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## Banes of an Income Tax: Legal Fictions, Elections, Hypothetical Determinations, Related Party Debt*

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***Abstract***

This paper examines the United States tax treatment of so-called 'related party debt,' especially in transactions involving entities under common control. As a matter of economics and common sense, it is hard to see how such transactions can meet the normal tests used by United States law to distinguish debt from equity. The hallmark of debt is an unconditional promise to pay a sum certain on demand or at a fixed maturity in the reasonably foreseeable future; a transaction between legal entities under common control each of which is ultimately just a piece of paper is hard to reconcile with this standard. The paper suggests that the widespread recognition of related party debt as debt may stem from unquestioning acceptance of legal fictions like the corporate form, tolerance of elective elements in the tax system, and the common use of hypothetical tests to determine tax consequences.

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My objective in this paper is to bring a little sunshine to the subject of related party debt. Or, to be more specific, I propose to explore the treatment under the income tax of a relationship that purports to be debt entered into between legal entities subject to common control.[1] The income tax treatment — the wide acceptance — of this relationship is puzzling. The untutored eye does not perceive a relationship between separate (if related) persons in any real sense, nor do established authorities and 'in substance' analysis support the existence of debt. Yet acceptance of related party debt as debt is generally unquestioned. My thesis is that this ready acceptance flows from certain features of the income tax — legal fictions, elections, hypothetical determinations – which themselves are seldom placed in question, and which combine to make the remarkable phenomenon of related party debt appear perfectly normal and to place it virtually beyond inquiry.

## *1. Introduction*

The income tax system of the United States, like most other income tax systems, generally reflects the Haig-Simons concept of income. This concept holds that 'income is the *money value of the net accretion to one's economic power between two points of time*.'[2] The definition is important in two ways: it relates income to the accretion, or increase, of economic capacity within a prescribed time period and it points to the subject of taxation — the 'one' — whose increase in economic capacity forms the base of the tax.

As an instrument of social and economic policy, the Haig-Simons concept, and thus the income tax, rests on the notion that it is appropriate, reasonable and fair to link the burden that falls on each taxpayer with that taxpayer's ability to pay.[3] Such ability, in turn, is appropriately, reasonably and fairly determined according to periodic accretions to the taxpayer's wealth, in the form of income.[4]

1 Tax professionals necessarily remain tethered, to a lesser or greater extent, to the tax systems that are most familiar to them. The discussion that follows is grounded in the income tax system of the United States.

2 See Robert Haig, 'The Concept of Income — Economic and Legal Aspects' in Robert Haig (ed), *The Federal Income Tax* (1921) at 1, 7; Henry C Simons, *Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy* (1938) at 50.

3 There are, of course, differing views on the income tax, and specifically whether it is in fact an appropriate, reasonable and fair type of levy. One view is that a taxpayer's fiscal burden, his or her contribution to government resources, should be measured not by what flows to the taxpayer but, instead, by what the taxpayer removes from society, or consumes. This approach supports a consumption tax, whether sales, value added, or other form of levy that meters the taxpayer's burden in accordance with outflows rather than inflows. The approach is bolstered by the notion that accretions to wealth in private hands are requisite to economic growth, and that it is counterproductive to overall welfare to diminish that wealth by taxes on income not spent for consumption.

4 An associated, but independent, rationale for the income tax is that persons with greater ability to pay have evidenced greater utilisation of government services and other benefits that taxes fund. If this were in fact the case, a requirement that such persons pay a greater amount of tax would be tied to the costs those taxes defray.

Since it is generally necessary to expend resources in the pursuit of wealth, the concept of *accretion of economic power* is logically net of expenses incurred by the taxpayer in order to derive the income subject to tax.[5] Such expenses will vary depending on the type of income-producing activity, and thus the costs reasonably needed to achieve wealth accretion will differ substantially from taxpayer to taxpayer. For example, the costs incurred by a taxpayer to earn income from the manufacture and sale of a product may be greater or less than the costs incurred by another taxpayer in manufacturing and selling a similar product, and may differ even more from the costs incurred by another taxpayer in earning income from the rendering of services. An income tax takes such variances into account by permitting subtractions from the tax base, in the form of deductions, for profit-seeking expenditures, subject to certain limitations. As proper costs of earning income, these deductions are entirely consistent with the Haig-Simons concept.[6]

There are, of course, many differences between the US income tax system (or any other income tax system) and the pure Haig-Simons view of income. Much has been written about the problematic concept of realisation, generally used to mark the point at which accretion is sufficiently objectified for the resulting income to enter into the tax base.[7] In addition, various types of accretion have been declared to fall outside that base, for various reasons. Certain costs of earning income have been inflated, accelerated, or denied deductibility.

In addition to these obvious, and much discussed, divergences from the Haig-Simons concept, there are various features of the US income tax that operate in more subtle ways to subvert the 'ability to pay' concept. Among these are three features on which little comment is ever offered but which profoundly affect the economic and legal landscape of the income tax. These are (1) legal fictions, (2) elections, and, (3) hypothetical 'as if' determinations — all firmly embedded in the tax system and each worthy of independent analysis. When these features converge, as I believe they do in the relationship known as related party debt, the result is a leading tax reduction tool. Such debt is generally accepted as debt because a tax system that readily accepts legal fictions, countenances numerous elections and relies upon hypothetical tests to determine the tax base does not find it at all strange that related party debt should be treated, in general, just like debt between parties that are not related.

5 This is independent of the point that periodic accretion includes, of necessity, periodic consumption.

6 As a general matter, only profit-seeking expenditures should reduce income. The purpose of the limitation is to distinguish between legitimate costs of producing income and expenses for personal consumption. Another major limitation on deductibility involves timing and the factual connection between income and the costs of its production. Thus, a current expense is immediately deductible, whereas expenses conferring a lasting benefit are deducted over a period of time.

7 See, for example, David Shakow, 'Taxation Without Realization: A Proposal for Accrual Taxation' (1986) 134 *U Penn LR* 1111.

## 2. *Legal Concepts, Economic Distortions*

If taxable income is the periodic accretion of economic power, taxation must depend on the accurate measurement of that accretion. Clearly, a distortion in any element of the formula (taxable income equals gross income less related deductible costs), whether in the cognisable cost of an asset, recognised gain, or related costs, will result in a corresponding distortion of the base subject to tax. As distortions multiply, the gap between accretion of economic power and taxable net income widens. Distortions are, of course, exacerbated by unsurprising taxpayer efforts to bend elements of the measurement process to the goal of minimising liability. Intentional tax reduction involves, in essence, only a few basic techniques — reduction of gross income, inflation of deductible expenses, deflection of the tax base to others standing in a favoured tax position. All these techniques are greatly enabled by features of an income tax system that lend themselves to manipulation at the taxpayer's will.

### *A. Legal Fictions*

Most nations that follow a rule of law accept as given certain important legal fictions. Indeed, a basic aspect of legal training, absorbed by law students throughout the world, is that the 'law' operates with unshakable acceptance of such fictions. In these circumstances, it would be practically impossible for any jurisdiction to disregard fictions altogether in shaping its rules of taxation, if only because those fictions have important non-tax consequences.

One ubiquitous legal fiction is the corporate form — as fictitious a construct as could be imagined. 'Legal persons' owing their existence to rules of law, corporations generally can act in their own capacity, sue and be sued, take and hold property. They were adopted in 17th Century England as a mechanism to spur trade by shielding merchants from unlimited liability, and have always been an economic extension of their owners enjoying a special privilege granted by the sovereign.[8] Developments in legal and economic systems in most industrialised countries and the advent of public shareholding (whereby ownership by large numbers of people became common) gave the corporation an entirely new role. In addition to being a business accommodation, a security mechanism, the corporation became a virtually autonomous economic unit conducting business without control, or even oversight, by its owners.[9] The corporation thus came to form associations on its own, and to function itself as a shareholder and partner in business associations. In this manner, the corporation has become so accepted, so

8 US income tax law nevertheless recognises the economic identity between corporation and shareholder in various places where the recognition is beneficial to taxpayers, such as S corporations, the deemed paid foreign tax credit and the treatment of limited liability companies. See IRC (Internal Revenue Code) ss1341, 902, 960; 26 CFR (Code of Federal Regulations) ss301.7701–2, 3.

9 Thus, many corporations operate, in reality, wholly independently of their shareholders. It is clear that these owners, with some exceptions, have no say in regard to day-to-day operations of these large constructs. Managers (who need not be owners) are basically free of owner-determined constraints, except in extreme cases.

anthropomorphised, that it is perceived not only by those trained in the law, but in the popular press and by the public generally as having a real existence apart from both its owners and its managers.[10]

The corporate 'person' is also malleable. Unlike the human being with which the tax law equates it, the corporation is perpetual; but it may be quietly terminated at the will of managers and shareholders. The corporation can also be brought quickly into life and then transformed into a different corporation, loaded with features to support 'economic substance,' or merged into other corporations by filing appropriate documents with appropriate authorities. It cannot be deprived of life and freedom under the US Constitution.[11] In the modern world, it can migrate to countries other than the one in which it was formed,[12] facing no immigration issues, with fiscal authorities in the new motherland welcoming the new corporate citizen without extensive inquiries into its lineage, substance, or purpose. In brief, the corporation has much greater possibilities than the natural person — requiring the tax laws to adopt commensurately multi-faceted rules and broadly (if quietly) affecting tax policy at both the stage of its formulation and that of its implementation.

Corporations, however, are only pieces of paper. There is nothing 'real' about a corporation, nothing tangible, nothing capable of acting except through human agents, nothing with an independent will, intent, or moral capacity of its own. It is hard to understand what prosecutors mean or intend when they occasionally speak of criminal penalties for corporate malfeasors.[13] Penalties that do not affect individuals have little deterrent power, and the individuals harmed by corporate prosecutions may easily be persons (owners) other than the malfeasors (managers).

Non-legal policymakers in the field of taxation, especially economists, are perhaps less likely to think about entities, including corporations, as independent persons, as opposed to extensions of the persons who own or control them. And it may be that a truer concept of the modern corporation is an economic business

10 The first indication of an abusive use of the corporate form in US tax matters came in the 1930s when, as a result of differences in tax rates, corporations were used to park income away from the higher rates imposed on individuals. In 1934, Congress introduced the personal holding company rules, imposing a penalty tax on these 'incorporated pocketbooks' by taxing earnings accumulated in corporate solution. The sanctity of the corporation was not questioned – although a simpler and economically more acceptable result would have been achieved by 'piercing the corporate veil' and attributing income of the incorporated pocketbook to its owners.

11 With few exceptions, corporations have all the constitutional and legal rights of a natural person. Although corporations cannot vote, they can lobby elected members of the government and cannot be deprived of life, liberty, or property without due process of law. *First National Bank of Boston v Bellotti* 435 US 765 (1978).

12 See, for example, IRS Field Service Advice Memorandum 200117019 (27 April 2001), involving a corporate 'continuation' from the United States into Canada.

13 See, for example, Larry Thompson, Deputy Attorney General of the United States, '"Zero Tolerance" for Corporate Fraud' *Wall Street Journal* (21 July 2003) at A10: 'It is a bedrock principle of American law that business organizations, including corporations, may be held to account by the criminal law for the wrongdoing of employees or agents.'