© 2023 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

VIEWPOINT
tax notes federal

Are We Missing Billions in Hidden Corporate Tax Subsidies?

by Donald B. Susswein, Kyle Brown, and J. Anthony Coughlan

Donald B. Susswein

Kyle Brown

J. Anthony Coughlan

Donald B. Susswein, Kyle Brown, and J. Anthony Coughlan are with the Washington National Tax office of RSM US LLP.

In this article, the authors report that the tax expenditure budgets maintained by Treasury and the Joint Committee on Taxation do not include billions in deferred capital gains taxes that meet those agencies' official definition of a tax expenditure. They argue that either the exclusion of these items is incorrect or the underlying Haig-Simons concept used to define a tax expenditure needs clarification or revision.

The views expressed are solely the authors' and are not intended as legal tax advice.

Copyright 2023 Donald B. Susswein, Kyle Brown, and J. Anthony Coughlan. All rights reserved.

Introduction

This article reports our surprising finding that there are billions in deferred corporate and individual capital gains taxes missing from the official tax expenditure budgets. The rules allowing these deferrals meet the definition of a tax expenditure as promulgated by Treasury and the Joint Committee on Taxation. The implications of this finding are unclear but could include (1) a possible revision or reconsideration of the iconic Haig-Simons definition of economic income, or (2) an overdue correction to the government's method of maintaining the tax expenditure budgets.

According to the JCT's official explanation, any rule deferring tax on realized capital gains is supposed to be classified as a tax expenditure. As the JCT explains, "Normal income tax would tax capital gains in full in the year the gains are realized through sale, exchange, gift, or transfer at death. . . . Further deferrals of tax . . . beyond the year of sale, [or] exchange . . . are classified as tax expenditures."[1] Treasury maintains a similar standard both for its "normal" tax definition and its "reference tax" definition.

In fact, the tax expenditure budgets maintained by these agencies have never listed the billions in capital gains taxes routinely deferred in tax-free corporate mergers and acquisitions. We are not talking about unrealized gains. We are talking about corporate and individual capital gains fully realized in arm's-length exchanges of readily valued or publicly traded stock or property.

[1] *See* JCT, "Estimates of Federal Tax Expenditures for Fiscal Years 2022-2026," JCX-22-22, at 6 (Dec. 22, 2022).

For more *Tax Notes® Federal* content, please visit www.taxnotes.com.

© 2023 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

We are also not talking about a mere change in legal form. No one could object to not listing those as tax expenditures.[2] We are talking about exchanges that substantially change the parties' economic holdings before and after the deal. Examples would include the tax-free merger of companies like Exxon and Mobil into Exxon Mobil Corp. or the tax-free transfer of $1.65 billion in Google stock to the founders of a 2-year-old startup like YouTube, deferring individual and corporate capital gains taxes on as much as $1.65 billion of realized capital gains in a single deal. These and thousands of similar arm's-length exchanges clearly meet the official definition of a tax expenditure (there would be no feasibility problem with taxing the Exxon or Google deals if they failed to satisfy all of the technical requirements for tax-free treatment). But they are seemingly invisible to the tax expenditure budgets.

If this anomaly is just an inadvertent oversight the solution would be simple: Add the cost of the capital gain deferral rules of subchapter C to the tax expenditure budgets. That would correct what would otherwise appear to be a massive understatement of the amount of corporate welfare hidden in the tax code. There is not necessarily anything wrong with these rules as a policy matter. But the tax expenditure budgets exist to expose and estimate the budgetary cost of any special rules that depart from a normal definition of economic income. These capital gain deferral rules meet the official definition of a tax expenditure, as promulgated[3] by Treasury and the JCT, but are not listed.

To be clear, there is nothing inherently wrong with the definition of income for "normal" tax purposes that is used for tax expenditure purposes. That definition, on its face, is clear, objective, and seemingly agenda-free. It cannot be criticized as subjective or tendentious (as the JCT, under the leadership of Ed Kleinbard, described certain academic critiques of the tax expenditure concept or process). Those critiques, at least as far as the definition of income is concerned, do not seem valid. By the mid-1990s the official definition of income satisfied the standard, for a suitably objective definition, outlined in the JCT's 2008 study. It was a "generally accepted formal definition of net income," based on a "rigorous framework developed from first principles."[4] Our point is that, after arriving at a principled and objective definition of income in the mid-1990s, based on a "generally accepted formal definition of net income," the agencies responsible for implementing their own definition, for some reason, have not been applying it.

The official, objective definition of income (for normal tax purposes) is Haig-Simons income except for items administratively infeasible to tax.[5] That definition includes any net accretion to wealth or net worth even if saved or reinvested and not consumed (other than items of income considered infeasible to tax). The policy of subchapter C, however, is to defer the capital gains tax on capital gains that are rolled over into a new business activity or endeavor in corporate form. Thus, the provisions that implement that policy appear to meet a clear, objective, and agenda-free definition of a tax expenditure. Yet, they are not listed.

On the other hand, these omissions might be fully justified if the definition of economic income purportedly used for tax expenditure purposes — seemingly identical to the Haig-Simons definition in this context — is clarified or revised. That could be more important than any error or inconsistency in maintaining the tax expenditure budgets. Indeed, determining the appropriate baseline measure of economic income is critical to determining the progressivity of the tax system,

[2] The same concerns that support the exclusion of unrealized gains under a normal tax would apply to the conversion of a sole proprietorship into a corporation with a single shareholder, or similar transactions in which there is no arm's-length exchange and no substantial change in the taxpayer's economic position. In addition to administrative feasibility, it is not consistent with Haig-Simons to tax unrealized gains without also repealing the existing limitations on deducting capital losses.

[3] Fifty years ago, the staffs of the JCT and Treasury were reluctant to offer any specific definition of a tax expenditure. By the 1990s, however, they assumed that responsibility and defined the term as including any provision that defined income more loosely than it would be defined under a so-called normal income tax, which for realized capital gains is identical to the Haig-Simons definition of economic income. Boris I. Bittker and Lawrence Lokken, *Federal Taxation of Income, Estates and Gifts*, para. 3.6 (2023).

[4] JCT, "Estimates of Federal Tax Expenditures for Fiscal Years 2008-2012," JCS-2-08, at 4-5 (Oct. 31, 2008).

[5] This does not appear to mean the difficulty of estimating an item, because it does not appear on a tax return. It refers to the infeasibility of taxing the item in a practical income tax system. Bittker and Lokken, *supra* note 3, para. 3.6.

For more *Tax Notes® Federal* content, please visit www.taxnotes.com.

based on a comparison of average tax rates (taxes divided by economic income) for different income groups.

Some leading administration economists have criticized, as an unwarranted departure from Haig-Simons, the failure of the JCT and Treasury to include unrealized gains, particularly the unrealized gains of very wealthy taxpayers, in the denominator of the fraction used to compute average tax rates.[6] The White House has seemingly embraced this position.[7]

Our concern here is realized capital gains, not unrealized gains. We note in passing, however, our agreement with the exclusion of unrealized gains from economic income. In addition to any feasibility issues, it would not be consistent with Haig-Simons to tax unrealized net gains on a mark-to-market system without repealing or substantially modifying the existing limitations on deducting capital losses. That could be like applying Haig-Simons to all net increases in net worth without a corresponding adjustment to the taxpayer's tax liability, on account of net decreases in net worth that may occur in different years. The need for such a mechanism, at least to the extent of prior recognized losses, has been acknowledged by leading supporters of the mark-to-market concept.[8]

We are talking here about gains that are realized, generally in voluntary transactions (at least at the entity level, with shareholder consent implied, if not explicitly required by the corporate law, when the shareholders purchased their shares with the knowledge that management might engage in mergers and acquisitions). The realized gains are almost universally viewed as economic income consistent with a traditional Haig-Simons definition. The tax provisions that defer taxes on that income are not included, however, in the tax expenditure budget. In addition, the gains are not included in AGI and do not appear to be included in the denominator of the average tax rate fractions. The administration's point about excluding unrealized gains from the concept of economic income may not be valid, in our view, among other reasons because their exclusion, in a system with limitations on capital losses, does not violate Haig-Simons principles. Here, the gains deferred are realized in essentially voluntary, tax-free mergers. They do appear to be Haig-Simons income, as that concept is generally interpreted. That suggests to us that the Haig-Simons definition may need clarification or revision, or may not be the appropriate standard for defining economic income for any purpose. The issue is thus larger than just the tax expenditure budget.

We recognize that, for generations of law professors and tax economists, the Haig-Simons definition has been considered a key part of what makes an income tax different from a sales or consumption tax. However, the omission of these tax deferral rules may be telling us that Haig-Simons is the wrong standard, or that it needs substantial revision or clarification.

Congress, of course, is free to adopt a more forgiving definition of income than Haig-Simons, perhaps moving more towards a hybrid income and consumption tax. But if we are professing to measure or grade the actual income tax against a purportedly objective standard of what constitutes an income tax, and the Haig-Simons standard does not reflect our view of what really constitutes economic income for that purpose, it may be the wrong standard. Perhaps some of the government's top tax experts — and more importantly Congress and Treasury over the last half-century — do not really consider the deferral of tax on realized capital gains to be anything special, unfair, or abnormal (in an income tax) as

[6] *See* Greg Leiserson and Danny Yagan, "What Is the Average Federal Individual Income Tax Rate on the Wealthiest Americans?" White House Council of Economic Advisers blog (Sept. 23, 2021). Media reports included statements such as, "The White House noted that its estimate of the tax rate for the wealthiest households is 'much lower' than other groups' estimates of top income tax rates." Naomi Jagoda, "White House: 400 Wealthiest Families Paid Average Tax Rate of 8.2 Percent," *The Hill*, Sept. 23, 2021. The "other groups" mentioned of course include the tax economists at Treasury and the JCT.

[7] The White House has explained the president's proposal to tax certain unrealized capital gains as a response to "America's wealthiest households paying a lower tax rate than working families. In a typical year, billionaires pay an average tax rate of just 8 percent." *See* White House release on the Biden economic plan (Feb. 6, 2023). This is evidently a reference to a group studied in the 2021 study. The JCT and Treasury report that the highest income groups they study pay an average tax rate in the range of 25 percent.

[8] *See* Reuven S. Avi-Yonah and David Gamage, "Billionaire Mark-to-Market Reforms: Response to Susswein and Brown," *Tax Notes Federal*, July 25, 2022, p. 555 ("All serious BIT reforms have mechanisms for refunding losses, at least to the extent of prior recognized gains."). Donald B. Susswein and Kyle Brown, "Mark-to-Market Mechanism: MIA? A Response to Avi-Yonah and Gamage," *Tax Notes Federal*, Oct. 3, 2022, p. 79 ("Unfortunately, the mechanism the professors describe, and say is needed to prevent double taxation, does not appear to exist in the leading proposal in this area."). The latter reference was to a bill introduced by Senate Finance Committee Chair Ron Wyden, D-Ore.

© 2023 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

For more *Tax Notes® Federal* content, please visit www.taxnotes.com.

© 2023 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

long as the realized gains are promptly reinvested, even in a completely different line of business. If so, that could signal a potential paradigm shift.

We can only speculate on the possible basis for such a shift in perspective. The exclusion of these nonrecognition rules may reflect a different and more accurate view of what capital gains (on income-producing assets) really are. In a 21st-century economy of internet startups and influencers, unlike an economy of steel mills, railroads, and automobile plants, it may be more apparent that a capital gain on income-producing property (including a trade or business) is often nothing more than an increase in the market's assessment of the present value of a stream of future ordinary income, from rents, sales, or fees, none of which are guaranteed. The capital appreciation is not generally in plant or equipment (at least not as it would be measured if the company was liquidated and the plant or equipment were sold for salvage). Generally, the appreciation in a business occurs in what accountants call goodwill, such as branding, reputation, or an inspired workforce or inspirational leader.

Our point, however, is not to advance any speculative explanation for the exclusion of these items but rather to present our findings. They are two-fold: the surprisingly simple, stark, and consistent bias in subchapter C towards allowing the deferral of corporate and individual capital gains as long as the gains are promptly or immediately reinvested in another corporate business, and the even more surprising fact that these tax deferrals are not listed in the tax expenditure budgets.

In Subchapter C the Norm Is Deferral

Using seven simple variations on a basic fact pattern, we illustrate how the principal corporate nonrecognition rules apply to transactions in which capital gains are realized in arm's-length exchanges of substantially different, sometimes fundamentally different, businesses or business assets. We contrast the rules to the JCT's official benchmark for a normal income tax for tax expenditure purposes, which is identical in this context to the Haig-Simons definition of income. That is, capital gains taxes on realized gains are supposed to be paid, not deferred, even if the gains are immediately reinvested in another business or profit-making activity, as occurs in a corporate merger. We also compare the rules of subchapter C to somewhat similar rules for partnerships and like-kind exchanges.

As we demonstrate, the policy of subchapter C is remarkably simple and straightforward: Gains on capital and business assets[9] that are realized, but promptly or immediately rolled over into other business or investment activities (in corporate form), even in a fundamentally different business with almost no continuing investment in the original business, should not be taxed currently. Deferral is the norm, not the exception.

Of course, that is completely contrary to Haig-Simons and the normal tax concept purportedly used to define a tax expenditure. Even so, these special capital gain deferral rules cannot be found on the list of tax expenditures.

Example 1. Assume that taxpayer T purchases or acquires farmland (Dwightacre) for $0. If T develops Dwightacre into a successful beet farm and then sells it for $1 million, he is viewed as realizing capital gains of $1 million. He must pay taxes on that $1 million at his applicable tax rate.

Example 2. If T exchanges Dwightacre for a beachfront condominium (also worth $1 million) to use as his vacation home, the result would be the same. What T receives has the same $1 million value. Because the beachfront condo is materially different from Dwightacre, it is taxed as if T had received $1 million of cash.

Example 3. If T contributes the Dwightacre beet farm (worth $1 million) to a newly formed corporation for 25 percent of its stock, while M contributes Blackacre (a potato farm with a value of $3 million and a tax basis of $0) in exchange for 75 percent of its stock, both taxpayers realize gain on the exchange. T would realize $1 million and M would realize $3 million. That is because they

[9] By business assets we do not mean only "assets used in a trade or business" under section 1231. The gain on inventory assets contributed in a tax-free exchange is not accelerated in a tax-free corporate merger or acquisition. However, the total gains on those assets, as compared with the gains on capital assets (and section 1231 assets that give rise to capital gains), may not be significant. Note that, even if the character is preserved in the hands of the transferee corporation, the gain has been shifted from one taxpayer to another taxpayer. That is the way the tax expenditure budgets treat shareholders and corporations.

For more *Tax Notes® Federal* content, please visit www.taxnotes.com.

© 2023 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

have received something different from what they had before. That is, stock in a newly formed $4 million corporation holding a different mix of assets than the assets they each held before the transaction. Section 351 provides that the gain is deferred. Each taxpayer is potentially taxable on his gain later if they were to sell their shares. This is referred to as nonrecognition of the realized gain.[10]

Example 4. If T and M form a farming partnership instead of a farming corporation the same deferral (or nonrecognition) occurs under section 721. But as we explain later, because only the partner pays taxes, with the partnership treated as a reporting entity, and any contributing partner's built-in gain is allocated back to the contributing partner when that gain is realized by the partnership under normal tax accounting rules, there is an argument for excluding section 721 transactions from the tax expenditure budget that does not exist for section 351 transactions.[11] In any event, even if section 721 and section 351 transactions are viewed similarly, then the same issue that we are raising for section 351 exists for section 721. Their exclusion from the tax expenditure budget cannot be reconciled with the definition of a normal income tax.

Example 5. The same tax deferral (or nonrecognition) that would occur under section 351 (in Example 3) results if T and M already held Dwightacre and Blackacre in two separate farming corporations that merged or reorganized into a single farming corporation.[12]

Example 6. The same deferral (or nonrecognition) would result (as in examples 3 and 5) even if Blackacre was worth much more than Dwightacre. Dwightacre might be a closely held beet farm worth $1 million and Blackacre could be a chain of fast-food restaurants, whose publicly traded shares were worth a total of $100 million. Blackacre and its owners might want to secure their own source of beets, or they might simply have concluded that beets were growing in popularity and planned to sell beets to other restaurants using their industry connections. Blackacre's business is not required to have anything to do with farming or food. It might be in the office supply business, manufacturing and selling paper for use in office printers and copiers. Its management might simply have concluded that this was a good time to diversify into beet farming.

Example 7. Similar tax deferral (or nonrecognition) would apply if T arranged with M to exchange T's entire interest in the Dwightacre beet farm (worth $1 million) for a parcel of M's land currently in use as a blueberry farm, Blueberry Hills, with a $1 million value. T might even intend to use Blueberry Hills for a different purpose, such as building rental housing. Dwightacre and Blueberry Hills are both required to be used by T in a business or similar productive enterprise and be of a "like kind" but that refers to the nature of the property and not its grade or quality, and would include the exchange of urban real estate for a ranch or farm. M is not required to retain Dwightacre (he can sell it) and T is not required to continue to retain any indirect interest in Dwightacre, even a de minimis interest as in Example 6. In 2017 this rule was limited by the Tax Cuts and Jobs Act to real estate assets.

In examples 3, 4, 5, 6, and 7 the transaction generally must involve no distribution of cash or unrelated assets. In some cases that is permitted but the receipt of cash or unrelated assets is generally taxable because T has partially cashed out of his investment (in cash, as in Example 1, or extraneous property like the vacation home in Example 2).

In examples 3, 4, 5, and 6 the assets contributed to the business entity generally must be contributed with the expectation that they will be retained for some time for some business or investment purpose, and the parties generally must intend to continue to hold their shares or units in the corporation. Although there is a great deal of law addressing these requirements, in a

[10] This is illustrated by an example in reg. section 1.351-1(a)(2): *Example (1).* C owns a patent right worth $25,000 and D owns a manufacturing plant worth $75,000. C and D organize the R Corporation with an authorized capital stock of $100,000. C transfers his patent right to the R Corporation for $25,000 of its stock and D transfers his plant to the new corporation for $75,000 of its stock. No gain or loss to C or D is recognized.

Although neither C nor D independently satisfy the requirement of owning 80 percent or more of the corporation's shares immediately after the transaction, that requirement is applied in the aggregate to all transferors participating in a common plan. *See* Bittker and James S. Eustice, *Federal Income Taxation of Corporations and Shareholders*, para. 3.09 (2020).

[11] *See generally* section 704(c).

[12] *See generally* section 368.

For more *Tax Notes® Federal* content, please visit www.taxnotes.com.

© 2023 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

simple case in which there is no intention or expectation that the contributing shareholders will cash out, or that the transferred assets will be sold or disposed of, the policy of subchapter C is clearly to allow deferral of realized capital gains, both at the shareholder level and the corporate level (when the entities might otherwise be viewed as swapping appreciated assets). However, there is no requirement that Blackacre and Dwightacre be operated together or produce any synergies or managerial efficiencies. A classic example in the regulations under section 351 involves an individual patent right holder, and an individual owner of a manufacturing plant, who contribute their very different assets for 25 percent and 75 percent of the stock of a new company. The gain realized by each contributor is not taxed currently on the exchange. However, there is no requirement that the patent rights be used by the company in its manufacturing activities. It might simply license the patent rights to other manufacturers. Also, either party, or neither party, can hold actual managerial control. Dwightacre and Blackacre can effectively be run as two separate farms or two separate businesses, and they can be managed by anyone.

Note that in examples 3 and 4, the business entity cannot be an investment company that holds a diversified portfolio of corporate shares or publicly traded assets (like a mutual fund). Aside from that rule and the general business purpose and continuity-of-business enterprise rules (easily satisfied in a simple case with at least some, minimal continuing indirect ownership of the transferred assets), there is no requirement that there be any actual synergies or managerial efficiencies from combining different sets of business assets.

The official definition of a tax expenditure appears to apply to transactions 3, 5, and 6 and similar transactions involving the organization or reorganization of a corporation that are realization events (and that are more than a mere change in form or legal status). Yet these well-known nonrecognition rules are not included in the tax expenditure budgets maintained by Treasury and the JCT.

Example 4 may not be a tax expenditure (even if examples 3, 5, and 6 are tax expenditures). With a partnership, any built-in gain of a contributing partner is generally realized in the ordinary course at the same time it would be realized absent the contribution (imputing the partnership's actions to the partner), and that gain is allocated back to the contributing partner, who is the only person who pays taxes. The partnership does not pay any taxes and thus does not have any taxes deferred. If the partner's taxes are also not deferred, then there would arguably be no tax expenditure. Unlike a corporation and its shareholders, the partner and the partnership are not treated as distinct taxpayers for tax expenditure purposes or otherwise. The partnership is merely a reporting unit that files an information return.

Example 7 is listed as a tax expenditure. Notably, that practice only began in 1988 in the JCT's version of the tax expenditure budget.[13] Treasury began listing like-kind exchanges as a tax expenditure in 2015.[14] No explanation apparently exists for the change in practice by either agency. There is obviously a distinction in that there is no business entity involved, and there is no continuing indirect ownership interest, even a de minimis interest, in the assets the taxpayer exchanges for property of a like kind. At the same time, there must be some similarity between the assets surrendered and the replacement assets.

The Apparent Revenue Effects

The apparent effects of these policies, in dollar terms, may be seen more clearly in a case based loosely on the creation of a company like Apple Inc. This example (involving a hypothetical Steve's Computer Co. worth $150 million when Steve is age 25, two years after Steve founded the company) could also be extended to Google's acquisition of YouTube (worth more than $1.5 billion about two years after that startup was founded). Just multiply the numbers by 10.

[13] *Compare* JCT, "Estimates of Federal Tax Expenditures for Fiscal Years 1988-1992," JCS-3-87 (Feb. 27, 1987), *with* JCT, "Estimates of Federal Tax Expenditures for Fiscal Years 1989-1993," JCS-3-88 (Mar. 8, 1988). Like-kind exchanges are first listed in the 1989-1993 publication.

[14] *Compare* Treasury Office of Tax Analysis, "Tax Expenditures FY 2016," *with* Treasury Office of Tax Analysis, "Tax Expenditures FY 2017." *Compare* White House, "Fiscal Year 2016 Analytical Perspectives of the U.S. Government Economic and Budget Analyses" (Feb. 3, 2015), *with* White House, "Economic Assumptions and Interactions With the Budget" (Feb. 9, 2016).

For more *Tax Notes® Federal* content, please visit www.taxnotes.com.

© 2023 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

We assume a capital gains rate of 20 percent and a top ordinary income tax rate of 37 percent and assume a discount rate of 5.56 percent. We also assume that the appreciated assets of the target and potential merger partner — predominantly business goodwill of the two companies obviously from completely different businesses — are both reasonably expected to produce a level 15-year stream of anticipated future ordinary income (from rents, license fees, operating profits from the sale of products or services) after which they have no value (assuming no further enhancement to the goodwill of the target assets or the preexisting acquirer assets).[15]

Let us assume that Steve, working from his mother's garage for two years, with a small amount of borrowed capital, creates a new business, Steve's Computer Co., that is worth $150 million when Steve is 25. It has yet to make a profit, but it has future projected income of $15 million annually for 15 years, assuming no further future enhancements or improvements to the business, from selling computers or licensing its intellectual property for an annual license fee. If Steve sells the business for $150 million in cash he would be taxed on the date of the sale or exchange. The capital gains tax would be $30 million, and that would presumably be viewed as a tax expenditure of $25.5 million because he did not incur the ordinary income tax rate.

In contrast, under the rules described above, Steve could also exchange all of the assets of Steve's Computer Co. (or all of its stock) for $150 million of highly liquid, widely held stock in a new corporation formed jointly with IBM, a much bigger and more diversified company. Steve and IBM would both need to contribute operating business assets to the newly formed corporation to qualify under section 351. If Steve were already operating as a corporation (a matter of indifference for a startup with little or no profits if his exit strategy was to merge into a big corporation) he could merge directly into IBM.

If IBM were worth $10 billion, the combined assets would be worth $10.15 billion after the exchange. Steve's $150 million of IBM stock would represent an approximate 1.5 percent continuing interest in the future income that might be generated by Steve's Computer Co. (now a division of IBM). For the most part, however, Steve is completely divesting himself of 98.5 percent of the benefits and burdens of owning Steve's Computer Co. in exchange for an approximate 1.5 percent indirect interest in the preexisting business assets of IBM. This is an exchange of one asset (100 percent of the stock and assets of Steve's Computer Co.) for a materially different asset (IBM stock). The IBM stock is materially different even though, for 1.5 percent of its assets immediately after the merger, it includes Steve's Computer Co. Even if we were only looking at the 98.5 percent that is completely different, Steve would be viewed, economically, as swapping 98.5 percent of his company for something different.

Under current tax law, that acquisition is free of any capital gains taxes for Steve, Steve's Computer Co., IBM, and IBM shareholders.

If both the main divisions of IBM and Steve's Computer Co. perform as expected, there will be no winners or losers. If Steve gets his 1.5 percent share of the combined earnings from the merged companies distributed as dividends, his annual after-tax cash flow (after corporate-level and shareholder-level taxes) will be substantially unchanged. That is, if the combined company performs as expected (replicating the performance predicted for Steve's Computer Co. and IBM's pre-merger assets), Steve's after-tax cash flow (with full distributions of his share of corporate earnings) will be almost identical to his cash flow if he had never sold the business. However, Steve has almost completely diversified out of Steve's Computer Co. and he still faces no upfront capital gains tax because of the capital gains deferral rules of subchapter C. Steve's $30 million capital gains tax, on the exchange, would be deferred until the time he sold the IBM shares.

The exact value of the deferral would depend on whether and when Steve sold the IBM stock (or perhaps donated it to charity, or passed it to his

[15] The future cash flow or income of the target, as well as the acquirer, is typically estimated and compared by the parties in negotiating and agreeing on any acquisition or merger. Treating both as 15-year level streams, assuming no future enhancements to the company's goodwill or other asset values, is a simplifying assumption. Note that the actual Apple almost went bankrupt in 1997, 17 years after its initial public offering, as its original technical innovations and brand had apparently declined substantially in value by then. Later managerial innovations created the company now worth $3 trillion.

For more *Tax Notes® Federal* content, please visit www.taxnotes.com.

© 2023 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

heirs, raising other issues). Of course, just because we don't know the exact amount of deferral would not mean the deferral can or should be ignored. The Congressional Budget Act of 1974 is clear that unwarranted tax deferral is supposed to be viewed as a tax expenditure or hidden tax subsidy. Presumably, the economists who maintain the tax expenditure budgets could estimate an average or typical holding period for that purpose.

To use an admittedly quite long period as an illustration, if Steve did not sell his IBM stock for 40 years, the present value of a $30 million capital gains tax due in 40 years is only $3.4 million. That means the deferral benefit might be worth $26.6 million. That is almost as valuable as a complete exclusion of the capital gains tax, which would certainly be viewed as a tax expenditure. It is approximately the same value as the evident $25.5 million value of the capital gains break. Whatever the actual average deferral would be, that deferral benefit is ignored in the tax expenditure budgets.

This analysis does not even address the deferral of any gains at the corporate level. Because there is a double tax with the corporate income tax, there is a deferral of the capital gains realized by Steve's Computer Co. or IBM when each corporation swaps some of its assets on a tax-free basis. By convention, the corporate deferral might be assumed to be a ratable 15-year deferral. That is, if the deal had been done as a taxable exchange of each merger partner's goodwill in their exchanged assets, each corporate acquirer would be allowed to amortize the other party's gain as their purchase price. If it were all goodwill, which would be typical, the amortization would be ratable over 15 years. In effect, the forgone corporate capital gains tax for the government translates into forgone corporate amortization deductions for the taxpayers. The IBM shareholders have also deferred capital gains taxes, although the change to any one IBM shareholder's economic position is not as dramatic.

Whatever the actual numbers are, the more important point may be that these deferrals are evidently not viewed as anything unfair, special, or abnormal. The JCT and Treasury do not list or score these deferrals in the tax expenditure budget. That is what raises questions, in our minds, about the continued viability of the Haig-Simons concept, that an accretion to wealth or net worth is income even if it is immediately reinvested.

Conclusion

The full implications of these findings are uncertain — and we welcome any suggested corrections or clarifications to our observations — or our views on their implications. A regulation issued in 1957, under since-repealed section 1002, provides one possible rationale for disregarding unrecognized gains. It explains that:

> sections 351(a), 354, 361(a), 371(a)(1), 371(b)(1), 721, 1031, 1035 and 1036 . . . describe certain specific exchanges of property in which at the time of the exchange particular differences exist between the property parted with and the property acquired, but such differences are more formal than substantial. As to these, the Code provides that such differences shall not be deemed controlling, and that gain or loss shall not be recognized at the time of the exchange. The underlying assumption of these exceptions is that the new property is substantially a continuation of the old investment still unliquidated; and, in the case of reorganizations, that the new enterprise, the new corporate structure, and the new property are substantially continuations of the old still unliquidated.[16]

As our seven basic examples illustrate, the notion that the corporate nonrecognition rules require the new enterprise or new corporate structure to be, in substance, a continuation of the old would only seem to be true, even on a look-through basis, to the extent the old property and the new property are both interests in a trade or business or other income-producing property. They do not have to be in the same line of business or managed or operated together.

Whether that is enough — as a matter of defining the economic income of the transferors

[16] Reg. section 1.1002-1(c).

For more *Tax Notes*® *Federal* content, please visit www.taxnotes.com.

— for a corporate or individual taxpayer's continuing investment to be treated as "substantially a continuation of the old investment still unliquidated" is the fundamental issue presented by the exclusion of these provisions from the tax expenditure budgets (and the exclusion of the nonrecognized gains from the computation of average tax rates).

More simply stated, what is the taxpayer's "economic income" when he realizes a capital gain that is rolled over into a continuing investment in another business or income-producing activity? And should the answer be the same if the capital gain is not withdrawn at all from the entity (because the gain has not even been realized)? This question is obviously relevant to the tax expenditure budgets but may be even more important to the question of whether unrecognized gains should be included in the determination of average tax rates (and other tax policy questions). This question also has tangential relevance to the treatment of unrealized gains. In our view, as we explain above, excluding unrealized capital gains from the definition of economic income until they are realized is not inconsistent with Haig-Simons or any other reasonable definition for a system that does not allow unlimited capital loss carrybacks, and does not allow capital losses to be used against more than $3,000 of ordinary income.[17] Be that as it may, if we do not consider the deferral of realized capital gains (that are reinvested in other income-producing property) to be a departure from a normal definition of economic income, that conclusion would apply, *a fortiori*, to gains on income-producing assets that have not been realized to begin with. They have not been removed from the business entity, even for a moment. ■

taxnotes®

Federal | State | International

Want to be renowned in the tax community?
Write for Tax Notes.

If you do, you will:

- Receive exposure in the world's leading tax publication
- Join a network of the best and brightest minds in tax

taxnotes.com/acquisitions

Your byline here.

[17] *See* note 8, *supra.*

© 2023 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

For more *Tax Notes® Federal* content, please visit www.taxnotes.com.