compensation in the form of gifts by assuming employee debts. Gain to the employee could be excluded from individual tax (as high as forty percent). But, if the USA tax does utilize the exception, then another problem could potentially force the individual to pay tax on "income" when no cash is received with which to pay it and with no opportunity to take a savings deduction.[104] This

98. Income from discharge of indebtedness is included in the definition of income under S. 722, *supra* note 2, § 3(a)(10).

99. *Id.* § 4(a)(9) (excluding from income discharge of indebtedness if not for "services, property or other valuable right").

100. S. 722, *supra* note 2, § 4(a)(3)(A).

101. I.R.C. § 102(a) (1996).

102. Hall and Rabushka would tax only "compensation," thus excluding gifts completely from the tax base. HALL & RABUSHKA, *supra* note 64, at 142, 144.

103. I.R.C. § 102(c) (West 1995) ("Subsection (a) shall not exclude from gross income any amount transferred by or for an employer to, or for the benefit of, an employee.") This is because those from an employer to an employee are not true gifts. The inquiry focuses on whether the donor had a "detached and disinterested generosity." *Id.*

104. S. 722, *supra* note 2, § 50.

arises in the context of the fact pattern of *Hayes*,[105] discussed previously, in which "form" is sometimes deemed the "substance" in the current Code.[106]

This distinction made little difference under the flat tax because the entire transaction stood outside the tax base, where the assignment of the note was not defined as compensation.[107] However, under the USA tax, if John, as in *Hayes*, gave Joann a note in return for her stock, and then assigned the note to Moriah, two outcomes could occur. If it were classified as a gift—an anomalous result that would lead to the abuse described above—then no tax would be incurred because it would fall outside the tax base. Alternatively, if there were a ban on employer/employee gifts, the government could enforce payment of tax on the value of the note as it is realized because it is not a gift, but a payment resulting from an employer-employee relationship since John is an owner-operator of the company.

An alternate ground for taxing the transaction can be found in another old case, *Old Colony Trust Co. v. Commissioner*,[108] where discharge of an obligation by a third party resulted in a tax liability to the taxpayer. The effect of Moriah paying off John's note enriches him in just the same way that a corporation paying its president's income tax enriches the president.[109] The result would be the same to John regardless of the rationale—he would have to pay a tax on the note just as Mr. Hayes did when he bought out his wife.[110] But this outcome, which fits into the modified definition of income under the current system,[111] would seem to run counter to the basic tenet of the USA tax—taxation of consumption—and deferral of taxes on savings. John will have to recognize the discharge of the note in a year in which he cannot realize a concomitant savings deduction, for he has nothing to deduct. He would presumably have already taken a deduction for the stock he originally purchased from Joann and then paid her on an installment basis using taxed income in repaying a debt. When the note is discharged by Moriah, he will then have income, but no cash with

105. Hayes v. Commissioner, 101 T.C. 593 (1993).
106. *See supra* note 33 and accompanying text.
107. *Id.*
108. 279 U.S. 716 (1929).
109. *Id.* The regulations also memorialize the cancellation of indebtedness of a shareholder by the corporation as a constructive dividend. Treas. Reg. § 1.301-1(m) (as amended in 1995); *see also supra* note 32 (discussing constructive dividend treatment of below market interest rate loans between related persons); BITTKER & EUSTICE, *supra* note 35, ¶ 8.05[6], at 8-46.
110. Hayes v. Commissioner, 101 T.C. 593 (1993).
111. *See* Feld, *supra* note 28.

which to either pay the tax or purchase a savings instrument to avoid the tax. Merely by taking the primary obligation rather than letting Moriah redeem Joann, John will be materially worse off. This seems to echo the outcome of Rev. Rul. 69-608 that "form is the substance here"[112]—an outcome that tax reform is supposed to eliminate.

4. *Sale of the Business and Tax Planning Under the USA Tax*

If John finally sells to Moriah, years later at a much larger value than when Joann redeemed her share, he faces a tax burden unless he reinvests. He too, can plan his tax burden and the timing of when, if ever, he pays a tax. If John has continued to reinvest in the business over the course of time, he will have potentially deferred taxes—or at least a good deal of it—well into the future. John would face a potential tax burden personally, but only to the extent that he does not utilize the savings deduction.[113]

III. THE USE OF TRUSTS: EXPLORING ALIMONY AND DEFERRED COMPENSATION

"Put not your trust in money, but put your money in trust."

— Oliver Wendell Holmes,
The Autocrat of the Breakfast-Table II

This part of the Article will explore, rather tentatively, how the flat tax and USA tax would change the basic structure of the current *income* tax treatment of trusts and estates. Because the proposals are incomplete and do not yet address some critical issues, our analysis is sometimes based on a blind-faith hope that we captured the essence of what the proponents have in mind.

112. BITTKER & EUSTICE, *supra* note 35, ¶ 9.06[6], at 9-45 n.214.
113. John would also be able to utilize such techniques as a "sale and seller redemption." *See* discussion *supra* note 79 and accompanying text.

A. *Taxation of Trusts Under Current Law*[114]

Trusts are separate legal entities that pay taxes on their current year's income, unless it is distributed to the beneficiaries (or unless the income is taxed directly to the grantor who retained some controls over the trust—referred to as a grantor trust). Trust income is generally determined in the same manner as for individuals and corporations. Dividends, gains, losses, and expense deductions are included or subtracted from gross income to arrive at taxable income. Income that is accumulated by the trust for later distribution to a beneficiary is taxed to the trust; the beneficiaries pay a tax on distribution under the so-called throwback rules, but the beneficiary receives a tax credit (with limits) for the tax paid by the trust.[115] In 1993, Congress compressed the tax rates for trusts and estates so that the highest individual rate bracket (39.6%) starts at $7,900 of taxable income.[116]

Although a creature of British common law, dating back to the Statute of Uses in 1535,[117] and as someone once suggested, perhaps "conceived in sin as a device to hide money from the King," the trust has become an integral part of American life. Because it is utilized as a means of dividing ownership of property into two historically denominated components—"legal" title and "equitable" title—it serves a wide number of purposes. By transferring legal title to property to a trustee, a settlor (grantor) can assure herself that a beneficiary (the equitable owner) will not have direct access to the trust property or that the property will be managed by the trustee so as to minimize the chance of its being dissipated. Conversely, in the alimony context, trusts offer the beneficiary spouse a measure of assurance that she will receive the support payments without the need to rely on periodic checks issued by the payor spouse. The trustee is also subject to a higher fiduciary duty than is an individual. However, trusts have historically been an ideal way to reduce one's tax burden. Examples of this are: (1) by shifting income-producing property to a lower bracket family member (but the increased rates on trusts starting with 1993 have curtailed this advan-

114. Our discussion of the income taxation of trusts under Subchapter J, I.R.C. §§ 641-692, will apply generally to estates as well.

115. I.R.C. §§ 661-668 (1996).

116. *Id.* § 1(e). These higher rates provide a disincentive for accumulation of income in a trust or estate and place into question the continued use of trusts for assignment of income purposes. However, the trust vehicle still offers estate and gift tax and generation skipping opportunities, as well as the traditional non-tax reasons for creating a trust in the first place.

117. 27 Hen. 8, ch. 10.

tage); (2) by avoiding a purportedly burdensome tax rule not applicable to trusts or their beneficiaries—alimony, for example;[118] and (3) by generating a current charitable deduction for a contribution of a remainder interest in property retained for a donor's use for the rest of her life.[119] These multiple types of trusts, while convenient for those taxpayers able to use them, create problems in resolving a number of income tax issues under our current system.[120]

Among the problems and issues are: (1) the role of state law in determining what is property ("corpus") and what is income; (2) the interrelationship between direct (non-trust) gifts of property and gifts of income; (3) the remaining role of assignment of income; (4) the timing and characterization of gains; (5) the difference between taxing the trust and taxing the beneficiary; and (6) what to do about expenses incurred by the trust on behalf of the beneficiary (more of a problem in a consumption tax system).

B. *Alimony Trusts*

1. *Fact Pattern*

In contrast to the facts of the Arnes case,[121] where Joann owned one-half of the family corporation stock, let us assume instead that another couple, Tom and Sue, are involved. Tom owns all the stock in a highly profitable fast food franchise (Max's Inc.) under a license and operating

118. For example, the limitation on "front-loading of alimony payments" (to distinguish spousal support from property settlements) and the requirement that liability for alimony payments ceases at the death of the payee spouse, under the alimony rules in I.R.C. §§ 71(b), (f), can be avoided by using an alimony trust under I.R.C. § 682.

119. *E.g.*, I.R.C. § 664 (1996).

120. Two of the many books on the income tax issues in trusts are: (1) HOWARD M. ZARITSKY & NORMAN M. LANE, FEDERAL INCOME TAXATION OF ESTATES AND TRUSTS (2d ed. 1993); and (2) Donna L. Seiden & Nicholas E. Christin, *Income Taxation of Trusts and Estates*, [Estates, Gifts & Trusts] Tax Mgmt. Portfolios (BNA), No. 852 (1996). The IRS, Statistics of Income Division, publishes helpful tax return data on a number of entities. Unfortunately, the latest information for estates and trusts was published in 1985 (for the 1982 study). While this is critical data in evaluating any reforms or abuses in the trusts and estates area, the IRS states that budgetary restraints have prevented more current studies. *See* Letter from Thomas B. Petska, Chief, Special Studies and Publications Branch, Statistics of Income Division, Internal Revenue Service, Washington, D.C., to Prof. Lester B. Snyder, Professor of Law, Univ. of San Diego School of Law (Oct. 9, 1996) (on file with the Authors).

121. *See* discussion *supra* Part II.

agreement with the national franchisor. Sue owns no stock and her former spouse, Tom, agrees to satisfy his entire marital obligation to her by creating an alimony trust. Under the terms of the trust agreement, Tom would transfer one-half his stock in the franchise to the trust.[122] The income from the trust (dividends paid by the corporation) would be paid to Sue for 15 years as the main source of spousal support; and at the end of that period the trust would end, with the stock reverting back to Tom, assuming they have no children. The trust would be otherwise irrevocable, and the trustee would be a bank. The corporation will guarantee payment of an eight percent dividend (from its pre-tax profits) on the $800,000 worth of stock being transferred to the trust. Tom's tax basis in the stock, which he originally received as an inheritance from his parents, is $200,000.[123]

2. *Results Under Current Law*

If Tom had retained full ownership of the stock and had paid over the dividends he received to his ex-spouse as alimony, Tom would have first included the dividends in his gross income. Assuming section 71 of the Code were otherwise complied with,[124] Sue would include the support payments in her gross income and Tom would be entitled to a deduction from gross income.[125] In effect, Tom would be allowed to assign or shift his income to Sue under a statutory regime created in 1942, as an exception to the fundamental principle prohibiting assignments of income (to preserve the graduated tax rate structure), as encunciated by Justice Holmes in the classic case of *Lucas v. Earl*.[126]

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122. We are assuming that the franchisor would permit Tom to transfer one-half his stock to a trust without violating their policy of restricting stock ownership only to those who are active managers. We are further assuming that there are no issues raised because of one person owning 100% of the stock, although, as will be developed in the next segment on deferred compensation trusts, Tom plans to expand the corporation by acquiring additional franchises and by issuing stock to three or four new unrelated investors.

123. We are assuming the inherited stock is not community property.

124. Among § 71 requirements for payments to a spouse to be deemed taxable alimony are (1) that they are made in "cash", (2) that they end at the death of the payee spouse, (3) that there is no front-end loading (substantially higher payments in the first three years), and (4) that they are made under a court decree or court approved agreement. I.R.C. § 71 (1996).

125. *Id.* § 215. The same result would occur if Tom received a salary from the corporation (deductible by the corporation if "reasonable") and paid the alimony out of that salary. *See* discussion of converting "wages" income to dividend income, *supra* Part II.C.2, and *infra* Parts III.B.3-4, under the flat tax and USA tax discussions.

126. 281 U.S. 111 (1930). Prior to 1942, alimony was neither deductible by the payor, nor taxable to the payee spouse. Gould v. Gould, 245 U.S. 151 (1917). In 1942, Congress changed this result by enacting what are now I.R.C. §§ 71, 215.

By transferring the stock to an alimony trust, we move to a different set of rules. Tom's stock transfer to the trust generates a realized gain of $600,000 (assumed fair market value of $800,000 less adjusted basis of $200,000).[127] However, the enactment in 1984 of I.R.C. section 1041 results in non-recognition of that gain, in effect allowing the transferor to escape tax on the realized gain, by shifting the burden to the transferee spouse who assumes the tax basis of the transferor.[128] Section 1041 applies to a transfer in trust as well. Thus, the alimony trust for Sue will result in the trust carryover of Tom's $200,000 basis, but assuming the trustee has no power to sell the stock during the fifteen-year term, there should be no further sale or distribution of the stock by the trust during that period.[129] The 1984 enactment of section 1041 has made the alimony trust a more attractive vehicle.

Once the stock is in an alimony trust, the spousal support provisions of sections 71 and 215 no longer apply. Instead, the taxation of the income derived by the trust is governed by the provisions of Subchapter J—the rules applicable to trusts and beneficiaries.[130] The recipient

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127. I.R.C. § 1001 (1996). For potential "special valuation" gift tax issue on transfers in trust for "family" members, where transferor retains an interest, see *Id.* § 2702. The income tax definition of "gift" does not necessarily mesh with the gift or estate tax definition. *See, e.g.*, Farid-Es-Sultaneh v. Commissioner, 160 F.2d 812 (2nd Cir. 1947).

128. I.R.C. § 1041(b) (1996). Prior to 1984, a transfer of property to a spouse as part of a divorce was deemed a taxable event to the transferor. U.S. v. Davis, 370 U.S. 65 (1962). The transferee spouse was not taxed on the property received and was allowed a stepped-up basis to its fair market value. Rev. Rul. 67-221, 1967-2 C.B. 63. *Davis* generated a host of problems, including the imposition of a heavy tax burden on the couple at an inopportune time, the lack of cash to pay the tax, the disparity between common-law state taxpayers and community property state taxpayers (where division of marital property was often inherently a tax-free equal division of jointly owned property), and the claimed whipsaw effect on the IRS where the transferor paid no tax, but the transferee received a fair market value basis. For a discussion of § 1041 rationales, see Asimow, *supra* note 50.

129. Complications arise in cases where the trust (or an estate) distributes property in satisfaction of a bequest or devise where the beneficiary is entitled, under state law, to a specific dollar amount or to specific property other than that distributed. I.R.C. § 643(d) (West 1995); Treas. Reg. Sec. 1.661(a)-2(f)(1) (as amended 1973). *See* ZARITSKY & LANE, *supra* note 120, ¶ 4.11 (for full discussion of this issue); *see also* Seiden & Christin, *supra* note 120, at A-78. This appears to be a vestige of the rule that satisfaction of a debt which generates gain results in tax to the debtor (the trust in this case-when the specific property received by the beneficiary is not the specific property willed to her).

130. I.R.C. § 682 (1996). It has been suggested that "wealthy individuals originated such 'alimony trusts' as an income-shifting device in the era before an alimony

spouse is taxable on the amount of trust income she is entitled to receive. The spouse who created the trust is not entitled to any deduction. In other words, Tom, in our example, would not be allowed a deduction for the dividend income generated by the trust he created. Technically, the dividend income would be included in the trust's income, but the trust would deduct the amount it was required to distribute to Sue, the sole beneficiary.[131] Section 682 creates an exception to the grantor trust rules[132] when normally a grantor, such as Tom, would be taxed on the trust income: (1) when the trust was used to pay his obligations; (2) when the trust was revocable or subject to a reversion in the grantor; or (3) when the trust was otherwise under his control. As a result, section 682 by-passes the grantor trust rules where the income (and expenses) of the trust are attributed to the grantor to be reported on his own return as if no trust existed.

The alimony trust does, however, raise a number of troublesome issues. To mention a few, the statute allocates the "amount of income of any trust" to the beneficiary spouse. Some confusion has developed in determining whether tax-exempt interest is taxable to the spouse, though not taxable to the trust. I.R.C. section 652(b), which states that income shall retain the same character as in the hands of the trust, would supposedly resolve that issue, but the IRS has litigated this point with mixed success. Another issue is whether the section 682 format is upset where the grantor retains the right to allocate income among beneficiaries, thereby taxing the grantor and not the beneficiary or trust. Questions arise on child support payments. Section 682 specifically excludes from its ambit amounts paid for child support, creating an allocation problem in cases where the trust instrument is not carefully drafted.[133]

The alimony trust rules do, however, have some advantages for the grantor. The restrictions in section 71, requiring alimony to end at the death of the recipient spouse, and the front-end loading rules are not applicable under section 682 trusts.

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deduction was permitted by the Code". MICHAEL J. GRAETZ & DEBORAH H. SCHENK, FEDERAL INCOME TAXATION PRINCIPLES AND POLICIES, 484 (3d ed. 1995).

131. I.R.C. §§ 651, 652 (1996).

132. *Id.* §§ 671-678.

133. For detailed discussion of these issues, see Roland L. Hjorth, *Divorce, Taxes, and the 1984 Tax Reform Act: An Inadequate Response To An Old Problem*, 61 WASH. L. REV. 151 (1986).

3. *Results Under the Flat Tax*

How would Tom, Sue, and their alimony trust fare under the proposed flat tax?

The proposal is silent on the taxation of trusts and estates. The flat tax statute is deceptively simple; the entire tax portion is contained in fewer than twenty pages. Since the alimony trust in our illustrative case is not a "business activity,"[134] it is not a taxable entity. The original proponents of the flat tax, Professors Hall and Rabushka, provide some clue in the question and answer chapter of their book:

> Q: What about nonbusiness entities such as trusts, estates. . . .
> A: [A] conventional personal trust, which holds stock[s] and bonds, deals entirely in after-tax income, so there is no reason for the tax system to pay attention to it.[135]

It is thus reasonable to assume that the intention of the proponents is not to tax the trust or its beneficiaries! This would herald the end of Subchapter J of the Code in what may first appear to be an unprecedented simplification of the income tax system. The presumption is that dividend or interest income has already been subject to one layer of tax at the business level (taking as a given that the business tax was not passed on to the consumer),[136] and to tax it again would contradict the removal of the double tax curse from the new tax regime.

While Tom, Sue, and the alimony trust would thus avoid tax on the trust income, this is arguably the same result as when Tom or Sue owned the stock directly. Dividends are simply not taxed to anyone.[137]

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134. H.R. 2060, *supra* note 1, §§ 11(a)-(b).
135. HALL & RABUSHKA, *supra* note 64, at 126.
136. In this Symposium, see Schenk, *supra*, note 86, and Reuven S. Avi-Yonah, *From Income to Consumption Tax: Some International Implications*, 33 SAN DIEGO L. REV. 1329 (1997) [hereinafter Avi-Yonah, *Income to Consumption*]. *See also* Reuven S. Avi-Yonah, *The International Implications of Tax Reform,* 69 TAX NOTES 913, 918 (1995) [hereinafter Avi-Yonah, *International Implications*].
137. While this may create an incentive in the closely-held corporation to leave the profits with the corporation to allow it to expand, the non-taxability of dividends may have the unintended result in a publicly-held corporation. These shareholders may pressure management to declare dividends, thereby creating the potential for less growth in our major corporations. *Cf.* ALVIN C. WARREN, JR., AMERICAN LAW INST., FEDERAL INCOME TAX PROJECT: INTEGRATION OF THE INDIVIDUAL AND CORPORATE INCOME TAXES, REPORTER'S STUDY OF CORPORATE TAX (1993) (report recommends a corporate level withholding tax which would be offset against taxable dividends to shareholders).

Similarly, Tom would have no tax on the transfer of appreciated stock to the trust, even without the help of a non-recognition provision such as section 1041. Since the tax base under the flat tax includes only "cash wages," any gain on the transfer of property to anyone is inherently not taxed.

However, tax reform comes with a new premium on tax planning, with higher stakes involved than under current law. If, instead of funding his alimony obligation through the transfer of stock to a trust for Sue, Tom were to take a salary, of say $120,000, from the corporation, out of which he paid Sue $60,000 in spousal support, Tom would remain taxable on the entire $120,000, with no deduction for the $60,000 alimony payment. Sue would not be taxed on the alimony, leaving her with more spendable income than Tom. The flat tax proposed rate of seventeen percent on Tom's income ($20,400), less the $60,000 paid over to Sue, leaves Tom with a spendable income of $39,600, compared to $60,000 for Sue. There is no obvious rationale for this result offered by the flat tax proponents. This appears to discriminate against those who receive their income from services in favor of those who have the means and ability to transfer the amount of capital necessary to yield the equivalent alimony to the recipient spouse.[138] It is not an assignment of income problem, which is non-existent in a flat tax world.[139] In other words, the goal of eliminating double taxation comes with a high price tag, at least in this context, for those who render services.[140]

The newly-created incentive in favor of dividend income versus salary also reverses the roles of government and shareholder-employees of closely-held corporations. Under current law, there is generally an advantage for the shareholder-employee to take a higher salary, thereby reducing the corporate level tax (and the concommitant double tax burden). Dividends, as such, are not deductible by corporations under

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Ostensibly the same issue is presented, but at least one tax would be collected.

138. Michael J. McIntyre and C. Eugene Steuerle recognize this disparity, adding that elimination of the alimony deduction "would complicate life for former spouses who reached divorce settlements before enactment of the flat tax." However, they point out that the alimony deduction reduces taxes paid by the couples *in the aggregate*, resulting in higher rates for other taxpayers. They further conclude that the impact of the taxation of alimony payments in families with children is unclear. MCINTYRE & STEUERLE, *supra* note 5, at 47-48.

139. But the family allowance (up to $21,400 as proposed) would create some incentive to shift income at the lower end of the income scale. This would also retain the "marriage penalty" at that level. *See* Edward J. McCaffery, *Equality of the Right Sort*, 6 UCLA WOMEN'S L.J. 289 (1996).

140. The flat tax methodology for curing the double tax on savings and capital investment, by taxing only wage income, should be compared with the more equitable (yet more complex) structure of the USA tax, in which *all* income is taxed in the first instance, with a deduction for savings. *See* discussion *supra* note 4.

current law, but "reasonable" salaries paid for services are deductible to the corporation.[141] The taxpayer-shareholder is thus put in the position of defending her salary against the IRS argument that a portion of the salary is merely a disguised dividend. Under the flat tax, the government would prefer "salary" rather than "dividend" treatment. As for Tom in our hypothetical case, the real difference between salary and dividend, in an economic sense (at least while he is sole owner of the corporate stock), may well be illusory, but the tax consequences are not. The alimony trust, in a flat tax world, would be a more advantageous way to meet one's support obligations than under current law, at least for higher income taxpayers with ample property to fund the trust. Taxpayers who are unable to fund an alimony trust with capital are left in the position of taxing the wage earning spouse on the entire income, creating spendable income disparities.

4. *Results Under the USA Tax*

In contrast to the simplified, but narrower, tax base of the flat tax, the USA tax is much more complex. The individual side of the USA tax is levied at graduated rates (from eight to forty percent) on worldwide net income (gross income, as we now know it, less a redefined list of deductions)[142] of U.S. citizens and resident aliens.[143] The "Big Pine-

141. I.R.C. § 162(a)(1) (1996); *cf. id.* § 162(m) (limiting deductions for salary paid to certain top executives to $1,000,000, unless the higher amount is based on performance standards).

142. Among the deductions allowed are: child support payments (expanding the alimony deduction), personal and dependency exemptions, and increased standard deduction ("Family Living Allowance"), a more limited mortgage interest deduction, a new education deduction ($2,000 for each student), a charitable deduction, and a general basis account (primarily a transition adjustment) for those assets acquired under the pre-consumption tax regime. S. 722, *supra* note 2, §§ 5,6, 7, 9, 10, 11, 57. A new credit for social security taxes paid by businesses and individuals is allowed. *Id.* §§ 21, 281-283.

143. *Id.* §§ 1, 2, 15. The business component of the USA tax, an 11% value added type tax, includes only sales in the United States, which opens up a number of international tax issues. *See* Avi-Yonah, *Income to Consumption, supra* note 136; Avi-Yonah, *International Implications, supra* note 136 (discussions of GATT issues raised by these proposals). A major asserted advantage of a destination principle VAT is that it results in export/import neutrality trade by allowing border tax rebates for exports and imposing a tax on imports. The flat tax on businesses does not allow for border rebates on exports. *Cf.* H.R. 4050, *supra* note 2 (adopting a modified VAT/income tax system with tax rebates for exports similar to the USA tax).

apple"[144] in the USA tax is the "unlimited savings account" for new net savings.[145] Savings includes investments in stock, bonds, and other securities, but excludes investment in land and certain other real estate and certain tangible personal property, such as coins, stamps, and other collectibles.[146] Withdrawals from savings (unless resaved) are taxable.[147] Unlike the classic consumption tax, borrowed money is generally not included in income, thus, interest and principal payments are not deductible.[148]

Returning to our illustrative case of Tom and Sue, the first question relates to Tom's transfer of one-half his corporate stock to an alimony trust for Sue.[149] Our search of the USA tax statute, as proposed, found

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144. Taken from Martin D. Ginsburg, *Life Under a Personal Consumption Tax: Some Thoughts on Working, Saving, and Consuming in Nunn-Domenici's Tax World,* 48 NAT. TAX J. 585, 588 (1995).

145. S. 722, *supra* note 2, §§ 50-58.

146. *Id.* § 53.

147. *Id.* § 54.

148. However, the USA tax attempts to curtail the use of borrowed money to save. Except for certain types of debt, such as mortgage debt on a principal residence and consumer debt up to $25,000, borrowing will generally reduce (but not below zero) the "net savings" deduction. JCT REPORT, *supra* note 2, at 3602. As Professor Alvin C. Warren, Jr., notes, by allowing a deduction for "net savings," the USA tax does not follow "the standard cash flow tax design of including all receipts (including borrowed receipts) and deducting all nonconsumption payments (including payments of interest and loan principal)." He then demonstrates that the USA tax method is more complex than the standard model and does not always "properly account for liabilities". Alvin C. Warren, Jr., *The Proposal For An "Unlimited Savings Allowance,"* 68 TAX NOTES 1103, 1104 (1995); *see also* Committee on Simplification American Bar Association Section of Taxation, *Complexity and the Personal Consumption Tax*, 35 TAX LAW. 415 (1982); NICHOLAS KALDOR, AN EXPENDITURE TAX (1955); Andrews, *supra* note 86; Lee A. Sheppard, *The Consumption Tax: Borrowing as a Tax Shelter,* 68 TAX NOTES 138 (1995) (discussing debt issues in both flat tax and USA tax).

149. We are assuming throughout this Article that all transactions and events occurred after the enactment of each of these proposals. Thus, the transition problems that would exist by transferring pre-USA tax stock—where the basis of the stock represents after-tax capital and would require a mechanism to avoid taxing it again under the new tax system—is not discussed here. Transition issues have been widely discussed. *See, e.g.*, Louis Kaplow, *An Economic Analysis of Legal Transitions,* 99 HARV. L. REV. 509 (1986); Michael J. Graetz, *Legal Transitions: The Case of Retroactivity in Income Tax Revision*, 126 U. PA. L. REV. 47 (1977); Shounak Sarker & George Z. Zodrow, *Transitional Issues in Moving to a Direct Consumption Tax*, 46 NAT'L TAX J. 359 (1993); Louis Kaplow, *Recovery of Pre-Enactment Basis Under a Consumption Tax: The USA Tax System*, 95 TAX NOTES TODAY 171-47, Aug. 28, 1995, *available in* Westlaw, TNT database, 95 TNT 171-47 (citing David F. Bradford, *Consumption Taxes: Some Fundamental Transition Issues* (forthcoming)). Some commentators take the position (perhaps an extreme one) that a new tax system is doomed because of the transition problems, notwithstanding instances of major changes in the tax law in the past 70-80 years. Granted these changes were not as formidable as would be required to move to a consumption tax, many of the concepts of current law would attach to the consumption tax proposals discussed in this Article. *See, e.g.*, Lewis Lyons, *Pearlman: Transition Problems May Stop Reform, But Not an Add-On VAT*, 96

no specific provision on alimony trusts (a section 682 analogue) and no provision on non-recognition of gain on spousal transfers in trust or otherwise (similar to section 1041 of current law). However, the answer might be built into the larger structure of the proposed statute itself.

The USA tax excludes the gain on the appreciated stock from the general gross income rules.[150] The withdrawal from savings rules in the unlimited saving account deduction would tax the transfer of stock (a savings asset) to a trust, but the trust provisions in the USA tax trump the general rule by not taxing transfers of savings assets to a trust.[151] The rationale for not taxing the transfer of stock to Tom's ex-spouse may be to treat the transfer as a gift of appreciated property, similar to current section 1041, even though the transfer is obligatory, as opposed to gratuitous. The trust, or Sue, would presumably take Tom's basis ($200,000) for the stock. But why only transfers to a trust? If Tom had transferred the stock to Sue outright in a divorce property settlement (disregarding community property issues by assuming Tom inherited the stock from his parents), would it be a gift or a taxable transfer?[152]

If Tom has no new investments or savings in that year to offset the gain on the transfer of the stock, his tax liability under the USA tax could be as high as $320,000 (forty percent x $800,000). Using more familiar jargon, his "realized" and "recognized" gain is the excess of the fair market value of the stock ($800,000) less its basis ($0), or $800,000.[153] Tom was allowed to deduct the full cost of the stock ($200,000) at the time of purchase (in a post-USA tax year), and has therefore previously recovered his investment.

TAX NOTES TODAY 158-1, Aug. 13, 1996, *available in* Westlaw, TNT database, 96 TNT 158-1 (interview with Ronald A. Pearlman, former Chief of Staff of the Joint Committee on Taxation).

150. S. 722, *supra* note 2, § 3(a)(11) This section defines income to include: "Gains on the sale or disposition of assets (other than savings assets)." Apart from the parenthetical exclusion of "savings assets," this is analogous to § 1001 in the current I.R.C.

151. *Id.* § 54(a)(1).

152. *Id.* § 56(c)(1) (section is directed at "gratuitous" transfers by "donors").

153. This is a return to the pre-section 1041 era (pre-1984), when the decision in U.S. v. Davis, 370 U.S. 65 (1962), holding a transfer of appreciated property in exchange for the release of marital property rights incident to divorce, was a taxable event to the transferor. The policy reasons for the enactment of § 1041, discussed *supra* note 48 and accompanying text, do not disappear in the USA tax, and thus a § 1041 analogue should be added to the proposal.

Assume, however, that the rules applicable to gratuitous transfers are also applicable to obligatory family transfers such as spousal support. The USA tax treats a "gift" of a non-cash saving asset as non-taxable (not deemed a "withdrawal") to the donor.[154] The receipt of the gift (or bequest) by the donee is not taxable, and the donee takes the donor's basis, if any, in the asset. There is no new savings deduction for the donee unless the asset is sold and the proceeds reinvested.[155] Cash gifts, such as withdrawal of money from a checking account, will presumably constitute taxable withdrawals to the donor.[156] Since the cash has been taxed, it has a basis (disregarding the difficulty in tracing basis in fungible property) equal to the amount of cash. The donee has no income on receipt of the cash, and if she saves it, the donee would be entitled to a full savings deduction.[157] In any event, on a transfer of a savings asset to an alimony trust as a non-cash gift by Tom, Sue and the trust itself would have no tax, but the trust would have a zero basis (assuming Tom deducted the purchase of the stock in prior years). The trust and beneficiary would then be taxed on the income from the stock, as will be described below.

The combination of the limited definition of a savings asset and the ability to borrow money to purchase a non-savings asset tax free, may well confirm the drafters' fears that the tax bar "is poised to do them in."[158] Professor Martin Ginsburg notes that the anti-abuse provisions[159] "sprinkled about the USA Tax," such as concerns that taxpayers will borrow against their savings to consume (instead of withdrawing the savings), suggest that there are inherent basic faults in the unlimited savings allowance.[160] For example, it is possible that none of the anti-abuse rules in section 58 of the USA tax prevent Tom from borrowing $800,000, using a nonsavings asset, such as land or his personal residence, or his deceased mother's jewelry collection as security, and transferring the funds to an alimony trust, thus avoiding the withdrawal tax. (Simply borrowing against his stock may be caught by one of the anti-abuse rules, providing the Treasury Department adopts appropriate

154. S. 722, *supra* note 2, § 56(c)(1).

155. *Id.* §§ 4(a)(3), 56(c)(1), 56(c)(3), 4(a)(12). Note that there is no need for the stepped-up basis rule in I.R.C. § 1014 under the USA tax (or the flat tax either), since savings assets are fully deductible at the time of acquisition, and non-savings assets are not on the favored "species" list.

156. *Id.* § 56(c)(3).

157. *Id.* § 56(c)(3).

158. Ginsberg, *supra* note 144, at 590.

159. *E.g.*, S. 722, *supra* note 2, § 58.

160. Ginsburg, *supra* note 144, at 590. For a critique of the the unlimited savings account and the use of borrowed money, see Warren, *supra* note 148.

regulations.[161]) The complicated rules applicable to the taxation of trusts would not seem to attribute any trust activity to the grantor, Tom, during the fifteen-year term of the trust, taxing only the beneficiary on distributions of trust income (and certain expenses incurred on her behalf).[162] Many more planning opportunities would undoubtedly surface.[163]

Under the USA tax, Tom and Sue do have the option to have Tom pay his alimony directly to Sue without the intervention of a trust. Unlike the flat tax, the USA tax provides for the inclusion in income of alimony (and child support) by the payee spouse and a deduction to the payor spouse.[164] The alimony rules are not as restrictive as the current law (for example, there are no front-end loading rules).

Assuming, however, that an alimony trust is workable for both spouses, what are the likely tax consequences to the parties? The USA tax does not tax trusts, but only distributions to beneficiaries.[165] While the grantor trust rules (not defined) are said to apply,[166] there is no provision, such as section 682 under current law, where the grantor trust rules are overridden in alimony trusts, taxing the trust income to the recipient spouse.[167] If the grantor trust rules do apply to the transferror

161. S. 722, *supra* note 2, § 58(c).
162. *Id.* §§ 141-146.
163. Professor Ginsburg posits the case of a wealthy person who borrows $12 million, secured by his residence, and then buys collectibles or land (non-savings assets). Over the years, he turns these assets back into cash and then consumes it. "He never borrows against his savings." Professor Ginsburg believes none of the anti-abuse rules reach this case. Ginsburg, *supra* note 144, at 596-97. Those who are studying the impact of the USA tax on behavioral and economic effects of the proposal should consider the range of activity non-savers might enjoy without paying taxes.
164. S. 722, *supra* note 2, §§ 3(a)(7), 5.
165. *Id.* §§ 141-146.
166. *Id.* § 144(a) ("The provisions of this subchapter [dealing with trusts and estates] shall apply to grantor trusts only if the grantor is an individual."). Employer-created deferred compensation trusts under current law are taxed as grantor trusts in some instances, I.R.C. §§ 402, 404 (1996), but where the employer is a corporation, the USA tax appears to hang that issue in limbo.
167. *See* discussion of § 682, *supra* notes 129-30 and accompanying text. Generally, a grantor trust is one where the grantor and not the trust or beneficiaries is taxed on the trust income. I.R.C. §§ 671-679 (1996). The rationale for taxing the grantor under these sections is based on retained control (such as a right to revoke the trust or the use of trust income to pay the grantor's obligations, including spousal support). Were the USA tax not to include a § 682 type provision, the grantor of an alimony trust could, arguably, be taxed on the trust income. Presumably, the grantor would then be allowed to deduct the amount paid as alimony to his ex-spouse. For a

spouse, many alimony trusts would lose their purpose—to avoid the alimony inclusion and deduction rules of sections 71 and 215.

In a major change from present law, the USA tax does not impose an income tax on non-business trusts.[168] The income is instead taxed *only when distributed* to the beneficiaries of the trust.[169] Advocates of the USA tax offer this rationale for not taxing the trust as a separate entity: "It is easiest to see why trusts and estates are not subject to the Individual Tax by viewing them as complex savings or brokerage accounts for their beneficiaries."[170] While in part true, the multitude of different types of trusts in our country, ranging from estate and family trusts, charitable trusts, personal residence trusts, land conservation trusts, voting trusts, alimony trusts, to qualified S corporation trusts, each having its *raison d'etre,* cover a variegated catch far beyond mere "savings or brokerage accounts." Eliminating a centralized taxable entity for trust income, and deferring tax until (or unless) distributed to beneficiaries, will increase opportunities for the type of tax avoidance which is not necessarily consistent with the goals of the USA tax.[171] Trust income can be accumulated and reinvested for periods of time,[172] through a non-taxable entity not subject to the savings and withdrawal rules, with no tax until the income is distributed. Given the value of deferral, enormous sums of tax revenue could be lost. The comparison to the present pass-through entities, such as partnerships and S corporations, where the owners are taxed on each year's income, *whether or not distributed*, is not applicable to the schematic proposed by the USA tax. Trusts with more than one beneficiary (spouse and children, for example) could be drafted to allow for distributions to one beneficiary one year and another beneficiary the next. Since trust income account-

complete discussion of the taxation of grantor trusts and the many related questions, see ZARITSKY & LANE, *supra* note 120, ¶ 17.01.

168. S. 722, *supra* note 2, §§ 141(a),(b).

169. *Id.* § 141(d).

170. Ernest S. Christian & George J. Schutzer, Alliance USA, *Unlimited Savings Allowance (USA) Tax System* (prepared for Alliance USA), *reprinted in* 66 TAX NOTES 1481, 1546 (1995).

171. In the income tax context, early doubts as to the constitutional validity of taxing shareholders on undistributed corporate income (a by-product of Eisner v. Macomber, 252 U.S. 189 (1920)) were laid to rest when Congress revised its method of taxing accumulated earnings of corporations in 1921 by taxing the corporate entity rather than the shareholders. *See also*, Helvering v. National Grocery Co., 304 U.S. 282 (1938).

172. Subchapter J of the current I.R.C. has an elaborate (yet complex) set of rules for distinguishing income from corpus, including the coordination of the trust instrument with state law. *See, e.g.*, REVISED UNIF. PRINCIPAL & INCOME ACT (1962 Act), 7B U.L.A. 150; Cal. Revised Principal & Income Act, CAL. PROB. CODE §§ 16301-315 (Deering 1991).

ing and allocations between principal and income are critical components of "distributable net income," the need exists for allocation and ordering in the distribution rules. By taxing only the beneficiaries, where the trust has charitable or tax-exempt organizations or non-resident aliens as beneficiaries, no trust income will ever be taxed.

There is a novel attempt in the USA tax to purportedly reduce the use of a trust to pay expenses that may not have been deductible by the beneficiaries had they paid the expenses out of their own pockets. Food, clothing, shelter, and pleasure autos come to mind, but many other consumption items could also be paid by the trust. There are two mechanisms to control this. The first, when there is only one beneficiary of the trust, is to have a "deemed" or constructive distribution of the amount of these expenses; and the second, when there are multiple beneficiaries, is to levy a special "proxy" tax on the trust itself, at the highest marginal tax rate for individuals (forty percent).[173]

The USA tax trust and estate provisions include some fairly comprehensive transition rules, which require separating the assets that were held by the trust before the effective date of the USA tax system ("initial assets") from those acquired after the effective date ("new assets").[174]

In summary, as for Tom and Sue, assuming these rules allow them to use an alimony trust, Tom could probably transfer one-half his corporate stock to the trust with no tax.[175] The trust itself would take his zero basis (given that Tom deducted the amount he paid for the stock at the time of purchase). Sue would not be taxed until she received a distribution of trust income or had some personal expenses paid by the trust. If the parties could arrange their divorce settlement so that Sue did not require all the trust income for her support, a significant amount of dividend income received from the corporation could be reinvested by

173. S. 722, *supra* note 2, § 143.

174. *Id.* § 141(d). Special basis rules and different rules for cash and in-kind property are also present in the USA tax rules. A "previously taxed amount" (PTA) and "non-previously taxed amount" (Non-PTA) are concepts included in the proposal which are supposedly necessary to avoid taxing previously taxed income or capital again. *Id.* § 142.

175. We are assuming, for this illustration, that the trust is allowed to hold the corporate stock, even though Sue is the beneficiary of the trust which is a 50% shareholder, and that the "prohibited transaction" excise tax would not apply to this type of nonqualified deferred plan.

the trust,[176] thereby reducing its current "distributable" income to Sue. Thus, there appears to be ample room for tax deferral on the corporate dividends or any other income received by the trust. Tom, of course, avoids the dividend tax altogether, but he also loses the income for the period the stock is held in trust.

When compared to current law, in which Sue or the trust would be taxed each year on the trust income, the flat tax offers the best deal by never taxing anyone on the dividend income. The USA tax generally places second best, although there is the possibility of tax-free accumulation of trust income. This accumulated income could be used, perhaps, to pay some expenses that arguably would not be deductible by Sue had she paid them herself (lawyers fees, for example). Additionally, some tax-free borrowing by the trust would provide more potential tax avoidance fodder, all of this without necessarily using the alimony trust exclusively as a "savings" or "brokerage" account, as the proponents of the USA tax would lead us to believe. Postponing the payment of tax is also still a formidable part of these proposals.

C. *Deferred Compensation Trusts: (The "Non-Qualified" Type)*

1. *Fact Pattern*

After his divorce from Sue, Tom expanded his fast food franchise operations. He formed a new corporation, Apple Valley, Inc. (Apple), which entered into agreements with Boston Foods, Inc., a national franchisor, to own and operate four franchise locations. Tom brought in three additional, unrelated investors in Apple, with each investor, including Tom, owning one-fourth of the common stock of Apple. Apple became highly profitable in a short period of time. Tom managed these franchises. There was a "qualified" retirement plan[177] for the regular employees, but Tom and his co-investors decided to establish a "non-qualified" deferred compensation plan solely for Tom, in order to

176. The statute, as currently drafted, does not appear to extend the unlimited saving account deduction to trusts, but we are assuming that will be corrected in any final draft.

177. I.R.C. §§ 401-417 contain detailed requirements for qualified plans. The Small Business Job Protection Act of 1996, H.R. 3448, 104th Cong., 2d Sess. (1996), makes several changes in the pension and retirement area, principally with regard to the simplification of "qualified plans". Except for nonqualified deferred compensation plans for state and local governmental employees, I.R.C. § 457, the type of plan discussed in this Article is not changed.

avoid the restrictions on highly paid ("top hat") employees in the regular retirement plan.[178]

To give Tom some assurance that he would receive the money at retirement, the employer, Apple, contributed the deferred portion of his salary ($100,000) to an irrevocable trust, administered by an independent trustee. The trust was not specially funded,[179] only the annual deferred salary was contributed to it. The deferred compensation plan for Tom was in compliance with IRS procedures. Furthermore, in accordance with IRS rules, the principal and income from the trust was subject to claims of the employer's creditors in the event of the employer's insolvency.[180] In effect, the trust funds are deemed owned by the corporate employer until Tom's retirement. As beneficiary of the trust, Tom had more protection than a mere naked promise to pay his compensation at a future time. The trust fund was segregated from the corporation's general funds, subject to creditor's rights.

2. *Results Under Current Tax Law*

In contrast to a "qualified" retirement plan, where the Code and Regulations contain enormously detailed requirements, the nonqualified plan is curiously subject to relatively few requirements.[181] In general, qualified plans permit employer and employee contributions to a tax-exempt trust, in which the income earned by the trust is not taxable until distributed to the employee at retirement. With specific dollar limits on each type of qualified plan, the amounts contributed by the employer are currently deductible from its gross income.[182] The employee excludes the employer's contribution (as well as her own, in most cases) from current gross income, and is not taxed until the amounts are received at

178. For example, §§ 401(a)(4) and 414(q) provide for disqualification of a plan that discriminates in favor of "highly compensated employees". I.R.C. §§ 401(a)(4), 414(q) (1996).

179. The nonqualified plan is deemed "unfunded" since the contribution to a trust is not vested in the employee and remains essentially an unsecured promise to pay.

180. Rev. Proc. 92-64, 1992-2 C.B. 422. This is the model grantor trust for unfunded deferred compensation arrangements, popularly known as "rabbi trusts".

181. The principal provisions applicable to qualified plans are found in I.R.C. §§ 401-417 (1996).

182. The "reasonable" salary limits apply to retirement plan contributions as well as to cash remuneration. *Id.* § 162(a)(1) I.R.C. § 162(m) imposes a $1 million cap on certain executive salaries, but the ceiling is lifted when it can be demonstrated (as it usually will be) that the employee's salary is based on "performance" factors.

retirement or earlier, if permitted. This is, indeed, the largest fringe benefit in the current income tax system. The Treasury Department estimates a revenue loss in excess of $60 billion per year caused by the postponement of Federal income tax on employer-sponsored qualified pension and retirement plans.[183]

In a nonqualified deferred compensation plan, the employer promises to hold part or all of the employee's salary until some future event, usually retirement. The employee is normally a highly-paid executive who is purposely not included in the qualified plan for the regular workers, in order to avoid the anti-discrimination rules.[184] However, unlike the qualified retirement plan, the employer cannot deduct the deferred salary until the employee receives it years later. The company, in effect, subsidizes the tax deferral by foregoing a current deduction and by paying taxes as the income is earned on the deferred amount. In other words, there is no tax-free build up as there is in the qualified pension trust. When the nonqualified plan consists of a mere promise to pay, "not represented by notes or secured in any way," the Service's rulings have long held that there is no "constructive receipt" of income for cash method taxpayers.[185]

When, as in our example, the deferred compensation arrangement involves the use of a trust, the plot thickens. The requirement that the trust not be "funded" means that the contributions to the trust are legally owned by the employer-grantor. The employee is deemed to be an unsecured creditor and can receive the proceeds of the trust at retirement only if the employer remains solvent. It is deemed a contingent promise. These trusts are called "rabbi trusts" because of a 1981 letter ruling

183. *Tax Expenditures Chapter From The President's Fiscal 1996 Budget*, 66 TAX NOTES 1037, 1040 (1995). In one sense, the high cost of this tax subsidy is one of the motivating forces underlying the movement to a consumption type tax which broadens the savings base beyond tax favored pension plans and the like. However, Congress should not adopt a radical or rapid change in the current system without recognizing the potential negative impact on the Treasury, the stock market, and the millions of American workers. Private pension plans are estimated to have assets of nearly $ 4 trillion, and account for 20-25% of the total equity in corporations. Lester B. Snyder & Jerry G. Gonick, *The Interrelationship of Securities Class Action Litigation and Pension Plan Tax Policy: What's Really At Stake?*, 21 SEC. REG. L.J. 123, 137 (1993); *see also* John C. Coffee, Jr., *Liquidity versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277, 1291 (1991).

184. Daniel I. Halperin, *Special Tax Treatment For Employer-Based Retirement Programs: Is It "Still" Viable as a Means of Increasing Retirement Income? Should It Continue?*, 49 TAX L. REV. 1, 22 (1993).

185. Rev. Rul. 60-31, 1960-1 C.B. 174; *see also* Sproull v. Commissioner, 16 T.C. 244 (1951), *aff'd per curiam*, 194 F.2d 541 (6th Cir. 1952); Treas. Reg. §§ 1.451-1(a), 1.451-2(a); Treas. Reg. § 1.402(b)-1(c)(1) (application of the annuity rules in § 72 on the taxability of receipt by beneficiary). Social security taxes are deductible by the employer when the wages are actually or constructively paid. *Id.* § 31.3111-3.

holding that a rabbi of a congregation was not taxable on the principal of a trust until he received it at retirement. The rationale used by the Service was that the trust assets were subject to the claims of his employer's creditors and were therefore subject to substantial limitations or restrictions.[186] Because of the uncertainty that developed as to the proper treatment of these trusts, in 1992 the IRS published a "model" rabbi trust that would receive "safe harbor" treatment in deferring compensation,[187] so that the employee would not be in constructive receipt of the assets in the trust until actual receipt in later years. Despite the IRS's reticence in blessing these plans, there has been a dramatic growth in the "earn now, pay later" arrangements in the past ten or so years, particularly for highly-paid executives in many large public companies.[188]

If the nonqualified deferred compensation trust is in compliance with the Service guidelines,[189] Tom and his corporate employer, Apple, will have the following tax results: (1) the transfer of the $100,000 of his earnings to the employer controlled trust account will not be deemed a transfer of property to Tom since it is an unsecured promise to pay money in the future;[190] (2) Apple, as grantor of the trust which was established to discharge its legal obligation, will be treated as owner of the trust and thus taxable on all the income (less deductions) of the trust—the trust itself is not a taxable entity, unless it fails to qualify as

186. Priv. Ltr. Rul. 81-13-107 (Dec. 30, 1980).

187. Rev. Proc. 92-64, 1992-2 C.B. 422. "Rabbi trusts" reportedly account for as much as 70% of nonqualified deferred compensation of highly paid executives at large public companies. Halperin, *supra* note 184, at 22 (citing Lee A. Sheppard, *Brisendine Provides Rabbi Trust Update*, 93 TAX NOTES TODAY 247-8, Dec. 6, 1993, *available in* Westlaw, TNT database, 96 TNT 247-8) (A. Thomas Brisendine is an IRS Branch Chief in the Employee Benefits section of the national office).

188. For an interesting article on the use of these plans by specific executives at several corporations, see Christopher Drew & David C. Johnson, *Special Tax Breaks Enrich Savings of Many in the Ranks of Management*, N.Y. TIMES, Oct. 13, 1996, at 1.

189. It is assumed in our case that since Tom owns only 25% of the Apple stock he is not a controlling shareholder of Apple and thus is eligible to defer his compensation. Rev. Proc. 88-3, 1988-1 C.B. 29. It is further assumed, although not free from doubt, that the deferred compensation trust can be permitted to invest its funds in the employer's stock without violating the "prohibited transaction" excise tax which was raised from 5% to 10% in the recently enacted Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1453, 110 Stat. 1755 (1996).

190. I.R.C. § 83(a) (1996); Treas. Reg. sec. 1.83-3(e); I.R.C. § 402(b).

a "rabbi trust";[191] (3) Tom will not be taxed until he receives payments from the trust;[192] and (4) Apple will not be allowed a deduction for the deferred compensation until actually received by Tom.[193]

Tom's use of the "rabbi trust" results in a gamble that the corporation's assets could be seized by its creditors. But the presumed conventional benefits of tax deferral, together with the lower corporate tax rate (34 percent) on Apple's inclusion of the trust investment income on its tax return rather than on the higher rate (39.6 percent) trust tax return, make the gamble worth taking under current law at least. An added benefit to taxing the investment income to the corporate employer (under the grantor trust rules), rather than to the trust or to the employee, is the 70-100 percent dividends-received deduction available only to corporate shareholders.[194] Thus, Tom's $100,000 deferred compensation, if invested in stocks of other corporations, would result in no more than a 10.2 percent tax [34 percent corporate rate x $30,000 net dividend] on the dividends received, rather than 39.6 percent if taxed to the trust or directly to Tom, had he taken the $100,000 as current cash compensation and invested it himself.[195]

3. *Results Under the Flat Tax*

As discussed above, in the context of alimony trusts, the flat tax proponents tell us that their tax system ignores trusts since it receives only after-tax income (income already assessed under the business level tax).[196] What then happens to deferred compensation plans such as "rabbi trusts"? The answer to that question depends first on how current labor compensation is itself taxed.

The tax treatment of labor under both tax proposals creates problems in two broad respects.[197] Under the USA tax, employee labor costs are not deductible by the business employer, purportedly following the VAT policy of not allowing labor cost deductions (since they are part of the

191. I.R.C. §§ 673-677; Treas. Reg. § 1.677(a)-1(d). If the trust should fail to qualify as a "rabbi trust" the income of the trust would probably be taxed at rates higher than corporate rates—39.6% for trust taxable income over $7,900 vs. 34% on corporate taxable income over $75,000. I.R.C. §§ 1(e), 11(b).

192. I.R.C. § 451; Treas. Reg. § 1.451-1(a).

193. I.R.C. § 404(a)(5); Treas. Reg. § 1.404(a)-12(b)(2).

194. I.R.C. § 243.

195. Note that the "rabbi trusts" are generally not permitted to invest in the employer's stock. Rev. Proc. 92-64, 1992-2 C.B. 422. For a thoughtful analysis of the differences or tax equivalencies between taking current compensation and qualified and nonqualified ("rabbi") trusts, see Halperin, *supra* note 184.

196. *See supra* note 136 and accompanying text.

197. Some of the material in this section is taken from Snyder & Gallegos, *supra* note 3, at 35-37.

measure of taxable "value added").[198] Employees, however, are taxable on wages under the USA tax, the same as other income.[199] When labor is not deductible by the employer, the amount paid as salaries and wages is in effect taxed at the business level. On the other hand, the flat tax allows a labor cost deduction to the business employer, but taxes *only* wages (and no other income) to the employee.

As for deferred compensation, the flat tax statute expressly allows a deduction to the employer for contributions to "qualified" plans.[200] Employer (and employee) contributions to a qualified retirement plan are not included in current taxable income of the employee.[201] The employee is taxed, as under current law, when the benefits are received in later years.[202] This is contrary to the normal treatment of other investments under the flat tax, in which wages are taxed currently and subsequent investment returns are excluded from income.

The fate of nonqualified deferred compensation plans ("rabbi trusts") is not clear under the flat tax. In fact, since trusts are non-existent for *flat tax purposes*, do the constructive receipt or economic benefit rules under current law prevent the use of specially-funded trusts exclusively

198. While neither proposal attempts to coordinate the separate social security tax provisions, there is a novel payroll tax credit, however, under the USA tax. The 7.65% payroll tax paid by employers remains intact under both the USA tax and flat tax. Since this payroll tax is deductible under current law, there would be an additional tax burden under the USA tax with nondeductible salaries and wages. The credit serves as a mitigation of that burden, but so long as the tax rate on employers (11%) exceeds the 7.65% rate there is still a disparity. The payroll tax credit also applies at the employee level.

199. *See supra* note 3 and accompanying text.

200. H.R. 2060, *supra* note 1, §§ 11(d)(1)(C), 63(c). While claiming to eliminate most of the Internal Revenue Code, the flat tax retains most of the detailed requirements of the retirement and pension plan rules (however, with considerable simplification in the anti-discrimination rules and limits on contributions, consistent with the goal of the flat tax to provide incentives to invest). *Id.* § 106. Unlike the USA tax, S.722, *supra* note 2, §§ 281-283, which provides a credit for social security taxes, the flat tax offers no such benefit for public retirement as it does for private retirement plans. The underlying policy for the payroll tax credit is discussed in Snyder & Gallegos, *supra* note 3, at 49-50 & n.194.

201. H.R. 2060, *supra* note 1, § 11(d); HALL & RABUSHKA, *supra* note 64, at 130.

202. Since the flat tax rate (say, 17%) is applicable to both the company and the employee, as well as to compensation received currently and at retirement, the concept of deferral itself may require reconsideration in a new "time value of money" regime. *See, e.g.*, Daniel I. Halperin, *Interest in Disguise: Taxing the "Time Value of Money"*, 95 YALE L.J. 506 (1986); Halperin, *supra* note 184.

for executives?[203] We should remind ourselves that the federal tax reforms do not generally override state law (unless the state consents, as in state tax laws).[204] Unless some form of human immortality is on the horizon, estates and trusts will continue to be created.[205]

In those instances when the company and the employee prefer to defer payment of wages to an executive through a fully vested trust (protected from creditors of the company), it is not clear whether the flat tax retains the constructive receipt provisions.[206] The IRS, or similar administrative agency, and the courts would then be required to decide whether deferred "wages" are taxed now or later. If taxed currently, then the need to value the portion of wages placed into a trust for later distribution to the employee triggers complex "present value" calculations.[207] However, interpretations of the flat tax will not necessarily follow principles in our present income tax. Indeed, the consumption tax precepts favor reinvestment of capital and income.

But do Tom and his compatriots at Apple really need a deferred compensation plan? There may, in fact, be a better way to reduce taxes under the flat tax, one which is quite consistent with the goals of those advocating its adoption. Remember that "economic growth" is what they have in mind. In fact, they want businesses to do exactly what they

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203. *See supra* note 198. In defining "retirement distributions," the flat tax statute refers to tax exempt trusts under I.R.C. § 501(a) (1996). The reference to "trusts" presumably refers to "qualified" pension plan trusts, and acknowledges the existence of trusts for some purposes. H.R. 2060, *supra* note 1, § 63(c)(1).

204. Michael Mazerov & Dan R. Bucks, *Federal Tax Restructuring and State and Local Governments: an introduction to the Issues and the Literature*, 33 SAN DIEGO L. REV. 1459 (1997).

205. Undoubtedly, articles will be written on the effect of tax reform on state law, including community property law, where fundamental rights and obligations are first identified.

206. H.R. 2060, *supra* note 1, § 63(a)(1)(A) (taxes wages "received during the taxable year"). We cannot find any reference to I.R.C. § 451 (or the regulations thereunder), which contains the constructive receipt rules. Under current law, as set forth above, the contribution by an employer of deferred compensation to an unrestricted trust for an employee is deemed constructive receipt. The flat tax purports to "repeal" the current income tax law, but retains the pension plan rules in I.R.C. §§ 401-420. H.R. 2060, *supra* note 1, § 106(b). It appears, however, that the statute, as now written at least, allows an employer deduction only for amounts contributed to specified plans, none of which is a nonqualified deferred compensation plan. *See id.* §§ 11(d)(1)(C), 63(c). The reference to "eligible deferred compensation plan" (as defined in I.R.C. § 457)—which covers only governmental employees—would indicate that the proponents of the flat tax presumed that other nonqualified plans ("rabbi" and regular trusts) were taxable currently. Since I.R.C. § 83 is also repealed, as well as the rulings under current law holding that transfers to "rabbi" trusts were not completed transfers, the flat tax resurrects the valuation and timing issues that § 83 was intended to resolve.

207. For an example of such a ruling under current law, see Priv. Ltr. Rul. 92-06-009 (Nov. 11, 1991).

cannot do under current law—plow back the profits into business expansion, purchase new equipment, and defer taxing profits, not labor.

The centerpiece of both the flat tax and USA tax, under the business tax component of these proposals, would allow full deductions for "business" assets purchased in the current year—no depreciation schedules or other recovery of capital concerns, as under current law.[208] This should be contrasted with the "penalty" tax on accumulated earnings under current corporate tax law, when a 39.6 percent tax is imposed almost exclusively on closely-held corporations, which are required to prove that the earnings are retained "for the reasonable needs of the business."[209] Although the penalty tax may not be a major source of litigation, it serves as an inhibiting factor in the growth of some small businesses. To illustrate this issue again, as we did in our discussion of the *Arnes* case in Part II of this Article,[210] if Tom could forego a portion of his salary (that he would have deferred under current law) and instead allow it to be retained by the corporation for expansion of the business, the consequences to the corporation and Tom would be greater after-tax yields. If Tom spends more managerial time at Apple than the other investors, stock options[211] or dividends from a specially created class of stock could provide a higher after-tax return. Thus, the portion of Tom's salary which is retained by the corporation is not deductible as such, but the purchase of new assets provides the same result. Converting the taxable salary to non-taxable dividends or stock

208. H.R. 2060, *supra* note 1, § 11(d)(2)(A)(i). The deduction is referred to as a "business input" for "the amount paid for property sold or used in connection with a business activity". Curiously, wages and retirement benefits are deductible from "gross active income" under §§ 11(d)(1)(B), (C), but are excluded from the definition of "business input" by § 11 (d)(2)(A)(i), along with "personal use" property not connected with a business activity. Perhaps this is explained as an attempt at GATT and VAT compliance where labor costs are technically part of the value added tax base, and thus also explaining the rationale for taxing only wages in the component of the flat tax which taxes individuals. *See* Avi-Yonah, *Income to Consumption*, *supra* note 136; Schenk, *supra* note 86.

209. I.R.C. §§ 531, 535(c) (1996). The supposed rationale for this tax is to preclude the retention of earnings in a corporation instead of distributing them as taxable dividends to the shareholders.

210. *See supra* notes 66-73 and accompanying text.

211. It appears that stock options are not "cash" wages and thus not taxable on the spread between the exercise price and the fair market value of the stock (which should increase with expansion of Apple). Compare Stock options under the USA tax, in which the purchase of the stock is allowed as a savings deduction. S. 722, *supra* note 2, §§ 50-53.

options allows both Tom and Apple to avoid taxes (even though the seventeen percent tax rate is applicable to the business and Tom) at *both* the business tax and individual tax levels. This plan may invite "tax avoidance" scrutiny by the IRS under current law, but appears affirmatively legitimate under the consumption-tax philosophy of the flat tax.

4. *Results Under the USA Tax*

The problems with "rabbi trusts" and other nonqualified deferred compensation plans disappear under the USA tax. The employer is not allowed to deduct wages, salaries, or other cash payable for services by "employees,"[212] including contributions to "retirement" plans.[213] However, there are a number of tax-deferral options available under the USA tax, which are not as readily available under present law. Many of these choices allow the employer to be the savings vehicle by holding the funds for business use. For example, employees are not taxed until they actually receive their salaries, permitting a simple deferred compensation contract. If the employee wants protection against the employer's creditors, the parties can utilize a funded trust account without the need to comply with the "rabbi" trust rules. The key to this flexibility is the "unlimited savings account," in which amounts contributed to a trust fund, on behalf of an employee (or by the employee himself or herself), are deemed "savings" and, thus, offset the inclusion of current salary or other income.[214] This applies to all retirement plans. In addition, the investment income accumulated in the trust fund is not taxed until deemed withdrawn under the net savings rules of the USA tax.[215] As described above,[216] trusts, as such, are not taxable entities under the USA tax; beneficiaries are taxed only on distributions (other than certain expenses paid by the trust). Thus, if a beneficiary receives a distribution and does not re-invest it in conformity with the savings rules, the beneficiary will be then taxed on that amount as consumption.

Tom and Apple have considerable flexibility in deferring taxes in this context. Tom can receive special dividends on his stock, reinvest the

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212. Payments to "independent contractors" (self-employed businesses) are deductible, however. For problems caused by retaining this present law distinction, see Snyder & Gallegos, *supra* note 3, at 47-49.
213. S. 722, *supra* note 2, §§ 205(a)(4)(A), 205(a)(4)(D)(i).
214. Christian & Schutzer, *supra* note 170, at 1507, 1512-1513.
215. S. 722, *supra* note 2, §§ 50-58.
216. *See supra* Part III.B.4.

dividends with Apple (for more stock), and, in effect, pay no current tax.[217] Payment of dividends by Apple will not entitle it, however, to the payroll tax credit. They can enter into a deferred compensation arrangement in which the salary (or a portion of it) is contributed to a trust,[218] resulting in a net savings deduction to Tom as an offset to his deferred compensation. Whether the trust can then purchase the employer's stock may be problematic, but it does not appear to be a "prohibited transaction" under the more liberal savings rules of the USA tax.[219] Furthermore, the employer's purchase should be less problematic when, as in the case of Tom, the employee is not a majority shareholder of the purchasing company.

In sum, the net savings deduction refocuses our views on tax planning by providing Tom and his employer more intentionally tax-favored alternatives. The fact that the business employer receives no deduction for compensation-related payments could impact some incentive for employer-based pension plans in the future. However, some companies, such as Apple, may enjoy more growth and expansion by purchasing fully deductible assets. The variables will require careful planning in each case, and unlike the flat tax, with one rate for businesses and individuals (seventeen percent), the USA tax, with different rates for businesses (eleven percent) and individuals (eight to forty percent), will require even more reliance on accountants and tax lawyers.

IV. CONCLUSION

The flat tax and, to a lesser extent, the USA tax are much simpler than the current income tax. Both proposals are a more efficient way to tax capital investors—an improvement over the ambiguities inherent in the meaning of "capital gains," and an elimination of the never-ending

217. S. 722, *supra* note 2, §§ 50-58, 53(b). Individuals can deduct purchases of financial assets (such as stock); businesses can deduct purchases of business assets, but not financial assets, such as stock in another corporation. Peter L. Faber, *Tax Reform and Corporate Acquisitions*, 33 SAN DIEGO L. REV. 1541 (1997).

218. The taxability of trust income to the employer corporation under the grantor trust rules of present law as to nonqualified plans is deemed unnecessary under the USA tax, where trusts are generally not taxed, thus perhaps explaining the provision which does not permit corporations to be grantors in grantor trusts. S. 722, *supra* note 2, § 144.

219. The model "rabbi trust," under current law, generally prohibits ownership of the employer's stock by the trust. *See supra* note 196.

wrangling in Congress on lowering the rates on these gains. The central feature of the business tax under both proposals—an immediate expensing of business asset purchases—may well accomplish the goal of shifting the tax advantage away from labor and retirement compensation toward significantly more accumulation of business and investment profits. The flat tax creates a new exclusion from taxation of income from savings and investment for individuals; the USA tax essentially postpones taxation of this type of income. Tax-favored treatment of savings thereby becomes the *norm* of the new tax system, not the exception thereto, as under current tax law. Both proposals, however, have their own serious flaws. The treatment of borrowed money is only partially dealt with under the USA tax, and totally ignored under the flat tax. As a result, in a system which puts its main emphasis on the assumed distinctions between taxable "consumption" and non-taxable "savings," borrowed money can be used for both purposes without limit, thus encouraging tax avoidance schemes which are *not* consistent with the policy goals of these proposals.

The flat tax's failure to recognize the existence of trusts and estates as separate entities may, in many instances, represent a simplification of a complex Subchapter of the present Code. Yet, with both trust and beneficiary exempt from tax, for all time, have they not taken the goal to avoid double-taxation too far? Likewise, the USA tax, by imposing a tax on distributions to beneficiaries, but not upon the trust entity, has neglected to recognize the various types of trusts in this country, many of which do not resemble a "savings or brokerage" account. The traditional state law distinctions between "corpus" and "income" will be more difficult to trace without a centralized entity.

The elimination of the need for a deferred compensation trust under both the flat tax and USA tax can be scored as a simplification. While top executives might miss the "rabbi trust," they have many more options to defer wages, including the savings deduction under the USA tax or the conversion of wages into dividends or stock options under the flat tax. But the non-deductibility of labor costs and retirement contributions under the USA tax may jeopardize the present $4 trillion private pension plan system in this country, if employers decide to reduce these benefits for the average worker.

Critics of these consumption tax proposals label them as nothing more than a "wage" tax and a shifting of the tax burden to labor. A closer look at the current tax law, however, shows that eighty to eighty-five percent of the income tax revenue collected by the government already comes from wage and service related income.

In the final analysis, those of us who have accommodated our life styles to the present law should not fear its improvement, or even radical change. Instead of sitting back and assuming that "it will never happen," we should assume that such change is a distinct possibility. We would be better advised to seriously analyze the new tax proposals (and the many more to come) and their impact on international trade, small businesses, pension plans, and the stock market. There is a need to fashion the most equitable transition from the present system, while we examine further strengths and weaknesses in tax reform proposals.

The flat tax and USA tax require further work, but we do a disservice to ourselves in embracing the current income tax which was written for a different economic era.

APPENDIX

EFFECT OF BORROWING ON TAX DEFERRAL

The table below illustrates how borrowed money may be used in a business setting to defer taxes even more than apparently allowed under the flat tax proposal as written. The example assumes a 20% tax rate, a 10% annual yield on business investments, a 10% interest refund component on loss carryforwards, and a 10% interest rate on the loan (thus also eliminating arbitrage effects-which would only exacerbate this phenomenon). [This illustration is made using the flat tax proposal; generally, the same illustration could apply to the USA tax as well.]

The business borrows $100 in year 0, giving the lender a note bearing 10% interest per year. The loan is paid back in five equal installments of $26.38, consisting of principal and interest, beginning at the end of year 1. [The business buys new equipment for $100 in year 0 in preparation for sales beginning in year 1.] The flat tax allows the business to deduct the full $100 purchase price in year 0, the year of purchase. (Interest on the loan is not deductible, adopting the VAT concepts.) However, assuming that the business has insufficient income in year 0, the flat tax allows the business taxpayer an unlimited operating loss carryforward of the unused $100 purchase deduction with the addition of an interest refund component of $10, for a total carryforward to year 1 of $110. H.R. 2060, *supra* note 1, sections 11(d)(2)(A)(i).

Using the new equipment, the business generates $100 in sales in each of the five years that the loan is paid back. Variable expenses equal $50 per year and do not include interest on the loan. The cash remaining after the loan payment is made and taxes are paid is shown in the table as remaining with the business, but under the flat tax it could be distributed tax-free to the owners.

The business pays no tax until year 3. However, if the business were to reinvest the remaining cash in additional business assets at any time through year 3, when it first begins to pay taxes in this example, it could augment its tax deferral by creating new loss carryforwards, offering expansion opportunities as well.

The AICPA guide to the consumption tax debate (*see supra* note 74) advocates the exclusion of borrowed money from income on the theory that loan proceeds represent the net present value of the cash stream of loan repayments (including interest). The table demonstrates this principle. However, when the business uses these loan proceeds to generate loss carryforwards that free up cash and defer taxes, it obtains a significant benefit from the use of borrowed money, which would refute the AICPA's exclusion of borrowed money from the tax base. As the table shows, the before tax cash remaining at the end of year 5 is \$141.84, and \$115.36 after taxes for the entire period. The use of \$100 of borrowed funds produced a net before tax yield of 41.84% and an after tax yield of 15.36%. Moreover, the tax paid (\$26.48) was deferred until years 3 to 5.

ITEM/YEAR	YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5
Sales	100	100	100	100	100
Expenses	50	50	50	50	50
Gross Profit (sales-exp.)	50	50	50	50	50
Loss Carryfwd (+10% int)	110	66	17.6	0	0
Taxable Income	0	0	32.4	50	50
Tax Paid (20%)	0	0	6.48	10	10
Remaining Loss Carryfwd	60	16	0	0	0
Cash on Hand (sales-expenses-tax pd)	50	50	43.52	40	40
Loan Payment	26.38	26.38	26.38	26.38	26.38
Cash Remaining	23.62	23.62	17.14	13.62	13.62
Total Cash on Hand From Previous Period + 10% Return	0	25.98	54.56	78.87	101.74
Total Cash on Hand at End of Period	23.62	49.60	71.70	92.49	115.36