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Michael R. Laisné

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The Benefits of Tax Deferral or: How I Learned to Stop Worrying and Love Deferral

MICHAEL R. LAISNÉ[*]

ABSTRACT

This Article demonstrates how tax deferral is beneficial and why it is an important tool for facilitating investment, thus leading to greater economic growth. As the debate in Congress over tax reform intensifies, it is critical that new and existing tax policy tools are used to promote investment. Currently, the Chairs of the House Ways and Means Committee and the Senate Finance Committee have committed to instituting tax reforms. This Article presents an analytical framework, consisting of economic and finance theory, for evaluating tax policy related to tax deferral. It then uses this framework to show that tax deferral is economically beneficial when it encourages investment in substantial projects. This Article demonstrates how, under the correct circumstances, tax deferral (1) eliminates market distortions by preventing deadweight loss from taxation and (2) promotes the most efficient roles for investors, businesses, and the government by allowing the best suited to gain the benefits of the time value of money. The analytical framework is then applied, using examples, to well-known instances of deferral, including Internal Revenue Code sections 351, 721, 1031, and 368. Finally, this Article makes several tax policy proposals, involving the expansion of tax deferral, targeted at stimulating economic growth, that the United States government should consider enacting involving these code sections.

I. INTRODUCTION

Critics have attacked tax deferral[1] arguing that the costs associated with it exceed its benefits.[2] However, this Article shows that tax deferral is a

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[*] Michal R. Laisné, Esq., J.D., LL.M., *summa cum laude*, in Taxation. The author wishes to thank Professor Jordan M. Barry for his assistance, supervision, and guidance in the writing of this paper, and the author's parents and family, Michael, Kiki, and Daphne Laisné, for their love and support.

1. Throughout this article, "tax deferral" and "deferral" will be used interchangeably.

2. *See* Chris Sanchirico, *Camp's Investment Tax Plan: Implications for Lower Tax Rates on Capital Gains?*, TAX POLICY CTR. (Jan. 30, 2013), http://taxvox.taxpolicycenter.org/2013/01/30/camps-investment-tax-plan-implications-for-lower-rates-on-capital-gains/; David J. Herzig, *Am I the Only Person Paying Taxes? The Largest Loophole for the Rich – Exchange Funds,* 2009 MICH. ST. L. REV. 503, 509–12 (2009); J. Clifton Fleming et al., *Deferral: Consider Ending It Instead of Expanding It*, 86 TAX NOTES 837, 838 (2000); David Elkins, *The Myth of Realization: Mark-to-Market Taxation of*

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critical part of the U.S. tax code and a significant benefit to the economy.[3] Many businesses and investors reap the benefits of tax deferral[4] and, with the struggling economy, tax deferral is more important than ever.[5] Moreover, a plethora of new laws are regularly proposed impacting businesses and investment.[6] The Chairs of both the United States House Ways and Means Committee and the United States Senate Finance Committee have publicly committed to tax reform, and it is critical to determine under what circumstances the tax code should encourage greater tax deferral going forward.[7]

This Article demonstrates how tax deferral is beneficial and why it is an important tool for facilitating investment, thereby leading to greater economic growth.[8] The best types of deferral result in businesses investing in substantial projects, rather than a mere sale of property.[9] An example of beneficial deferral would be when a sole proprietor and a property owner transfer their assets into a corporation to form a new, long-term business venture. This is a substantial project because the parties, by combining their assets, formed a new corporation, creating an ongoing business that should run more productively, with the mixture of assets of the property and business, than it did before, with the assets separated. This Article develops an analytical framework, utilizing economics and finance, that can be used

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Publicly-Traded Securities, 10 FLA. TAX REV. 375, 382 (2010); Samuel D. Brunson, *Taxing Investors on a Mark-to-Market Basis*, 43 LOY. L.A. L. REV. 507, 513–14 (2010); Clarissa Potter, *Mark-to-Market Taxation as the Way to Save the Income Tax - A Former Administrator's View*, 33 VAL. U. L. REV. 879, 879, 882, 886 (1999); Deborah H. Schenk, *An Efficient Approach to Reforming A Realization-Based Tax*, 57 TAX. L. REV. 503, 03–504 (2004).

3. See generally *infra* Part II.B.

4. Throughout this Article, "businesses and investors" is used interchangeably with "private economic investors," "private actors," and "private investors."

5. *See generally* Robert Samuelson, *Why is the U.S. Economy Struggling?*, REALCLEARPOLITICS (Feb. 18, 2013), http://www.realclearpolitics.com/articles/2013/02/18/why_job_creation_is_so_hard_117050.html.

6. *See* Small Business Investment Enhancement and Tax Relief Act, H.R. 30, 113th Cong. (2013); Creating Jobs from Innovative Small Businesses Act of 2013, H.R. 122, 113th Cong. (2013); Dave Camp, Summary Description of Ways and Means Discussion Draft: Financial Products (2013), *available at* http://waysandmeans.house.gov/uploadedfiles/final_sm_bus_passthrough_legislative_text_03.12.13.pdf.

7. *See* Kelly Phillips Erb, *Baucus and Camp Talk Reform as Tax Road Show Rolls On*, FORBES (July 30, 2013), http://www.forbes.com/sites/kellyphillipserb/2013/07/30/baucus-camp-talk-reform-as-tax-road-show-rolls-on/.

8. It is important to remember that tax deferral is very different from tax evasion. Tax evasion is illegal and involves the deliberate under-reporting of taxes. Zoe Prebble & John Prebble, *The Morality of Tax Avoidance*, 43 CREIGHTON L. REV. 693, 702 (2010). On the other hand, tax avoidance is acting within the law to mitigate the tax owed. *Id.* Tax deferral is one of the less problematic versions of tax avoidance because taxes are merely being deferred; nothing is being done to permanently and immediately reduce the tax base. *Cf.* Willard B. Taylor, *Payroll Taxes – Why Should We Care? What Should Be Done?*, 137 TAX NOTES 983, 986 (Nov. 26, 2012) (stating that the choice of entity between a partnership and an S Corporation will change the payroll tax-base for owner-employees of the business).

9. *See infra* Part II.B.1–2.

to determine whether specific instances of tax deferral are beneficial.[10] This Article then applies the framework to several examples, demonstrating tax deferral benefits as they apply to specific Internal Revenue Code ("IRC") sections.[11] Finally, based on this analysis, this Article proposes tax policy changes that will result in an improved tax climate.[12]

Part II of this Article demonstrates why deferral is beneficial when it encourages investment in substantial projects.[13] Part III applies this framework to well-known instances of deferral in IRC sections 351, 721, 1031, and 368.[14] Part IV presents tax policy proposals involving some of the code sections detailed in Part III; each of these proposals would expand tax deferral and further economic growth.[15]

II. The Inefficiencies of Immediate Taxation

A. *Effects of Deferral*

The inefficiencies of immediate taxation consist of two main parts. First, immediate taxation creates market distortions, either directly or indirectly.[16] Second, it is usually more efficient for private actors to invest funds and capitalize on the time value of money than it is for the government; thus, this improved efficiency results in greater economic growth.[17]

1. *The Ideal Market and the Inefficiencies of Taxes*

Immediate taxation can cause two primary types of market inefficiencies.[18] First, there are the direct effects of taxation; taxes that prevent transactions from occurring due to the increased cost on the exchange.[19] Even if taxation does not prevent a transaction from occurring directly, it may still have indirect effects.[20] It can cause the parties to transactions to take on debt in order to enable the exchange to occur, thus creating negative implications for the party incurring the liability.[21] Further, even if the transaction occurs with the extra tax burden, the additional costs

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10. *See infra* Part II.B.
11. *See infra* Part III.
12. *See infra* Part IV.
13. *See infra* Part II.B.
14. *See infra* Part III.
15. *See infra* Part IV.
16. *See infra* Part II.A.1.
17. *See infra* Part II.A.2.d.
18. *See infra* Parts II.A.1.a–b.
19. *See infra* Part II.A.1.a.
20. *See infra* Part II.A.1.b.
21. *See infra id*.

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of taxation on the initial transaction result in the availability of fewer resources to at least one of the private actors, possibly inhibiting any future transactions between the parties.[22] The following sections of this Article discuss the direct and indirect inefficiencies of taxation in greater detail.

a. Direct Effects of Taxation

In order to understand the benefits of deferral, it is important to review how markets function, including the theories of supply and demand and deadweight tax loss.[23] A market can be depicted as a graph with vertical and horizontal axes.[24] The vertical axis represents the desired price of an item for buyers and sellers, while the horizontal axis depicts the quantity that suppliers are willing to sell and that consumers are willing to purchase.[25] This graph contains both a supply curve and a demand curve.[26] A downward slope typically represents the demand curve, because the less expensive an item is, the greater the number of sales transactions consumers will desire.[27] Whereas, the supply curve normally appears as an upward sloping curve, because as buyers are willing to pay more for an item, sellers will want to engage in more transactions.[28]

In an ideal market, taxes do not burden transactions.[29] However, in the real world, taxes impact transactions, as illustrated in *Figure 1* below.[30] In *Figure 1*, the Deadweight Tax Loss triangle represents transactions that would normally occur but do not because of taxes on transactions.[31] This phenomenon is known as deadweight tax loss.[32] This illustrates how taxes can directly cause transactions not to occur.[33] Tax policy should strive, within reason, to mitigate these direct tax distortions in markets where more transactions are desired.[34] Tax deferral allows transactions to occur that otherwise might not happen, because immediate taxation results in deadweight loss.[35] Thus, by eliminating the distortions that immediate

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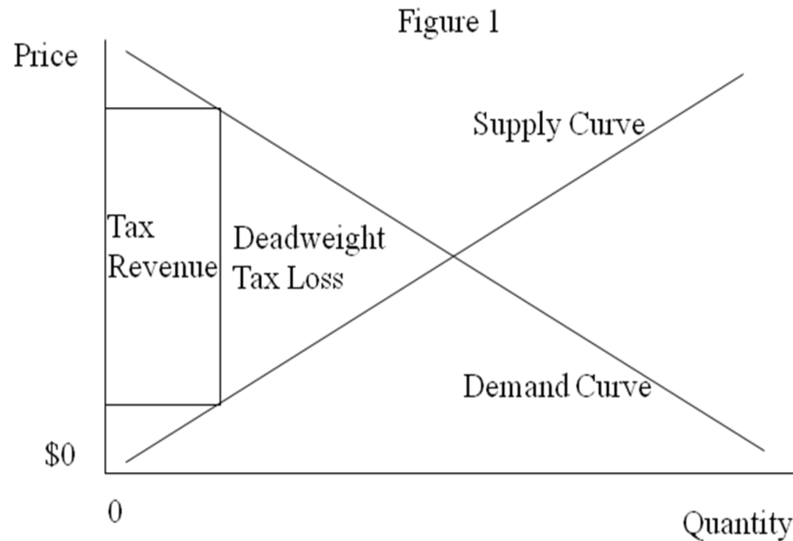
22. *See infra id*.
23. N. GREGORY MANKIW, ESSENTIALS OF ECONOMICS 75–77, 160 (3d ed. 2003).
24. *Id.* at 76.
25. *Id.*
26. *Id.*
27. RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 5–6 (8th ed. 2011).
28. *Id.* at 11.
29. *See* MANKIW, *supra* note 23, at 159–77.
30. *Id.* at 163.
31. *Id.* at 163–64, 168–69.
32. *Id.*
33. *See id.*
34. *See* Theodore P. Seto, *Four Principles of Optimal Tax System Design* 6 (Loyola Law Sch. Legal Studies Paper, Paper No. 2008-36), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1303717.
35. *See* MANKIW, *supra* note 23, at 163.

taxation causes, deferral creates a more efficient market for investments in substantial projects.[36]

Figure 1



See MANKIW, *supra* note 23, at 163, fig. 6.

b. Indirect Effects of Taxation

Even if taxes do not directly prevent a given transaction, they may have a number of indirect effects on the parties to the transaction, thereby impacting future investment in substantial projects.[37] Indirect effects of taxation may take many forms.[38] For example, these effects may require companies to take on more debt and prevent subsequent transactions from occurring.[39]

Increased debt burden can have negative consequences on private economic actors.[40] Some commentators argue that the debt-to-equity ratio

36. *See id.*

37. These indirect effects can also be described as externalities. *See* Thomas Helbling, *Externalities: Prices Do Not Capture All Costs*, INT'L MONETARY FUND (Mar. 28, 2012), http://www.imf.org/external/pubs/ft/fandd/basics/external.htm.

38. *See id.*

39. *See infra* notes 47–50 and accompanying text.

40. *See* Neil Kokemuller, *The Advantages and Disadvantages of Debt and Equity Financing*, HOUSTON CHRON., http://smallbusiness.chron.com/advantages-disadvantages-debt-equity-financing-55504.html (last visited Feb. 9, 2014).

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of a firm's capital structure does not matter.[41] However, this is not entirely true. On the one hand, debt certainly provides some tax benefits, such as the interest expense deduction.[42] Still, there are negative business implications associated with debt that cannot be overlooked.[43] First, as the level of debt increases, more cash flow is needed to compensate for the interest expense, whereas equity does not carry this obligation.[44] Second, debt limits a firm's flexibility to adapt to new situations because of the contractual obligations it owes to creditors.[45] Consequently, debt can reduce investments in substantial projects, or completely prevent a business from investing in these projects due to increased obligations.[46]

The second indirect effect of immediate taxation stems from the fact that private economic actors control limited resources.[47] Thus, even if a tax does not make an initial transaction unaffordable, the extra cost of a tax on an initial transaction may cause one or more of the transferees to be unable to engage in a later investment in a substantial project.[48] This is because the upfront tax on the initial transaction depletes the resources of the participants in the transaction.[49] The aggregate impact of both of these effects is fewer transactions, causing greater inefficiency in the market and hampering economic growth.[50]

2. *The Most Efficient Roles for Investors, Businesses, and the Government*

This portion of the Article discusses the most efficient roles for investors, businesses, and the government. First, the incentives for private actors, such as investors and businesses, and the incentives for the government are discussed.[51] Then, the concepts of the time value of money

41. *See* IVO WELCH, CORPORATE FINANCE 497–98 (2d ed. 2011) (discussing the Modigliani-Miller proposition).
42. 26 U.S.C. § 163(a) (2012).
43. *See generally* Kokemuller, *supra* note 40.
44. *See id.*
45. *See* Aswath Damodaran, *Debt and Value: Beyond Miller-Modigliani*, STERN SCHOOL OF BUSINESS, http://people.stern.nyu.edu/adamodar/pdfiles/country/levvalue.pdf (last visited Feb. 6, 2014). *See also* Martin v. Peyton, 158 N.E. 77, 79 (N.Y. 1927) (discussing creditors exuding control over a business).
46. *See supra* notes 40–45 and accompanying text.
47. *See* The Taxation Committee of the New Zealand Law Society, The Corporate Taxpayers Group, and the Taxation Committee of the New Zealand Institute of Chartered Accountants, *Report: Improving The Operation of New Zealand's Tax Avoidance Laws*, UNIVERSITY OF AUCKLAND BUSINESS SCHOOL, ¶2.47 (2011).
48. *See infra* Part II.A.2.
49. *See supra* Part II.A.1.a.
50. *See supra* notes 47–49 and accompanying text.
51. *See infra* Part II.A.2.a.

and net present value are explained.[52] Next, these financial theories are applied to examples involving the consumption tax and deferral.[53] Finally, private investment is compared to government investment.[54]

a. Incentives

This part of the Article will show most economic actors have their own sets of strengths and weaknesses. Further, in order to have the best economic results, policies should take advantage of actors' strengths, while accounting for accompanying weaknesses. Private actors are highly motivated by incentives that contribute significantly to individual wealth.[55] While, the government, in contrast, typically has access to funds at significantly lower interest rates.[56]

There is significant value in placing the primary responsibility for investment in substantial projects and, thus, placing economic growth in the hands of businesses and investors.[57] First, businesses and investors are more incentivized than governmental decision makers because private economic actors receive greater personal benefits from successful projects and have more at stake should a project fail.[58] Second, governments may frequently make decisions based on what is popular at the time, and not what is most economically desirable.[59] Additionally, if government resources are not used efficiently, the government and its officials may not see any repercussions for their failures or any benefits from successes.[60] Thus, the government is not incentivized to make the most efficient investment decisions.[61] It is true government might be better suited to handle extremely large infrastructure projects such as roads.[62] However, businesses and investors are typically better suited for choosing and investing in the best, relatively smaller-scale, but still substantial, projects.[63] Further, businesses and those who run them are incentivized to take risks

52. *See infra* Part II.A.2.b.
53. *See infra* Part II.A.2.c.
54. *See infra* Part II.A.2.d.
55. *See* Mark J. Perry, *Why Socialism Failed*, FOUNDATION FOR ECONOMIC EDUCATION (June 1, 1995), *available at* http://www.fee.org/the_freeman/detail/why-socialism-failed.
56. Binyamin Appelbaum, *Era of Low-Cost Borrowing Benefits U.S. Government*, N.Y. TIMES (Feb. 27, 2012), http://www.nytimes.com/2012/02/28/business/era-of-low-cost-borrowing-benefits-federal-government.html.
57. *See* Perry, *supra* note 55.
58. *See id.*
59. *See* Brian M. Reidl, *50 Examples of Government Waste*, HERITAGE FOUND. (Oct. 6, 2009), http://www.heritage.org/research/reports/2009/10/50-examples-of-government-waste.
60. *See* Perry, *supra* note 55.
61. *See id.*
62. Lucas Eaves, *5 Things the Government has Done Right*, INDEP. VOTER NETWORK (Apr. 12, 2013), http://ivn.us/2013/04/12/5-things-the-federal-government-has-done-right-2/.
63. *See* Perry, *supra* note 55.

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that could result in either earning a great amount of wealth or failing, losing everything.[64] In other words, their incentive is to do what is best for the business and invest in the most productive and substantial projects.[65] Further, because tax revenue is based on profits, what is best for maximizing profits is also likely beneficial for increasing tax revenue.[66] Finally, if an economic actor has to borrow funds, it is more efficient when that entity is the government because it can generally borrow funds at a lower rate than any other economic actor.[67] In addition, taxpayers also benefit because the savings from tax deferral, at least in the aggregate, makes it easier to justify creating more private sector jobs. For these reasons, investments to help grow the economy can best be left in the hands of businesses and investors.

b. Time Value of Money and Net Present Value

Two additional, but important, concepts are the principles of time value of money and net present value. These principles taken together allow economic productivity to further accelerate growth.[68] The time value of money principle states that having a dollar today is worth more than having a dollar tomorrow because a dollar today will increase its value due to interest or increases in the value of an investment.[69] Net present value is a formula, based on the time value of money, used to determine how valuable or costly a project is and whether an investor, or business, should pursue that project.[70] In order to understand these principles, one must understand the concepts of rate of return, present value, future value, and net present value.

Rate of return ("*r*"), is calculated in two steps.[71] The first step is to subtract the amount of money initially invested ("c_0") from the amount of money after year one ("c_1").[72] The second step is to divide the difference

64. *See id.*
65. *See id.*
66. Generally, as profits increase, so does taxable income. *See* 26 U.S.C. § 1 (2012).
67. *See* Appelbaum, *supra* note 56.
68. *See infra* notes 69–70 and accompanying text.
69. Bruce J. Sherrick et al., *Time Value of Money and Investment Analysis: Explanations and Spreadsheets Applications for Agricultural and Agribusiness Firms* 1, CTR. FOR FARM & RURAL BUS. FINANCE DEP'T OF AGRIC. & CONSUMER ECONOMICS & DEP'T OF FINANCE, UNIV. OF ILLINOIS, URBANA CHAMPAIGN (Sept. 2000), http://www.agweb.com/assets/import/files/timevaluemoneyp1.pdf.
70. Rosemary Peavler, *Net Present Value (NPV) as a Capital Budgeting Method*, ABOUT.COM, http://bizfinance.about.com/od/Capital-Budgeting/a/net-present-value-npv-as-a-capital-budgeting-method.htm (last visited Feb. 9, 2014).
71. WELCH, *supra* note 41, at 14.
72. *Id.*

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between these numbers by the amount initially invested, c_0.[73] This results in *Equation 1* below:

Equation 1: Rate of Return = r = $\frac{C1-C0}{C0}$

The next step is to understand how to calculate the future value of money; this is done by finding the rate of return, *r*, and then multiplying the value of the initial investment, c_0, by the sum of one plus *r*; this is shown in *Equation 2*.[74]

Equation 2: Amount of money after one year: $c_1 = c_0 (1 + r)$

If the entire amount from *Equation 2* is reinvested at the same rate of return, then the amount of money after period ("*t*") increases exponentially, and this can be calculated using *Equation 2* and raising the sum of one and *r* to the power of the number of years that the funds are reinvested, *t*, as shown in *Equation 3*.[75]

Equation 3: Amount of money after period t: $c_t = c_0 \text{ x } (1 + r)^t$

Furthermore, present value ("$PV(c_0)$") can be calculated by dividing the future value, c_1, by the sum of one plus *r* for that period; this denominator increases exponentially for each period.[76] In the context of present value, the rate of return can be thought of as the opportunity cost—the rate of return on other projects that an investor could have pursued instead.[77]

Equation 4: Present Value = PV(c0) = $\frac{C1}{1 + r1}$

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73. An example of this would be if *X*, an investor, initially invested $1,000 and a year later had $1,100 in the investment; then the rate of return would be calculated by applying these values to equation 1: $\frac{\$1,100-\$1,000}{\$1,000} = 10\%$. *See id.*

74. An example of this would be if *X* had $1,000 and wanted to invest it in a project with a rate of return of 10% for 1 year; the future value would be calculated as: *c1 = $1,000 x (1 + .10)= $1,100*. *Id.* at 16. This is a mere reorganization of mathematical expression of the calculation for rate of return. *See* discussion *supra* Part II.A.2.b.

75. If the facts are the same as footnote 74, only *X* will keep the money invested and reinvest it for three periods; the amount available after the third period would be calculated by the following equation: $c3 = \$1,000 \text{ x } (1+.10) \text{ x } (1+.10) \text{ x } (1+.10) = \$1,000 \text{ x } (1+.10)^3 = \$1,331$. *Id.* at 17.

76. This equation can be demonstrated by the following example: assume that *X*'s project will make $2,000 one period into the future; *X* can invest the money in the bank for a return of 10% per period; the present value can be calculated as follows: PV(c0) = $\frac{\$2,000}{1 + .10}$ = $1,818.. *See* WELCH, *supra* note 41, at 24.

77. *Id.* at 25.

The final financial concept required to evaluate a tax policy using the time value of money is net present value ("NPV").[78] To find the NPV, the present value of future cash flows is calculated then added together subtracting the initial investment; this is shown in *Equation 5*.[79]

Equation 5: NPV = (-Initial Investment Cost) + $\frac{C1}{1+r} + \frac{c1}{(1+r)^t}$

One of the most important conclusions derived from the concept of NPV is that firms and investors will invest in projects that are most likely to be successful and provide the greatest rewards;[80] in other words, they will invest in those projects that result in a greater NPV and create the largest return in the period *t*, with the lowest opportunity cost.[81] For example, if a corporation can either put $1,000 in a bank account at 5% interest over two years or invest the $1,000 in a project and generate cash flows of $550 from the project each year for two years, it will select to invest in the project, because the net present value is $22.68, a positive value.[82] This NPV can be compared to the NPV of other projects in order to facilitate the selection of the most financially rewarding project.[83] Thus, firms will try to find the investment with the lowest opportunity cost and the largest return.[84]

c. *Consumption Tax, Time Value of Money, and Deferral*

One way to demonstrate the time value of money principle is to compare the consumption tax with the income tax.[85] Under an income tax, income is taxable when earned; thus, income tax is an immediate taxation.[86] If individual *T* earns $100 subject to a 20% income tax, she is taxed on it immediately and will have $80 to spend.[87] This occurs whether she saves the funds, spends the funds, or invests them.[88] Under a consumption tax model, taxes are imposed only when goods are purchased.[89] If items are taxed at 20% and banks offer a 10% interest rate, *T* can either (1) spend the

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78. *Id.* at 28.
79. *Id.*
80. *See* Peavler, *supra* note 70.
81. *See* WELCH, *supra* note 41, at 28.
82. NPV = -1000 + $\frac{550}{1+.05} + \frac{550}{(1+.05)^2}$ = 22.68. *See id.*
83. *See* Peavler, *supra* note 70.
84. *See* WELCH, *supra* note 41, at 25; *see also id.*, *supra* note 70.
85. Joseph Bankman & David A. Weisbach, *The Superiority of an Ideal Consumption Tax Over an Ideal Income Tax*, 58 STAN. L. REV. 1413, 1417–20 (2006).
86. *Id.* at 1417–18.
87. *See id.*
88. *See id.* at 1417.
89. Edward McCaffery, *Three Views of Tax* 11–14, (Univ. S. Cal. Law Sch. Legal Studies Research Paper Series, Working Paper No. C05-3).

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money and purchase goods valued at $80 or (2) save it and spend the money at the end of some interest period. The taxpayer's second choice is a form of tax deferral because the taxpayer is delaying taxation by saving instead of purchasing taxable goods.[90] *Equation* 2 shows that the second option effectively permits the taxpayer to spend $110 at the end of the interest period.[91] Her buying power is $88, netting her $8 more for saving and avoiding the tax for the period of time during which she chooses not to consume.[92] Recall that this is because $110 is taxed at 20% upon consumption.[93]

Similarly, the time value of money concepts can be applied to other types of deferral. Assume that the tax rate is 50% on gains and the interest rate for savings is 10%. *T* has an asset with a basis—the original cost to acquire an asset minus applicable depreciation or amortization—of $80,000 and a fair market value of $100,000. She wants to exchange property with *X*, whose property holds the same fair market value and basis. If there is no deferral, *T* and *X* will recognize a $20,000 gain on the exchange and be taxed at the 50% tax rate, resulting in a tax bill of $10,000 each. *T* and *X* receive no time value of money benefit on the $10,000 because they were taxed immediately. However, if there is deferral, *T* and *X* will be able to invest their saved funds, $10,000 each, which will increase to $10,500 after taxes on the interest.[94] Now, assume *T*'s new property has the same fair market value a year later.[95] *T* now sells her property and recognizes a gain of $20,000, subject to the 50% tax rate. This results in a tax bill of $10,000. However, because of deferral and the time value of money, she is still $500 better off than she would otherwise have been.

Of course, there may be a question as to who should reap the benefits of deferral in a given transaction. Assume that there is a hypothetical transaction between *A* and *B* for *A*'s substantially appreciated property in exchange for *B*'s cash. The two can choose to either structure the transaction so that it would be tax free, with *B* taking a carryover basis in the new property, or with taxation—*B* would get a stepped-up basis in the property and *A* would be taxed. Although, at first glance, it may appear that only the seller, *A*, gets a benefit from the tax free exchange and the time value of money, in reality, it depends on the outcome of the negotiation. Since this is a tax deferred transaction, *B* can now negotiate a lower price,

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90. *See generally* Bankman & Weisbach, *supra* note 85, at 1417–20.
91. Using the future value formula, the following equation is used: *$100 x (1 +.10) = $110*. *See supra* note 74.
92. *See* discussion *supra* Part II.A.2.b.
93. This will leave T with 80% of her income, *$110 x 80% = $88*.
94. *$10,000 x 10% (interest rate) = $1,000. $1,000 x 50% (tax rate) = $500*.
95. Step 1: *$10,000 x (1.1) = $11,000*. Step 2: *$11,000 x (1-.20) = 10,500*.

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allowing her to keep more cash and, thus, B benefits from the time value of money. Therefore, tax deferral can make either actor better off than he or she would have been without deferral and provides an incentive for both actors in the transaction.

d. Government Investment versus Private Investment

When comparing public financing to private investment it is important to keep some facts in mind. Governments need to be funded; and, when tax deferral includes an exit process that ensures taxation in the future, this funding is not inhibited.[96] Moreover, governments should also care about time value of money, and they have an incentive to give this benefit to the economic actors who can best utilize it.[97] Further, while companies and investors may prefer exemption over deferral, they certainly prefer deferral over present taxation because of the significance of the time value of money, as explained earlier.[98] Indeed, deferral is an excellent compromise between immediate taxation and exemption.[99] While it is true that government spending results in some good things, it is difficult to ensure that the best economic choices are made when the government lacks the strong profit incentives of private actors.[100] In contrast, private actors almost always have wealth maximization as a primary goal.[101] Eventually, this additional wealth should be recognizable as income and, thus, aggregate tax revenue will be increased.[102] While it is true that political and social concerns may impact a firm's decisions, the firm's goal is usually simple, to maximize profits for its owners.[103] Moreover, governments can borrow at a lower rate than companies or investors; thus, if an economic actor needs to borrow, it is more practical for the government to borrow and give the tax deferral benefits to businesses and investors.[104] In this way firms grow, job creation is maximized, more investments can be made, the economy grows, and more tax revenue is ultimately available to the government.

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96. *See* Alan J. Auerbach, *Reforming Capital Gains Taxation*, 135 TAX NOTES 1399, 1399 (2012). One major concern involving deferral is that if an investor holds property until his or her death, the beneficiary of the investor's estate will get a basis step-up. *Id.* Therefore, an investor can defer tax until he or she dies and completely avoid it by passing the asset on to his or her heirs. *Id.* However, this problem is not really a deferral issue; it is a step-up in basis issue. *See id.* This problem could be avoided by simply extending deferral and adopting a carryover basis rule at death. *See id.*

97. *See* discussion *supra* Part II.A.2.a–b.

98. *See* discussion *supra* Part II.A.2.c.

99. *See supra* note 96–98 and accompanying text.

100. *See* discussion *supra* Part II.A.2.a.

101. *See id*.

102. *See* 26 U.S.C. § 1.

103. *See* discussion *supra* Part II.A.2.a.

104. *Cf.* Appelbaum, *supra* note 56.

B. Analytical Framework

This Article uses an analytical framework based on the concepts discussed above to determine whether current tax code sections or policy proposals involving deferral are beneficial. This analytical framework will consist of two parts, (1) whether the statute or proposed tax policy eliminates market distortions for investment in substantial projects by private actors and (2) whether the statute or policy creates efficient pro-growth investment.

1. Eliminating Market Distortions

For the reasons highlighted above, beneficial tax policy will reduce, as much as possible, certain market distortions, such as taxation on transactions that promote investment in substantial projects.[105] This will lessen the direct distortions caused by deadweight tax loss for such transactions, leading to more investment in these projects.[106] Moreover, it will curtail the indirect effects of taxation so businesses and investors will not need to borrow and will not lose the opportunity to participate in future investments.[107] As a result, beneficial tax deferral will lessen the impact of these distortions and inefficiencies, allowing for greater investment in substantial projects.[108]

2. Efficient Pro-Growth Investment

Firms and investors have the most incentives to invest in the most productive and substantial projects because they have more to gain and lose than the government does.[109] It is common for businesses and investors to rely on NPV to choose the best projects.[110] The result is that deferral gives investors and businesses the advantage of the time value of money.[111] In the aggregate, giving private actors this advantage has a net positive effect on overall economic growth.[112] The significant benefit of the incentives that private actors have to invest in substantial projects and the time value of money is that growth yields further growth.[113] In addition, the government also has the ability to borrow at lower rates.[114] Thus, it is in a better

105. *See* discussion *supra* Part II.A.1.
106. *See supra* Part II.A.1.a.
107. *See supra* Parts II.A.1.a–b.
108. *See supra* Parts II.A.1.a–b.
109. *See* discussion *supra* Part II.A.2.a.
110. *See* discussion *supra* Part II.A.2.b.
111. *See id.*
112. *See id.*
113. *See id.*
114. *Cf.* Applebaum, *supra* note 56.

position to take on debt and allow private actors to defer taxation. And, it is more efficient for the government to borrow funds than it is for private economic actors.

In sum, the types of transactions that tax deferral should promote are ones that create economic growth. These are transactions that are not mere sales, but rather investments in larger projects. For example, if a sole proprietor needs property for a new project, he or she will want to form a partnership with the investor who owns the property. This new venture or project can create economic growth.[115] Thus, by taking advantage of fewer market distortions and the time value of money, tax deferral encourages investment in productive projects and leads to economic growth.[116]

C. Another Framework

Professor Daniel Shaviro introduced another framework to examine realization and recognition efficiency.[117] The IRC often refers to provisions involving deferral as involving nonrecognition.[118] Shaviro applies this framework to various IRC code sections.[119] His framework conveys many excellent arguments; however, his framework is different from the one in this Article.[120] Professor Shaviro's form of efficiency focuses on preventing distortions[121] (focusing on what he calls "Time One distortions," which, in this Article, occur when deferral begins, and "Time Two distortions," which, in this Article, occur when deferral ends),[122] and preventing overhead costs, including lawmaking, tax planning, administration, and litigation.[123]

On the other hand, while this Article's framework includes reducing distortions, Shaviro's "Time One" and "Time Two" distortions are not discussed because they do not have a strong impact given the time value of money advantage.[124] All of the examples mentioned in this Article involve basis carryover rules with a fair market value greater than basis at the time deferral begins.[125] This Article's framework also has a much stronger

115. *See* discussion *supra* Part II.A.2.
116. *See* discussion *supra* Part II.B.1.
117. Daniel N. Shaviro, *An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax*, 48 TAX L. REV. 1, 24–36 (1992).
118. *See, e.g.*, 26 U.S.C. §§ 721, 1031(a) (2012).
119. Shaviro, *supra* note 117, at 36–65.
120. *Compare id.* at 24–36, *with* discussion *supra* Part II.A–B.
121. Shaviro, *supra* note 117, at 25–32.
122. *Compare id.*, *with* discussion *infra* Part III.
123. Shaviro, *supra* note 117, at 24.
124. *Id.* at 25–32.
125. *See* discussion *infra* Part III. There are a few scenarios that could occur. First, if the value has increased at the end of deferral, then the taxpayer gets the advantage of the time value of money, plus the increase in actual value, minus some additional taxation. Second, if the value goes down some,

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emphasis on the time value of money and focuses on the proper roles for taxpayers and the government in terms of who should invest and who should borrow.[126] Further, the goal of this framework is determining, by decreasing market distortions and promoting efficient pro-growth investment, which uses of deferral are beneficial when efficiency is related to determining the best economic actors to invest in substantial projects and the ones best suited to borrow.[127] Although both Professor Shaviro's framework and this Article's framework focus on deferral, they measure two important but different areas of tax policy.[128]

III. THE BENEFITS OF DEFERRAL: THE ANALYTICAL FRAMEWORK IN ACTION

In this part, the analytical framework will be applied to various code sections. These are sections 721, 351, 1031, and selected section 368 reorganizations.[129] Of course, each of these areas is very broad and entire papers could be written about them individually. Thus, the descriptions of these areas of tax law are not meant to be exhaustive. Instead, they present a general guide to demonstrate how the analytical framework should be applied.

A. *Section 721*

1. *Introduction*

For this first example, we will examine the case of a hypothetical entrepreneur named General Buck.[130] He has been working very diligently at his sole proprietorship, General Buck Sole Proprietorship; so much so, that it is now worth $100,000. However, he needs more land in a developed city to help build his business. If he is not successful in acquiring land, his business will become stagnant. Most of the land in the city was purchased years ago and has appreciated in value substantially. Some of the

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but not enough for the adjusted basis to be equal or greater than the current fair market value at time two, then the taxpayer still gets the benefit of the time value of money, loses some value, and still gets taxed on her gain, but to a lesser extent. Further, assuming there is loss property, the taxpayer still gets the time value of money benefit and gets the tax benefit of claiming the loss, but loses value. Theoretically, in the context of this framework, there is not too much to cause the taxpayer to get locked-in, especially when the taxpayer has already gained from the time value of money.

126. *See* discussion *infra* Part II.

127. *See* discussion *infra* Part III.

128. *Compare* Shaviro, *supra* note 117, at 25–32, *with* discussion *infra* Part III.

129. 26 U.S.C. §§ 351, 368, 721, 1031 (2012).

130. Named after Gen. "Buck" Turgidson, played by George C. Scott, from Dr. Strangelove. DR. STRANGELOVE OR: HOW I LEARNED TO STOP WORRYING AND LOVE THE BOMB (Columbia Pictures Corp. & Hawk Films 1964).

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individuals who own the land would like to own part of Buck's company in exchange for their land.

When a partnership is formed and property is placed in the partnership in exchange for a partnership interest, the transaction is not treated as a sale.[131] Instead, the partnership gets a carryover basis in the property equal to the new partner's adjusted tax basis in the transferred asset.[132] Further, the new partner's adjusted tax basis in the partnership interest is the same as it was for the new partner's contributed property.[133] This nonrecognition event is what triggers the tax deferral.[134] The partner's tax basis is adjusted upward when the partnership earns income that is allocated to the partner.[135] On the other hand, losses allocated or distributions made to a partner lower the tax basis, but never lower it below zero.[136] However, distributions are normally tax free, unless the distribution is cash and the amount of cash exceeds the tax basis, in which case the partner recognizes gain to the extent that the cash exceeds the tax basis.[137] The portion that exceeds the basis is immediately taxable.[138] The tax deferral on the original transaction ends when the partnership sells the item contributed or, for the selling partner, when the partner sells his or her interest in the partnership.[139]

2. Analysis

Section 721 deferral results in the benefits required by the previously highlighted analytical framework.[140] First, it helps prevent both direct and indirect market distortions that impede investment in productive projects.[141] As discussed earlier, one key advantage of deferral is that it allows markets to operate free of taxation by removing the deadweight tax loss.[142] In this example, section 721 allows Buck to transfer his active, ongoing business into a partnership along with an investor's property to form a new, more

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131. 26 U.S.C. § 721(a).

132. 26 U.S.C. § 723 (2012).

133. 26 U.S.C. § 722 (2012). The full calculation of basis includes the cash plus adjusted basis of any property, determined under 26 U.S.C. § 1011(a) (2012); partner's share of liabilities, under 26 U.S.C. 752(a) (2012); and any gain recognized under 26 U.S.C. § 721.

134. *See* 26 U.S.C. § 721.

135. 26 U.S.C. § 705(a)(1)(A) (2012); Treas. Reg. 1.705-1(a)(2) (2013). Additionally, the basis is increased for contributions of property and tax exempt income. 26 U.S.C. §§ 705(a)(1)(B), 722. Further, an increase in liability will increase basis. 26 U.S.C. § 752(a).

136. 26 U.S.C. §§ 704(d), 705(a)(2), 705(a)(2)(A), 733 (2012). Outside basis also decreases for non-deductible partnership expenses and is reduced for the partner's share of liability. 26 U.S.C. §§ 705(a)(2)(B), 752(b).

137. 26 U.S.C. § 731(a).

138. 26 U.S.C. § 731(a).

139. *See* 26 U.S.C. §§ 741, 1001 (2012).

140. *See* discussion *supra* Part II.B.

141. *See* discussion *supra* Part II.A.1.

142. *See* discussion *supra* Part II.A.1.a.

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profitable venture free of the direct and indirect distortions of immediate taxation.[143] In terms of direct distortions, if there were no tax deferral, the deal might fail to materialize; investors would need to raise prices to compensate for the tax consequences, and this could become a cost greater than what Buck is willing or able to accept. Alternatively, even if the deal does materialize, indirect distortions could occur.[144] For example, the partnership, Buck, or the investor might have to take on debt to compensate for the increased tax cost, leading to the negative implications discussed earlier.[145] Another indirect consequence is the parties might need to forego future deals involving substantial projects due to the tax costs of this transaction.[146]

This form of tax deferral also results in efficient, pro-growth investment.[147] Tax deferral in this scenario would help create growth, because it would give the private actors, consisting of the partnership, Buck, and the investors, an opportunity to benefit from the time value of money.[148] This is the best scenario because they would have the greatest incentive to choose the best projects and investments based on NPV.[149] Additionally, although the government may need tax revenues, it is in a much better position than Buck, the partnership, or the investors to get a loan, for the reasons discussed earlier.[150] As can be seen from the previous examples of the time value of money, this creates a scenario where growth begets growth both for the business, on a micro level, and for the economy, on a macro level.[151] Therefore, section 721 is an excellent example of the type of beneficial tax deferral that should be encouraged.

B. Section 351

1. Introduction

Now, assume all the same facts as above except Buck has an additional goal: to take his business public, at some time in the future, in order to raise funds. To do this, he needs to find individuals or other entities who want to invest in his sole proprietorship in the form of General Buck Corporation.[152] To do this, Buck and his investors will utilize section 351. At first glance,

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143. *See* 26 U.S.C. § 721.
144. *See* discussion *supra* Part II.A.2.b.
145. *See* discussion *supra* Part II.A.1.b.
146. *See* discussion *supra* Part II.A.1.b.
147. *See* discussion *supra* Part II.B.2.
148. *See* discussion *supra* Part II.A.2.b.
149. *See* discussion *supra* Part II.A.2.b.
150. *See* discussion *supra* Part II.A.2.d.
151. *See* discussion *supra* Part II.B.2.
152. *See How to Choose the Right Business Entity*, NATIONWIDE INC., http://www.nationwide-incorporators.com/article-how-to-choose-right-entity (last visited Jan 21, 2014).

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section 351 appears to be very similar to section 721.[153] When someone invests property in a corporation there is no gain or loss recognized, and the investor uses the basis he had in his property as the new basis in his stock, creating tax deferral.[154] Additionally, there is no gain or loss recognized until the investor sells the stock.[155] However, a key difference between sections 721 and 351 is that immediately after the contribution occurs the transferor or group of transferors must control ". . . at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock . . . ."[156] This is due to the section 368(c) control requirement.[157] While section 351 deferral is very useful, the control group requirement makes it less flexible than section 721 deferral.[158]

2. Analysis

As with section 721, section 351 tax deferral meets the first criterion of the analytical framework because it reduces market distortions for transactions that result in substantial projects.[159] It allows Buck and the investors to form a new, more profitable venture, free of taxation, provided that the transaction meets the control group requirement.[160] As with partnerships, it is better policy to encourage transactions that create new business ventures.[161] If there was no section 351, the increased costs of taxation could take Buck or his potential investor out of the deal.[162] Further, if there is a deal in spite of immediate taxation, the indirect consequences of taxation could harm one or more of the parties to the transaction, which could result in the business taking on more debt or prevent the parties from investing in future productive projects.[163]

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153. *See generally* Symposium, *Opportunities and Pitfalls Under Sections 351 and 721*, WM. & MARY L. SCH. SCHOLARSHIP REPOSITORY (2007) (discussing the differences between Sections 351 and 721).

154. 26 U.S.C. § 358(a)(1) (2012); 26 U.S.C.§ 358(a)(1)(A)(i)–(iii) (stating the basis is decreased by "the fair market value of any other property . . . received by the taxpayer" and "the amount of . . . [cash] received by the taxpayer, and . . . the amount of loss to the taxpayer which was recognized on such exchange. . . ."); 26 U.S.C. § 358(a)(1)(B) (stating this basis is increased by the amount treated as a dividend and the amount of gain a shareholder recognized on the exchange).

155. 26 U.S.C. §§ 1001(c); 1011(a).

156. 26 U.S.C. §§ 351(a); 368(c).

157. 26 U.S.C. § 368(c).

158. *Compare* 26 U.S.C. § 351, *with* 26 U.S.C. § 721.

159. *See* discussion *supra* Part II.A.1.

160. *See* 26 U.S.C. § 368(c).

161. *See* discussion *supra* Part II.B.2.

162. *See* discussion *supra* Part II.A.1.

163. *See* discussion *supra* Part II.A.1.

Section 351 also meets the second criterion because, like section 721, tax deferral under section 351 promotes efficient, pro-growth investment.[164] The private economic actors are incentivized to choose high NPV projects, and they are the parties best situated to receive time value of money benefits.[165] This allows the corporation, Buck, and the investors to take advantage of the time value of money, leading to a scenario where the private investors thrive, contributing to more economic growth.[166] For these reasons, section 351, like section 721, is a beneficial form of deferral.

C. Section 1031

1. Introduction

Now assume that Buck's firm, General Buck Corporation, owns a factory that it values, but the corporation could be more productive if it had a laboratory instead. Strangelove, Limited Liability Corporation ("LLC"), owns land with a laboratory that the LLC utilizes, but the LLC could be more productive if it had a factory instead.[167] Each asset has a basis significantly lower than its current fair market value. Both of these firms are willing to transfer ownership of their respective real property in a like-kind exchange, but only at the right price.

Tax deferral for section 1031 like-kind exchanges works as follows: If a taxpayer exchanges like-kind property and the relinquished property was used productively in a business or in an investment, and the acquired property will be held for one of these purposes, the taxpayer takes a carryover basis in the acquired property equal to the basis the taxpayer had in the relinquished property.[168] The deferral ends when the taxpayer sells the like-kind property acquired in the transaction.[169] At that point, the adjusted basis is subtracted from the selling price, which could result in a taxable gain or loss.[170] This form of deferral is also subject to additional restrictions.[171] There are several types of property that are excluded from tax free like-kind exchanges: stock, inventory, indebtedness, interests in

164. *See* discussion *supra* Parts II.B.2, III.A.2.

165. *See* discussion *supra* Part II.B.2.

166. *See* discussion *supra* Part II.A.2.b.

167. *See supra* note 134. Strangelove, LLC is named after the character Dr. Strangelove played by Peter Sellers.

168. 26 U.S.C. § 1031(a), (d).

169. 26 U.S.C. §§ 1001(a), 1011(a).

170. *Id.*

171. 26 U.S.C. § 1031(a)(3) (stating the transaction will qualify under Section 1031 only if the acquired property is identified as such within forty-five days after the taxpayer transfers the relinquished property, and the acquired property is received within the sooner of 180 days of the transfer of the relinquished property or the due date of the taxpayer's tax return).

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trusts and partnerships, and causes of action.[172] Still, the types of property that are considered to be like-kind for the purposes of section 1031 are extremely broad.[173] For example, real property can be exchanged for any other real property.[174]

2. Analysis

As was the case in the previous examples, section 1031 tax deferral meets the criteria of the analytical framework.[175] First, it removes the market distortions and inefficiencies that are caused by taxation.[176] It allows General Buck Corporation and Strangelove, LLC, to exchange assets tax free, which each party can now use more effectively.[177] If there were no section 1031, this transaction might not occur at all. Even if there were a transaction without section 1031 deferral, indirect consequences of taxation may result; future investment in productive projects might fail to materialize due to the costs of taxation.[178] Alternatively, the parties might have to take on debt in order to compensate for the added expenses of taxation, leading to the negative consequences examined previously. [179]

The tax deferral of section 1031 also satisfies the second criterion because it results in a greater amount of more efficient, pro-growth investment in substantial projects.[180] It places General Buck Corporation and Strangelove, LLC, in a position to trade their like-kind property and leaves both with property that they can more profitably use in their businesses.[181] The lack of taxation allows these parties to take advantage of the time value of money and to invest their tax-deferred funds.[182] Once again, the government is in the best position to take a loan and let the

172. 26 U.S.C. § 1031(a)(2) (stating that the following items do not qualify for like-kind exchanges: "(A) stock in trade or other property held primarily for sale, (B) stocks, bonds, or notes, (C) other securities or evidences of indebtedness or interest, (D) interests in a partnership, (E) certificates of trust or beneficial interests, or (F) choses in action"). 26 U.S.C. § 1031(d) (stating how the basis in the acquired property can be adjusted under certain circumstances).

173. *See* 26 U.S.C. § 1031; *see, e.g.*, 124 Front St., Inc. v. Comm'r, 65 T.C. 6, 7–9, 15 (1975) (finding that, where under agreement Corporation *X* exercised its option to purchase real property with funds advanced by *Y* and thereafter exchanged properties with *Y*, the agreement between parties contemplated a valid exchange and not a sale of the option from *X* to *Y*); *see also Tax Deferred Exchange Frequently Asked Questions*, EXETER, http://www.exeter1031.com/EEL_FAQs.aspx (last visited Feb. 8, 2014).

174. *See 124 Front St.*, 65 T.C. at 7–9, 15; *see also* EXETER, *supra* note, 173.

175. *See* discussion *supra* Part II.B.

176. *See* discussion *supra* Part II.B.1.

177. *See* 26 U.S.C. § 1031(a)(1).

178. *See* discussion *supra* Part II.A.1.

179. *See* discussion *supra* Part II.A.1.b.

180. *See* discussion *supra* Part II.B.

181. *See* discussion *supra* Part III.C.1.

182. *See* discussion *supra* Part II.A.

private economic actors invest in the best projects.[183] This creates a scenario, due to the time value of money, where the growth prospects of the business are improved, as is the growth of the economy as a whole.[184] For these reasons, section 1031 tax deferral is a beneficial form of deferral.

D. Section 368: Selected Corporate Reorganizations

1. Introduction

Now assume that it is years later and General Buck Corporation has been very successful. The company is considering acquiring Kong Technologies, Inc., which holds assets and possesses human capital that is valuable to General Buck Corporation.[185] The two firms are willing to make a deal, but only at the right price; tax deferral reduces the transaction costs and helps facilitate an agreement.[186] There are many ways to obtain deferral through corporate reorganizations.[187]

When a target corporation transfers assets to an acquiring corporation, there will be no gain or loss recognized if the transaction is pursuant to a reorganization plan and the target corporation receives stock in a corporation that is part of the reorganization.[188] The shareholders in the target corporation only recognize gains to the extent that they receive property other than stock.[189] Additionally, the target shareholders get a carryover basis in their new stock, and the acquirer gets a carryover basis in the new property.[190] Finally, in some cases the acquiring corporation will inherit the target's tax attributes.[191] The deferral ends when one of the parties sells the carryover basis asset.[192] Section 368(a)(1) describes seven categories of tax free reorganizations.[193] This Article will discuss four of these, the A, B, C, and D type reorganizations, next.

Type A reorganizations are statutory mergers or consolidations.[194] Under a merger, the acquiring corporation purchases the target and assumes

183. *See* discussion *supra* Part II.A.2.
184. *See* discussion *supra* Part II..
185. *See supra* note *130*. Kong Technologies, Inc. is named after Major "King" Kong, played by Slim Pickens.
186. *See* discussion *supra* Parts III.A.2, B.2.
187. *See* Barnet Phillips, *Structuring Corporate Acquisitions – Tax Aspects*, TAX MGMT. (BNA), 2011, at A-1.
188. 26 U.S.C. §§ 361, 357 (2012); Phillips, *supra* note 187, at A-1.
189. 26 U.S.C. §§ 354, 356; *see* Phillips, *supra* note 187, at A-2.
190. 26 U.S.C. §§ 358, 362; *see* Phillips, *supra* note 187, at A-1.
191. 26 U.S.C. § 381; *see* Phillips, *supra* note 187, at A-3.
192. 26 U.S.C. §§ 1001, 1011.
193. 26 U.S.C. § 368(a)(1).
194. *Id.*

all assets and liabilities of the target.[195] A consolidation occurs when two or more companies come together to form a new corporation.[196] For either the merger or the consolidation to be tax free, three conditions must be satisfied: (1) the merger or consolidation must be considered to be a merger or consolidation under a valid jurisdiction, (2) all liabilities and assets of the target must become the liabilities and assets of the acquirer, and (3) the existence of the target corporations must cease.[197] This type of reorganization allows the acquiring company to pay up to 60% of the amount with boot.[198] However, this can be more complex than a type C reorganization.[199]

Next, the Type B, C, and D reorganizations will be reviewed.[200] Type B reorganizations are different from type A reorganizations in a few ways including: not permitting the use of boot, allowing only voting stock to be used by the acquirer or its parent, not obligating all assets and liabilities to be acquired, and requiring the acquirer to satisfy the same control requirement as in section 351.[201]

The type C reorganization "is an acquisition by one corporation of substantially all of the assets of another corporation solely in exchange for voting stock of the acquiring corporation or its parent."[202] An advantage of type C reorganizations is that it can be less complex than type A reorganizations, but it also has the limitation of having the same control requirements as type B reorganizations.[203] Type C reorganizations are more limited than type A reorganizations, because only 20% of the consideration can be boot.[204]

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195. BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS 94.2.1. 94–26 (3d ed. 2003).

196. *See Consolidation Strategy*, BOUNDLESS, https://www.boundless.com/management/strategic-management/common-types-of-corporate-strategies/consolidation-strategy/ (last visited Mar. 16, 2014).

197. *See* PILLSBURY TAX PAGE, Statutory Mergers: A Reorganizations (Oct. 15 2006), http://www.pmstax.com/acqbasic/Arg.shtml (last visited July 29, 2014)

198. Derek P. Usman, *Who Wants Cake? Section 368 Tax-Free Reorganizations for Corporations*, USMAN LAW GRP., *available at* http://dusmanlaw.com/wp-content/uploads/2010/07/WHO_WANTS_CAKE-SECTION_368_TAX-FREE_REORGANIZATIONS_FOR_CORPORATIONS_by_Derek_P_Usman_Usman_Law_Group_PC_Chicago_Illinois.pdf.

199. *See* Charles Kelliher, *Corporations: Reorganizations*, UCF COLL. OF BUS. ADMIN. FACULTY 7-8, 7-13 (Jan. 24, 2014), *available at* http://www.bus.ucf.edu/faculty/ckelliher/file.axd?file=2014%2f1%2fchapter_7_notes_2014.pdf.

200. 26 U.S.C. § 368(a)(1)(B)–(D).

201. *See* BITTKER & LOKKEN, *supra* note 195, at 94.2.3, 94-36; Kelliher, *supra* note 199, at 7-10–7-11; 26 U.S.C. § 368(c).

202. *See* BITTKER & LOKKEN, *supra* note 195, at 94.2.4, 94-40.

203. *See* Kelliher, *supra* note 199, at 7-13; 26 U.S.C. § 368(c).

204. Usman, *supra* note 198.

Finally, there are two main subcategories of type D reorganizations: divisive and acquisitive.[205] Divisive type D reorganizations require 80% ownership of the spinoff after the restructuring, and the stock of the spinoff must be distributed to the shareholders of the original corporation.[206] The second type D reorganization is the acquisitive type, which requires the acquiring firm to place substantially all of its property into the target and also requires the target to control 50% of the total value of stock or voting power of the parent.[207] The Type D acquisitive reorganization is considered the equivalent of "the minnow swallowing the whale."[208]

2. Analysis

Section 368 tax deferral limits tax distortions and inefficiencies, and encourages more efficient, pro-growth investment.[209] First, its use will allow General Buck Corporation to acquire Kong Technologies, Inc., so that they can form a more productive business by combining their resources, resulting in investment in a substantial project. If there were no section 368 reorganizations the merger might not occur, because of the increased tax costs associated with the transaction.[210] Alternatively, even if the deal occurred, it could lead to indirect inefficiencies, precluding the parties from participation in future, productive transactions, or it could cause a party to take on debt that could lead to the negative implications discussed earlier.[211]

Further, this tax deferral encourages efficient, pro-growth investment.[212] Like the other examples, the benefits of the time value of money will be best utilized by private economic actors, because they will invest in projects that carry the best NPV; and, as a result of the time value of money, this will allow the business to grow more than if there was a tax on the initial transaction.[213] Thus, section 368 tax deferral leads to overall economic growth.[214] Further, as discussed above, if borrowing is necessary the

205. *See* Jerald David August, *Tax-Free Asset Acquisitions Involving S Corporations*, 46 USC LAW SCH. INST. ON MAJOR TAX PLANNING 2204 (1994).

206. *See* DONALD M. DEPAMPHILIS, MERGERS, ACQUISITIONS, AND OTHER RESTRUCTURING ACTIVITIES: AN INTEGRATED APPROACH TO PROCESS, TOOLS, CASES, AND SOLUTIONS 429 & n. 8 (7th ed. 2014).

207. *See* August, *supra* note 205; Charles Kelliher, *supra note* 199, at 7-15.

208. Kelliher, *supra* note 203, at 7-15.

209. *See generally* 26 U.S.C. § 368.

210. *See* discussion *supra* Part II.A.1.

211. *See* discussion *supra* Part II.A.2.

212. *See* discussion *supra* Part II.B.2.

213. *See* discussion *supra* Part II.B.2.

214. *See* discussion *supra* Part II.B.2.

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government is likely to get the best interest rates.[215] Therefore, section 368(a) reorganizations are a form of beneficial tax deferral.[216]

IV. TAX POLICY PROPOSALS

Overall, the above analyses have shown that tax deferral in these situations is beneficial to businesses and investors and, as a result, beneficial to the economy as a whole, because these instances of tax deferral encourage private actors to invest in substantial projects.[217] The tax deferral options discussed in Part III are very beneficial in the context of sections 351, 1031, and 368 reorganizations.[218] However, these sections can be improved and expanded. Below, the paper reviews two proposals for improving tax deferral. The first proposal is to increase deferral opportunities for investing in corporations under section 351 and reorganizations under sections 368(a)(1)(B), (C), and (D). The second proposal is to expand the like-kind exchange rules under section 1031.

A. *Modifying Section 368(c) Control Requirements*

Given this Article's framework, section 721 is a very efficient use of deferral because there is no control group requirement.[219] However, section 351 and parts of section 368(a) incorporate the section 368(c) control requirement.[220] As discussed earlier, section 368(c) contains the 80% control requirement.[221] This rule suffers from two drawbacks. First, 80% is a very high and arbitrary threshold. Second, the control requirement can be planned around.[222] Therefore, lowering the control requirements would reduce the complexity of tax deferral.

First, the 80% control group requirement is unnecessary; lowering it would result in the aforementioned tax deferral benefits.[223] Further, the

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215. *See* discussion *supra* Part II.A.2.
216. *See* discussion *supra* Part II.B.
217. *See* discussion *supra* Part III.
218. *See* discussion *supra* Parts III.B–D.
219. *See* discussion *supra* Part III.B.1.
220. *See* 26 U.S.C. §§ 351(a), 368(a).
221. *See* discussion *supra* Part III.B.1; III.D.1.
222. *See* Mark J. Silverman and Aaron P. Nocjar, *Partnership Mixing-Bowl Issues,* Practising Law Institute Tax Planning for Domestic & Foreign Partnerships, LLCs, Joint Ventures & Other Strategic Alliances 2013, 63 (Jan. 2013), *available at* www.steptoe.com/assets/attachments/3608.PPT; David B. Friedel and Yaw O. Awuah, *Sec. 351 Control Requirement: Opportunities and Pitfalls*, The Tax Advisor, AICPA, (July 1, 2014); PricewaterhouseCoopers, This Month In Taxation, WASHINGTON NATIONAL TAX SERVICES 2–4 (Sept. 2011) *available at* http://www.pwc.com/en_US/us/tax-services-multinationals/newsletters/mergers-and-acquisitions/assets/pwc-this-month-ma-september-2011.pdf ; Annette Nellen, Tax Considerations for High-Tech Start-Ups, SAN JOSE STATE UNIV. COLL. OF BUS., 7 (2001) (stating that a partnership can be used to avoid immediate taxation in lieu of a corporation) *available at* http://www.cob.sjsu.edu/nellen_a/Startup.pdf.
223. *See* discussion *supra* Part II.B.

control requirement is excessive and arbitrary.[224] The requirement does serve legitimate purposes; it makes it difficult for a sale to be disguised as an investment in a business, and it prevents the use of a corporation as a vehicle to pay a lower tax rate.[225] However, the threshold could easily be lowered to some number between 55 and 70% and still carry similar protections against mere sales. Additionally, under certain conditions, there are methods for planning around the control requirement, including tax planning involving a partnership with ownership interest redeemable for the corporation's shares or modifying corporate instruments to provide shares with "exotic voting rights."[226] The control requirement forces the parties to adopt tax strategies that include undesirable features.[227] This is a nuisance because the parties only wanted to receive shares in the corporation, not to be a part of a partnership with redeemable partnership interests and not receive shares of a corporation with "exotic voting rights."[228] Not only would a decrease in the control requirement encourage more beneficial deferrals, it would reduce the unnecessary use of these tax planning arrangements.

B. Section 1031 Active Business Security Exemption

The second proposal is to expand section 1031 tax deferral by adding an active business securities exemption. The exclusion of securities from section 1031 deferral stems from the large amount of lost revenue that the unabated tax free exchange of securities causes.[229] The new rule would state that section 1031 deferral applies to exchanges of securities when the exchange of the property underlying the security would have qualified for section 1031 treatment.[230] This provision would allow for exchanges that substantially comply with the current section 1031 access to the tax benefits of this section, but are not presently permitted due to their form.[231]

For example, if A Corp has real estate and B Corp only holds a piece of real estate, then *B*'s stock is exchangeable for *A*'s real estate, qualifying for

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224. *See* 26 U.S.C. § 368(c).

225. *See* PricewaterhouseCoopers, supra note 222, at 2–4. *Cf.* Charles Zubrzycki, *A Detailed Analysis of a Disguised Sales Transaction – In re G-I Holdings* ,LEXIS TAX STAFF ANALYSIS (Nov. 2 2010).

226. *See* Silverman & Nocjar, *supra* note 222, at 63; Friedel & Awuah, *supra* note 222; PricewaterhouseCoopers, *supra* note 222, at 2–4.

227. *See* Silverman & Nocjar, *supra* note 222, at 63; Friedel & Awuah, *supra* note 222; PricewaterhouseCoopers, *supra* note 222, at 2–4.

228. *See* Silverman & Nocjar, *supra* note 222, at 63; Friedel & Awuah, *supra* note 222; PricewaterhouseCoopers, *supra* note 222, at 2–4.

229. Howard J. Levine, *Tax-free Exchanges under Section 1031*, 567, TAX MGMT. PORT., 2011, at A-37.

230. *Cf.* 26 U.S.C. § 1031.

231. *Cf. id.*

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section 1031 like-kind exchange treatment. This type of exchange does not unduly hamper the purpose of excluding section 1031 deferral to securities because it still excludes many types of exchanges involving securities from section 1031 deferral.[232] Additionally, it allows for the substance of the transaction to prevail.[233] Finally, this change would expand the tax benefits of section 1031 tax deferral.[234]

V. CONCLUSION

This Article has demonstrated the benefits of deferral and its vital place in our economy. It began by explaining basic economic and financial principles and created an analytical framework based upon these principles.[235] It examined and explained how the types of deferral contained in sections 721, 351, 1031, and 368 are beneficial under this framework.[236] Finally, this Article presented some policy proposals for expanding tax deferral within the context of sections 351, 1031, and 368.[237] Without tax deferral, investment in substantial projects would suffer due to tax distortions and other inefficiencies.[238] This would lead to a reduction in economic growth, as economic actors would not be using their greatest strengths, thereby preventing the most efficient use of the time value of money principle. Tax deferral, utilized correctly, reduces market distortions, encourages investment in substantial projects, and creates growth, both for businesses and for the economy as a whole.[239]

232. *Cf.* 26 U.S.C. § 1031.
233. *See supra* notes 228-230 and accompanying text.
234. *See* discussion *supra* Part IV.B.
235. *See* discussion *supra* Part II.
236. *See* discussion *supra* Part III.
237. *See* discussion *supra* Part IV.
238. *See* discussion *supra* Part II.B.1.
239. *See* discussion *supra* part II.B.

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