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TRUMP'S "BIG-LEAGUE" TAX REFORM: ASSESSING THE IMPACT OF CORPORATE TAX CHANGES

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This Article reviews and assesses corporate tax reforms advocated by President Donald Trump during his presidential campaign and signed into law since taking office (the Tax Cuts and Jobs Act of 2017), in light of economic theory and the Modigliani-Miller Irrelevance Theorem. The Article argues that companies will adapt polcies in light of new taxation measures, thereby impacting the effectiveness of reform. In support of this conclusion, the Article surveys two empirical studies—one in relation to the repatriation efforts of President Bush's Homeland Investment Act and another in relation to unexpected changes to the taxation of Canadian income trusts—to highlight how reform measures can lead to unanticipated results. The Article then applies the principles of these studies, the general economic theories, and the Modigliani-Miller Irrelevance Theorem to cast uncertainty on the net effect of Trump's tax reforms. Next, the Article reviews the constitutionality of a "border adjustment tax." This tax was proposed during the election campaign, but was ultimately jettisoned in the final tax reform bill. Specifically, it analyzes whether such a policy is constitutional or whether it is an unconstitutional direct tax, not apportioned between the States that does not qualify as income under the Sixteenth Amendment. The Article shows that such a constitutional challenge is a difficult undertaking given the substantive arguments in favor of constitutionality, the rarity of judicial intervention in overturning tax laws, and the wide discretion of Congress to levy taxes on income. Finally, the Article concludes by considering the role of economic analysis on constitutional challenges to tax legislation and provides an overview of the arguments, both for and against, utilizing economic analysis in this regard. The conclusion includes a review of the various cases and defining principles (emphasizing the decisions of Judge Richard Posner) where economic analysis has been used in the statutory interpretation of tax laws.

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Introduction

President Donald Trump's campaign promise that he would usher in "big-league"[1] changes to tax laws came to fruition with the December 2017 passing of the *Tax Cuts and Jobs Act of 2017*, which included, among other things: rate cuts; deduction and bracket eliminations (including limitations on the corporate deductibility of interest); a "one-time" repatriation tax on corporate profits held abroad; eliminating the alternative minimum tax ("AMT"); changing capital expense rules, and adopting a business "territorial tax system."[2] Despite campaigning on a promise to institute a "border adjustment tax" ("BAT") (that would have favored do-

1. *See* Matthew Rocco, *Trump Says 'Big-League' Tax Reform Details Coming in Week,* Fox Bus. (Feb. 9, 2017), http://www.foxbusiness.com/politics/2017/02/09/trump-says-big-league-tax-reform-details-coming-in-weeks.html.

2. *See* Jacob Pramuk, *The White House Just Outlined Its Tax Plan. Here's What's in It,* CNBC (Apr. 26, 2017), https://www.cnbc.com/2017/04/26/the-white-house-just-outlined-its-tax-plan-heres-whats-in-it.html.

mestic industry),[3] the final reform bill ultimately left this controversial provision out.

This Article argues, in light of economic theory and the *Modigliani-Miller Irrelevance Theorem* ("MMT"), that new taxation measures impact corporate decision-making in a way that leads to unintended results that can limit the effectiveness of reform. Section I of this Article presents the Trump tax reforms, including the promises campaigned on, the post-election White House pronouncements, and the adjustments made in the final bill, with a focus on the tax changes that impact businesses and corporations. Section II presents several economic theories, including the MMT, and surveys the results of two empirical studies (one involving the repatriation efforts of President Bush's *Homeland Investment Act of 2004* and another in relation to an unexpected change in 2006 to the way that Canadian income trusts were taxed) and several other recent academic studies. Collectively, these studies will show that new tax reforms do not always generate their desired results due to firms' tendencies to adapt their policies in light of new tax measures to obtain more favorable treatment. Section II concludes by applying these theories to the Trump tax reforms to show how the changes may lead to unexpected results as companies adjust their policies.

Section III will examine whether a BAT is an unconstitutional direct tax[4] that is not apportioned among the states and that does not qualify as income under the Sixteenth amendment.[5] This Section will highlight both sides of this debate and will survey the limited instances where federal tax legislation has been overturned by the courts on constitutional grounds. In so doing, the Article will also briefly survey the history of the constitutional sections at play, discuss the interpretive variance in the definition of "tax on income," and examine the ongoing debate in academic literature and case law on the purpose and breadth of the definition of "direct tax." Additionally, this Section surveys other legal arguments that might be presented in a BAT challenge to further illustrate that a successful challenge to the BAT on constitutional grounds would be a very difficult undertaking given the substantive arguments in favor of its constitutionality, the wide discretion of Congress to enact tax laws, and the rarity of judicial intervention in this area.

Lastly, in Section IV, the Article considers the role of economic analysis on the issue of tax law constitutionality and briefly reviews the history of economic analysis in matters of tax litigation (with particular attention given to the decisions of Judge Richard Posner). It also attempts to deduce an interpretative tool for determining the applicability of economic analysis on constitutional questions. Section IV also reviews the argu-

3. *See The White House Hints That Tax Reform Could Pay for the Border Wall*, THE ECONOMIST (Feb. 3, 2017), http://www.economist.com/blogs/democracyinamerica/2017/01/taxes-and-tariffs.

4. U.S. CONST. art. I, § 2, cl. 3, *amended by* U.S. CONST. amend. XVI.

5. U.S. CONST. amend. XVI.

ments for and against the use of economic analysis in tax litigation, in light of particular instances where such analysis has been applied. The Article concludes that economic analysis could potentially be utilized under "public interest theory"[6] or in cases where the legislation discriminated against certain regions.[7] Such applications of economic analysis, however, would require significant data (which may be difficult to generate).

I. Trump Tax Reform: Fulfilling Campaign Promises

On October 22, 2016, at a campaign rally in Gettysburg, Pennsylvania, President Trump stated that he "couldn't stand by and watch any longer."[8] He explained that he was going to help change a "broken system" by entering into a "contract between Donald J. Trump and the American voter" to restore honesty, restore accountability, and bring change to Washington.[9] His contract identified six measures to "fight corruption and special interest collusion," seven actions to "protect American workers," five actions to "restore security and the constitutional rule of law," and a detailed plan for his first 100 days in office—including several legislative enactments that he was going to fight to quickly pass.[10]

One such measure was a substantial tax reform proposal, which Trump described as a "*Middle Class Tax Relief and Simplification Act*,"[11] aimed at providing tax relief to middle class Americans, simplifying the tax code, and growing the American economy. The plan included sweeping reforms aimed at encouraging investment and creating jobs such as: rate drops for middle class individuals and families, the removal of several tax brackets (from seven to three), eliminating the marriage penalty and the Alternative Minimum Tax ("AMT"), and repealing the death tax.[12]

The plan also promised "revenue neutrality" and "fiscal responsibility." It claimed to accomplish this goal by reducing or eliminating certain deductions and loopholes for higher income earners and by putting an end to the way "carried interest" was treated for partnerships that were not

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6. *See* Richard Posner, *Economics, Politics, and the Reading of Statutes and the Constitution*, 49 U. Chi. L. Rev. 263, 265 (1982) [hereinafter *Posner Economics*].

7. *See generally* Richard A. Posner, *The Constitution as an Economic Document,* 56 Geo. Wash. L. Rev. 4, 28 (1987) [hereinafter *Posner Constitution*].

8. *See* Trump Pence Campaign, https://www.donaldjtrump.com/press-releases/donald-j.-trump-delivers-groundbreaking-contract-for-the-american-vote1 (last visited Feb. 1, 2017). *See also* Deroy Murdock, *Trump's Gettysburg Address Overflows With Conservative Ideas*, Nat'l Review (Oct. 26, 2016), http://www.nationalreview.com/article/441458/donald-trump-contract-american-voter-gettysburg-address.

9. *Id*.

10. Trump Pence Campaign, *supra* note 8.

11. *Id.*

12. *See generally* Robert W. Wood, *Trump Tax Plan Could Impact 2016 Year-End Planning*, Forbes (Nov. 14, 2016), http://www.forbes.com/sites/robertwood/2016/11/14/trump-tax-plan-could-impact-2016-year-end-planning/#24abab7d530d. *See also* Reuters, *How Donald Trump's Tax Repatriation Plan Will Create Jobs*, Fortune (Nov. 24, 2016), http://fortune.com/2016/11/24/donald-trump-repatriation-tax-plan-jobs/.

creating jobs or engaging in risk.[13] In theory, these cuts would be paid for by a one-time "deemed repatriation" of corporate profits held internationally (at a discounted 10% tax rate) that would no longer allow corporations to defer income earned abroad and by reducing (or eliminating) loopholes for "special interests."[14]

The reform measures relating to business and real estate[15] taxation were also significant. Trump's campaign plan mirrored the June 2016 "*Better Way*" corporate tax overhaul introduced by Republican House Speaker, Paul Ryan, and House Ways and Means Committee Chair, Kevin Brady.[16] It promised to make "America's tax rate one of the best in the world" through a reduction in the corporate tax rate to 15 percent.[17] In addition, Trump proposed an "up-front" deduction for major projects, the removal of the business deduction for interest on debt, and a "border adjustment" policy that would favor exporters over importers by allowing export revenue to be excluded when a company calculated its taxable income.[18] Trump also canvassed the idea of a tariff on imports by "executive order" in the range of 5 to 10 percent.[19]

A. *Initial Reception*

The Trump campaign's tax proposals quickly attracted criticism by economists and corporate interests (including Koch Industries).[20] For example, Nobel Prize recipient and Columbia Professor, Joseph Stiglitz, commented on Trump's proposed tax plan at a January 6, 2017 meeting of the American Economic Association stating, "There is a broad consensus that the kind of policies that our president-elect has proposed are among the policies that will not work."[21] Further, Rebecca Kysar suggested that Trump's tariff by "executive order" was unconstitutional given the "Origi-

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13. *See* Wood, *supra* note 12.

14. *See id.*

15. *See* Peter Grant & Laura Kisisto, *Real-Estate Industry Braces for Tax Upheaval*, Wall St. Journal (Dec. 30, 2016), http://www.wsj.com/articles/real-estate-industry-braces-for-tax-upheaval-1482871455.

16. *See* A Better Way Plan, http://abetterway.speaker.gov/?page=tax-reform (last visited Sept. 24, 2017).

17. *See* Trump Pence Campaign, *supra* note 8.

18. *See id.*

19. Rebecca Kysar, *Is Trump's Tariff Plan Constitutional?* N.Y. Times (Jan. 3, 2017), https://www.nytimes.com/2017/01/03/opinion/is-trumps-tariff-plan-constitutional.html.

20. *See House Republicans are Proposing a Big Corporate Tax Cut that Walmart Hates,* Vox (Dec. 25, 2016), http://www.vox.com/2016/12/25/14069822/corporate-tax-border-adjustability.

21. Rich Miller, *Trumponomics Gets the Thumbs Down from Nobel-Winning Economists*, Bloomberg (Jan. 1, 2017), https://www.bloomberg.com/news/articles/2017-01-06/trumponomics-gets-thumbs-down-from-nobel-prize-winner-economists.

nation Clause"[22] of the U.S. Constitution whereby all tariffs (as well as taxes and other revenue generating laws) must originate with Congress.[23]

Additionally, Lawrence Summers, former Harvard President and economic advisor to President Barack Obama, in an op-ed piece published by the *Washington Post* on January 8, 2017[24] identified three problematic elements of the Trump-Ryan proposals: the immediate deductibility of "investment outlays" (in the year they are made), the non-deductibility of debt interest payments, and the BAT.[25] Summers also suggested that the World Trade Organization and the global economic community at large would likely interpret these changes as "protectionist" in possible violation of U.S. treaty obligations. Summers based his hypothesis on the likelihood that the proposal would cause U.S. dollar appreciation, damage foreign debtors, and increase global volatility as "U.S. foreign assets are mostly held in foreign currencies whereas debts are largely in dollars."[26]

B. *Post Election White House Announcements and Critiques*

On April 26, 2017, the White House formally announced several tax reforms. In a summary briefing to reporters, Chief Economic Advisor, Gary Cohn, and Treasury Secretary, Steve Mnuchin, stated that the Trump administration would cut the number of tax brackets from seven to three (at 35, 25, and 10 percent respective rates); adopt a "territorial tax system"; cut the corporate tax rate to 15 percent; eliminate certain deductions (including mortgage interest and charitable contribution deductions); institute a "one-time tax" of money held abroad by U.S. corporations; and remove the estate tax, Obamacare taxes, and the AMT.[27]

Although the White House included a fact sheet with their briefing, there were several ambiguities in the announcement, including: the "income ranges" for the new personal tax brackets, the tax rate for the "one time" overseas corporate tax, and the details on the White House's suggestion to move to a "territorial tax system."[28] Additionally, the fact sheet did not clearly indicate when Congress would introduce the formal legislation for these reforms. Some commentators responded to the announcements by suggesting that the reforms would be less effective as many large

22. U.S. Const. art. I, § 7, cl.1.

23. Kysar, *supra* note 19.

24. Lawrence Summers, Opinion, *Trump and Ryan are Right to Tackle Corporate Taxes. But Their Approach Would do Harm*, Wash. Post (Jan. 8, 2017), https://www.washingtonpost.com/opinions/trump-and-ryan-are-right-to-tackle-corporate-taxes-but-their-approach-would-do-harm/2017/01/08/e7abd204-d429-11e6-9cb0-54ab630851e8_story.html?utm_term=.437f93c2aa26.

25. *Id.*

26. *Id.*

27. Pramuk, *supra* note 2.

28. *Id*.

companies in technology make and leave profits in lower tax countries—as such the lower corporate rate would not have a significant impact.[29]

C. *The Tax Cuts and Jobs Act*

On November 2, 2017, a Republican-sponsored tax reform bill, the *Tax Cuts and Jobs Act*,[30] was introduced to Congress incorporating most (but omitting some) of the tax reform proposals campaigned on by President Trump and also identified by the White House in their spring briefing. The bill passed through both the House and the Senate without significant opposition and was signed into law by President Trump on December 22, 2017 who described the reform as a "boon for the middle-class."[31] The bill ushered in significant changes for both individual and corporate tax filers, facilitating what has been described as a "mad scramble to understand the bill's impact on both a macroeconomic level and an individual level."[32]

From a corporate perspective, the final bill jettisoned the controversial BAT provision but included corporate rate cuts (permanently to 21 percent), a deduction for pass throughs, a repeal of the AMT, the establishment of a territorial system of taxation for businesses, and a one-time mandatory repatriation tax of 8 percent on illiquid assets and 15.5 percent on liquid assets held overseas.[33] The bill also set interest deduction limits, changed the rules pertaining to capital expensing (allowing for large scale immediate write-offs), and implemented anti-base erosion measures, while preserving credits for clean energy and "carried interest loopholes" for certain fund managers.[34]

In the Section that follows, the Article introduces several financial theories as well as empirical studies to show how firms will adjust their behavior in light of new tax reform measures. As a result, sweeping tax reforms can have untended consequences. The Article will also address the specific unintended consequences that could occur in light of the reforms passed in the *Tax Cuts and Jobs Act of 2017.*

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29. *See* Yoree Koh, *Trump Tax Plan Doesn't Solve Tech's Multibillion-Dollar Overseas-Cash Problem,* WALL ST. JOURNAL (Apr. 27, 2017), https://www.wsj.com/articles/trump-tax-plan-doesnt-solve-techs-multibillion-dollar-overseas-cash-problem-1493298005.

30. Tax Cuts and Jobs Act of 2017, H.R.1, 115th Cong. (2017).

31. *See* Shannon Pettypiece, *Trump Signs $1.5 Trillion Tax Cut in First Major Legislative Win,* Bloomberg (Dec. 22, 2017), https://www.bloomberg.com/news/articles/2017-12-22/trump-signs-1-5-trillion-tax-cut-in-first-major-legislative-win.

32. *See* Bob Bryan, *It's Done: Massive Republican Tax Bill Passes Congress in Generational Overhaul,* BUS. INSIDER (Dec. 20, 2017), http://www.businessinsider.com/trump-gop-tax-reform-bill-pass-house-bracket-rates-changes-2017-12.

33. See *What's in the Final Republican Tax Bill,* REUTERS (Dec. 19, 2017), https://www.reuters.com/article/us-usa-tax-provisions-factbox/whats-in-the-final-republican-tax-bill-idUSKBN1ED27K.

34. *Id.*

II. How Firms Adjust Behavior in Light of New Taxes

A. *The Modigliani-Miller Irrelevance Theorem Origins, Central Premise, and Application*

The *Modigliani-Miller Irrelevance Theorem* ("MMT") was developed by economists Franco Modigliani and Merton Miller while the two authors worked as professors at Carnegie Mellon University. They later jointly published their research in a 1958 paper entitled "The Cost of Capital, Corporate Finance and the Theory of Investment" in the *America Economic Review*.[35] This paper was later supplemented and partially corrected in a 1963 follow-up paper entitled "Corporate Income Taxes and the Cost of Capital: A Correction."[36]

The central premise of the MMT is that the value of a company is independent of its capital structure. The MMT holds that it is irrelevant whether a company is capitalized with debt or equity provided certain assumptions are met (no taxes; no transaction, bankruptcy, or agency costs; no asymmetrical information; and the presence of efficient markets). In other words, management of a company cannot change its value by manipulating its balance sheet composition.[37]

The corollary of the MMT is that in a world where taxes, transaction costs, and inefficient markets exist—a reality that has often led to criticism of the MMT[38]—companies will be willing to make changes to their poli-

35. Franco Modigliani & Merton H. Miller, *The Cost of Capital, Corporate Finance and the Theory of Investment,* 48 Am. Econ. Rev. 267 (1958) [hereinafter *MM 1958*].

36. Franco Modigliani & Merton H. Miller, *Corporate Income Taxes and the Cost of Capital: A Correction,* 53 Am. Econ. Rev. 433 (1963) [hereinafter *MM 1963*].

37. *See generally MM 1958*, *supra* note 35. *See also* Herbert Hovenkamp, *Neoclassicism and the Separation of Ownership and Control,* 4 Va. L. & Bus. Rev. 373, 396 (2009) ("Modigliani-Miller extends this observation to choices about the firm's financial structure. In the absence of transaction or agency costs, the value of the firm is invariant to the way that it is financed—either by increasing ownership through equity or by increasing borrowing through debt. The corollary is that in the presence of such costs, the firm will select the more profitable alternative. As a result, the firm's choice about whether to issue more shares or take on more debt is driven entirely by the presence of frictions in the system, such as taxes, agency problems, other internal inefficiencies, or imperfect information, but not by any notion that the firm is inherently more valuable under one or another form of organization. Further, its choice of a debt-to-equity ratio is entirely independent of the individual wishes of shareholders."); Remus D. Valsan & Moin A. Yahya, *Shareholders, Creditors, and Directors' Fiduciary Duties: A Law and Finance Approach*, 2 Va. L. & Bus. Rev. 1, 30-31 (2007) ("Suppose there is a firm that lives for one period. The firm has a cash flow x, which has an expected value of E[x]. The face value of debt is D, and the shareholders are the residual claimants. The shareholders will receive the maximum of x – D or $0. The debt holders have first claim on the cash flow if the firm cannot pay them D. Hence, the debt holders will receive the minimum of D or x. The value of equity, therefore, is E[max [0, x – D]], while the value of debt is E[min [x,D]]. The value of the firm is the value of equity plus the value of debt, which is equal to E[max [0, x – D]] + E[min [x, D]] = E[x]. The value of the firm is independent of capital structure as only the expected value of x is determinate of the value.").

38. *See* Razeen Sappideen, *Imputation of the Corporate and Personal Income Tax: Is It Chasing One's Tail?* 15 Am. J. Tax. Pol'y 167, 172-73 (1998) ("The Modigliani-Miller theo-

cies and capital structure to benefit from or mitigate against the existence of these costs.[39] Peter H. Huang and Michael S. Kroll have described this predilection as the "*Reverse M&M Theorem.*"[40] Notably, the MMT authors in their 1963 paper acknowledged this phenomenon.[41]

The effects of the MMT have been identified in academic literature and in corporate decision making across various contexts, including: deal structuring[42] (where it has been noted that lawyers can design deals to

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rem has been criticized on the grounds that neither of its assumptions reflect reality. For example, markets are imperfect, corporations and shareholders pay taxes, and the corporation's investment decisions are very much dependent on its dividend and financing decisions. Nonetheless, the theorem provides deep insights into the nature of corporate inflows and outflows and their impact, or lack thereof, on corporate investors.").

39. *See generally* Adam O. Emmerich, *Hybrid Instruments and the Debt-Equity Distinction in Corporate Taxation,* 52 U. Chi. L. Rev. 118, 137 (1985) ("It is surprisingly difficult to identify specific reasons why the Modigliani-Miller model does not correspond to empirical observation. The root of the problem would seem to lie in the assumptions upon which the model apparently depends, which do not hold true in the real world. For example, the Modigliani-Miller analysis ignores taxes, though a real firm's capital structure obviously will affect the value of the firm by affecting the amount of taxes that it must pay. As the firm increases the amount of debt that it carries, an increasing proportion of its earnings must go to creditors in the form of interest payments. Because such payments are deductible from earnings in computing taxable income, while comparable payments on equity (*i.e.*, dividends) are not, the increased debt will result in tax savings, and the firm's cost of capital will fall.").

40. *See* Peter H. Huang & Michael S. Knoll, *Corporate Finance, Corporate Law and Finance Theory,* 74 S. Cal. L. Rev. 175, 191 (2000) ("The Reverse M&M Theorem also suggests how to evaluate the tax law's treatment of capital structure, such as its relative treatments of debt and equity. If the other M&M assumptions were true, the tax advantage provided by debt would have no social welfare cost. Firms would use more debt, but this would simply be equivalent to a reduction in corporate taxes. It is because the other assumptions are not true that the tax-advantaged treatment of debt has real economic costs. Because bankruptcy and financial distress costs are positive, the tax-favored treatment of debt encourages more debt, increasing these costs. Moreover, because not all activities and assets have the same financial distress costs, some activities can support more debt than others. Accordingly, the tax system mis-allocates investment by encouraging investment in projects that can be heavily debt-financed and discouraging it in projects that cannot.").

41. *See MM 1963*, *supra* note 36, at 293.

42. *See* Michael S. Knoll & Daniel M.G. Raff, *A Comprehensive Theory of Deal Structure: Understanding How Transactional Structure Creates Value,* 89 Tex. L. Rev. 35, 47-48 (2010) ("Instead, we believe that the reverse Modigliani-Miller theorem provides the comprehensive theory of transactional structuring that Professor Fleischer is seeking. For more than a quarter of a century, the legal literature has sought to assess what transactional lawyers do by compiling a comprehensive list of high-value-added tasks performed by business lawyers. The literature has proceeded by looking at what lawyers do and trying to distill from those observations what tasks are central. Such an approach produces an ad hoc list of factors with no assurance that the resulting list is exhaustive and not redundant. In contrast, our approach starts with finance theory (particularly the Modigliani-Miller theorem of capital-structure irrelevancy) and draws directly from that theorem's assumptions the factors that can potentially affect value. It is because that theorem is widely accepted by economists as true (albeit not an accurate description of reality) that it provides assurances that all relevant factors have been included. It is, therefore, a much better place to begin an analysis than an ad hoc list. Because it provides a complete partitioning of the factors through which transactional structures can create value, the reverse Modigliani-Miller theorem provides a grounding that an analyst, a deal principal, or an agent (such as a lawyer or a banker) can use to

reduce taxes and transactions costs),[43] financial engineering, transfer pricing,[44] securities innovation,[45] financing and derivatives hedging,[46] regulatory matters (including the enactment of various corporate, business, and securities statutes and regulations),[47] and litigation.[48] The MMT has also been cited as a major factor in influencing bankruptcy matters[49] and the

evaluate an assertion that some transactional structure is better than an alternative structure. That grounding comes in two forms. First, an analyst or practitioner can look directly at the sizable finance literature on deal structures for literature analyzing a specific deal structure. Second, and more to the point, an analyst or practitioner can use the approach directly by comparing how two or more alternative structures differ in terms of providing informational content, affecting transaction costs (including agency costs), and affecting regulatory costs."). *See also* Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 YALE L.J. 239 (1984).

43. Knoll & Raff, *supra* note 42, at 45.

44. *See generally* Robert Ackerman & Elizabeth Chorvat, *Modern Financial Theory and Transfer Pricing,* 10 GEO. MASON L. REV. 637 (2002).

45. *See* Mark P. Gergen & Paula Schmitz, *The Influence of Tax Law on Securities Innovation in the United States,* 52 TAX L. REV. 119, 120 (1997) ("From the perspective of finance, the tax law is riddled with opportunities for 'pure tax arbitrage' meaning opportunities to take risk-free and costless financial positions that have a positive yield in taxes saved."). *See also* David F. Bradford, *Fixing Realization Accounting: Symmetry, Consistency and Correctness in the Taxation of Financial Instruments*, 50 TAX L. REV. 731, 739-43 (1995).

46. *See* Huang & Knoll, *supra* note 40, at 185-86 ("First, hedging can create value for shareholders by reducing taxes. Although the corporate tax structure is fairly flat, there is an important asymmetry. Firms with positive taxable income in any year pay taxes, but firms with a loss do not get refunds. Instead, these firms have no tax liability. Because of this asymmetry, a firm with highly volatile earnings will have a higher expected tax liability than a firm with steady earnings. This creates an incentive for firms to hedge in order to reduce their taxes. By making their income more stable, such firms can reduce their expected taxes. Since the government takes less, more is left for shareholders.").

47. *Id.* at 189 ("However, because the M&M assumptions are not accurate, the laws regulating investor relations can affect the firm values through taxes, and information and agency costs. Consider corporate law, which in the United States is state law. Although each state has its own corporate law, more than half of the Fortune 500 and more than forty percent of the companies listed on the New York Stock Exchange are incorporated in Delaware. If the law had no effect on value, it would be surprising to find so many firms incorporated in such a small state where many of them had no other operations. Although commentators have debated whether Delaware law increases or decreases total value, the Reverse M&M Theorem tells us where to look.").

48. *See generally* Sappideen, *supra* note 38, at 171. *See also* Alvin C. Warren, Jr., *The Relation and Integration of Individual and Corporate Income Taxes*, 94 HARV. L. REV. 719, 748-49 (1981).

49. *See* Emmerich, *supra* note 39, at 137-38, ("It has been suggested that the existence of positive costs of bankruptcy explains why an all-debt capital structure is not even theoretically desirable. The expected cost of bankruptcy will increase as the firm takes on more debt because the firm is more likely to go bankrupt as its fixed obligations increase. A firm's optimal debt-equity ratio would be the point at which the marginal decrease in the cost of capital resulting from the addition of debt equals the marginal increase in the expected cost of bankruptcy. If the expected cost of bankruptcy is relatively trivial, however—and it seems that it is—this argument does not explain observed deviations from an all-debt capital structure.").

effect that "bankruptcy costs" have on the value of a firm.[50] John Ayer notes, "Modigliani and Miller have helped to focus attention on the degree to which bankruptcy (or the threat of bankruptcy) imposes a real-world cost that may vary from the 'ideal' assumptions."[51]

Surprisingly, given its importance to financial theory, the MMT has been the subject of very little judicial review. Professor Merton Miller, nonetheless, has been cited in an expert capacity in a variety of cases, including commodity futures trading[52] and securities regulation.[53] He also appeared as an expert witness in cases regarding eminent domain[54] and in a class action matter relating to losses sustained after the "Black Monday" stock market crash of October 19, 1987.[55] Additionally, various theories in corporation finance—jointly developed by Modigliani and Miller and ancillary to the MMT—have been discussed in the context of bank-

50. John D. Ayer, *The Role of Finance Theory in Shaping Bankruptcy Policy*, 3 Am. Bankr. Inst. L. Rev. 53, 82-83 (1995) ("As previously noted, Modigliani and Miller was a kind of 'clean test- tubes' hypothesis from its inception. No one ever suggested that leverage is irrelevant 'in the real world.' The discussion generally turns on ways in which Modigliani and Miller fails to conform to 'the real world.' In the real world of bankruptcy, there is the matter of 'bankruptcy costs.' The question here is whether and to what extent leverage, by increasing the possibility of bankruptcy, imposes 'deadweight costs' that may absolutely reduce the value of the firm. At least potentially, these costs are of two different sorts: 'direct costs', such as professional fees (there is a small but important literature attempting to measure these direct costs); and perhaps of greater interest, 'indirect costs' (costs that arise when customers refuse to do business with a firm at risk of bankruptcy, or the higher costs of doing business that a firm faces in such a plight).").

51. *Id.* at 59-60 ("Regarding debt-equity structure, in an earlier time it was conventional wisdom that there was a proper leverage structure for any given firm. Indeed, one of the goals of regulatory policy was to assist in finding and enforcing that regulatory structure. Modigliani and Miller argue (in the same vein as before), that under defined assumptions it makes no difference what the debt-equity structure might be—the value of the firm remains the same in any event. It is important to stress that no one (least of all Modigliani and Miller) supposes that the ideal world resembles the real world. Nor must it follow that the real world must necessarily be made to perform more like the ideal. The real point of the Modigliani and Miller propositions is that they help formulate useful avenues of inquiry. If the real world varies from the ideal, then why? Thus Modigliani and Miller has helped to focus attention on the seeming inconsistencies in the tax treatment of different kinds of claims (the corporation gets to deduct interest from income before taxes, but there is no corresponding deduction for dividends, to take just one example).").

52. *See* Elliott v. Commodity Futures Trading Comm'n, 202 F.3d 926 (7th Cir. 2000), *reh'g and suggestion for reh'g en banc denied* (May 11, 2000).

53. *See* Bd. of Trade of Chi. v. SEC, 187 F.3d 713 (7th Cir. 1999), *reh'g denied* (Oct 07, 1999); *see also* Metlyn Realty Corp. v. Esmark, Inc., F.2d 826 (7th Cir. 1985).

54. *See* Lakehead Pipeline Co. v. Ill. Commerce Comm'n, 296 N.E.2d 345, 348 (D. Ill. 1998), *as modified on denial of reh'g* 696 N.E.2d 345 (July 16, 1998).

55. *See* Spicer v. Chi. Bd. Options Exch., Inc. 844 F. Supp. 1226, 1237 (N.D. Ill. 1993).

ruptcy,[56] tax law (in the context of deduction disputes),[57] and antitrust.[58] The judiciary has also acknowledged the MMT in a tort case involving wrongful misappropriation,[59] a telecommunications matter,[60] an Arizona public utilities case,[61] a fraudulent conveyances case,[62] a case involving the constitutionality of the *Regional Rail Reorganization Act of 1973*,[63] and a case involving taxation.[64] The area where the MMT has led to the most judicial review is in breach of contract cases that involve damage assessments related to the savings and loan industry.[65] In 2003, Roger Citron identified the area where most judicial review of the MMT has taken

56. *See In re* Lahijani, 325 B.R. 282, 289 (B.A.P. 9th Cir. 2005).

57. *See* Grojean v. Comm'r, 248 F.3d 572, 574 (7th Cir. 2001) ("At a high enough level of abstraction, it is true, the difference between providing and enabling the provision of funding may disappear. Indeed, at that level, the difference between equity and debt, as methods of corporate financing, disappears."). *See also MM 1958*, *supra* note 35, at 361 ("But at the operational level, because of various frictions that some economic models disregard, such as transaction and liquidity costs, there really is a substantive and not merely a formal difference between lending and guaranteeing.").

58. United States v. Tracinda Inv. Corp., 477 F. Supp. 1093 (C.D. Cal. 1979).

59. *See* FMC Corp. v. Boesky 852 F.2d 981, 997 (7th Cir. 1988).

60. *See* MPower Commc'ns Corp. v. Ill. Bell Tel. Co., 457 F.3d 625, 631 (7th Cir. 2006). *See generally* Michael J. Barclay & Clifford W. Smith, Jr., *The Capital Structure Puzzle: The Evidence Revisited*, 17 J. Applied Corp. Fin. 8 (2005); Merton H. Miller, *Leverage*, 46 J. Fin. 479 (1991); Stewart C. Myers, *Capital Structure*, 15 J. Econ. Perspectives 81 (2001).

61. *See* Ariz. Corp. Comm'n v. Citizens Util. Co., 584 P.2d 1175, 1183 n.7 (Ariz. Ct. App. 1978) ("There is some disagreement among economists as to whether capital structure has any effect on cost of capital. Some contend there is no such effect."). *See also MM 1958*, *supra* note 35.

62. *In re* Consol. Capital Equities Corp., 175 B.R. 629, 633 (Bankr. N.D. Tex. 1994).

63. *See In re* Penn Central Transp. Co., 384 F. Supp. 895 (Reg'l Rail Reorg. Ct. 1974).

64. *See* S. Pacific Transp. Co. v. Dep't of Revenue, 11 Or. Tax 138, 152 (1989) ("With this issue we have reached a level of financial theory which may be described as one of diminished clarity. One school of thought appears to be that capital structure has very little effect on the cost of capital. The extreme position of that school is the Modigliani-Miller proposition which holds that capital structure does not affect the total cost of capital. However, this proposition is subject to the realities that taxes do impact capital costs. In short, the proposition may not apply except in a 'perfect market.'").

65. *See* United States v. Winstar Corp., 518 U.S. 839 (1996); Bluebonnet Sav. Bank FSB v. United States, 67 Fed. Cl. 231 (2005), *aff'd sub nom.* Bluebonnet Sav. Bank FSB v. United States, 466 F.3d 1349 (Fed. Cir. 2006); LaSalle Talman Bank, F.S.B. v. United States 64 Fed. Cl. 90 (2005); Cal. Federal Bank, FSB v. United States 245 F.3d 1342, (Fed. Cir. 2001), *reh'g and reh'g en banc denied* (Jul 10, 2001); Glendale Federal Bank, FSB v. United States, 43 Fed. Cl. 390 (1999).

place: the Court of Federal Claims.[66] Citron notes, however, that not all decisions have looked upon MMT favorably.[67]

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66. Rodger D. Citron, *Culture Clash? The Miller & Modigliani Propositions Meet The United States Court of Federal Claims,* 22 Rev. Litig. 319, 321-22 (2003) ("In turn, the Court of Federal Claims has become a forum for evaluating the relevance of the basic principles of corporate finance—specifically, the Miller & Modigliani ('M&M') Propositions concerning capital structure and debt-equity ratios—to claims by savings and loan institutions for lost profits damages. In their 1958 article, Professors Merton Miller and Franco Modigliani set out a number of foundational principles of corporate finance, including the principle that the value of a private firm is independent of the mix of debt and equity used to fund its assets. The results thus far are mixed. The courts have not embraced the M&M Propositions, as evidenced by their decisions to allow plaintiffs to present claims for lost profits damages and, in a smaller number of cases, their discussion of the M&M Propositions. Nevertheless, courts generally have arrived at the results dictated by the M&M Propositions in awarding damages to claimants."); *see also id.* at 323 ("The United States, citing the M&M Propositions, has insisted that the only recoverable damages by a claimant are its mitigation costs—that is, the costs associated with obtaining replacement capital. The thrift claimants have responded that they were unable to mitigate and, therefore, should be entitled to present claims for lost profits damages. Furthermore, they have argued that the M&M Propositions are not relevant to the evaluation of their claims given the availability of deposit insurance, which they insist is a subsidy of that particular form of debt.").

67. *See Glendale*, 43 Fed. Cl. at 401 n.4 ("The court finds the testimony of Nobel Laureate Merton Miller, a brilliant scholar, regarding the value of leverage of little utility in this case. Professor Miller testified that any contention that Glendale lost something of value was meritless because leverage, standing alone, has no value. Plaintiffs convincingly point out that, notwithstanding the general principle of finance for which Dr. Miller won the Nobel Prize in Economics in 1990, the situation of thrifts and other lending institutions is different, because they have access to low-cost, government insured borrowings (retail deposits) which are unavailable to other institutions. In addition, the court realizes that other factors, including a thrift's management, the markets it operates in, and its retail branch network, are all relevant to taking advantage of the access to leverage and profiting from it. Banks are ultimately in the business of making money by lending money, and generating a return based on the spread between interest earning assets and interest bearing liabilities."). *See also* Citron, *supra* note 66, at 323-24 ("In 1999, the Court of Federal Claims entered a $909 million judgment, one of the largest ever entered against the United States, in the first supervisory goodwill damages decision, Glendale Federal Bank v. United States. In allowing the thrift claimant to present a claim for lost profits, the trial court did not agree with the United States' arguments based upon the M&M Propositions and expressly rejected the testimony of Dr. Miller as 'theoretical.' The trial court did not, however, award lost profits. Subsequently, in 2001, an appeals court vacated the judgment in Glendale and remanded the case to the trial court for further proceedings. In the journey from the Supreme Court's decision in Winstar to the current damages decisions, the lower courts developed a more complete understanding of the economics of the savings and loan industry, and of the accounting techniques used by regulators during the 1980s. As a result, the courts generally have awarded judgments that amount to the reimbursement of reliance expenditures. At the same time, the courts generally have not been persuaded to apply the M&M Propositions in resolving the thrifts' claims for damages. Indeed, the only trial court decision to embrace the M&M Propositions—a summary judgment in favor of the United States and against California Federal Bank on the thrift's claim for lost profits—was reversed by the Federal Circuit, which concluded that the thrift was entitled to a trial on that particular claim.").

B. *Behavioral and Policy Adaptation in Response to New Taxes*

When MMT assumptions fail (for example, in the presence of taxes) a corporation will adapt its policies. Gergen & Schmitz note, "From the perspective of finance, the tax law is riddled with opportunities for 'pure tax arbitrage,' meaning opportunities to take risk-free and costless financial positions that have a positive yield in taxes saved."[68] Tax policies have also been cited by Miller as an influence in the creation of "zero-coupon bonds."[69] In fact, companies have always used tax inconsistencies to maximize their value.[70] These policies also influence acquisitions and corporate cash held internationally.[71]

When corporations are taxed, an increase in those taxes will reduce the company's value.[72] As a result, a company will have an incentive to change its policies and its capital structure to obtain more preferential tax treatment. One of the most readily identifiable examples of this is the deductibility by a firm of interest payments on debt. Hovenkamp notes:

> [T]o the extent that debt receives tax treatment that is more favorable than the treatment given to dividends, the impact will be to shift firms more toward debt. This could result in excessive leverage and fixed interest cost commitments that cannot be paid in the event of a financial downturn.[73]

In other words, taxes cause companies to finance with debt instead of equity because interest payments have historically been deductible against income, whereas dividend payments have not.[74]

Given the MMT and the fact that interest payments are deductible while dividends are not, one would expect to see significant evidence of

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68. Gergen & Schmitz, *supra* note 45, at 120. *See also* David F. Bradford, *Fixing Realization Accounting: Symmetry, Consistency and Correctness in the Taxation of Financial Instruments*, 50 TAX L. REV. 731, 739-43 (1995).

69. *See* Merton H. Miller, *Financial Innovation: The Last Twenty Years and the Next*, 21 J. FIN. AND QUANTITATIVE ANALYSIS 459, 461-63 (1986).

70. *See generally* Knoll & Raff, *supra* note 42.

71. *See Does U.S. Corporate Tax Rate Incentivize Foreign Acquisitions,* FORBES (Oct. 31, 2013), http://www.forbes.com/sites/joeharpaz/2013/10/31/does-u-s-corporate-tax-rate-incentivize-foreign-acquisitions/#2b6b78fb69e8.

72. *See* MM 1958, *supra* note 35; *see also* Merton Miller, *Debt and Taxes*, 32 J. FIN. 261, 261-75 (1977); Alan Kraus & Robert Litzenberger, *A State-Preference Model of Optimal Financial Leverage*, 28 J. FIN. 911, 911–22 (1973); Harry DeAngelo & Ronald Masulis, *Optimal Capital Structure Under Corporate and Personal Taxation*, 8 J. FIN. ECON. 3 (1983); John Graham, *How Big Are The Tax Benefits of Debt?*, 55 J. FIN. 1901, 1901–41 (2000); Richard Green & Burton Hollifield, *The Personal-Tax Advantages of Equity*, 67 J. FIN. ECON. 175 (2003).

73. Hovenkamp, *supra* note 37, at 396.

74. *See* Sappideen, *supra* note 38, at 171 ("The corporation income tax is said to encourage debt financing rather than equity financing because interest is ordinarily deductible under most tax systems, whereas dividends are not. The over reliance on debt financing is claimed to cause a welfare loss by increasing the vulnerability of corporations to bankruptcy. In other words, the elimination of the double taxation of dividends, it is claimed, will reduce the occurrence of bankruptcy not only by making equity financing more attractive vis-a-vis debt financing, but also by making equity holdings more attractive in their own right.").

the widespread use by firms of debt over equity; however, this is not exactly the case. There are many companies that choose to finance their activities solely with equity, despite the tax deductibility of interest payments.[75] Further, the introduction of taxes into the MMT model leads to a difficult calculation in determining the optimal debt to equity ratios.[76] It has been suggested by Emmerich that sometimes a company will choose equity over debt because of other costs (assumed to be zero in the MMT), such as increased bankruptcy risk due to higher levels of leverage. Emmerich explains, "A firm's optimal debt-equity ratio would be the point at which the marginal decrease in the cost of capital resulting from the addition of debt equals the marginal increase in the expected cost of bankruptcy."[77] Another factor that impacts corporate debt to equity ratios is the personal rates of taxation for shareholders or holders of debt.[78] Also,

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75. Emmerich, *supra* note 39, at 137.

76. *See* Valsan & Yahya, *supra* note 37, at 31 ("When corporate taxes are taken into account, the analysis gets complicated. Suppose interest payments are tax deductible, then the value of equity is E[max [0, (1 – t)x – (1 – t)D]], where t is the corporate tax rate, the value of debt is E[min [x, D]], and the value of the firm is E[x | x<D, (1 – t)x + tD | x>D]. Now the value of the firm is increasing in the amount of debt, and this suggests that the firm should be fully leveraged. This is never observed, nor would anyone believe this to be a reasonable strategy. Various authors have sought to explain what could be constraining the leverage decisions of a firm, with a view to determining the optimal debt level. For example, a group of scholars argued that as the firm borrows more, there is a higher risk of bankruptcy costs. These costs can be direct, such as the expenses that need to be paid to lawyers when liquidating the assets of a firm. They can also be indirect, such as lost profits, the disruption of supplies, managers demanding higher compensation for potential unemployment, and other such costs that may result if the firm declared bankruptcy. In fact, bankruptcy costs can be taken to be a metaphor for all such disadvantages that a highly leveraged firm may signal to market participants. If taxes and bankruptcy costs were the only costs and benefits to debt and equity, the discussion would be trivial. Debt, in fact, has many other advantages beyond tax deductions.").

77. Emmerich, *supra* note 39, at 138.

78. *See Id*. at 138-39 ("A firm's optimal debt-equity ratio would be the point at which the marginal decrease in the cost of capital resulting from the addition of debt equals the marginal increase in the expected cost of bankruptcy. If the expected cost of bankruptcy is relatively trivial, however—and it seems that it is—this argument does not explain observed deviations from an all-debt capital structure. Moreover, Merton Miller has shown that the Modigliani-Miller hypothesis remains intact once the personal income tax is taken into account in addition to the corporate tax. While payments on debt are deductible at the corporate level, debt holders are taxed more heavily than equity holders at the individual level because much of the return on equity may be unrealized capital gains that will not be taxed for years to come while interest payments are taxed immediately as ordinary income. There is an equilibrium debt-equity ratio for the corporate sector as a whole that depends upon the corporate tax rate and the individual tax rates of all the various investors; each firm adopts a particular capital structure in order to appeal to a particular class of investor that is seeking investments with a particular tax characteristic. Miller argues, however, that there is no optimal capital structure for any given firm and that it is still true "that the value of any firm, in equilibrium, [is] independent of its capital structure, despite the deductibility of interest payments in computing corporate income taxes.").

tax costs are an area where a tradeoff is recognized between the "Coase Theorem,"[79] transaction costs,[80] and regulatory costs.[81]

It is difficult to accurately measure the empirical effects of tax changes on corporate and financial decision-making.[82] Doidge and Dyck note, "Tax policy changes are limited because such changes are rarely significant or separable from other changes and are often widely anticipated. Consequently, results may not be economically significant or may be open to multiple interpretations."[83] Despite this uncertainty, the two case studies that follow give support to the notion that tax changes can significantly influence corporate decision-making, often resulting in unintended consequences that neutralize the intended impact of the reform in question.

C. *Case Study 1: Income Repatriation & the Homeland Investment Act*

The *Homeland Investment Act* ("HIA") was passed in 2004 as part of the larger *American Jobs Creation Act of 2004*[84] ("AJCA")—a reform that, among other things, changed incentives on export taxes and interest expense allocation policies and introduced various incentives for domestic business and agricultural production. Dharmapala, Foley, and Forbes ("Dharmapala") suggest that the HIA (which is officially known as *Section 422: Incentives to Reinvest Foreign Earnings in the United States*)[85] was designed to encourage American companies, who earned income abroad, to bring those earnings back into the U.S. so that the income could be reinvested domestically.[86] To generate this result, the HIA allowed for a

79. The Coase Theorem refers to a legal and economic theory, developed by Ronald Coase, whereby, in the absence of externalities and transaction costs, parties will negotiate to achieve an optimal (efficient) outcome regardless of how property rights are initially allocated. *See generally* Barbara White, *Coase and the Courts: Economics for the Common Man,* 72 IOWA L. REV. 577 (1987).

80. *See generally* R. H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937).

81. *See generally* Victor Fleischer, *Regulatory Arbitrage*, 89 TEX. L. REV. 227 (2010).

82. Craig Doidge & Alexander Dyck, *Taxes and Corporate Policies: Evidence from a Quasi Natural Experiment,* 70 J. FIN. 45, 45 (2015).

83. *Id.*

84. *See* American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418 (2004).

85. Pub. L. No. 108-357, § 422, 118 Stat. 1418 (2004).

86. *See* Dhammika Dharmapala, C. Fritz Foley & Kristin J. Forbes, *Watch What I Do, Not What I Say: The Unintended Consequences of the Homeland Investment Act,* 66 J. FIN. 753, 761 (2011). *See also id.* at 759-60 ("These rules create incentives and opportunities for firms to reduce their tax obligations and suggest that certain kinds of firms are most likely to benefit from a tax holiday. Desai, Foley, and Hines (2007) show that because the tax costs of repatriations are higher for firms that operate abroad in low tax jurisdictions, such firms have lower repatriations. Another common strategy to avoid U.S. repatriation taxes involves the indirect ownership of foreign affiliates, either through holding companies or through affiliates in tax havens that do not impose repatriation taxes. Under these kinds of ownership arrangements, earnings do not need to be returned to the U.S. before they are invested elsewhere around the world, thereby avoiding U.S. repatriation taxes. Altshuler and Grubert (2003) and Desai, Foley, and Hines (2003) illustrate that holding company structures have

tax holiday to firms repatriating foreign earnings provided the funds were used for certain prescribed activities, including "hiring and training domestic workers, domestic infrastructure and capital investments, R&D . . . ."[87]

Using data on repatriations from 1996 to 2005 obtained from the U.S. Bureau of Economic Analysis, CompuStat, and ExecuComp, Dharmapala presented evidence showing that despite the HIA's strong political support—proponents suggested that it would provide internal financial relief to firms to fund R&D, investment projects, M&A activity, and lower debt—domestic investment did not rise as a result of the tax break.[88] In fact, domestic investment failed to rise despite survey answers and public statements indicating repatriated funds would be used for domestic purposes from firms that directly lobbied for the Act and that were under "financial constraints."[89] Dharmpala suggests that their study gives "an opportunity to test several hypotheses about financial constraints, corporate governance, and the effectiveness of government regulations that aim to incentivize certain forms of corporate spending."[90]

Dharmpala also notes that the HIA was promoted with an incorrect assumption: that companies would access financial foreign resources to eliminate "financial constraints" in the United States.[91] As such, the HIA

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these effects, and Desai, Foley, and Hines (2006) show that affiliates in tax havens are instrumental in facilitating deferral of U.S. taxes, whether or not they are classified as holding companies. The evidence therefore suggests that firms that face low tax rates abroad and firms that make use of holding company structures or tax haven affiliates have the most to gain from a tax holiday on repatriations.").

87. *Id.* at 761 ("U.S. repatriations only qualified for this tax holiday if they met several criteria. Most relevant to the analysis in this paper, repatriations had to be used for certain domestic activities in accordance with a domestic investment plan in order to qualify for the tax holiday. Investments that were permitted uses for the repatriated funds included: hiring and training domestic workers, domestic infrastructure and capital investments, R&D, financial stabilization (including debt repayment) for the purposes of U.S. job retention or creation, and certain acquisitions of business entities with U.S. assets. Uses that were explicitly not permitted for repatriations under the tax holiday were: executive compensation, intercompany transactions, dividends and other shareholder distributions, stock redemptions, portfolio investments, debt instruments, and tax payments.").

88. *Id.* at 753-54 ("Figure 1 presents aggregate data from the U.S. Bureau of Economic Analysis and shows that repatriations increased from an average of $62 billion per 2000 to 2004 to $299 billion in 2005 under the tax holiday. After repatriations fell back to $102 billion.").

89. *Id.* at 753.

90. *Id.* at 754.

91. *Id.* at 754-55 ("The framers of the Act justified the tax holiday based on the premise that these firms' domestic operations were financially constrained. If this were true, repatriated cash could be invested in U.S. projects that had a positive value for the firm based on the temporarily lower cost of internal capital but that were not profitable at the higher cost of external finance. Financially constrained firms that did not currently have any attractive investment projects could also use the repatriations to pay down debt or increase cash reserves in order to reduce or eliminate future financing constraints. Studying firms' responses to the HIA shows whether the reduced tax costs of accessing internal funds spurred domestic activity or affected debt levels, shedding light on the role of financial constraints."). *See also id.* at 756 ("The regression results and additional evidence in this paper

did not produce the intended results. The authors note, "The overall effect of what firms did differed from what their public statements indicated they would do and from what the regulations ostensibly intended."[92] In other words, the companies used the money for other purposes, not for domestic U.S. investments.

The Dharmapala study provides three conclusions that are relevant to an analysis of the Trump tax reform. First, the underlying motivations and assumptions surrounding the enactment of the HIA were flawed. Specifically, the authors note that "the domestic operations of U.S. multinationals were not financially constrained at the time of the Act." The authors also state, "The ability to access an internal source of capital at a lower cost did not boost domestic investment, domestic employment, or R&D."[93] Second, the authors suggest that "agency problems" and poor governance did not widely affect U.S. multinationals.[94] Finally, because of the "fungibility of money"—in other words, the way that money is easily substituted and redirected—the regulations pursuant to the HIA, designed to influence corporate financial policy, were ultimately less effective.[95]

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are inconsistent with the claim that the domestic operations of MNEs were financially constrained and that the tax holiday spurred U.S. job creation or investment for firms that repatriated. More specifically, higher levels of repatriations were not associated with increased domestic capital expenditures, increased domestic employment compensation, increased R&D expenditures, or reduced debt levels. These results hold not only for the full sample of firms, but also for subsamples of firms that appeared to be financially constrained or that lobbied for the Act.").

92. *Id.* at 783.

93. *Id.* at 782 ("Statements by Congressmen and lobbyists indicate that they believed that reducing repatriation taxes would increase the domestic activities of U.S. MNEs. This paper's results clearly show that the tax holiday did not have this effect. Even firms that showed some evidence of being financially constrained or that explicitly lobbied for the tax holiday did not increase domestic investment, domestic employment, or R&D. Moreover, around the time of the HIA, repatriations were positively associated with parents sending capital to their foreign affiliates, suggesting that parent companies were round tripping capital in order to repatriate it at the lower tax rate. This behavior is also inconsistent with the view that parent operations were financially constrained.").

94. *Id*. ("If U.S. multinationals had serious agency problems, then managers would have been likely to respond to the ability to access cash at a lower cost under the HIA in ways that maximized their private return instead of shareholder value. For example, managers may have increased their own compensation or engaged in empire building through acquisitions or investment. Managers might also have paid down debt in order to reduce future constraints on their operations by reducing their fixed obligations. The results indicate that increases in repatriations under the HIA did not have these effects. Instead, the estimates imply that every extra dollar of repatriated cash was associated with an increase of $0.60-$0.92 in payouts to shareholders, largely in the form of share repurchases. Although this response was concentrated among firms characterized by stronger corporate governance, the results indicate that agency problems were not significant, on average, in the full sample of firms.").

95. *Id*. ("A key goal of the legislation was to increase investment and employment in the U.S. The HIA included specific guidelines on how cash repatriated at the lower tax rate could be used in order to promote this goal. This paper clearly shows, however, that these guidelines were ineffective in getting repatriating firms to increase their domestic activities.").

D. *Case Study 2: Canadian Income Trusts, Tax Fairness Plan, 2006*

A recent Canadian study by Craig Doidge and Alexander Dyck provides strong support—using a "quasi natural experiment" of the unanticipated changes to the way that income trusts were taxed in Canada[96]—for the validity of the MMT and for the proposition that business managers in the face of significant tax reform will adopt new policies and seek out tax shelters to obtain more favorable treatment.[97] In their study, the authors produce "statistically and economically significant" evidence on the impact of taxes on business decision-making.[98]

On October 31, 2006, after the close of markets, the federal government of Canada enacted legislative measures[99] that effectively changed the way that income trusts were taxed. These measures eliminated trusts' previous tax advantages and implemented a new regime (labeled a "Tax Fairness Plan" ("TFP")). In the TFP, new trusts would be taxed similarly to corporations, allowing a transition window of four years for existing trusts to comply.[100] The change was largely unanticipated by the markets, and it resulted in a significant price response.[101] The study shows how unexpected tax reforms can result in measured changes to "corporate policies."[102]

Doidge and Dyck observed that the affected trusts (which included numerous publicly traded entities) could access "tax shields" to offset the TFP.[103] The study also examined the subject of leverage. It showed how

96. *See* Doidge & Dyck, *supra* note 82, at 46 ("Unlike many tax policy changes analyzed in prior literature (e.g. the Tax Reform Act of 1986), the tax change we exploit was largely unanticipated, dramatic (the corporate tax rate increased from 0% to 31.5%), and was not contaminated by other information or policy changes.").

97. *See Id*. at 48.

98. *See Id*. at 46.

99. *See* Archived-Canada's New Government Announces Tax Fairness Plan, Dep't of Fin., Gov't of Canada, https://www.fin.gc.ca/n06/06-061-eng.asp (last visited Feb. 1 2017).

100. *See* Doidge & Dyck, *supra* note 82, at 46. *See also id.* at 53 ("[K]ey feature of the TFP was new tax on distributions made by certain publicly traded flow-through entities, although REITs were excluded. The tax rate on trust distributions was equivalent to the rate paid by corporations.").

101. Doidge & Dyck, *supra* note 82, at 46. See *also id.* at 48 ("Equity values f[ell] by 14% over the shortest meaningful event window and 19% over a longer window.").

102. *See* Doidge & Dyck, *supra* note 82, at 46.

103. *See* Doidge & Dyck, *supra* note 82, at 48. *See also id.* at 69 ("Perhaps most interesting are the investment (capital expenditures/lagged total assets) results in models (7) and (8). Given the tax rules for trusts, financing investment with internal funds was costly. Therefore, to the extent that external finance is costly, the tax incentives could discourage investment for trusts. In both the parsimonious specification and the one that controls for lagged growth opportunities, cash flow, leverage, and industry investment, we find that firms invest significantly less after they convert to trust status. If firms invested at optimal levels prior to converting to trust status, the results suggest that they made a considerable compromise to a fundamental corporate policy to access the tax benefit.") (noting that personal taxes affect the value of tax shields); *id.* at 84, ("We find that personal taxes affect the value of tax shields and that tax shields are worth more for firms that have a low tax investor clientele that is

leverage changed in accordance with the modifications to tax incentives. The authors note, "Prior to the TFP, when debt had no value as a tax shield, trusts had lower leverage than when they were organized as corporates. With the loss of the trust tax shield (due to the TFP), trusts could increase leverage to create an alternate source of tax shields."[104]

Additionally, Doidge and Dyck's study established that firms will alter their levels of debt in response to new tax measures. Specifically, Canadian income trusts sought to "increase leverage" to create new "tax shields" to replace those eliminated by the TFP.[105] Further, the study illustrated that tax changes affect a firm's investment behavior,[106] as well as their payout ratios and "cash holdings."[107] In addition, the authors pre-

most hard hit by the tax. While these results are based on Canadian data, they likely have broader significance as the Canadian tax system has similarities to that of the United States, for instance, a degree of double taxation of corporate income and higher personal taxes on interest compared to equity income.").

104. Doidge & Dyck, *supra* note 82, at 56.

105. Doidge & Dyck*, supra* note 82, at 84 ("Consistent with the tax interpretation of the event study, we find that firms decreased their leverage after becoming a trust and increased it after the TFP, providing them with additional tax shields when the trust tax shield expired in 2011. To access the tax benefit, firms made accommodative changes to other corporate policies such as payout, cash holdings, and investment after becoming a trust. These changes were reversed after the TFP."). *See also id.* at 48 (discussing the effect on leverage prior to the enactment of the TFP, "Prior to TFP, when debt had no value as a tax shield, trusts had lower leverage than when they were organized as corporates. With the loss of the trust tax shield due to the TFP, trusts could increase leverage to create an alternate source of tax shields. . . . After controlling for observable and unobservable firm characteristics, plus industry and year effects, we find that trusts increased their leverage by six percentage points relative to corporates, an economically significant change given that the average debt to value ratio was about 20% in 2006.").

106. Doidge & Dyck, *supra* note 82, at 49 ("To fully capture the tax benefits of the trust structure, trusts had to pay out all earnings. This made it costly to build up cash holdings and to use these holdings to finance investment. Therefore, trusts had a tax incentive to increase payout and decrease cash holdings, and, to the extent that external finance is costly, they had a disincentive to invest. The evidence is consistent with these predictions. Prior to the TFP, trusts had higher payout and lower cash holdings than when they were organized as corporates. After the TFP, they reversed these changes by reducing payout and increasing cash holdings. More interesting are the results for investment. In frictionless markets, Modigliani and Miller (1958) show that investment policy determines value. Our results suggest that trusts altered their investment policy in response to tax incentives. In the pre-TFP period, trusts' investment in fixed assets was significantly lower than when they were corporates. In the post-TFP period, trusts significantly increased their investment relative to corporates. The fact that trusts altered their investment decisions to access a tax benefit signals the power of tax incentives to affect corporate policies.").

107. *Id*. at 76 ("The evidence in this section shows that there were significant changes in payout, cash holdings, and investment after the TFP. Combined with the evidence in Section V.A, the simplest interpretation is that firms were willing to make substantial accommodative changes to these policies to access the tax benefit but reversed them when the tax benefit was lost. Most interesting are the investment results as investment policy is central to value creation.").

dicted that the tax reform would have an impact on acquisitions.[108] The evidence from the study suggests that firms changed their "corporate policies" in response to tax measures (in seeking out "tax shields") or in light of tax incentives to obtain the most favorable result.[109] Additionally, this observation is supported by a large body of academic literature on the impact of tax on corporate debt ratios.[110] In all, the tax reform to Canadian income trusts in 2006 threatened "financing efficiencies."[111]

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108. *Id*. at 49 ("Given the tax advantage of the trust structure prior to the TFP, we predict that trusts were more likely to be acquirers and less likely to be targets compared to corporates. Similarly, with the loss of the tax advantage due to the TFP, we predict that trusts were more likely to be acquired after the TFP as takeovers are one channel that can change organizational form and potentially offer more tax shields. The results are consistent with these predictions.").

109. Doidge & Dyck*, supra* note 82, at 49. *See also id.* at 84-85 ("We find that this principle also applies when the tax savings opportunity is an organizational form choice. By organizing themselves as trusts, firms could avoid paying corporate taxes. In the absence of frictions and other costs associated with being a trust, the tax benefit could increase value by a maximum of 31.5%. However, trusts had to make accommodative changes to a number of corporate policies to access the tax benefit. For example, our evidence suggests that trusts made potentially inefficient and costly changes to their investment policies. As a result, the net tax benefit of being a trust was likely worth less than the potential gross benefit of 31.5%. While we cannot quantify the exact magnitude of this difference, the idea that firms are willing to make costly changes to important policies to gain preferential tax treatment is consistent with all our other evidence that suggests taxes have an important impact on corporate decision-making.").

110. *See generally* Michael Bradley, Gregg Jarrell & E. Han Kim, *On The Existence of an Optimal Capital Structure: Theory and Evidence*, 39 J. FIN. 857, 857-78 (1984); John Graham, Michael Lemmon & James Schallheim, *Debt, Leases, Taxes and the Endogeneity of Corporate Tax Status*, 53 J. FIN. 131, 131-62 (1998); John Graham, *Debt and the Marginal Tax Rate*, 41 J. FIN. ECON. 41, 41-74 (1996); John Graham, *Do Personal Taxes Affect Corporate Financing Decisions?*, 73 J. PUB. ECON. 147, 147-85 (1999); Jeffrey K. MacKie-Mason, *Do Taxes Affect Corporate Financing Decisions*? 45 J. FIN. 1471, 1471-93 (1990); Arthur Korteweg, *The Net Benefits to Leverage*, 65 J. FIN. 2137, 2137-70 (2010).

111. *See* Benjamin Alarie & Edward M. Iacobucci, *Tax Policy, Capital Structure and Income Trusts,* 45 CAN. BUS. L.J. 1, 19 (2007) ("A complete efficiency analysis of the recently announced tax. Some observations, however, follow directly from the preceding analysis. More consistent tax treatment of businesses on the basis of underlying business characteristics will obviously result in less tax-driven variation in the choice of organizational form. To the extent that tax considerations have driven the adoption of potentially inappropriate forms, the reforms are a welcome development. On the other hand, there will also be a loss associated with this more consistent tax treatment of income trusts and corporations that is widely ignored. Eliminating the differential tax treatment of income trusts and corporations will mean that the commitment of income trusts to pay out cash will no longer be firmer than that of a corporation with a high dividend policy (and will not be as firm as an obligation to pay interest on arm's length debt). That is, corporate finance considerations, like the agency costs of debt and bankruptcy costs, explain why income trusts were key in allowing businesses to maximize the tax advantages of debt, while tax considerations help to explain the corporate finance attractions of the income trust. Reform jeopardizes these potential financing efficiencies.").

E. *Implications for Trump Tax Reform*

Since the impact of tax reform is difficult to measure and anticipate, some tax experts advocate against dramatic measures.[112] Consequently, results of tax reform may be "open to multiple interpretations."[113] Based on the above case studies and corporate finance theories, however, several implications can be identified in regards to the Trump tax reforms. This Section will discuss these implications as they apply to the specific tax reforms of reducing corporate tax rates, removing deductions for interest on debt, changing the capital expenditure rules, and reforming corporate repatriation measures.

A reduction in corporate tax rates (especially when combined with a repatriation holiday, as discussed below) would, on its face, infer an influx in domestic cash and investment. Given the Dharmapala study, however, the effect on domestic investment is not a certainty. Another reform is a limit on the business deductibility of debt interest payments (to be capped at thirty percent of taxable income). The deductibility of interest on corporate debt is a topic that has been debated for many years. It has been the source of "significant conceptual and operational problems for the federal tax on corporate income throughout its history."[114] Interest deductibility originated in 1918 as a measure (initially temporarily) to equalize the effect of the "excess profits tax" of World War I.[115] Proponents of

112. *See generally* Alan Auerbach, *Corporate Restructuring: Tax Incentives and Options for Corporate Tax Reform*, 43 TAX LAW. 663, 691 (1990) ("The most significant problem confronting whether and how to reform the tax treatment of corporate debt and equity is understanding the impact of taxation on corporate financial policy. There is little evidence to support the view that changes in the tax environment have spurred the borrowing boom of the past few years. While the tax advantages of debt have increased for some equity holders, they have decreased for others. The increased incidence of tax losses has contributed further to a decline in the value of interest deductions overall. The rise in equity retirements appears to be associated with conversions of equity into debt much more than with a reduction in dividends. The economists' 'dividend puzzle' remains largely intact. But the ability to redeem equity without incurring the tax cost of dividends does little to explain why net equity retirements have increased, especially when favorable tax treatment also would have been available to future distributions from the retired equity. Given this uncertainty, we should tread carefully toward significant changes in corporate taxation. Rationalizing the treatment of debt and equity is a sufficiently desirable objective that legislation to accomplish it should be considered, even if recent changes in corporate financial policy are not tax-driven. Nonetheless, available alternatives do have their drawbacks, offering either revenue losing windfalls or new complications and distortions. These costs must be measured against the costs of maintaining the current system, regardless of how difficult they are to estimate.").

113. *See* Doidge & Dyck, *supra* note 82, at 45.

114. Alvin C. Warren, Jr., *The Corporate Interest Deduction: A Policy Evaluation*, 83 YALE L.J. 1585, 1585 (1973).

115. *Id.* at 1586 ("When the excess profits tax was repealed in 1921, the full interest deduction was retained as part of, the corporate income tax, without any explanation by Congress in the legislative history.").

interest deductibility cite the concept of "net income" as a basis for its existence, stating that interest is an "expense" like rent or cost of goods.[116]

Those who oppose interest deductibility, however, state that a reduction in the cost of debt will lead to more leverage, which in turn will increase "volatility," "distress costs," and "externalities."[117] The deduction is said to be an "inefficient unneutrality"[118] that is not critical in "defining the concept of corporate income"[119] in the tax system. Additionally, the deduction has been the subject of extensive litigation.[120] Setting limits on the deductibility of interest, based on an application of the MMT, would infer a reduction in the desirability of leverage by firms.[121] Knoll has suggested that this is a good thing and that it will lead to enhanced innovation by growth-oriented firms.[122] Also, less debt may help to moderate excessive risk.[123] This point is debatable, however, and it has been argued by Netter that "debt has an important function in controlling management from engaging in non-value maximizing strategies."[124] Levmore also claims that tax laws already adopt a "Modigliani-Miller perspective" and that they motivate companies to focus on "real variables," making excessive debt loads undesirable.[125] For these reasons, the tax effect on debt loads may be insignificant.

116. *Id.* at 1589 ("Interest payments are as much expenses of producing income as are rent, wages, and the cost of supplies or productive assets; thus denying deductibility would make the tax pro tanto a levy on gross income. Dividends, on the other hand, are seen as a division of the profits of the enterprise, and not an expense of doing business. This distinction is sometimes supported by an analogy between corporate and non-corporate business enterprises.").

117. *See* Joseph B. Allen, *Seeking True Financial Reform: Ending the Debt-Equity Distinction*, 3 WM. & MARY BUS. L. REV. 243, 243-68 (2012).

118. Warren, *supra* note 114, at 1606.

119. *See generally id*. at 1605.

120. *See id*. at 1605.

121. *See* Michael S. Knoll, *Taxing Prometheus: How The Corporate Interest Deduction Discourages Innovation and Risk-Taking,* 38 VILL. L. REV. 1461, 1516 (1993) ("Because current tax law allows corporations to deduct interest but not dividends and retained earnings, debt financing is taxed more favorably than is equity financing. Thus; the existing tax law encourages corporations to increase leverage. However, not all corporations can increase leverage as easily. Because high-risk, high-growth projects employing intangible assets cannot support as much leverage as can low-risk, low-growth projects employing tangible assets, the existing corporate tax law discourages investment in the former in favor of investment in the latter. This misallocates capital within the corporate sector and discourages investment in precisely those industries and activities that many commentators consider to be critical to the economic future of the United States.").

122. *See id.*

123. *See* Tim Edgar, *Financial Instability, Tax Policy, and the Tax Expenditure Concept,* 63 SMU L. REV. 969, 1031 (2010).

124. *See* Jeffry Netter, *Ending the Interest Deductibility of Debt Used to Finance Takeovers is Still a Bad Idea: The Empirical Evidence on Takeovers, Restrictions on Takeovers, and Restrictions on Deductibility of Interest*, 15 J. CORP. L. 219, 222 (1989).

125. *See* Saul Levmore, *The Positive Role of Tax Law in Corporate and Capital Markets*, 12 J. CORP. L. 483, 490 (1986) ("Thus, the law can be described as adopting a Modi-

As discussed by Warren, with a limitation of interest deductibility, firms could "shift the focus of tax minimization by encouraging alternatives to long-term indebtedness, such as leasing and short term borrowing."[126] Also, firms may choose not to engage in certain investment projects that will become unprofitable given the limits of the interest deduction.[127] As such, this loss of investment would have a negative impact on the domestic economy. On the other hand, a modified solution would be to allow for dividend payment deductions; however, for several reasons, this is unlikely to be enacted.[128] Such measures could also create "moral hazard" for corporate managers.[129]

Trump's reforms also change the way that capital investments are deductible. Large capital investments (under certain parameters) would be completely deductible by businesses in the year they are made (hereinafter "the large capital investment expense") rather than amortized over time. If a large capital project is deductible in the year the expense is incurred, this tax incentive may motivate firms to increase their debt ratios to leverage acquisitions or new capital investments and, therefore, obtain more favorable tax shields through the full deductibility of the investment. Problematically, increased leverage will increase the chance of a firm going bankrupt, which given the MMT, may decrease its value.[130]

Moreover, companies under significant debt burdens could end up in a worse financial position with the new limitations on debt interest deductibility.[131] Given the MMT, it is reasonable to anticipate that some companies may seek tax jurisdictions where interest on corporate debt is fully deductible. Similarly, these companies may reasonably hold on to cash resources and may wait to make capital investments until after the reforms are passed, impacting the short-term use of their funds.[132] The large capital investment expense will not benefit all companies equally because cer-

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gliani-Miller perspective and encouraging managers to focus on real, rather than financial, variables. The positive effect of tax law in this setting can be stated even more strongly. One can view the Code as recognizing that excessive-debt (compared to agency cost considerations alone) will be encouraged by the combined presence of tax-exempt investors and the interest expense deduction. The task, in support of efficient corporate and capital markets (in agency cost, or real terms), is to discourage debt, and the rules governing midstream distributions of debt, whether in redemption, reorganization, or dividend distribution, accomplish just that by refusing non-recognition treatment. The tax laws governing exchanges involving debt, thus, can be deemed to discourage both excessive debt financing and irrelevant or even destructive 'financial fiddling' by managers with the capital structure of the ongoing corporation.").

126. Warren, *supra* note 114, at 1610.

127. *See id*. at 1615.

128. *Id*. at 1609.

129. *See* Allen, *supra* note 117, at 254.

130. *See generally* Stephanie Ben-Ishai, *Debt or Equity? A Puzzle For Canadian Bankruptcy Law*, 53 CAN. BUS. L.J. 416, 416 (2012).

131. *See* Dan McCrum & Eric Platt, *Trump Corporate Tax Plan May Yet Reshape the World for Investors*, FIN. TIMES (February 1, 2017); *see also* Warren, *supra* note 114, at 1618.

132. McCrum & Platt, *supra* note 131.

tain public utility companies are limited in "the amount of profit they are allowed to make.[133] Lawrence Summers has suggested that the combined effect of the business rate reduction, the reduction of interest deductibility, and the large capital investment expense could increase "inequality."[134] Summers further notes that the interest deductibility rules for banks and business organizations that do not operate as corporations (e.g. partnerships) are uncertain.[135] Additionally, Howard Gleckman demonstrates that tax cuts could have a negative effect on the national deficit.[136]

Another of Trump's reforms introduces a "one-time" tax repatriation holiday. This tax holiday would enable U.S. firms to repatriate funds held overseas with only a 15.5 percent payment (as opposed to the current 35 percent rate) on cash reserves and an 8 percent payment on equipment. Repatriation holidays are not a new initiative, and as previously identified in the Dharmapala study, domestic investments do not necessarily increase when such repatriation tax incentives are introduced. As a result, if a U.S. corporation becomes more successful and more competitive globally, one cannot predict a corresponding increase in capital investments and employment in America.[137] In fact, a study by Brennan—which examined the "long-term effects" of the 2004 U.S. repatriation holiday—concluded that although there was a short term influx of cash returned to the U.S. pursuant to the holiday, the government's efforts were ultimately a "net failure." Brennan reached this conclusion because repatriated funds were "substantially offset" by increased amounts of foreign profits invested abroad.[138] Thus, when changing tax regimes, lawmakers need to be sensitive to both the short-term implications and the long-term consequences

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133. *Id*.

134. Summers, *supra* note 24 ("[P]ensions, 401(k)s, life insurance, holdings by foreigners and the like render most individual capital income-tax free, where the remainder is taxed at highly preferential capital gains and dividend rates, and where the estate tax is easily avoided and likely to be eliminated.").

135. Lawrence Summers*, US Tax Reforms Vital but Donald Trump's Plan is Flawed*, FIN. TIMES (Jan. 8, 2017), https://www.ft.com/content/7e5900ec-d401-11e6-b06b-680c49b4b4c0.

136. *See* Howard Gleckman, *Bet on a Tax Cut, Not a Tax Reform*, THE HILL (February 3, 2017), http://thehill.com/blogs/pundits-blog/economy-budget/317123-bet-on-a-tax-cut-not-tax-reform.

137. *See generally* Kimberly A. Clausing, *The Tax Policy Briefing Book: International Taxation*, TAX POL'Y CTR. (Dec. 17, 2007), http://www.taxpolicycenter.org/briefing-book.

138. *See* Thomas J. Brennan, *What Happens After A Holiday? Long-Term Effects Of The Repatriation Provision of the AJCA,* 5 NW. J. L. & SOC. POL'Y 1, 2 (2010) ("These findings help elucidate the full effect of the AJCA tax holiday and serve as a basis for evaluating whether the law achieved desired policy goals. Assuming that a return of foreign earnings to the United States was the sole policy goal, the AJCA was unarguably a short-term success, as substantial amounts of cash were returned to U.S. parent corporations during the window permitted by § 965.9. However, this short-term success must be weighed against the accompanying long-term effects. This Article shows that since the holiday window, there has been a dramatic increase in the rate at which firms add to their stockpile of foreign earnings kept overseas. The long-term result has been an aggregate increase in new foreign earnings added to the overseas stockpile that is greater than the amount of funds repatriated pursuant to the

that occur after firms have adjusted their policies to adapt to the new regime.[139]

At the heart of the repatriation reform is a larger question: what measures (including taxation) can the U.S. government use to keep companies and their profits from moving overseas altogether? An efficient outcome to this problem is challenging given the complexity of the Internal Revenue Code and given the often times conflicting tax policy objectives of revenue, redistribution, and equality.[140] Several recent studies have, nonetheless, addressed this question. These studies have also sought to determine the most effective means of repatriating foreign income earned abroad by U.S. multinational companies.[141] Such tax reforms start by ad-

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holiday. From this perspective, it seems that the AJCA may have been a net failure in achieving the policy goal of returning foreign earnings to the United States.").

139. *See id.* at 17 ("The pattern of behavior exhibited by firms increasing permanently reinvested foreign earnings may well have been brought about by the AJCA tax holiday. An intended consequence of the holiday was to cause substantial amounts of permanently reinvested foreign earnings to be returned to the United States. A collateral consequence of substantial proportions, however, is the conditioning of firms to expect future such holidays and to arrange their affairs accordingly. In this way, the AJCA holiday may have been responsible for the long-term classification of an increased fraction of foreign earnings being labeled as permanently reinvested overseas and also for a long-term increase in the amount of earnings generation that firms carry out overseas rather than in the United States. The findings of this Article are broadly consistent with changes in firm behavior that will allow firms to take the fullest advantage of an anticipated future tax holiday. However, the findings demonstrate only statistical correlation and not causation, and it is possible, for example, that other intervening events or changes over time may have caused the observed differences in firm behavior rather than simply the fact of the AJCA tax holiday. Nevertheless, the changes in patterns demonstrated by the methods of this article are sufficiently substantial in terms of dollar magnitude and statistical significance that they provide strong evidence of a conditioned behavioral change in firms created by the AJCA tax holiday. These findings are important not only for evaluating the long-term impact of the AJCA tax holiday, but also for evaluating the merits of other proposed temporary holidays and amnesties, both in the arena of permanently reinvested foreign earnings and in other areas that allow for the possibility of a second holiday at some future point. Lawmakers must exercise care in weighing not only the short-term intended consequences but also the long-term behavioral changes induced by the prospect of future holidays. In the case of the AJCA tax holiday, these long-term effects were substantial and perhaps outweighed the short-term benefits, resulting in a net policy failure, at least to the extent that the policy goal was the long-term net return of foreign earnings to the United States.").

140. *See generally* Edward Yorio, *Federal Income Tax Rulemaking: An Economic Approach*, 51 FORDHAM L. REV. 1, 51 (1982); Terrance O'Reilly, *Principles of Efficient Tax Law: Apocrypha*, 27 VA. TAX REV. 583 (2008); Adam Chodorow, *Economic Analysis in Judicial Decision Making – An Assessment Based on Judge Posner's Tax Decisions*, 25 VA. TAX REV. 67 (2005); Daniel Shaviro, *An Economic and Political Look at Federalism in Taxation,* 90 MICH. L. REV. 895 (1992); and Leo Martinez, *Tax Collection and Populist Rhetoric: Shifting the Burden of Proof in Tax Cases,* 39 HASTINGS L.J. 239 (1988).

141. *See e.g.*, Joseph McWeeney, *Cat and Mouse – How Can The U.S. Government Keep American Companies in America?*, 14 DEPAUL BUS. & COM. L.J. 357 (2016); Joshua Simpson, *Analyzing Corporate Inversions and Proposed Changes To The Repatriation Rule*, 68 N.Y.U. ANN. SURV. AM. L. 673 (2013); Robert Bloink, *Is United States Corporate Tax Policy Outsourcing America? A Critical Analysis Of The Proposed Tax Holiday For Trapped CFC Earnings,* 56 VILL. L. REV. 833 (2012).

dressing the root of the problem, which Joseph Simpson describes as "high U.S. tax rates, a global system of taxation, and high regulatory costs."[142] Reflecting these studies, available academic literature cites alternative measures to repatriation holidays, such as: a lowering of the corporate rate[143] (which has been implemented by the Trump reforms), adopting a national retail sales tax,[144] a combined wealth and consumption tax,[145] adopting a territorial or hybrid-territorial system of taxation (like that of

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142. Simpson, *supra* note 141, at 716.

143. *See* McWeeney, *supra* note 141, at 383-84; *see also* Simpson, *supra* note 141, at 718-20, ("[T]he United States could follow Canada's lead and lower its corporate tax rates. Canada dropped its corporate tax rates from 38% to 15% over the last thirty-two years, with tax revenues fluctuating based on economic growth and not declining with tax rates. In fact, Canada collects 1.9% of GDP in corporate tax revenues with a 15% rate, while the United States only collects 1.6% of GDP with a 35% corporate tax rate. U.S. marginal tax rates are the highest in the OECD. Although some may argue that, due to the effect of credits and deductions, effective tax rates in the United States are competitive internationally even though United States' marginal tax rates are not, it is marginal tax rates that companies use to make investment decisions. These investment decisions are often new corporate projects, which may require the creation of new jobs. High corporate tax rates have been shown to increase the size of the informal economy and have large adverse effects on investment, foreign direct investment, and entrepreneurship. Even President Obama's Economic Recovery Advisory Board stated that '[t]he high effective tax rates that apply to corporate investments result in significant economic distortions and a lower tax rate on corporate investments would result in desirable changes in a number of areas.' For instance, lowering the U.S. corporate tax rate could increase the competitiveness of the United States in attracting business activity. Many proposals suggest lowering tax rates in a revenue-neutral fashion by broadening the corporate tax base. There are also many arguments that this is a fair outcome, one being that shareholders are already taxed on the income received from corporations. As lower rates also have the advantage of decreasing the incentive for corporations to shift income abroad, they could mitigate the problems created by a shift towards a territorial tax system. Income shifting was estimated to cost the U.S. government $90 billion in 2008 alone, or 30% of corporate tax revenues. Thus, ideally a territorial tax system with lower tax rates would be implemented to enhance U.S. competitiveness and support growth, as OECD analysis has found that 'corporate taxes are the most harmful type of tax for economic growth.") (citations omitted).

144. *See generally* Bruce W. Bennett, *Cashing In or Cashing Out? The Fair Tax Act of 1999,* 27 J. LEGIS. 69 (2001).

145. *See generally* Beverly I. Moran, *Capitalism and the Tax System: A Search For Social Justice,* 61 SMU L. REV. 337 (2008).

Germany or Japan),[146] a flat tax regime,[147] and also streamlining regulations.[148]

III. The Constitutionality of a Border Adjustment Tax

A. *The Border Adjustment Tax and Its Potential Economic Impact*

As previously discussed in Section I, during the election campaign there were several discussions of changes to import and export taxation under a policy referred to as a "Border Adjustment Tax" ("BAT"). This BAT would allow exporters to exclude revenue from exports when they were calculating their total taxable income. Additionally, companies would not be able to deduct the cost of imports that they purchased. This reform would attempt to remedy the problem presented by the current tax regime, which discourages U.S. companies from investing at home the profits they make abroad.[149] The Trump administration believed the BAT would generate significant revenue; however, not all commentators agreed.[150] Alan Reynolds at the CATO Institute, for example, considered

146. *See* McWeeney, *supra* note 141, at 385, ("Finally, one of the greatest incentives a company possesses to invert is created by the repatriation tax that is levied on foreign income that is brought into the U.S. A territorial system would eliminate the need for this type of tax. A repatriation tax seems to be an antiquated instrument used during a time when global business was less feasible. I believe that technology has broken down many of the burdens bestowed upon global business and it is in our best interest to knock down any other barriers to creating a truly global marketplace. Additionally, a repatriation tax causes a phenomenon known as 'trapped income'. In 2015, the amount of 'trapped' income was estimated to be $2.6 trillion. Adopting a territorial tax system would allow the corporate tax rate to stay where it's encouraging U.S. companies to stay at home, while putting their best foot forward abroad. The greatest risk with a territorial system is its vulnerability to tax avoidance schemes like shifting income abroad to make it look as if profits were being earned in a foreign domicile. Countries like Germany and Japan have found success with a hybrid territorial system which incorporates anti-abuse provisions such as: taxing at least a fixed percentage of foreign earnings and limiting companies' ability to channel income to subsidiaries in low-tax countries.") (citations omitted); *see also* Simpson, *supra* note 141, at 717-18.

147. *See generally* John T. Plecnik, *The New Flat Tax: A Modest Proposal For a Constitutionally Apportioned Wealth Tax,* 41 Hastings Const. L.Q. 483 (2014).

148. Simpson, *supra* note 141, at 720 ("Another suggested alternative is to streamline U.S. regulations, which would support territorial taxation and lower tax rates in reducing the incentive for corporate inversions. Some targets for modification may include SOX, the FCPA, Dodd-Frank, the securities litigation system, and other regulations mentioned in Section I(C). Performing a cost-benefit analysis on the controversial provisions of existing laws and regulations may provide a means for assessing the desirability of changing the existing regulatory structure and for setting priorities for legislative action.").

149. *See* Ronald D. Rotunda, *What You Didn't Know About Our Federal Income Tax*, Verdict Justia (June 2017), https://verdict.justia.com/2017/06/05/didnt-know-federal-income-tax.

150. *See* H.C., *The White House hints that tax reform could pay for the border wall,* The Economist (Jan. 2017), http://www.economist.com/blogs/democracyinamerica/2017/01/taxes-and-tariffs.

the BAT unnecessary, because he believes lowering the U.S. corporate rates would achieve the desired revenue goals.[151]

The April 26, 2017 tax policy statement by the White House did not include a border adjustment component,[152] and ultimately, the Trump administration decided to remove the BAT from the final tax reform bill;[153] however, given the numerous references to the BAT during the campaign, an analysis of its viability and constitutionality is relevant. Detractors of the BAT suggest that any cost to importers would likely be extended to consumers in the form of higher prices.[154] Also, the BAT may hurt importers with small "profit margins," potentially resulting in layoffs in the employment sector.[155] The BAT, as a protectionist measure, may also breach a fundamental notion of fairness[156] and may have an adverse effect on "locational neutrality."[157]

BAT policies could also result in a strengthened U.S. dollar. In this light, Neil Irwin of the *New York Times* suggests a strengthened U.S. dollar may cause the "trade balance" to result back to the level it was prior to the tax reform.[158] Irwin also states that an increase in the value of the U.S. dollar could put negative pressure on emerging market banks and other financial institutions that hold a large amount of U.S. denominated bonds.[159] The BAT also presents a new scenario for exploitation through tax arbitrage, which Lawrence Summers predicts would "force burdensome tax hikes or spending reductions on the federal government"[160] and would present a mischief to international trade.[161]

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151. *See* Alan Reynolds, *Cut the Corporate Tax Rate; Drop The BAT*, CATO AT LIBERTY (May 2017), https://www.cato.org/blog/cut-corporate-tax-rate-drop-bat.

152. Pramuk, *supra* note 2.

153. *See* Jacob Pramuk, *Republicans scrap border adjustment from tax reform plan,* CNBC (July 27, 2017), https://www.cnbc.com/2017/07/27/top-republicans-behind-tax-plan-say-border-adjustment-tax-is-dead.html.

154. *See* Phil Wahba, *Walmart, Target and Other Retailers Are Teaming Up to Fight Trump's Border Tax*, FORTUNE (Feb. 2017), http://fortune.com/2017/02/01/walmart-target-border-tax-trump/.

155. *See id.*

156. *See generally* Leo P. Martinez, *Tax Collection and Populist Rhetoric: Shifting the Burden of Proof in Tax Cases,* 39 HASTINGS L.J. 239, 276 (1988).

157. *See generally* Daniel Saviro, *An Economic and Political Look at Federalism in Taxation,* 90 MICH. L. REV. 895, 975-76 (1992).

158. Neil Irwin, *The Major Potential Impact of a Corporate Tax Overhaul*, N.Y. TIMES (Jan. 2017) https://www.nytimes.com/2017/01/07/upshot/the-major-potential-impact-of-a-corporate-tax-overhaul.html?_r=0.

159. *See id.*

160. *See* Summers, *supra* note 24.

161. *See generally* John H. Jackson, *National Treatment Obligations and Non-Tariff Barriers,* 10 MICH. J. INT'L L. 207 (2012).

B. *Border Adjustments and the Apportionment Clause*

There is a question, asked by Nathan J. Richman of *Tax Analysts,* as to whether the BAT is unconstitutional as an "unapportioned direct tax not covered by the 16th Amendment."[162] Under the U.S. Constitution, Congress is authorized to "lay and collect Taxes, Duties, Imposts and Excises";[163] however, this power is curtailed by the Apportionment Clause,[164] which states that any "direct tax" must be apportioned amongst the states, according to their respective numbers.[165] Theodore B. Olson, the U.S. Solicitor General under President George W. Bush, suggested this restriction was enacted to ensure that states with larger populations would not collude to pass tax laws with a disproportionate effect on "less populous states" (e.g. taxes based on land size).[166] On the other hand, Calvin Johnson states that the "apportionment of tax was brought into the Constitution to impose a disincentive on slavery."[167]

The apportionment requirement was later curtailed, in regards to the collection of income taxes, when the states ratified the Sixteenth Amendment[168] to the Constitution.[169] As such, Benjamin Rippeon, legal counsel to Koch Industries Inc. and BAT opponent, in an interview with Nathan J. Richman, suggests the issue of constitutionality can be distilled to two questions: (1) Can the BAT safely be characterized as an "income tax under the 16th amendment"? (2) If it cannot, is the BAT an unconstitu-

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162. Nathan J. Richman, *Could a Court Find the Border Adjustment Unconstitutional?* TAX ANALYSTS (Apr. 2017), http://www.taxanalysts.org/content/could-court-find-border-adjustment-unconstitutional.

163. U.S. Const. art. I, § 8, cl.1.

164. U.S. Const. art. I, § 2, cl.3.

165. *See generally* Derek Devgun, *International Fiscal Wars For The Twenty-First Century: An Assessment of Tax-Based Trade Retaliation,* 27 L. & POL'Y INT'L BUS. 353, 403 (1996).

166. Theodore B. Olson, *If Retail Politics Doesn't Kill This $1 Trillion Tax, the Supreme Court Should*, WASH. POST (May 3, 2017), https://www.washingtonpost.com/opinions/if-retail-politics-doesnt-kill-this-1-trillion-tax-the-supreme-court-should/2017/05/03/4a623b42-2f77-11e7-9dec-764dc781686f_story.html?utm_term=.c5a58e43509f.

167. Calvin H. Johnson, *Fixing The Constitutional Absurdity of The Apportionment of Direct Tax,* 21 CONST. COMMENT. 295, 296 (2005).

168. *See generally* Angela P. Harris, *Vultures In Eagles Clothing: Conspiracy and Radical Fantasy In Populist Legal Thought,* 10 MICH. J. RACE & L. 269, 280 (2005) ("A host of challenges are regularly asserted against the propriety of the Sixteenth Amendment, which was ratified in 1913 and gave Congress the authority to impose income taxes without regard to apportionment. To prove that the Sixteenth Amendment was never in fact ratified, it must be shown that at least three states' ratifications were improper and void. In their efforts to do this, protesters have called attention to the existence of numerous procedural and clerical errors in the ratification process in several states. The ratification process in Oklahoma was particularly riddled with mistakes and lapses in procedural regularity, and so the argument that Oklahoma's ratification was improper is a favorite of protesters."); *see also* Christopher S. Jackson, *The Inane Gospel of Tax Protest: Resist Rendering Unto Caesar – Whatever His Demands,* 32 GONZ. L. REV. 291, 301-07 (1996).

169. U.S. Const. amend. XVI.

tional "direct tax" or a constitutional "indirect tax"?[170] This Article will now address these two questions.

C. *Does BAT Qualify as an Income Tax Under the Sixteenth Amendment?*

One of the first individuals to publically question the constitutionality of the BAT was Theodore B. Olson.[171] Olson posited that the BAT was not a tax on income (and thus not covered by the Sixteenth Amendment) since businesses that "use imported materials or components" cannot deduct their full costs. In other words, an "income tax" must be a tax on a "gain" or "net increase"; therefore, calculating revenue without deducting all the costs is not a "tax on income."[172] He further suggests that deducting costs of "materials or parts acquired abroad" from gross receipts is a necessary component to the calculation of gross income.[173] This principle was identified in the case of *Sullenger v. Commissioner of Internal Revenue*,[174] which dealt with the calculation of income for a meat distributing company. *Sullenger* established that cost of goods sold must be subtracted from gross receipts to determine gross income. The U.S. Supreme Court's decision in *Doyle v. Mitchell Brothers Co.* further supports the *Sullenger* argument.[175] In *Doyle*, a corporation in the lumber manufacturing business was entitled, for the purpose of calculating its net income, to deduct the value of cut stumpage.[176]

Erik Jensen provides support to the argument that Congress' power to define a tax as "income" is subject to "specific limitations."[177] This proposition refutes the conventional wisdom that Congress is not restricted by "fine distinctions" in the definition of income[178] and that Congress can define what "income" means—potentially rendering the concept void of any static meaning.[179] Jensen notes that the phrase "taxes on incomes"

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170. *See* Richman, *supra* note 162.

171. Olson, *supra* note 166.

172. *Id*.

173. *Id*.

174. Sullenger v. Commissioner, 11. T.C. 1076 (1948).

175. Doyle v. Mitchell Bros. Co., 247 U.S. 179 (1918).

176. *Id.*

177. *See* Erik M. Jensen, *The Taxing Power, The Sixteenth Amendment, and the Meaning of "Incomes*,*"* 33 Ariz. St. L.J. 1057, 1064 (2001).

178. *See generally* Marjorie E. Kornhauser, *The Constitutional Meaning of Income and the Income Taxation of Gifts*, 25 Conn. L. Rev. 1, 24 (1992).

179. *See* Daniel N. Shaviro, *Psychic Income Revisited: Response to Professors Johnson and Dodge*, 45 Tax L. Rev. 707, 711 n.17 (1990); *see also* Victor Thuronyi, *The Concept of Income*, 46 Tax L. Rev. 45, 54 (1990) ("[I]ncome could mean the same thing as consumption or wealth, or something else, depending on the criteria we choose for determining tax equity.").

has a meaning and that the definition should be determined "by the time-honoured distinction between income taxes and consumption taxes."[180]

A number of cases have dealt with the definition of income as it pertains to the Sixteenth Amendment.[181] In opposition to Olson's argument, Bruce Fein,[182] citing the case of *Commissioner v. Sullivan*,[183] has pointed out that deductions are a matter of "legislative grace" and that deductions can be refused by Congress. Specifically, Fein notes that such congressional action has been done in the past with respect to deductions for expenses incurred in trafficking controlled substances.[184] Fein also notes that the Internal Revenue Service ("IRS") will disallow deductions for expenses that are not, on their face, illegal.[185] In support of his argument, Fein cites the case of *New Colonial Ice Co., Inc. v. Helvering*,[186] which stands for the proposition that to deny a deduction is not the equivalent of imposing a new tax because a new corporation can be taxed on gross income.[187]

D. *Is the BAT a Direct or Indirect Tax?*

If the BAT is not a tax on income covered by the Sixteenth Amendment, then the next question is whether it is a direct or indirect tax. If it is a direct tax, then it must be apportioned amongst the states. The court has wide discretion on constitutional determinations and, as noted by Calvin Johnson, can "avoid apportionment by defining 'income tax' broadly enough to cover the tax at issue or by defining 'direct tax' narrowly enough to exclude the tax at issue."[188] Those in support of the BAT being a direct tax argue that not accounting for the full cost of goods sold makes the tax one on the value of the property, in contrast to an indirect tax, which generally deals with matters such as "manufacture, sale . . . consumption," or doing business.[189]

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180. Jensen, *supra* note 177, at 1062.

181. *See* Brushhaber v. Union Pac. R.R. Co., 240 U.S. 1 (1916); Carver v. United States, No. CIV. 82-74787, 1983 WL 386 (E.D. Mich. July 19, 1983).

182. Bruce Fein, *Border Adjustment Debate Shouldn't Be Distracted By Constitutional Doubts*, WASH. TIMES (May 10, 2017), http://www.washingtontimes.com/news/2017/may/10/border-adjustment-and-constitution/.

183. *See* Commissioner v. Sullivan, 356 U.S. 27, 28 (1958) ("Deductions are a matter of grace, and Congress can, of course, disallow them as it chooses. At times, the policy to disallow expenses in connection with certain condemned activities is clear.").

184. *See* Controlled Substances Act, 21 U.S.C. §§ 801-971 (1970).

185. Fein, *supra* note 182.

186. New Colonial Ice Co. v. Helvering, 292 U.S. 435 (1934).

187. *See id.* at 440 ("The power to tax income like that of the new corporation is plain, and extends to the gross income. Whether and to what extent deductions shall be allowed depends upon legislative grace, and only as there is clear provision therefor can any particular deduction be allowed.").

188. *See* Calvin H. Johnson, *Apportionment of Direct Taxes: The Foul-up in the Core of the Constitution*, 7 WM. & MARY BILL OF RTS. J. 1, 3 (1998).

189. Richman, *supra* note 162.

There is wide debate on both the historic origins and the definitional breadth of the term "direct tax." While a direct tax is not defined in the Constitution, Gale Ann Norton suggests that its definition originated with Adam Smith[190] and that there was ambiguity on its interpretation by the Founding Fathers.[191] Calvin Johnson, on the other hand, suggests that the phrase "direct tax" in 1787 was synonymous for "apportioned tax"[192] and further argues that "taxes for which a uniform rate is required—duties, excises, and imposts—cannot be direct taxes."[193] The U.S. Court of Appeals, D.C. Circuit, has indicated that "[o]nly three taxes are definitely known to be direct"—capitation, real property tax, and personal property tax.[194]

The Apportionment Clause has also had a controversial effect on tax law policy and constitutional litigation.[195] Several constitutional challenges, alleging unapportioned, direct tax violations have been previously undertaken.[196] Recently such a challenge was sought (without success) in the case of a compensatory damages award for emotional distress and loss of reputation brought by an employee against a former employer.[197] Additional court challenges have also been brought on this topic in the areas of executor liability[198] and several other actions[199] in relation to the constitutionality of Obamacare.[200]

Bruce Ackerman has argued from original intention that the apportionment requirement for direct taxes is a "constitutional anomaly"[201] with "tainted origins"[202] that relate to slavery. Ackerman believes the apportionment requirement should be narrowly construed and cannot serve

190. Gale Ann Norton, *The Limitless Federal Taxing Power,* 8 HARV. J.L. & PUB. POL'Y 591, 605 (1985).

191. *See id.* at 605. *See also* J.H. Riddle, *The Supreme Court's Theory of a Direct Tax*, 15 MICH. L. REV. 566, 566 (1917) ("The authoritative opinion of those who have examined the records is that there was no definite meaning agreed upon in the convention and that it was a vague term.").

192. Johnson, *supra* note 167, at 314.

193. *Id*.

194. *See* Murphy v. I.R.S., 493 F.3d 170, 181 (2007). *See also* Fernandez v. Wiener, 326 U.S. 340, 352 (1945); Pollock v. Farmers' Loan & Trust Co., 158 U.S. 601, 637 (1895). *See generally* Johnson, *supra* note 167.

195. Johnson, *supra* note 167, at 296.

196. *See* Bromley v. McCaughn, 280 U.S. 124, 136 (1929); Spreckels Sugar Ref. Co. v. McClain, 192 U.S. 397, 413 (1904).

197. *Murphy*, 493 F.3d at 171-73.

198. *See* Brief of Petitioner, Grandy v. Comm'r, No. 26157-10 (T.C. Feb. 24, 2012).

199. *See* Brief for Landmark Legal Foundation as Amici Curiae Supporting Respondents, Dep't of Health and Human Services v. Fla., No.11-398 (U.S. Feb. 10, 2012) 2012 WL 484060.

200. *See* Brief for Landmark Legal Foundation as Amici Curiae Supporting Appellants, Liberty Univ. v. Geitner, No. 10-2347 (4th Cir. Mar. 6, 2013) 2013 WL 821216.

201. Bruce Ackerman, *Taxation and the Constitution,* 99 COLUM. L. REV. 1, 23 (1999).

202. *Id.* at 4.

as a constitutional barrier to tax reform.[203] He suggests that the Founders did not "have a very clear sense of what they were doing in carving out a distinct category of 'direct' taxes for special treatment."[204] He further argues that with the exception of *Pollock v. Farmers' Loan & Trust Co.*[205] (which led to the adoption of the Sixteenth Amendment), the Supreme Court has consistently and explicitly engaged in "restrained interpretation of the direct tax clauses" for nearly two centuries.[206]

Ackerman's rejection of an expansive interpretation of direct taxation would support the constitutionality of the BAT and would further create a situation that is "politically absurd" without the apportionment requirement (in that it would require citizen of poorer states to pay higher tax rates).[207] Ackerman concludes that no taxes (not even a land tax) should be considered direct based on the constitution and that "American law should leave no stone unturned in its effort to root out any residue of its original compromise with slavery—and the 'direct tax' clause is a small, but potentially damaging, stone."[208]

Erik Jensen refutes Ackerman's original interpretation, stating that the "idea that the founding generation was reconciled to an unlimited, or nearly unlimited, taxing power is wishful thinking, a warping of historical understanding."[209] Nonetheless, Jensen also acknowledges Congress' ability to "do almost anything in the tax area."[210] Jensen posits that the Constitution in its original form divided taxes into two categories: direct (subject to the apportionment requirement) and indirect (generally consumption taxes subject to the uniformity rule).[211] He further argues, citing *The Federalist No. 21*,[212] that direct taxes have the apportionment rule because, unlike consumption taxes, there are no "natural limitations on their use."[213] Jensen, however, notes that direct taxes do extend beyond just capitation and real estate taxes to capture all other taxes that are not "indirect."[214] In this light, to understand "direct taxes" we must first grasp what is captured by "indirect taxes." Jensen argues indirect taxes should be understood as "duties and excises on articles of consumption."[215]

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203. *Id.*

204. *Id.*

205. *See* Pollock v. Farmers' Loan & Trust Co., 158 U.S. 601 (1895).

206. Ackerman, *supra* note 201, at 6.

207. *Id*. at 2.

208. *Id*. at 58.

209. Erik M. Jensen, *Taxation and the Constitution: How To Read The Direct Tax Clauses,* 15 J.L. & Pol. 687, 689 (1999).

210. *Id.* at 692.

211. *Id.* at 694.

212. The Federalist No. 21, at 106-11 (Alexander Hamilton) (Clinton Rossiter ed., 1999).

213. Jensen, *supra* note 209, at 694-98.

214. *Id*. at 698.

215. *Id*. at 701.

James Campbell takes a somewhat different approach from Jensen, citing the case of *Hylton v. United States*[216] (particularly the oral arguments of Alexander Hamilton) that the Framers of the Constitution knew exactly what they meant by the term "direct taxation" and that the term represented "basically an apportioned property tax."[217] He refutes the argument that apportionment was a "vestigial trace of the Founders' long-since repudiated 'bargain with slavery,' " but rather suggests that the apportioning of direct taxation was a "rough attempt to proportion taxes to wealth and the 'ability to pay.' "[218] Nevertheless, Campbell acknowledges that the Framers deliberately narrowed the class of direct taxes and that "direct taxes" were "near synonyms" for "internal taxes" (levied by the states).[219] In reviewing the question of "indirect" versus "direct," Campbell suggests that the relevant questions for indirect taxes include: can the cost be "shifted" to others?;[220] is the tax burden one that can be avoided?; and is it an expenditure?[221]

Robert Natelson has argued that the distinction between indirect and direct taxation was "widely understood" by the Founders and that "direct tax" was "more expansive than commonly realized."[222] Natelson, based on his research of writings in the Founder's era, provides the following definition, "A tax was direct if it was imposed on people's lives, homes, or on the productive occupations by which they supported and expressed themselves. Direct taxes, in other words, were levies on living and producing."[223] Indirect taxes, on the other hand, include everything that was "not direct," or "duties imposed not principally for regulation but for the raising of revenue."[224] Natelson further notes that the principal targets of indirect taxation "were consumption (especially of luxuries), domestic and foreign trade, and enumerated business and official transactions."[225]

Daniel Hemel from the University of Chicago Law School has stated that the BAT is a combination of an "impost" and an "excise" tax. Furthermore, he notes that Article 1, Section 8, Clause 1 of the Constitution states that duties, imposts, and excises "do not have to be apportioned

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216. Hylton v. United States, 3 U.S. (3 Dall.) 171 (1796).

217. James R. Campbell, *Dispelling the Fog about Direct Taxation,* 1 BRIT. J. AM. LEGAL STUD. 109, 111 (2012).

218. *Id.* at 114.

219. *Id.* at 115.

220. *Id.* at 169.

221. *Id.*

222. Robert G. Natelson, *What The Constitution Means by "Duties, Imposts, and Excises" and "Taxes" (Direct or Otherwise),* 66 CASE W. RES. L. REV. 297 (2015).

223. *Id.* at 318.

224. *Id.*

225. *Id.*

among the states."[226] He cites, in favor of his position, *Flint v. Stone Tracy Co.*,[227] where the Supreme Court held that a corporate tax did not require apportionment.[228] In any event, as noted by Bruce Fein, just because the BAT denies deductions for importing goods, does not mean that it is a direct tax. In support, Fein cites *National Federation of Independent Business v. Sebelius*, which suggests taxes levied for refusing to engage in a transaction for the purchase of health insurance are not direct taxes.[229]

Another consideration in the direct-indirect analysis is the issue of consumer shifting. This issue has particular relevance in the BAT constitutionality debate. Jensen has suggested that it was the Founder's intent for indirect taxes to be taxes on imports or consumption articles that could be "shifted" to consumers through price adjustment.[230] Thus, with an indirect tax, a consumer has a choice: decide to buy the product and pay the tax, or not buy the product. If the indirect tax is too high, then revenue will decrease because of lower sales.[231] Calvin Johnson has noted that Professor Jensen's interpretation of Founder intent has historical support.[232] On the other hand, defining indirect taxes as "shiftable taxes" is "contradicted by a far larger number of important usages," including James Madison's assumption before the Virginia Ratification Convention that direct taxes included shiftable taxes[233] and John Jay's use of specific direct taxes on goods.[234]

IV. Economic Analysis in a BAT Constitutional Challenge

A. *Other Consitutional Considerations*

It is uncommon for federal tax legislation to be struck on constitutional grounds.[235] It happened in 1919 by the U.S. Supreme Court in *Eisner v.*

226. Daniel Hemel, *Border Tax May Be Bad Idea, But It's Not Unconstitutional*, The Hill (May 12, 2017, 9:00 AM), http://thehill.com/blogs/pundits-blog/economy-budget/333083-border-tax-may-be-bad-idea-but-its-not-unconstitutional.

227. Flint v. Stone Tracy Co., 220 U.S. 107 (1911).

228. *Id*. at 171 ("What we have said as to the character of the corporation tax as an excise disposes of the contention that it is direct, and therefore requiring apportionment by the Constitution.").

229. Fein, *supra* note 182.

230. *See* Erik M. Jensen, *In the Apportionment of Direct Taxes: Are Consumption Taxes Constitutional?*, 97 Colum. L. Rev. 2334, 2359 (1997).

231. *Id.* at 2337.

232. *See* Johnson, *supra* note 188, at 67-69.

233. *Id*. at 69.

234. *Id*.

235. *See generally* Stephen W. Mazza & Tracy A. Kaye, *Restricting the Legislative Power to Tax in the United States,* 54 Am. J. Comp. L. 641, 641-42 (2006) [hereinafter Mazza Kaye *Restricting*]. *See also* Tracy A. Kaye & Stephen W. Mazza, *United States—National Report: Constitutional Limitations on the Legislative Power to Tax in the United States,* 15 Mich. St. J. Int'l. L. 481 (2007).

Macomber,[236] which examined the question of whether Congress could tax, as income and without apportionment, a lawfully issued stock dividend (issued by the Standard Oil Company of California) under the Sixteenth Amendment. The Court found that the provision of the *Revenue Act*[237] in question was invalid[238] because "neither under the Sixteenth Amendment nor otherwise has Congress power to tax without apportionment a true stock dividend made lawfully and in good faith, or the accumulated profits behind it, as income of the stockholder."[239] The Court held that the Amendment "must be construed in connection with the taxing clauses of the original Constitution and the effect attributed to them before the amendment was adopted."[240]

The Court further reasoned that the Sixteenth Amendment did not extend Congress' taxing power to "new subjects, but merely removed the necessity which otherwise might exist for an apportionment among the states of taxes laid on income."[241] As a result, it was essential to define what is characterized as "income"—a matter which could not be done by Congress alone due to its inability to alter the Constitution by legislation.[242] Justice Brandeis, however, in his dissenting opinion, cautioned the Court to declare an act of Congress invalid, except in a "clear case."[243]

Another factor that supports the constitutionality of the BAT is what Bruce Fein identifies as the U.S.'s propensity for "buy American" measures, such as Alexander Hamilton's championing of high import duties in his "*Report on Manufacturers*," the *Buy American Act of 1933*,[244] and the ten percent surcharge President Nixon applied on "dutiable imports" to favor American goods.[245] Further, it has been identified by O'Hara and Dougan that the Supreme Court has "fairly consistently" upheld taxes that apply only to select industries while exempting other industries.[246]

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236. Eisner v. Macomber, 252 U.S. 189 (1920).

237. Revenue Act of September 8, 1916, ch. 463, 39 Stat. 756.

238. *See* Scott A. Taylor, *Corporate Integration in the Federal Income Tax: Lessons From the Past and a Proposal for the Future,* 10 VA. TAX REV. 237, 247 (1990).

239. *See* Eisner, 252 U.S. at 219.

240. *Id.* at 205.

241. *Id*. at 206.

242. *Id.* In order to amend the Constitution it would require a two-thirds vote in Congress and the approval of seventy-five percent of the States.

243. *Id.* at 238.

244. Buy American Act of 1933, 41 U.S.C. §§ 8301–8305 (2012).

245. Fein, *supra* note 182.

246. Erin A. O'Hara & William R. Dougan, *Redistribution Through Discriminatory Taxes: A Contractarian Explanation of the Role of the Courts,* 6 GEO. MASON L. REV. 869, 908 (1998). *See also* Lake Lanier Theatres v. Hall County, 189 S.E.2d 439 (Ga. 1972); Marchetti v. United States, 390 U.S. 39 (1968); Allied Stores of Ohio, Inc. v. Bowers, 358 U.S. 522, 526-27 (1959); United States v. Kahriger, 345 U.S. 22 (1953); United States v. Sanchez, 340 U.S. 42 (1950); Carmichael v. S. Coal & Coke Co., 301 U.S. 495 (1937); Sonzinsky v. United States, 300 U.S. 506 (1937); A. Magnano Co. v. Hamilton, 292 U.S. 40 (1934); United States v. Doremus, 249 U.S. 86 (1919); Quong Wing v. Kirkendall, 223 U.S. 59, 62 (1912);

Gale Ann Norton has suggested that Congress' taxing power is nearly "limitless"[247] and that there is case law support for the proposition that a tax "too high, oppressive, burdensome, restrictive or even destructive does not provide a basis upon which the courts can void a tax invoked by Congress."[248] As an example, Norton cites the *Crude Oil Windfall Profit Tax Act of 1980*,[249] which the Supreme Court found to be constitutional[250] despite its imposition of a large tax burden on oil producing companies in a geographically "non-uniform" manner (Alaskan oil was exempted from the tax).[251] Norton further points out that courts have generally used a different standard with respect to taxation matters (as opposed to other acts of Congress) than with respect to due process,[252] just compensation,[253] and equal protection.[254] Norton also indicates that there are procedural obstacles[255] to tax constitutional challenges, including a strong presumption in favor of the constitutionality of tax legislation.[256]

Other than the not apportioned between the states and not qualifying as income direct tax arguments are there other potential constitutional angles for a BAT challenge? One potential argument is that of "horizontal inequity"[257] under the Uniformity Clause.[258] This argument is based on the manner in which the BAT discriminates against importing businesses. Given the existence of precedent interpreting the Uniformity Clause as concerning geography[259] and given Congress' wide discretion to draw distinctions between taxpayers, this horizontal inequity argument is unlikely

McCray v. United States, 195 U.S. 27 (1904); Gundling v. City of Chicago, 177 U.S. 183 (1900); Royall v. Virginia, 116 U.S.572 (1886); Ky. R.R. Tax Cases, 115 U.S. 321 (1885); McMillen v. Anderson, 95 U.S. 37 (1877).

247. *See* Norton, *supra* note 190, at 591.

248. *See* Ptasynski v. United States, 550 F. Supp. 549, 555 (D. Wyo. 1982), *rev'd on other grounds*, 462 U.S. 74 (1983).

249. *See* Norton, *supra* note 190, at 592.

250. *See* United States v. Ptasynski, 462 U.S. 74 (1983).

251. *See* Norton, *supra* note 190, at 593-95.

252. *Id*. at 608. *See also* Heiner v. Donnan, 285 U.S. 312, 326 (1932) ("That a federal statute passed under the taxing power may be so arbitrary and capricious as to cause it to fall before the due process of law clause of the Fifth Amendment is settled.").

253. *See* Norton, *supra* note 190, at 608. *See also* Welch v. Henry, 305 U.S. 134, 143 (1938).

254. *See Id*.; *see also* City of Pittsburgh v. Alco Parking Corp., 417 U.S. 369 (1974); A. Magnano Co. v. Hamilton, 292 U.S. 40, 44 (1934); Barclay & Co. v. Edwards, 267 U.S. 442 (1925); McCray v. United States, 195 U.S. 27, 57 (1904).

255. Norton, *supra* note 190, at 621-24.

256. *See* Regan v. Taxation with Representation, 461 U.S. 540, 547-48 (1983); Madden v. Kentucky, 309 U.S. 83, 87-88 (1940); Nicol v. Ames, 173 U.S. 509, 514-15 (1899).

257. *See* Mazza Kaye *Restricting*, *supra* note 235, at 655-57.

258. U.S. CONST. art. I, § 8, c1. *See also* Norton, *supra* note 190, at 597-99.

259. *See* Jeffrey S. Kinsler, *Circuit-Specific Application of the Internal Revenue Code: An Unconstitutional Tax,* 81 DENV. U. L. REV. 113 (2003).

to succeed.[260] Furthermore, the argument is even less viable if all importing companies were equally affected.[261]

Another angle would be to attack the unfair treatment that a few companies are given under the BAT as a challenge under the Equal Protection Clause.[262] As pointed out by Stephen W. Mazza and Tracy A. Kaye, however, there are many examples in the Internal Revenue Code of "exclusions, deductions, credits and tax rate deductions that favor certain taxpayers, investment and business activities over others."[263] While there are many theories as to why this reality exists,[264] and despite the costs of deferral,[265] courts may consider this to be a question better suited for Congress to answer.[266] Lastly, given the BAT's tendency to favor exporting companies by requiring importing companies to bear the costs of the tax, a potential alternative argument based on the Taking Clause of the Fifth Amendment may be available.[267]

In this Section, the Article has outlined the various reasons and considerations why a constitutional challenge to the BAT is unlikely to succeed. In the next Section, the Article will address the controversial issue of judges using economic analysis when assessing the constitutionality of tax reform and will address how such analysis could be applied in the case of a BAT judicial review.

B. *The Case for Economic Analysis on BAT Constitutionality*

Given the U.S. Supreme Court's reluctance to challenge Congress on tax matters, overturning the BAT on constitutional grounds is a very challenging undertaking. Another question arises: is it possible for the Courts to use economic theory (particularly the irrelevant impact that the legislation may have in light of the MMT and the empirical studies previously shown) to influence the question of BAT constitutionality under the Sixteenth Amendment? For example, if a BAT was ultimately neutral or ir-

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260. *See* Regan v. Taxation with Representation, 461 U.S. 540, 547-48 (1983); United States v. Ptasynski, 462 U.S. 74 (1983); Fernandez v. Wiener, 326 U.S. 340 (1945); Poe v. Seaborn, 282 U.S. 101 (1930),); Brushaber v. Union Pac. R.R. Co., 240 U.S. 1, 24 (1916).

261. *See* Norton, *supra* note 190, at 601. *See also* Hylton v. United States, 3 U.S. (3 Dall.) 171 (1796).

262. *See* Mazza Kaye *Restricting*, *supra* note 235, at 668-71.

263. *See Id*. at 668.

264. *See generally* Daniel Shaviro, *Beyond Public Choice and Public Interest: A Study of the Legislative Process as Illustrated by Tax Legislation in the 1980s*, 139 U. PA. L. REV. 1 (1990).

265. *See* Yorio, *supra* note 140, at 23-24.

266. *See* Apache Bend Apartments, Ltd. v. United States, 702 F. Supp. 1285 (N.D. Tex. 1988), *rev'd* 987 F.2d 1174, 1180 (5th Cir. 1993).

267. *See* Norton, *supra* note 190, at 621-24. *See also* Citizens' Savings & Loan Ass'n v. Topeka, 87 U.S. (20 Wall.) 655 (1874); Webb's Fabulous Pharmacies, Inc. v. Beckwith, 449 U.S. 155, 163 (1980); Nashville, Chattanooga, & St. Louis Ry. v. Walters, 294 U.S. 405 (1935); Myles Salt Co. v. Board of Comm'rs, 239 U.S. 478 (1916); Fernandez v. Wiener, 326 U.S. 340, 358 (1945).

relevant in its impact on trade, but disproportionately affected certain import heavy states or if a BAT negatively impacted domestic consumers and drove import companies overseas, would the court supplement the constitutional question with an application of economic cost-benefit analysis, and if so, under what parameters?

Despite Judge Jerome Frank once famously noting that a case may turn on what a judge "had eaten for breakfast,"[268] factors such as political ideology[269] and economic analysis[270] often influence constitutional questions. In fact, there are numerous articles that have identified the role of economic analysis in the judicial decision-making of U.S. Courts.[271] For example, Judge Richard Posner, arguably the leading figure in the law and economics movement, advocated for seeing the entire constitution as an "economic document."[272] Judge Posner incorporated this theory in a wide array of his published opinions. In this manner, he has consistently relied on economic analysis (using both positive and normative arguments) in his judicial decision-making.[273]

Judge Douglas H. Ginsburg has also outlined the role that economic analysis has played in antitrust law in the U.S. Supreme Court. Judge Ginsburg points out that starting in the 1970s, the court recognized economic analysis to promote "economic efficiency" and "consumer wel-

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268. *See* Jerome Frank, Law and the Modern Mind 34-35 (1930).

269. *See* Frank B. Cross, *The Ideology of Supreme Court Opinions and Citations,* 97 Iowa L. Rev. 693 (2012).

270. *See* Hous. Found., Inc. v. Forman*,* 421 U.S. 837 (1975).

271. *See* Nancy Whitmore, *Congress, The U.S. Supreme Court and Must-Carry Policy: A Flawed Economic Analysis,* 6 Comm. L. & Pol'y 175 (2001); *See also* John D. Echeverria, *The Track Record on Takings Legislation: Lessons from Democracy's Laboratories,* 28 Stan. Envtl. L.J. 439 (2009); James P. Karp, *An Alternative to the United States Supreme Courts Economic-Based Rationale in Takings Analysis,* 2 Vill. Envtl. L.J. 253 (1991); Barton H. Thompson Jr., *The Endangered Species Act: A Case Study in Takings & Incentives,* 49 Stan. L. Rev. 305 (1997); Barton H. Thompson Jr., *Judicial Takings*, 76 Va. L. Rev. 1449 (1990); Frank B. Cross, *Political Science and the New Legal Realism: A Case of Unfortunate Interdisciplinary Ignorance,* 92 Nw. U. L. Rev. 251 (1997); Arpan A. Sura, *An End-Run Around The Taking Clause? The Law and Economics of Bivens Actions for Property Rights Violations,* 50 Wm. & Mary L. Rev. 1739 (2009). *See also* Charles W. Collier, *The Use and Abuse of Humanistic Theory in Law: Reexamining the Assumptions of Interdisciplinary Legal Scholarship,* 41 Duke L.J. 191 (1991); Frank B. Cross, *The Ideology of Supreme Court Opinions and Citations,* 97 Iowa L. Rev. 693 (2012); Barry Friedman, *The Politics of Judicial Review,* 84 Tex. L. Rev. 257 (2005); Earl M. Maltz, *The Prospects for a Rival Of Conservative Activism in Constitutional Jurisprudence,* 24 Ga. L. Rev. 629 (1990); Joel Marrero, *The Efficiency of Fairness: A Law and Economics Analysis of the Bakke-Grutter Diversity Rationale,* 29 Chicana/o-Latina/o L. Rev. 69 (2010); Adrian Vermeule, *The Judiciary is a They, Not an It: Interpretive Theory and The Fallacy of Division,* 14 J. Contemp. Legal Issues 549 (2005).

272. *See generally Posner Constitution*, *supra* note 7.

273. *See* Larry L. Chubb, *Economic Analysis In The Courts: Limits and Constraints*, 64 Ind. L.J. 769 (1989).

fare."[274] He further notes that the Supreme Court's opinions in this area have relied, to an increasing measure, on the work of leading economists[275] and that it is "not uncommon to see briefs on both sides of a case" present economic arguments.[276] He cites, as a contributing factor, the work of Judge Robert Bork[277] on the original intent of the Sherman Act.[278] Ginsburg argues that economic analysis has "promoted consistency in antitrust jurisprudence," and as a result, the Court has revisited previous decisions that were based on a "shaky foundation."[279]

Additionally, Judge Posner's "public interest theory" and "interest group theory,"[280] identified by George M. Cohen, could provide a potential economic framework for analyzing the BAT. Following Mr. Cohen's reasoning, public interest legislation (which promotes equity and efficiency) should be interpreted to maximize public welfare,[281] whereas legislation that favors a specific group should be restricted to the lawmaker's intent.[282] One could argue that if the BAT (on the basis of public interest theory) has adverse consumer or trade effects that outweigh revenue production, then its enactment should be challenged. The difficulty lies in interpreting which of the two categories most suitably fits the BAT (Posner himself advocates for interest group theory for ambiguous cases).[283]

This dichotomy further begs the question: how easy is it to determine legislative intent? Given this difficulty, Posner suggests interpreting the Constitution to give broad powers to Congress. This interpretation would favor the constitutionality of the BAT as within Congress' power.[284]

For example, Judge Posner has used economic analysis in a case involving the statutory interpretation of an investment tax credit recapture law

274. Douglas H. Ginsburg, *Originalism and Economic Analysis: Two Case Studies of Consistency and Coherence in Supreme Court Decision Making,* 33 Harv. J.L. & Pub. Pol'y 217 (2010).

275. *Id.* at 222-23.

276. *Id*. at 222.

277. Robert H. Bork, *Legislative Intent and the Policy of the Sherman Act,* 9 J.L. & Econ. 7 (1966).

278. *See* Douglas H. Ginsburg, *An Introduction To Bork (1966),* 2 Competition Pol'y Int'l 225 (Spring 2006).

279. Ginsburg, *supra* note 274, at 222.

280. *See Posner Economics*, *supra* note 6, at 265. *See* George M. Cohen, *Posnerian Jurisprudence and Economic Analysis of Law: The View From The Bench,* 133 U. Pa. L. Rev. 1117, 1128-29 (1985).

281. *See* Cohen, *supra* note 280, at 1128-29. *See generally* Richard Posner, Economic Analysis of Law 16 (2d ed. 1977) at 409.

282. *See* also Cohen, *supra* note 280, at 1129. *See also* Richard Posner, *Statutory Interpretation—in the Classroom and in the Courtroom*, 50 U. Chi. L. Rev. 800, 817 (1983).

283. *See* Cohen, *supra* note 280, at 1130. *See also Posner Economics*, *supra* note 6, at 279.

284. *See* Cohen, *supra* note 280, at 1130. *See also Posner Economics supra* note 6, at 285.

where there was ambiguity with respect to the intent of Congress.[285] In this case, as pointed out by George M. Cohen, Posner arguably ignored his interpretative framework (noted above) and, instead, relied on "textual" and "policy" arguments.[286] This decision was criticized in dissent by Judge Dumbauld as "expansive"; alternatively, Dumbauld argued for the interpretation of tax statutes from a "literal" perspective.[287]

Walter Hellerstein has shown that economic analysis was used in dealing with taxation issues on a state business level[288] in matters including "state tax exportation"—the question of whether non-residents are affected by a state tax requires an analysis of the tax's impact on a "geographic basis."[289] Further, in *Commonwealth Edison Co. v. Montana*,[290] several coal companies (and out-of-state utility customers) unsuccessfully used the theory of state tax exportation to challenge a Montana coal severance tax on the basis that it violated the Commerce Clause.[291] As Hellerstein notes, this case highlights the difficulty in using economic analysis on constitutional questions. Even with an analysis of "the relevant market, the geographic mobility of the factors of production, and the elasticity of demand for a taxed product," the court must still address fairness and benefits.[292]

Hellerstein also identifies the use of economic analysis in the question of state taxation of federal contractors[293] (in contravention of the Supremacy Clause)[294] and in state taxes on lessees of federal property.[295] Notably, the Supreme Court also used economic analysis when addressing the question of the right to a refund for unconstitutional taxes when it "struck down an exemption for locally produced alcoholic beverages from an excise tax on the wholesale sale of liquors" that gave advantages to local business and thus "discriminated against interstate commerce."[296]

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285. *See* A.O. Smith Corp. v. United States, 619 F.2d 1220 (7th Cir. 1982).

286. *See* Cohen, *supra* note 280, at 1146.

287. *See* A.O. Smith Corp., 619 F.2d at 1220.

288. *See* Walter Hellerstein, *Selected Issues in State Business Taxation,* 39 VAND. L. REV. 1033, 1041 (1986).

289. *Id.* at 1042-45. *See also* Brief for Appellants at 8, Commonwealth Edison Co. v. Montana, 453 U.S. 609 (1981); Brief for Robert W. Edgar as Amici Curiae Supporting Appellees, at 2, Commonwealth Edison Co. v. Montana 453 U.S. at 609 (1981).

290. Commonwealth Edison Co. v. Montana, 453 U.S. 609 (1981).

291. U.S. CONST. art. I, § 8, cl.3.

292. Hellerstein, *supra* note 288, at 1048.

293. *Id.* at 1049. *See also* Washington v. United States*,* 460 U.S. 536 (1983).

294. U.S. CONST. art. VI, cl.2. *See also* Washington v. United States, 460 U.S. 536 (1983). *See also* Kern-Limerick, Inc. v. Scurlock, 347 U.S. 110 (1954); Alabama v. King & Boozer, 314 U.S. 1 (1941).

295. *See* United States v. City of Detroit 355 U.S. 466 (1958). *See also* United States v. County of Fresno*,* 429 U.S. 452 (1977).

296. Hellerstein, *supra* note 288, at 1053. *See* Bacchus Imps., Ltd. v. Dias*,* 468 U.S. 263 (1984).

Another type of economic analysis applicable to a BAT challenge would be on the basis of regional discrimination. However, such discrimination would need to be proven (which would be difficult). Judge Posner has stated, "the Constitution has to make provision for preventing the federal system from degenerating into a loose confederation, riddled with externalities"; nonetheless,[297] it is uncertain at this point if the BAT would present this problem. Even Posner himself has stated that judges should not use economics in all constitutional cases.[298] There is a tension between the principles of *stare decisis*[299] and economic analysis.[300] For example, O'Hara and Dougan note that discriminatory taxes will redistribute wealth, but that wealth redistribution alone is not a basis for a tax to be unconstitutional.[301] The BAT would be a form of wealth transfer that operates "regardless of initial endowments,"[302] and while there is an argument that the "indirect transfer" nature of its operation is less efficient than other redistribution methods,[303] this seems to be a question of economics rather than law.

C. *The Case Against Economic Analysis on BAT Constitutionality*

Laurence Tribe has argued strongly against judicial reasoning by way of economic analysis.[304] He argues that this form of reasoning is just an "accountability-avoiding device"[305] and that the courts should not "discern the values implicit in the text" of the Constitution[306] because this practice promotes adjudicating by politics rather than law.[307] Jonathan Macey has also noted that despite "massive attention" given to economic analysis in the law, it has had little effect on the actual outcomes of cases. Accordingly, Macey notes that "traditional common-law reasoning" is more efficient and is not "appreciably different" from economic reason-

297. *Posner Constitution*, *supra* note 7, at 28.

298. *Id*. at 31.

299. *See* Thomas R. Lee, *Stare Decisis in Economic Perspective: An Economic Analysis of the Supreme Court's Doctrine of Precedent,* 78 N.C. L. REV. 643 (2000).

300. *See Posner Constitution*, *supra* note 7, at 36-37

301. *See* O'Hara & Dougan, *supra* note 246, at 869. *See also* discussion at 894, ("American courts have never categorically prohibited discriminatory taxes. Instead, the Supreme Court has taken the position that legislatures can break individuals into classes for separate tax treatment so long as the classification is 'based upon some reasonable ground' and is 'not a mere arbitrary selection.' "). *See also* Magoun v. Ill. Tr. & Sav. Bank, 170 U.S. 283, 294 (1898); Allegheny Pittsburgh Coal Co. v. Cty. Comm'n, 488 U.S. 336, 344 (1989); State Bd. of Tax Comm'rs v. Jackson, 283 U.S. 527, 537 (1931).

302. O'Hara & Dougan, *supra* note 246, at 887.

303. *See id*.

304. Laurence H. Tribe, *Constitutional Calculus: Equal Justice or Economic Efficiency,* 98 HARV. L. REV. 592 (1985).

305. *Id.* at 620.

306. *Id.* at 619.

307. *Id.*

ing.[308] Further, it has been suggested by George M. Cohen that even Judge Posner himself has applied economic reasoning "selectively and incompletely," more in line with his political leanings than as a "cautious and conscientious application."[309]

The use of economic analysis in judicial reasoning usually centers on contractual disputes[310] and the question of the efficient allocation of resources: in tort cases (e.g. the famous Hand Formula),[311] in antitrust law, or in property rights.[312] Alternatively, Macey notes that it is not as obvious in cases of criminal law.[313] Similarly, Yorio states that economics is infrequently applied in tax law analysis.[314]

A study by Larry L. Chubb on the first three hundred published opinions by Judge Posner revealed that while in theory Judge Posner has explained almost all areas of law via economic theory, his opinions, up to the point of the study, relied on economic analysis in only a small number of cases.[315] These cases primarily involved either common law cases, matters involving economic market regulation, or questions of constitutional rights and federalism.[316] Further, Chubb notes that economic analysis was not frequently used by Posner in tax law or public welfare cases.[317]

In contrast, a subsequent study on Judge Posner's tax opinions, conducted by Adam Chodorow, provides "a rich and substantial body of material through which to study economic analysis as a tool available for judges in deciding cases."[318] In the study, Chodorow states that Judge Posner utilized four methods of economic analysis in his tax cases:

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308. Jonathan R. Macey, *The Pervasive Influence of Economic Analysis on Legal Decisionmaking,* 17 HARV. J. L. & PUB. POL'Y 107, 107 (1994).

309. Cohen, *supra* note 280, at 1117-18.

310. *See* Bach v. Long Island Jewish Hosp., 267 N.Y.S.2d 289 (Sup. Ct., Nassau County, 1966).

311. *See* United States v. Carroll Towing Co., 159 F.2d 169 (2d Cir. 1947).

312. *See* Fountainbleau Hotel Corp. v. Forty-five Twenty-five Inc., 114 So.2d 357 (Fla. Dist. Ct. App. 1959).

313. *See* Macey, *supra* note 308, at 110.

314. *See* Yorio, *supra* note 140.

315. *See* Chubb, *supra* note 273, at 791, ("The use of economic analysis occurred, on average, in approximately eight percent of Posner's first 300 opinions. The use of economic explanation appeared in an average of 18 percent of his opinions. The use of economic precedent was very rare, accounting for an average of three percent of Posner's opinions. Finally, the majority of Posner's opinions used no economic analysis. The no economic analysis category represents on average approximately seventy-one percent of Posner's opinions. Therefore, at the outset of this section, it can be concluded that Posner has used economic analysis in less than ten percent of his opinions or at most between ten and twenty-six percent if the economic explanation category is considered.").

316. *See id*. at 792-94.

317. *See id*. at 792-93.

318. *See* Adam Chodorow, *Economic Analysis in Judicial Decision Making – An Assessment Based on Judge Posner's Tax Decisions,* 25 VA. TAX REV. 67, 70 (2006).

> [T]he first is as a tool to draw inferences from evidence. Second, he uses economic analysis to help construe ambiguous statutes. Third, he uses such analysis to help him determine whether a transaction has economic substance, such that the Internal Revenue Service ("Service") should respect the form of the transaction. Finally, Judge Posner has promoted the use of economics-based tests as efficient, especially in comparison to more traditional multifactor tests, because it curtails judicial discretion, reduces uncertainty, and signals to potential litigants the likely outcome of any litigation.[319]

This gives support to the application of economic analysis to the BAT constitutionality determination; however, one would need to first see the specific legislation in question for a complete analysis.

Macey argues that economic analysis is not really that helpful in cases of "value judgment."[320] This argument is in line with Anthony D'Amato's position—in light of cases wrongly decided on the basis of economic analysis—that perhaps law and economics are not "descriptive" but rather "normative." D'Amoto ponders that if this fact is the case, then what values support the analysis at all.[321] Further, the lack of a "compelling normative justification" with respect to economic analysis causes this theory to lead to greater uncertainty, making it less likely to be adopted by the Court.[322] Furthermore, one could argue that a protectionist tax policy like the BAT is a value judgment on behalf of the government, and it is not the role of the courts to make such a judgment. It could also be as Laurence Tribe aptly notes, "Treating a constitutional court's task as merely one of toting up marginal costs and benefits also ignores the crucial questions of what counts as a cost or a benefit – and who gets to decide that issue?"[323] Another problem that Macey points out when using law and economics is that that judges would need to know a wide range of economic theories in order to decide cases.[324]

Conclusion

There was an initial period of uncertainty as to what Trump's tax reforms would look like when formal legislation was ultimately intro-

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319. *Id.* at 70-71.

320. Macey, *supra* note 308, at 114.

321. Anthony D'Amato, *Legal Uncertainty,* 71 Cal. L. Rev. 1, 43-44. (1983).

322. *Id.* at 45.

323. Tribe, *supra* note 304, at 595.

324. Macey, *supra* note 308, at 116 ("By contrast, if judges attempted to decide cases using economic analysis, they would have to familiarize themselves with an astonishing number of highly specialized disciplines in addition to basic microeconomics. These additional specialties include econometrics, corporate finance, labor economics, industrial organization, and public choice, to name a few.").

duced.[325] This led to some frustration,[326] and even questions of whether the changes would take the form of "tax relief" or merely "tax reform."[327] Some even believed that Trump's proposals were merely "rhetoric."[328] However, on December 20, 2017, despite a myriad of last minute changes and partisan resistance, the Trump administration achieved what some consider a "major victory" by obtaining Congressional approval on its $1.5 trillion tax reform bill.[329] The final tax bill introduced significant changes to the ways that businesses and corporations are taxed, including, among other things, corporate rate cuts, deduction pass throughs, a repeal of the AMT, establishing a corporate territorial system, implementing a "one-time mandatory" repatriation tax, and changing the rules governing capital expenses (allowing large capital investment expenses as immediate write offs), interest deduction limits, carried interest, clean energy credits, and anti-base erosion measures.[330]

This Article presented several economic theories, including the Modigliani-Miller Irrelevance Theorem, and corresponding empirical evidence to show how firms will adapt their policies and change their behaviors in light of new tax measures. It also showed how such observations could be expected to materialize in the case of the tax reforms at issue; particularly, the corporate rate cut changes, the changes to interest deductibility rules, and the capital expense amortization and repatriation mechanisms. As a result, Trump's tax reforms,[331] while purporting to encourage positive growth for the economy and enhancing business transactions,[332] may in fact lead to unintended or irrelevant consequences.

Ultimately, the border adjustment component of Trump's initial tax reform proposal was left out of the final tax reform bill. Nevertheless, if this policy were to be revived in the future there is a question of whether it

325. Howard Gleckman, *Trump May Have Killed The House GOP's Business Tax Reform*, Forbes (Jan. 17, 2017), http://www.forbes.com/sites/beltway/2017/01/17/trump-may-have-killed-the-house-gops-business-tax-reform/#2d3cf40b66c2.

326. Jake Novak, *Impatience over Trump Tax Cuts is Growing,* CNBC (Feb. 2, 2017), http://www.cnbc.com/2017/02/02/mr-president-where-are-the-tax-cuts.html.

327. Howard Gleckman, *Bye-Bye, Tax Reform; Hello, Tax Relief,* Forbes (Jan. 25, 2017), http://www.forbes.com/sites/beltway/2017/01/25/bye-bye-tax-reform-hello-tax-relief/#60eb911e5154.

328. Stuart Gibson, *Tax Reform: The Devil You Know*, Forbes (Jan. 13, 2017), http://www.forbes.com/sites/taxanalysts/2017/01/13/tax-reform-the-devil-you-know/#4e040c8a1f8a.

329. Michael C. Bender, Janet Hook & Richard Rubin, *Trump Cheers GOP Tax Overhaul, Slams Democrats Who Opposed It,* Wall St. Journal (December 20, 2017), https://www.wsj.com/articles/trump-cheers-gop-tax-overhaul-slams-democrats-who-opposed-it-1513795294.

330. *See* Reuters, *supra* note 33.

331. *See* Jacob Pramuk, *Paul Ryan: We Can't Start on Tax Reform and Infrastructure Until Spring,* CNBC (Feb. 2, 2017), http://www.cnbc.com/2017/02/02/paul-ryan-we-cant-start-on-tax-reform-and-infrastructure-until-spring.html.

332. Anita Balakrishnan, *Trump Tax Reform Should Lead to More M&A, Says Cisco CEO Chuck Robbins,* CNBC (Jan. 25, 2017), http://www.cnbc.com/2017/01/25/cisco-ceo-chuck-robbins-trump-tax-reform-good-for-business.html.

would be constitutionally valid. Overturning the BAT on constitutional grounds, however, would face a significant uphill battle and would be unlikely since Congress has wide latitude in authorizing new tax policies and successful constitutional challenges are rare in the tax arena. A successful challenge would require proving that the BAT is not a "tax on income" and that it is an unconstitutional "direct tax" unapportioned among the several states. Both aspects face significant opposition in terms of academic thought, constitutional interpretation of Framer's intent, and case law. Similarly, history does not favor a successful challenge to the BAT given Congress' past actions: limiting deductions, instituting protectionist measures, and enacting discriminatory tax laws; these actions were not overturned by the court.

The Article also addressed the issue of whether economic analysis could be used in assessing the constitutionality of certain tax reform (such as the BAT). The use of economics in judicial analysis is controversial and is not widespread in matters dealing with value judgments (which arguably includes tax policy). There is also not a discernible heuristic from case law to govern when economic analysis should be applied in a given case. Courts, in matters of tax litigation, have nonetheless used economic analysis in the past—particularly Judge Posner. A potential application of economic analysis on tax reform measures is through a "public interest theory"[333] (the adverse impact on consumers from the reform offsetting the potential revenue gains) or through a notable negative impact the reform may have on a particular region. Both applications, however, require significant data, which is potentially difficult to obtain, in order to prove their viability.

333. *See Posner Economics*, *supra* note 6, at 265.