INTERVIEW WITH
CHARLES I. KINGSON

*by Jasper L. Cummings, Jr. and Alan J.J. Swirski**

CHARLES I. KINGSON

INTRODUCTION: Charles Kingson currently is an adjunct professor of law at New York University School of Law and a lecturer at the University of Pennsylvania Law School. He is a long-time practitioner who has frequently written about the most difficult issues in the tax law.

Q You practiced for many years at Willkie Farr & Gallagher, beginning in 1969. What are the major changes you have seen in the practice of tax law since then?

A In 1969 everything was simpler. The Code was so much shorter that people could understand most of it, and they would carry the thinking of one area of tax law into the others. The way research was done reinforced this. Flipping through pages of the CCH Standard Federal Tax Service would reveal a lot of connections you will not make by asking a computer for materials that mention rupee currency swaps.

That broad approach, looking at the Code as a whole, fostered common standards of analysis not only by individuals but also—more importantly—among firms. One purpose of tax discussion groups was to learn the framework that other law firms used. They shared my views of what was acceptable, and I think implicitly reinforced them.

In that atmosphere, even skirting penalties was out of the question and in fact somewhat shameful. I remember a public corporation's asking me to forestall a really deserved negligence penalty. I did it by giving away deficiency after inane deficiency, until the agent was ecstatic. The company, more concerned about its reputation, thanked me. I doubt that would happen today.

Another difference was that there was less money on the table. That fact led more able people to choose the Service as a career, legends whose thinking matched that of the top firms. A corollary was that lawyers who went into tax at those firms did so because of their turn of mind, not because they thought of it as the road to riches or power. As a result, both government and non-government practitioners thought of themselves primarily as upholding the tax system. A person would not crow about peddling secret interpretations that preyed on it.

To a significant degree I think this still obtains. The best people, a vast majority, have that attitude today. But their consensus has not been able to hold. Both the money at stake and the materials that proliferated under the Freedom of Information Act have caused things to get out of hand. In the 1970s, Professor Robert Hellawell wrote a joking article in the *Tax Law Review* about 2039. He foresaw the Code as twenty volumes, with one-fifth of the populace engaged in interpreting it, and whole journals devoted to a single section. It is 2006, and a practitioner's Code and regulations weigh nearly 20 pounds; he or she and their counterparts at the Service know less and less outside narrow areas; and in my experience a couple of specialists had not heard of, let alone read, cases like *Court Holding*. Instead, they invent transactions based on exegesis of some private ruling or technical advice memorandum.

Much blame for this situation attaches to promoters, who have made the term aggressive synonymous with sleazy. But it also rests to a significant degree with the judiciary. The Supreme Court, which—with the honorable exception of Justice Scalia, appears to regard tax cases as foisted on clerks not smart enough to get out of the way—has three times held that risk does not determine who owns property. The clearest example is *Frank Lyon*, which validated the decision of Jerry Reinsdorf, an agent in Chicago auditing real estate transactions, to quit; to market them himself; and to legitimately make enough money to buy the Bulls and White Sox.

For the old consensus, we have substituted the anomaly of teaching lawyers ethics. But ethics rest on shared standards, which we have largely lost. *ACM* and *Compaq* and *IES* and *Frank Lyon*—basically the same case, repurchase agreements—were decided on incoherent and inconsistent grounds. (Judge McKee's dissent is a masterly critique of the *ACM* rationale.) More recently, though, Judge Leval in *Castle Harbour* went through the taxpayer's enormous misleading documentation to strip away the pretense of equity

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and focus on the repurchase agreement that made the transaction (like those in the other cases) a loan.

Q You have focused particularly on international taxation. In 1981, you wrote in the *Columbia Law Review* that the United States was able to afford abuse of its international tax rules after World War II because the country was so wealthy. You saw the U.S. as less able to afford such abuse in the early 1980s, leading you to recommend that we adopt rules more to protect our interests as opposed to relying on international "norms" that might not be followed by other countries also pursuing their own interests. Compare today with 1981 in this regard.

A My 1981 article said that both foreign owners of U.S. businesses and U.S. owners of foreign businesses were eroding our corporate tax base by deductions. Foreign owners did this by interest deductions on excessive debt and by taking advantage of third country treaties. We have largely dealt with that, although not perfectly, in the anti-earning-stripping sections and by limiting the benefit of using third country treaties.

For U.S. owners of foreign businesses, there were two aspects. I said that because countries in the European Union and Canada discriminatorily overtaxed U.S. businesses abroad, we compensated by undertaxing their domestic earnings. We did this by allocating too many deductions to domestic income under the then 861 regulations. Thanks to Steve Shay, the 1986 Act largely fixed that by section 864(e). Even though the European Union is still discriminating against U.S.-owned businesses (by giving deductions rather than credits to local owners), the issue has abated as the European Union itself has had to prohibit tax discrimination among member states.

But what has really changed is the world's economy. In 1981, U.S.-owned business abroad consisted of heavy industry in high-tax countries that discriminated against it. Now it is not the GMs going abroad with plant and equipment, but the Pfizers and Microsofts going abroad with intangible wealth. When your assets are patents and know-how, you can manufacture in low- tax countries like Ireland and Singapore. German and British and Canadian and French discrimination against U.S.-owned heavy industry becomes relatively less important (although of course not to them); and those countries, like the U.S., have been lowering their corporate tax rates to compete.

Q Currently proponents of a "territorial system," that would exempt from U.S. taxation business income earned abroad, have become quite vocal. Subject to some exceptions that might be built into such a system, such a change would largely obsolete the Subpart F and foreign tax credit rules that have so long been the focal points of U.S. international taxation. How do you feel about a shift to territoriality?

A We tried territoriality—the exemption of profits earned abroad—in Puerto Rico. It was a fiasco, and we have repealed it. It didn't work because U.S. companies could transfer intangibles to companies operating in Puerto Rico that were exempt from U.S. tax. At one time, pharmaceutical corporations were saving $100,000 in U.S. tax for every Puerto Rican employee that they employed, at an average wage of $15,000. Exemption does not work when it primarily encourages moving intangibles into low-tax jurisdictions.

More germane, we've got the exemption or territorial system right now. High-tech companies repatriate high-taxed earnings, and high foreign tax credits eliminate U.S. tax not only on those earnings, but also exempt from U.S. tax one-half their income from U.S. exports. When the foreign earnings are low-taxed, the high-tech companies accumulate them abroad until they're exempted from U.S. tax by section 965.

Q You recently wrote about The Great American Jobs Act Caper (i.e., the 2004 Tax Act). You see it as the first major U.S. tax act to *encourage* exportation of jobs abroad. You identify the encouragers as (1) the "one time" permission to repatriate deferred income at low tax rates that you referred to above, and (2) the enhancement of the ability to cross-credit foreign tax against domestic income through the elimination of the "baskets." Do you see this as a part of a larger trend toward territoriality?

A Yes. I think that the high tech companies have really pulled off the hat trick.

First, they beat the intercompany pricing rules. They have been able, despite all the work on 482 and 367, to transfer intangibles to Ireland and Singapore after we stopped the advantage of transferring them to purportedly create jobs in Puerto Rico. Next, those companies beat back the PFIC rules, which would have stopped them from investing the income from those intangibles in non-productive portfolio assets abroad without incurring U.S. tax. Before 1998, once more than 50% of a foreign subsidiary's assets were bank deposits and bonds, all the income of that subsidiary from then on would in effect be taxed currently by the U.S. But in 1997, the PFIC rules were changed to exempt income of a foreign subsidiary. Subsidiaries of high-tech companies could therefore keep their intangibles profits abroad in passive assets. Notice that they didn't use them to compete, which is the justification for encouraging low-taxed profits abroad.

By 2002, the high-tech companies were beginning to say, although not in these words, that "We need this money that we siphoned abroad to recreate U.S. jobs." Under that rationale, the 2004 Jobs Creation Act allowed them to replace the money they had paid

out in dividends by bringing their foreign bank deposits back to the U.S. tax-free.

In short, by taking advantage of the U.S. tax system: outfoxing intercompany pricing rules; justifying the accumulation of bank deposits abroad in the name of tax simplicity; and claiming that those bank deposits would replace lost jobs, companies have succeeded in exempting U.S. profits from U.S. tax. As to the "one-time" permission to repatriate you mentioned, any teenager knows what just this once means.

I think this has been one of the most brilliant, farsighted and ingenious rip-offs of the U.S. tax base ever accomplished. To counter it, the article suggests that foreign tax credits—like deductions—be allocated fungibly among repatriated and unrepatriated foreign earnings. It also suggests reinstating the PFIC rules for foreign subsidiaries.

Q You were an early opponent of the VAT (1973 *Cornell Law Review* article). Now Michael Graetz is advocating adoption of a credit method VAT for reasons such as the climbing cost of government, particularly social programs, and the deficit. What are your current feelings about the VAT?

A I was very much against VAT. I won't go into economic arguments like regressivity, but rather mention three issues I think are not sufficiently addressed. First, newspapers talk about the importance of consumer confidence. Proponents of VAT should deal with how it might affect consumer confidence and spending. Second, VAT is not simple—you have to make a lot of political and technical decisions. It's clear to me that you're not going to tax cancer care at the same rate as you do Gulfstream jets or Prada, so significant political questions must be answered in fashioning a VAT. Similarly, as a technical issue, if VAT is a tax on consumption, you should determine when a product is consumed. If someone buys a tractor or builds a factory and consumes it over 10, 20, or 30 years, should he pay tax for those periods right away or at a discounted rate? The choice again becomes fairness or complexity.

Finally, there is the very real problem of transition rules. If you say to a 25-year old that he's going to pay VAT instead of income tax, his savings at retirement will not have been taxed. When he spends those savings in retirement, they will have been taxed once, by VAT. But the retirement savings of a 65-year old or even of baby boomers have already been subjected to income tax. If we impose VAT when those savings are spent in retirement, older people's savings will have been taxed twice. This issue, hanging over any VAT, has been swept under the table.

Q In your 1976 *Yale Law Journal* article on "The Deep Structure of Taxation: Dividend Distributions," you argued that *Waterman Steamship Corp. v. Comm'r*, 430 F.2d 1185 (5th Cir. 1970) was wrongly decided. It ruled that a pre-stock-sale dividend to a corporate shareholder was part of the stock sale price because the stock buyer indirectly funded the "dividend." You argued that the taxation of corporate distributions should largely rely on form. Have events of the "tax shelter" years changed your views?

A Subchapter C uses form to deny that economic change has occurred—to pretend that after the merger of AOL and Time Warner things remain the same. At the same time, it has made taxability depend on such minute irrelevancies as who is primarily liable for an acquisition expense or whether Procter & Gamble puts the grocery store it acquired into a subsidiary.

Even by its terms, subchapter C stresses form. Its provisions contain eight or nine types of acquisitions, each with its own arcane and meaningless rules: whether a merger is pursuant to a state statute; which charter survives; whether you merge upwards or downwards can all determine tax consequences. Similarly, a stock purchase can be treated as an asset purchase by filing an election, and loss can be elected on liquidation of a subsidiary by selling some stock to a friend.

One case in subchapter C that made sense to me in rejecting form was *Bausch & Lomb*. The Second Circuit disregarded a circular flow of parent stock to and from its 79%-owned subsidiary. But the Service's regulations now disregard that case; and although circular flows of cash are not given effect, those of stock are. In a *Waterman*-type situation, where distribution of property by a subsidiary as a dividend or in redemption of stock makes a tax but not an economic difference, there seemed no reason to disregard form in the name of substance; and I think that's pretty much the law today.

As to your implied comparison with tax shelters, they flourish because cases like *Clay Brown*, *Frank Lyon* and *Cottage Savings*—despite their vigorous language about substance—let form prevail. In *Cottage Savings* (argued for the government by John Roberts), it is fitting that Justice Marshall's opinion relied on cases like *Marr*, which held that the constitutional ability to tax a reincorporation depended on whether the company became chartered in the same or a different state. In *ACM*, Judge McKee rightly suggested that if the *Cottage Savings* exchange had economic substance, just about any transaction does.

Q Offshore tax havens utilizing "asset protection trusts" have been under scrutiny by the Senate recently. Is this just another iteration of tax avoidance or does it reflect some more fundamental problem with taxing in the current day which could bear on whether an income tax is still viable?

A People cheat on their taxes in any system. They smuggle cigarettes into New York and liquor into Canada.

The fascinating thing to me about these asset protection trusts recently in the news is that they were evading a 15% tax. I thought if the tax rate was low enough, you wouldn't risk jail.

You don't scrap a tax system or marriage because people cheat. One time a lawyer in Switzerland called me. His client had cheated on his U.S. taxes and had a considerable amount of money. (Assets grow much faster without tax, he told me.) The cheater was in his 60's however, and the lawyer didn't know what the executor would do. I couldn't help him. People who cheat eventually have to have an executor, and he's not likely to go to jail for you.

Q What would be your best semi-attainable recipe for fundamental tax reform?

A I have thought about the concept of "fundamental" tax reform and conclude that you can't reform the fundamentals: who owns the income; is it for services or from the transfer of property; where is it earned; what costs do you allocate against it, etc. We've spent close to a hundred years studying these issues, and a new system shouldn't really throw all that out. What new system, its hour come round at last, will not need to encounter its own *Gregory, Horst, Frank Lyon* and the rest? A new system also upsets the economic expectations of those who relied on the tax advantages of home mortgage interest, municipal finance, and retirement plans.

When people say they want fundamental tax reform, they generally mean they want to shift the burden to other people.

My own ideas for reform are more modest. I'd like to see hedge fund managers pay tax at ordinary income rather than capital gain rates. Similarly, 60 to 70% of the NYSE is owned by persons exempt from capital gains tax; and the big advantage of capital gains isn't so much the rate as it is deferral. Therefore I think we should mark-to-market publicly traded securities every five years, as the Canadian Carter Commission recommended in the 1960's, or impose an interest charge. Since most of the shareholders are exempt from capital gains tax anyway, that isn't going to kill the market.

I would stop the erosion of the corporate tax base by high yield debt, which in terms of risk and reward is really equity, and make ownership of property determined by risk and reward. The corporate tax base is also being eroded by spinoffs. An investment banker once asked me (when I explained to him *Morris Trust*), "You mean I can sell a division tax-free and then distribute the proceeds tax-free?" This gets it just right; and we should stop the still-prevalent use of spinoffs to avoid corporate tax on the sale of what are economically divisions.

When people say they want fundamental tax reform, they generally mean they want to shift the burden to other people. Sidney Roberts used to say that you could tell someone's attitude on almost any tax issue by asking how he felt about progressive taxation. My classes are amazed when I tell them that for many years the top individual tax rate hovered around 90%, and that during his campaign for the presidential nomination George McGovern proposed a maximum estate tax rate of 100%. Now the proposed rate is 100 points less, and no one conceives of tax rates that were once taken for granted. But the pendulum can swing too far. Policymakers who keep talking about the death tax and the family farm should consider the annual French net wealth tax, and they should also be required to live for a year on that single farm.

Thank you for a great set of questions. ■

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