A MARKET-VALUE BASED CORPORATE INCOME TAX

by Joseph Bankman

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This article proposes replacing the corporate income tax with a market value tax, or MVT, under which tax liability would be measured by annual changes in the value of outstanding equity. If adopted in pure form, Bankman argues, an MVT would eliminate most of the complexity, distortion, and compliance costs now posed by the corporate income tax. Unlike reforms that would reduce the corporate income tax and other taxes with a consumption tax, an MVT would not reduce tax revenues, and would not shift the tax burden from capital to labor.

Bankman notes that an MVT is not without drawbacks, both political and theoretical. However, he concludes, many of these drawbacks are soluble through modifications to the MVT, and even an "impure" MVT — modified to dampen transitional gains and losses and the volatility of tax revenues — would significantly reduce the social costs now associated with the corporate income tax.

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The corporate income tax is an important, but flawed, source of revenue for the U.S. Treasury. The tax has been appropriately criticized for its role in the so-called "double taxation" of corporate profits. A more fundamental problem, perhaps, is that the corporate income tax — like the individual income tax — does not do a good job of measuring income. Accurate and inexpensive measurement of income is hobbled by the so-called "realization" requirement, by the legislative desire to favor some activities over others, and the inertial weight of long-standing practice. The result is a nonuniform system of taxation that distorts investment and imposes significant transaction and compliance costs.

In theory, it should be possible to replace the corporate income tax on publicly traded entities with a much superior market value tax (MVT). Under an MVT, tax liability would be measured by annual changes in value of outstanding equity. The amount of revenue raised under an MVT could be set *ex ante* to replicate, on a risk-adjusted present value basis, the revenue raised under current law.

If adopted in pure form, an MVT would virtually eliminate the transaction and compliance costs associated with the corporate income tax. Virtually all tax issues associated with publicly traded entities would disappear; taxable income could be determined and verified at little or no cost.[1] Perhaps more significantly, an MVT would dramatically reduce the distortionary effect the tax system has on investment, by eliminating the realization requirement and other sources of differential tax treatment within the corporate sector. An MVT could retain the revenue generated from the corporate sector — in marked contrast to consumption tax and other reforms that would dramatically reduce the tax burden on capital. An MVT could also retain the current distribution of the tax burden — again in sharp contrast to consumption tax and other reform proposals, which would shift the burden to labor income and to the poor. Finally, an MVT could

[1]The MVT described here retains the current (nonintegrated) feature of the corporate income tax and therefore does nothing to reduce the importance of debt vs. equity issues. The possibility of combining an MVT with partial or wholesale integration is discussed at a later point in this article.

be adapted to fit proposals that provide for partial or complete "integration" of the corporate- and shareholder-level taxes.

An MVT is not without drawbacks, both political and theoretical. An MVT would not apply to (and therefore could not resolve income measurement problems associated with) individuals and nonpublicly traded entities. An MVT would operate in tandem with current law, and the interaction between an MVT and current law would create distortions at the margin. In addition, a "pure" MVT would shift tax burdens among companies, shift risk from investors to the government, and raise liquidity concerns. However, many of these problems may be soluble through modifications to an MVT, and even an "impure" MVT would significantly reduce the social costs associated with current law.

This article provides a brief description of the operation of an MVT. It also discusses the operation of a property-tax variant of an MVT, in which annual tax liability is based on total value of outstanding equity, rather than increase in value. The constitutional prohibition on direct (property) taxes precludes federal adoption of the latter form of MVT. Readers may nonetheless find discussion of this form of MVT illuminating. In the interest of space, and keeping with the summary nature of this article, discussion of the social costs of current law has been omitted, as have most footnotes.

Readers of the tax policy literature will note that market-value based taxes have been proposed before, notably by David Shakow and Victor Thuronyi.[2] An important new paper that incorporates a market-value based tax is now circulating, in draft form, by Michael Knoll.[3] The analysis and proposal discussed here differs in important respect from those other efforts.[4] Still, this article may profitably read in conjunction with the work of Shakow, Thuronyi, and others, in suggesting that it may be possible to eliminate most of the problems of current law without giving up the revenue and fairness inherent in taxing income from capital.

I. Operation

The basic operation of an MVT is simple: publicly traded companies would pay an annual tax based on the change in value of their outstanding equity, plus the value of current distributions to shareholders and less the value of current and past shareholder contributions to capital. The rationale for this basic formula is also simple. Basing tax liability on the change of value of publicly traded equity would conform the tax to the so-called Haig-Simons definition of income, under which income is set equal to changes in wealth (including wealth consumed during the year). Perhaps more importantly, pegging tax liability to value would remove the effect of taxes from decisionmaking. Taxes could be reduced only by "hiding" value from shareholders and analysts.[5] This would be difficult to do, go against the grain (and reward structure) of business decisionmakers, and expose decisionmakers to criminal and civil actions for breach of securities laws or fiduciary duties. Including distributions in the tax base would prevent a business from avoiding tax simply by making a dividend of what would otherwise be taxed as current increase in economic income. Removing past and current contributions from the tax base would ensure that only the increased value of contributed capital is subject to tax. Simple adjustments to the formula could ensure sensible treatment of mergers and other forms of reorganization.

In general, determination of value (and hence, of tax) under a pure MVT would require only a few arithmetical calculations based on easily obtained records, such as daily stock prices and the amount of stock outstanding. Special problems would be posed, however, by the issuance of nonpublicly traded stock options and rights to employees. It is perhaps sufficient here to say that there are a number of alternative treatments for such options that would to a large extent replicate the effect of current law.[6]

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[2]*See* Victor Thuronyi, "The Taxation of Corporate Income — A Proposal for Reform," 2 *Am. J. Tax Policy* 109 (1983); David J. Shakow, "Taxation Without Realization: A Proposal for Accrual Taxation," 34 *U. Pa. L. Rev.* 1111 (1986). *See also* David Slawson, "Taxing as Ordinary Income the Appreciation of Publicly Held Stock," 76 *Yale L.J.* 623 (1967).

[3]Michael Knoll, "An Accretion Corporate Income Tax," unpublished manuscript (1995).

[4]David Shakow's proposal, for example, would levy a tax at the individual level on all sources of economic income, including economic income realized through increase in value of nonpublicly traded property. Among the many strengths of Shakow's article is the demonstration that valuation and liquidity problems of the tax may be much less than commonly believed. Thuronyi focuses only on publicly traded stock; like Shakow, Thuronyi proposes a tax on economic income imposed at the shareholder level. As is perhaps not surprising given the difference in proposals and the enormity of the general subject, the discussion here overlaps very little with the discussion in those two articles.

[5]While an MVT would eliminate the effect of taxes on corporate investments, it would not eliminate the effect of taxes on corporate financial structure. Unless an MVT were combined with an integration proposal, debt would still be favored over equity. *See supra* note 1.

[6]For options currently taxed to employees and deducted by the company, the appropriate rule would be to leave the options out of the tax base until exercised, and then to include the stock less basis (amount taxed to the employee upon receipt plus exercise price) in the tax base. Permanently removing the value of the option from the tax base would mirror the deduction presently given to the company. This is true because, all else equal, the value of publicly traded stock should fall by the value of the option. It would also have the same effect as would obtain had the company given the employee cash, and the employee contributed that amount to capital in exchange for stock rights. Including the stock less basis of exercised options in the tax base would ensure that the growth of the company, as measured by the rise in the stock, is subject to tax. The right approach for stock rights on which employee taxation is deferred is more complicated. The administratively simple approach would be to ignore such options until exercised. Unfortunately, this would have

(Footnote 6 continued on next page.)

Problems posed by employee stock options and rights would also be raised by any other nonpublicly traded equity interest in a publicly traded company. As an empirical matter, such interests comprise a minute fraction of market value, and appear to be issued only in large transactions. One possibility would be to require such interests to be periodically valued; another would be to include the interests in market value only when sold or exchanged for publicly traded interests, but to levy an "interest" charge on the excluded amounts for the deferral period.

An MVT could be modified to retain a number of current tax preferences and still simplify the law.

A slightly different problem would be raised by publicly traded companies that own stock in corporations or other entities now subject to corporate tax. Under current law, the company receives a deduction in varying amounts for dividends received.[7] No such deduction is received on gain realized from the sale or exchange of such stock. An MVT could mirror current law by allowing a company to deduct dividends received from market value and therefor taxable income, with the amount of deduction varying by ownership percentage. Otherwise, corporate-held stock would be treated like any other asset. An increase in the value of such stock would be reflected in an increase in the value of the corporate shareholder, and would constitute taxable income to the corporate shareholder.[8]

The treatment of corporate shareholders raises the much more general issue of integration of the corporate and individual income tax. The advantages to an MVT do not depend on integration, and it seems reasonable to discuss the proposal in the context of the current nonintegrated tax system. However, an MVT could be easily adapted to an integrated tax system. In that event, the MVT would replace both the current entity-level corporate tax and the shareholder-level tax on corporate distributions.

As is perhaps obvious, the elimination of taxes from decisionmaking would greatly reduce transaction costs. Adoption of an MVT would also simplify the determination of tax due. Current law adopts what might be described as a "building block" approach to tax liability. Tax liability of a publicly traded company is built on the tax consequences of tens of thousands of internal activities or transactions, each one of which must be characterized under an inconsistent and complex set of rules. Under an MVT, consideration of each "building block" transaction or activity is unnecessary. All that is needed are a few aggregate and for the most part easily obtained figures. Indeed, an MVT could be modified to retain a number of current tax preferences (and therefore require records as to certain transactions and activities) and still simplify the law, by dropping all other "building block" activities and transactions out of the determination of tax due.

Alternatively, it would be possible (but on a federal level, not constitutional) to adopt an MVT with the characteristics of a property tax. Under this form of MVT, companies would pay an annual tax on the average daily value of outstanding equity. As in the case of MVT described above, pegging tax liability to property value would eliminate the effect of taxes on decisionmaking and greatly simplify determination of tax due. Pegging the tax to average daily value rather than value as of the end (or start) of the taxable year would prevent what would otherwise be an incentive to make all distributions immediately before the valuation date.

II. MVT Income vs. Current Taxable Income

In any year for a given company, the amount of income recognized under an income-based MVT might be more or less than that recognized under current law. A company's stock might drop during a year of high income, or vice versa, because the market has already incorporated the present year's results and is now anticipating the results of future years. In general, however, more income will be recognized under an MVT than under current law, which allows taxpayers to defer unrealized gain, and contains preferences that would not exist under a pure MVT. The increase in income recognized under an MVT would be offset by lower tax rates to leave expected tax revenue constant. In this respect, an MVT can be seen as a (perhaps, the ultimate) "base broadening" measure.

While it may be easy to set MVT rates so as to leave aggregate expected tax constant, it would be nearly impossible to set rates so as to leave short-term tax constant for each company. Currently, the portion of tax paid varies in part by the benefit each company receives from the realization requirement. A company that engages primarily in long-term projects pays less tax, as a percentage of economic income, than a company with equal economic income that devotes fewer of its resources to such projects. Under a pure MVT, each company will pay the same portion of economic

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the effect of giving a company a deduction for the options in the year they are granted. Currently, however, a company can deduct the value of the option only when it is taken into income by the employee. A tax result similar to current law could be obtained by applying a form of "retrospective" tax at the time the value of the option is taken into income by the employee. In effect, the company would pay for the accelerated deduction. Other approaches are possible, including valuing such options for MVT purposes and limiting the period during which an option may stay outside the tax base.

[7]Sections 243-245. (Note that the dividends received deduction for dividends from certain foreign corporations would raise issues discussed at a later point in this article, in connection with outbound investment.)

[8]One drawback to current law is that it encourages taxpayers to game the system by combining tax-favored dividends with capital losses on the sale of stock ex-dividend, or by using debt to finance the purchase of dividend-paying stock. This, in turn, requires the various drd-related limitations and basis reduction provisions. An MVT that mirrors current law would require similar provisions. As noted in the text above, an MVT could avoid this and other issues if adopted in conjunction with a partial or complete integration of the individual and corporate taxes.

income in tax. In the short run, then, companies that disproportionately benefit from the realization requirement will pay more tax under an MVT — even an MVT that, in the aggregate, raises the same amount of revenue as current law. Conversely, companies that receive a disproportionately small amount of benefit from the realization requirement will pay less tax.

The shift in liabilities and incentives may be troublesome to those who believe the nation underfunds long-term investments; others may object to the windfall gains and losses or the short-term dislocative effects caused by the shift. None of these objections may be particularly compelling.[9] Still, such objections — and the related issue of political feasibility — may make it necessary to compromise the purity of the tax. An MVT could be modified to provide an incentive for long-term investments. To the extent the incentive is based on reliance considerations, it could be phased out as the existing stock of assets wears out.

III. Desirability of Tax Preferences

As noted above, the gap between taxable income and economic income is attributable in part to the realization requirement and in part to a combination of long-standing tradition and legislative desire to favor some activities over others. In its pure form, an MVT would eliminate all three sources of deviation from the ideal of economic income.

Is the elimination of tax preferences desirable? In theory, some activities may generate externalities that justify favorable tax treatment. In addition, even absent externalities, an efficient tax would be designed (all else equal) to minimize changes in behavior caused by the tax. This would require heavily taxing a price insensitive good or activity. In practice, the current patchwork of legislative preferences does not reflect either ideal, and a clean slate of income measurement would probably represent another advantage to the MVT.

As a practical matter, of course, it may be likely that any MVT adopted would be modified to retain certain preferences. Indeed, such a modification is likely to be a *sine qua non* for legislative approval. The modification could be effected simply by allowing qualifying activities or investments as a deduction against taxable income or a credit against tax due. The real advantage to an MVT in this respect is not that it could not be modified, but that its adoption would require the legislature explicitly to approve or reapprove deviations from the ideal. Indeed, so long as an MVT eliminated the complexity and distortion caused by the realization requirement, it could retain all other existing preferences, and still significantly improve social welfare.

Of course, an MVT that retained all existing preferences *and* contained a new preference that served as a surrogate for the realization requirement would simply mimic current law, with all of its difficulties.

IV. Tax Liability Shifts Under a Property-Based MVT

In general, a property-based MVT would involve the same shifts in tax liability as an income-based MVT. Aggregate tax liability under a property-tax based MVT could be set to equal current tax liability. And just as a pure income-based MVT would treat all sources of economic income equally, a pure property-based MVT would treat all sources of property value equally. No preferences would be given for property value not "realized" in the form of a sale, or invested in favored activities.

A property-based MVT could be modified to favor long-term investments or provide other investment incentives. Modifications to a property-based MVT would raise the same issues as discussed in connection with an income-based MVT.

V. Risk

Government revenue under current law is a function of corporate income. Government revenue under an MVT would be a function of market value. As an analytic matter, it may not be clear whether the switch to an MVT would increase the volatility of tax revenues. As an empirical matter, however, market values, as reflected in stock prices, have been significantly more volatile than corporate tax revenues, and seem more likely to be so in the future. The increased volatility of an MVT would disadvantage the government relative to current law. The government would be in the same position as charitable organizations (e.g., universities) and other investors whose assets are placed in diversified portfolios subject to wide swings from (undiversifiable) market risk.

On the other hand, the increased variance of governmental revenue would be matched by a reduction in taxpayer risk. To understand why this is so, consider the effect of an MVT in a one-company world. Assume that the company's taxable income computed under current law is invariant at $2 billion; the current tax rate is 50 percent and so tax is constant at $1 billion. Economic income outstrips taxable income, but with much greater variance: economic income (after taking current taxes into account) averages $3 billion but ranges from a loss of $3 billion to $12 billion. The tax rate is set at 33 percent to reflect a similar *ex ante* tax liability of $1 billion.

Under the current income tax, the government always collects $1 billion and the after-tax change in market value ranges from -$3 billion to +$12 billion. Under an MVT, the government collects one-third of the change in market value. Now the after-tax changes in market value range from -$2 billion to +$8 billion. The increased variance in taxes has reduced the variance of the after-tax value of the company. Because value is a function of risk (a fundamental premise of finance theory), by reducing the risk associated with

[9]The objection to windfall gains and losses, for example, if taken seriously, would rule out meaningful tax reform. The objection seems particularly weak when the ultimate owners of companies may have invested through intermediaries such as pension funds and hence have diversified portfolios that will produce offsetting gains and losses.

investment in the company, the government has increased the value of the company to investors. All else equal, and subject to liquidity-related concerns, a company should always prefer a tax on economic income, since such a tax will reduce its variance and hence reduce the risk associated with its investments.[10] At the other extreme, an invariant tax will exacerbate the riskiness of its investments.

The benefit from reducing the variance in company outcome may be understood by focusing on the decision of an automobile manufacturer to develop a new form of combustion engine. If the engine appears unpromising, the company faces a significant decline in its capitalized value. Under current law, that loss is effectively deductible only if the engine is abandoned, or as production occurs. Under an MVT, that loss would be deductible in the year it is reflected in stock price.

In at least one respect, the above examples exaggerate the amount of risk shifting inherent in an MVT. Under current law, the tax benefit of current losses is limited, under the net operating loss rules, to income recognized in past or future years.[11] The same set of restrictions would presumably apply to an MVT. These restrictions would have the effect of limiting the revenue loss due to huge downside swings in market value. Nonetheless, unless modified, an MVT will change the current allocation of risk between that now borne by the shareholders on the one hand, in the form of fluctuating return to investment, and that borne by the government in the form of fluctuating tax revenues.

It might be desirable to leave the government with the increased risk created by an MVT.[12] There is no reason, *a priori*, to think that risk is better placed on private taxpayers than on the government. Alternatively, the increased risk might be reduced or eliminated by providing for no-interest deferral of tax on gains, or refunds on losses, that exceed a certain percent of market value. This would have the same effect with respect to tax revenues that an interest rate "cap" has on mortgage payments.

Finally, the risk-adjusted value of tax paid could be set equal to that paid under current law by adjusting the tax rate upward to account for the increased risk assumed by the government. The government would then bear more risk but have a higher non-risk-adjusted expected return, in the form of a right to some portion of increase in value.[13] The government's stake in the company would be similar, economically, to other financial instruments such as calls and puts or stock appreciation rights. If the government wishes to return to its prior state with less risk and less expected revenue, it should be able to sell some of its appreciation-related rights at the start of each year in the market. Indeed, the government may be able to sell its right to taxes based on MVT income from a given company back to that company each year in return for an agreement to pay a fixed sum at the end of the year. Such a transaction would leave both parties with the same level of risk as under current law.

> ***The risk shifting inherent in an MVT would be virtually absent in a property-based MVT that looks to absolute value, rather than changes in value.***

Unfortunately, while it would be possible in the aggregate to offset the increased risk borne by the government with increased rates, it would not be practical to vary such rates on a company-by-company basis. In this respect, an MVT would benefit particularly risky companies. The government would assume the greater than average risk of such companies, but charge a risk premium (in the form of uniformly higher rates) set to compensate for the average risk assumed. The converse is true with respect to nonrisky companies. The reallocation of the tax burden would raise the same reliance issues as noted earlier, in the discussion of the relationship between taxable income and economic income.

The reallocation of tax burden due to risk shifting may be offset in part, however, by the elimination of the realization requirement. This offset would occur if, as seems likely, there is a correlation between risk and long-term projects. If such correlation exists, companies that benefit from the greater assumption of risk under income-based MVT will suffer from the lack of deferral inherent under an MVT.

The risk shifting inherent in an MVT would be virtually absent in a property-based MVT that looks to absolute value, rather than changes in value. Such a change would significantly dampen down the volatility of tax revenue.[14] Indeed, a pure property-based MVT may be less volatile than the current income tax.

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[10]Indeed, it can be shown that under certain plausible assumptions, a tax on the increase in economic income attributable to risk can be completely offset by shifts in taxpayer behavior. The tax on the other components of investment return — the premia attributable to the riskless interest rate and the inflation rate — cannot be so offset. *See* J. Bankman & T. Griffith, "Is the Debate Between an Income Tax and a Consumption Tax a Debate About Risk? Does it Matter?" 47 *Tax L. Review* 377 (1992).

[11]*See* sections 172, 1211, 1212.

[12]As is perhaps obvious, risk assumed initially by the government is eventually spread back into the economy, in the form of fluctuating levels of public services, government purchases and the like. *See* Bankman & Griffith, *supra* note 10, at 382.

[13]The revenue raised from taxation of income attributable to the riskless interest rate or inflation premium would clearly increase with increased rates. Whether the government can increase (or even collect) risk-adjusted tax on income attributable to the risk premium is discussed in note 10, *supra*.

[14]The following example may help illustrate the less volatile nature of a property tax. Assume a one-company world. In Year 1, the market value of the company rises from $9 to $10 billion. Market value rises to $12.5 billion by the end of Year 2, and then falls to $12 billion at the end of Year

(Footnote 14 continued on next page.)

VI. Liquidity

As noted immediately above, an MVT has the desirable property of levying the heaviest load on those companies with the highest increase in market value and, presumably, good access to capital markets. Conversely, companies with falling stock prices may receive a refund for past tax payments at a time when funds are most needed and when raising funds through the capital market may be difficult. In this respect, an MVT might help provide liquidity to the market.

On the other hand, focusing on tax due rather than refunds paid, and on the availability of cash from operations rather than access to capital markets, an income-based MVT may raise liquidity concerns. As an empirical matter, taxable income as currently defined is more closely correlated with the operating cash flow than is economic income. A company that experiences a large run in stock price may find itself without a cash flow from operations to make a tax payment.

This sort of liquidity problem would be greatly reduced if the MVT were modified, as suggested above, to provide a no-interest deferral on tax (or refunds) due to an extraordinary increase (or, in the case of refunds, decrease) in market value. Another solution would be to allow a company whose tax liability rises more than a given percentage of market value to set aside an amount of stock with a market value equal to the tax payment. The company could then have a designated period in which to sell the stock, with the proceeds going to the government.

VII. 'Boundary Problems'

The MVT proposed here does not have an unlimited scope but is confined to domestic publicly traded entities.[15] Distortions and problems of legal integration will predictably arise at the boundary of the MVT and other tax systems.

A. Nonpublicly Traded Companies

For the most part, the same tax rules govern publicly traded and nonpublicly traded C corporations.[16] As an empirical matter, however, most business enterprises that are not publicly traded are not organized as C corporations, but instead are organized as S corporations, sole proprietorships, partnerships, or limited liability companies taxed as partnerships. Recent administrative and statutory developments have expanded the availability of "passthrough" alternatives to C taxation.[17] As a result, there is now a sharp discontinuity in tax between publicly traded and nonpublicly traded entities. The former must pay the "double-level" tax required by Subchapter C, the latter obtain passthrough treatment. The discontinuity distorts decisionmaking, discouraging otherwise productive efforts to establish a public market in an enterprise.

The adoption of an MVT would add yet another discontinuity between a publicly traded and nonpublicly traded enterprise. The former would be subject to an MVT; the latter would not. Since an MVT would be set to replicate current revenues from publicly traded companies, the adoption of an MVT would not increase the aggregate tax cost of having a publicly held status. However, because the shift to an MVT would affect different companies differently, a particular company that is not publicly traded and subject to current tax law may find it advantageous or disadvantageous to go public and pay tax under an MVT. Thus, the decision as to whether to "go public" would not only be influenced by the tax cost of paying tax under Subchapter C, but the cost or savings realized by having income determined under an MVT. The incremental problem caused by this discontinuity is uncertain. If this problem is thought serious, an MVT might be modified to allow a company that has just gone public to elect to be treated under the rules applicable to nonpublic companies for a limited number of years. Since the market value of newly public companies is a small fraction of total market value, this modification would not be a significant source of revenue loss.

B. Foreign Investment

The treatment of outbound and inbound investment is complex even by tax standards and integrating any fundamental reform of the U.S. tax system with foreign investment will pose significant technical and policy-related problems. To focus first on outbound investment, and take but one example, a domestic corporation with foreign business operations is taxed on worldwide income but receives a credit for foreign taxes paid.[18] This credit is subject to a limitation that requires calculation of both U.S.- and foreign-source income.[19] This limitation could not be directly mapped onto an MVT, since under that tax there is no separate calculation of U.S.-source income, and an MVT entails different and lower rates of tax on a different definition of income. An appropriate response hereunder might be to allow a credit for foreign taxes (1) to the extent that foreign rates are no greater than the current average effective U.S. rate used to set rates under an

3. The amount of income subject to tax in Year 2 under an MVT is 250 percent of the amount subject to tax in Year 1 ($1 billion to $2.5 billion); in Year 3, income is negative and the government must repay some tax revenue collected in previous years. Under a property-based MVT, the amount subject to tax increases by only 25 percent from Year 1 to Year 2. In Year 3, the tax base is positive, rather than negative. The government thus collects, rather than refunds tax. The property tax base declines only by about 5 percent ($12.5 billion to $12 billion) in Year 3.

[15]For the possibility of a more encompassing market value tax, see Shakow, note 2, *supra*.

[16]Differences that depend on widespread stock ownership exist but are minor. For example, certain anti-tax shelter legislation applies to only to closely held corporations. *See, e.g.*, section 469(a)(2). (Passive loss rules apply only to individuals, closely held C corporations, and personal service corporations.)

[17]*See, e.g.*, Notice 95-14, 1995-14 I.R.B. 7 (Nonpublicly traded entities may escape Subchapter C status under proposed "check the box" rules.)

[18]Sections 61, 27, 901. Taxpayers can elect a deduction in lieu of a credit. Section 164(a).

[19]Section 904.

MVT; and (2) to the extent that the credit does not exceed total tax paid.[20] This would replicate the "heart" of the foreign tax credit limitation.

Analytically, an MVT will have the same effect on outbound versus domestic investment as described above with respect to publicly traded versus nonpublicly traded companies. The MVT rates would be set to leave the aggregate tax burden on outbound investment constant. However, as compared to current law, an MVT would shift tax liabilities among companies. Thus, compared again to current law, for any particular company, an MVT may increase or decrease the absolute or relative tax burden on outbound investment.

In one respect, an MVT would simplify rather than complicate issues surrounding outbound investment. Over the years, perhaps the most intractable aspect of outbound investment has been the determination of transfer prices between a domestic parent and foreign subsidiaries. The problem resolves itself through an MVT, since any profit "hidden" in the foreign subsidiaries should appear as an increase in market value of the parent corporation. Here, as elsewhere under an MVT, the problem of income determination is shifted from the taxpayer and the government to the market.

The basic treatment of income attributable to inbound investment would probably continue. Such investment would not be subject to an MVT tax. In theory, it might be possible to determine such income with reference to market value; in practice, it would be politically and practically difficult to apply an MVT to such income. As a result, the current definition of income would continue to apply to inbound investments.

Adopting an MVT for domestic companies while maintaining the current tax systems for inbound investors raises the same problems discussed above. In the aggregate, the MVT will not change the current tax burden of domestically domiciled publicly traded companies and therefore should not favor or disfavor inbound investment. However, a particular enterprise or industry may find an MVT less favorable than the current tax system, and less favorable than the tax system that governs its foreign competitors. In this fashion, an MVT could favor or disfavor a domestic company as against foreign investors. The different systems could also influence a company's place of domicile. As in the case of the publicly traded/nonpublicly traded companies, this distortion would come on top of existing distortionary elements of current law. As a result, the scope of the distortion is difficult to measure or even intuit.

[20] To illustrate the operation of such a rule, suppose that an income-based MVT levies a 4 percent rate on economic income, and that this corresponds to a 25 percent effective tax rate imposed under current law. A company would receive a credit for income taxes at the lower of the rate actually charged on foreign income or 25 percent. The credit would be subject to the second limit of U.S. taxes paid.