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Taxes, Agency Costs, and the Price of Incorporation

Saul Levmore

Hideki Kanda

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TAXES, AGENCY COSTS, AND THE PRICE OF INCORPORATION

Hideki Kanda and Saul Levmore***

INTRODUCTION

A large part of tax practice and theory deals with the questions of why and when different entities, or legal forms of organization, are subject to different tax rules. Central to these rules is the decision either to tax an entity, such as a corporation, partnership, or trust, on its income, and then also to tax those who receive distributions from the entity, or instead to integrate the entity and its beneficiaries so that only one tax is paid. By and large the tax policy literature has favored some form of integration and has been hostile to the separate tax levied on corporate profits. Nevertheless, the distinct tax on corporations has survived and, indeed, it has been strengthened in recent years.[1] In turn, tax practice and legislation have focused on the ability of investors to choose between singly and doubly taxed forms of

* Associate Professor of Law, University of Tokyo.

** Visiting Professor, Harvard Law School; Barron F. Black Research Professor of Law, University of Virginia.

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[1] The erosion and eventual statutory repeal, in the Tax Reform Act of 1986, of the *General Utilities* rule, which had excused corporations from recognizing gain on the appreciation of assets that were distributed to shareholders or sold to outsiders, ensures that both earnings and asset appreciation will be taxed at the corporate level. See General Utils. & Operating Co. v.

organization. Investors might voluntarily submit to a two-tier tax, both because the corporate form of organization is thought sufficiently valuable so that any extra tax is worth its cost and because the two taxes may be levied at rates and times that make the overall tax bill palatable or even preferable. Thus, if the tax rate on corporate earnings is lower than the individual rate, and if distributions, such as dividends out of these earnings, are postponed and taxed to shareholders only years after these earnings, two taxes may prove cheaper than one. Legislators can be expected to pass rules ensuring that the second tax is indeed collected and making it difficult for anyone who chooses this two-tier treatment to retain earnings profitably. If tax rates or firms' distribution policies are such that two taxes are more expensive than one, investors will gravitate toward partnerships, or other singly taxed forms, and tax collectors can be expected to force some business arrangements to submit to two-tier taxation. Contemporary discussion and legislation concerning "master limited partnerships," or large unincorporated enterprises with numerous passive partners whose "shares" are traded on an exchange, is one obvious manifestation of this instinct to restrain the ability of investors to choose between one and two-tier taxation. Another is the debate over the amount of debt taken on by corporate firms, and the suggestion that there be some limit on tax deductions for interest expenses. Such deductions obviously go a long way toward permitting a corporation to reduce its tax liability and to "escape" two-tier taxation.

In this Article we focus on the two questions that dominate this complicated area in which investors are motivated to choose one form of organization or another: To what extent can taxpayers choose one or two-tier taxation? And, more fundamentally, why are corporations separately taxed? In Part I we offer a descriptive, structural framework with which to understand the choice available to taxpayers. Our theme in this Part may not surprise tax lawyers because it is one that percolates in various areas of tax law. The suggestion is that those who can control the timing of their taxable events are taxed more heavily than those who cannot. Investors can choose the form of organization they please, but the more the form permits control

Helvering, 296 U.S. 200 (1935); I.R.C. §§ 311(b), 336(a) (1986). The *General Utilities* rule is discussed infra text accompanying notes 59-61.

All references to "the Code" in this Article will be to the Internal Revenue Code of 1986, as amended, 26 U.S.C. [I.R.C.] §§ 1-9602 (1988).

over such matters as distributions, the more likely it is that two taxes will be exacted. This structural theme offers a way of thinking about the taxation of entities, including corporations, partnerships, and trusts, and about the disparate treatment of dividends, stock dividends, and debt.

In Part II we suggest that the separate tax on corporations may offer a remarkable means of minimizing a firm's agency costs. The central idea is that the separate tax on corporations "equalizes" shareholders' preferences for corporate transactions even though shareholders are in diverse individual tax circumstances. Our argument suggests that the two-tier tax plays an important organizational role and that the choice among tax treatments may in large part be one about agency problems and their solution. The corporate tax is interpreted as a substitute for contractual constraints on the agents of a firm. The analysis is both positive, in its suggestion that the tax system may reflect agency cost considerations, and normative, both because it offers a defense of the (much maligned) two-tier tax and because it has implications for reform proposals such as those involving the treatment of debt and the vertical integration of the tax system.

Finally, in Part III we combine the control and agency cost themes in order to understand the tax treatment of distinctive entities, some of which are favored with "pass through," or single tax, treatment even though they are organized in corporate form. The discussion touches on mutual funds, Real Estate Investment Trusts, Master Limited Partnerships, and other fashionable intermediaries. In the end, it is our view that current tax rules (both in the United States and elsewhere) are far more justifiable than is generally thought. At the same time, we suggest new arguments and avenues of reform.

I. Choice and Control

Two of the most important aspects of business planning are the decisions about organizational form and about sources of capital. Both decisions are greatly—but not exclusively—influenced by prevailing tax rules. Indeed, the volume of literature on the tax aspects of these matters probably exceeds that dealing with the "real," or organizational, attributes of the available alternatives.

A. Incorporation and Two-Tier Taxation

The decision regarding the form in which business is to be done can be thought of as a conjecture about future legislation and intentions both because the best choice for a given enterprise is likely to depend on future tax rates and on owners' desires for distributions of earnings, and because the choice of form, while not irreversible, is likely to be most inexpensively done at the outset rather than in midstream. The tax terms of this most important choice as to form are familiar. Setting aside (temporarily) the most recent, abnormal (inversion of) corporate and individual rates, investors choosing the corporate route have historically faced a corporate tax on earnings that is a bargain compared to the rate applicable to the same earnings of a solė proprietor or partnership.[2] When the corporation distributes (after-tax) profits to these investors, however, there is a second tax because dividends are income to the recipients and are not deductible to the distributing corporation. As every businessperson and law student quickly learns, however, this two-tier tax may turn out to be less onerous than a single tax. If the corporate rate is lower than the individual rate, and the distribution to shareholders is delayed beyond the year in which money is earned, then it is plain that two taxes may be cheaper than one; the present value of the second, deferred tax may become sufficiently small that it and the corporate tax together do not match the bite of an immediate tax at (higher) individual rates.[3] Moreover, these deferred distributions may come in the form of stock redemp-

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[2] Ignoring a 5% surtax that phases out the advantages of personal exceptions and lower tax brackets, the highest corporate tax rate is now 34% and the highest individual rate is now 28% (31% in 1991). These rates are "inverted" in the sense that over the previous 50 years the top corporate rate has generally been substantially lower than the highest individual rate. See B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 5.01 (5th ed. 1987); J. Eustice, J. Kuntz, C. Lewis & T. Deering, The Tax Reform Act of 1986: Analysis and Commentary ¶ 2.02 (1987) (discussing history of corporate tax rates). The discussion in the text focuses on the "normal" situation in which the corporate rate is lower than the individual rate (and, therefore, the partnership rate, because partnership income is taxed on a pass-through basis to the individual partners) both because the current inverted rates are so unusual and because there is reason to think that the inversion will be short-lived. With inverted rates, entrepreneurs will abandon the corporate form with its higher rates and Congress can be expected to recapture a second tax on such businesses by making the corporate form less expensive.

[3] Note that taxpayers may prefer one-tier, pass-through taxation because they expect losses in the near term and wish to recognize those losses at the level of investor taxation. If a corporation incurs losses, shareholders must await exchange treatment on their shares (or

tions or in the eventual liquidation of the firm, in which case the second tax, paid by distributees, may also be one that is assessed at lower rates than the taxes on dividends, proprietorship, or partnership earnings.

Technically speaking, the choice between one- and two-tier taxation involves more than a calculation of rate differentials and the expected period of deferral. Gain on appreciated property that is in corporate form may also be taxed twice; once when the corporation disposes of the property in question and again when shareholders sell their stock—which will have risen in value because of the (after-tax value of the) appreciation that has taken place in the corporation. Similarly, retained corporate earnings will be taxed not only upon eventual distribution but also, to a degree, when shareholders sell stock that has appreciated in their hands because their corporation has retained earnings.[4]

These complexities alter the details but not the essential fact of the traditional tradeoff. Incorporated businesses (not electing Subchapter S) are subject to an extra tax, but proprietors and would-be partners may prefer the corporate form for its tax advantages when the following conditions exist: the corporate tax rate is lower than shareholders' individual rates; distributions from the corporation to its shareholders can be deferred; and shareholders' sales of appreciated stock can be delayed. By contrast, sole proprietors, or pass-through entities such as partnerships, are taxed each year on the profits of the enterprise—at the relevant individual rates and regardless of their distribution policies.

This familiar tradeoff displays the essential characteristics of the "choice and control" theme that we seek to advance. Partners have limited control over the timing of their taxes, while shareholders of a corporation, by managing the timing of dividends and other payouts,

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liquidation of loss assets themselves) in order to receive individual tax benefits. The discussion in the text simplifies the development of its theme by considering only profits and not losses.

Setting aside possible tax advantages inherent in a one-tier system when losses are incurred, there are many tax advantages available to the corporate form not available to individuals or partnerships. These advantages arise chiefly from the fact that corporate shareholders may also be employees of the corporation, whereas individuals or partners are self-employed. Tax benefits extended under the corporate form may be nontaxable or deferred compensation. See Strecker, When Will the Corporate Form Save Taxes?, 18 Vand. L. Rev. 1695, 1704-25 (1965).

4 McLure, Integration of the Personal and Corporate Income Taxes: The Missing Element in Recent Tax Reform Proposals, 88 Harv. L. Rev. 532, 537 (1975).

do have control over the timing of the individual, or second, tax they pay. One might say that entrepreneurs and investors can, at the outset, choose between the one-tier and two-tier alternatives, that the two-tier regime may be a profitable gamble because one of its taxes can be postponed, but that the cost of this power to postpone or to control taxation is the extra tax—which may in the end prove more rather than less expensive. Control over timing comes at the price of an extra tax. To choose the option with more control is to choose the gamble of the two-tier tax.

Before continuing this examination of the connection between extra taxes and control over timing, it is useful to define control more carefully. All taxpayers have some dominion over the timing of their taxes because tax systems await recognition events and, more fundamentally, tax income and not expected and unrealized income. Partners or proprietors who wish to pay tax next year rather than in the present year might defer the sale of appreciated assets, rush the disposition of depreciated assets, undertake maintenance tasks (and their expense) that might normally have been done in the future, raise prices and delay sales, and take myriad other steps to control the timing of income—and therefore the timing of their own, individual (pass-through) taxation. Corporations can also control the timing of taxes in this way. But when we say that control is connected with extra taxation, we mean control that extends beyond these matters. Shareholders who postpone dividends, and thereby pay less tax now on their firm's earnings than would similarly situated partners, have exercised control over the timing of taxes that partners are *unable* to control. We will return to the difference between in-firm dispositions and distributions in Part II, but for the present it is sufficient to see, first, that choice of the corporate form may prove advantageous or disadvantageous in tax terms, and second, that the extra corporate tax is inextricably linked to the control that shareholders enjoy over the timing of distributions and, therefore, taxation.

B. Trusts

The relationship between control and taxation is perhaps clearest in the context of conventional trusts, that is trusts in which the settlor retains no significant interest so that the trust's income will be taxed either directly, and paid by the trustee, or through the trust's beneficiaries.[5] If a conventional trust accumulates no income, but rather makes distributions to the beneficiaries in amounts equal to or greater than the trust's earnings, then the trust pays no tax because it is allowed a deduction for these distributions.[6] The beneficiaries are taxed at their respective individual rates on this income they receive; the trust is merely a pass-through entity, or conduit, through which income flows to taxable distributees.

On the other hand, if a trust does accumulate earnings because it distributes less than it earns, then the trust pays tax on the accumulated earnings at rates similar to those applicable to individuals.[7] This tax is, however, a kind of down payment against the beneficiaries' ultimate tax liability. When accumulated income is eventually distributed, each beneficiary is then taxed under a "throwback rule," as if the distribution had been made in the year it was earned, with credit given for the taxes already collected from the trust.[8] The throwback rule works in ouly one direction, however, so that a high-bracket individual will owe some additional tax but no beneficiary will receive a refund—even though the trust was "overtaxed," as it turns out, on that beneficiary's share of the income.[9]

It would be incorrect to think of this one-way rule as yielding something more than one-tier taxation because, in fact, the more important imperfection is that the throwback rule does not require an interest payment. A trust thus often pays less tax than it should (under a strict pass-through system, if we knew who the ultimate beneficiary would be), and although the missing tax is eventually collected from the (high-bracket) distributee, it is collected without compensation for the time value of money. Conventional trust taxation might therefore best be described either as one-tier taxation or as something slightly at

[5] The discussion in the text is limited to conventional trusts, such as testamentary or inter vivos trusts, where the settlor retains no control over the trust or its earnings. Sections 671 to 678 of the Code also deal with grantor trusts, or trusts permitting the grantor to retain an interest or power over the trust. I.R.C. §§ 671-678 (1988). Generally speaking, the Code pierces these grantor trusts and taxes the settlor or grantor as if he or she continued to own the property directly. In any event, the single-tiered tax treatment of grantor trusts is perfectly consistent with the themes advanced in this Article.

[6] Id. §§ 651, 661.

[7] For 1990, the Code taxes the first $5,000 of trust income at 15% and provides for a 28% tax on income in excess of $5,000. Id. § 1(e). Individual rates also start at 15% and settle at 28%. Id. § 1(a)-(d).

[8] Id. §§ 666-667.

[9] Id. § 666(e).

variance with, and probably more favorable than, one-tier taxation. In any event, inasmuch as a central feature of these trusts is that either the terms of the trust or the trustee, rather than the settlor or the beneficiaries, controls the timing of distributions (and even the nature of investments and the timing of in-trust dispositions), it is plain that one-tier taxation (or even less) is associated with the beneficiaries' inability to control timing.

The tax rules that apply to trusts are sufficiently attractive that real businesses occasionally attempt to dress up as trusts. A well-known set of decisions distinguishes trusts from partnerships and from "associations" of investors. Both trusts and business associations may exhibit continuity of life, centralization of management, limited liability, and free transferability of interests, but only real businesses are said to have "associates" and a "business purpose."[10] The more that beneficiaries have voluntarily associated or have themselves created the "trust," or the more they have actively participated in operations, the more likely it is that trust treatment will be deuied.[11] And although the activities and potential endeavors of a "trust" may certainly reveal a business purpose, by and large courts will look to the trust instrument; the more it authorizes the conduct of a business, the more the "trust" will be reclassified as an association for tax purposes.[12]

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[10] Morrissey v. Commissioner, 296 U.S. 344, 356-59 (1935); Treas. Reg. § 301.7701-2(a) (as amended in 1983).

[11] See, e.g., *Morrissey*, 296 U.S. at 360-61 (entity is an association and not a trust because associates, unlike beneficiaries, plan a common effort); Bedell Trust v. Commissioner, 86 T.C. 1207, 1219-20 (1986) (trust lacks associates because no voluntary action by beneficiaries in creating or contributing to trust); Elm St. Realty Trust v. Commissioner, 76 T.C. 803, 814 (1981) (emphasizing active, voluntary participation by associates); Curt Teich Trust No. One v. Commissioner, 25 T.C. 884, 892 (1956) (lack of voluntary association dispositive despite trust's business activity); Sliskovich & Karlinsky, Tax Classification of Trusts: The *Howard* Case and Other Current Developments, 19 Loy. L.A.L. Rev. 803 (1986).

[12] See Sliskovich & Karlinsky, supra note 11, at 804; Note, Determining the Taxable Status of Trusts That Run Businesses, 70 Cornell L. Rev. 1143, 1151-56 (1985). For eases stressing the importance of the potential authority provided for in the trust instrument, see Helvering v. Coleman-Gilbert Assocs., 296 U.S. 369, 374 (1935) ("The parties are not at liberty to say that their purpose was other or narrower than that which they formally set forth in the instrument under which their activities were conducted."); Outlaw v. United States, 494 F.2d 1376, 1380-85 (Ct. Cl.), cert. denied, 419 U.S. 844 (1974); Nee v. Main St. Bank, 174 F.2d 425, 429 (8th Cir.), cert. denied, 338 U.S. 823 (1949); Fidelity Bankers-Trust Co. v. Helvering, 113 F.2d 14, 18-19 (D.C. Cir.), cert. denied, 310 U.S. 649 (1940).

Generally speaking, it is when an entity has *both* associates and a business purpose that it will be classified not as an "ordinary trust" but as a "business trust"—which is no trust at all for tax purposes.[13] Such a business trust[14] may be reclassified either as a corporation or as a partnership. The pertinent rules are somewhat confusing, but it is clear that if the business trust in question exhibits a consistent combination of those characteristics that distinguish a partnership, it will then be classified as a partnership—otherwise it will be regarded as a corporation.[15] Thus, if a group of lawyers form an organization to provide legal services in return for fees set by an executive committee, and they agree to profit-sharing and to dissolution on the death or withdrawal of any lawyer, and claims to these profits are not freely transferable, the Internal Revenue Service will surely disallow treatment as a trust and will reclassify the entity as a partnership. Corporations are distinguished from partnerships by the presence of continuity of life, centralized management, limited liability, and free

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[13] See *Outlaw*, 494 F.2d at 1385; Sliskovich & Karlinsky, supra note 11, at 821 ("For business trust status to be found, *both* the associates and business attributes must be present.").

[14] We use the expression "business trust" as it is used in the decisions that distinguish trusts from corporations and partnerships, and not in the sense of a business or Massachusetts trust in business organization law. See H. Henn & J. Alexander, Laws of Corporations 117 (3d ed. 1983). In the tax literature a business trust is an entity that pays taxes as a trust but is then regarded by the government or by the courts as a business not entitled to conventional trust treatment.

[15] The confusion arises in part because, although I.R.C. § 7701(a)(3) (1988) states that the "term 'corporation' includes associations," the regulations use the term "associates" in defining a corporation. See Treas. Reg. § 301.7701-2(a)(1) (as amended in 1983) (stating that corporations have associates, a business objective, continuity of life, centralization of management, liability for corporate debts limited to corporate property, and free transferability of interests). Thus, corporations have associates while trusts have more passive "beneficiaries who cannot share in the discharge of [the] responsibility [to protect and conserve property] and, therefore, are not associates in a joint enterprise for the conduct of business for profit." Treas. Reg. § 301.7701-4(a) (as amended in 1983). Finally, Treas. Reg. § 301.7701-3(a) (as amended in 1983) defines a partnership as a "syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business . . . is carried on, and which is not a corporation or a trust or estate." The straightforward way to distinguish among the three kinds of entities is to say that a trust has neither associates nor a business purpose; a partnership has associates and a business purpose; and a corporation has associates and a business purpose and also continuity of life, limited liability, and free transferability of interests. The form of these definitions, however, has generated less straightforward, deductive reasoning. An entity with both associates and a business purpose is not a trust, and one must then look for continuity of life, limited liability, and free transferability of interests in order to decide whether it is a corporation or a partnership.

transferability[16]—and this hypothetical organization is missing at least three of these four characteristics.[17]

In close cases, where an entity might be classified as either a partnership or a corporation without doing violence to the doctrinal distinctions, the Service will almost always insist that a business trust is really a corporation so that two-tier taxation applies.[18] This practice is quite consistent with the choice and control theme discussed above. If a business trust, denied the tax treatment that applies to conventional trusts, can make its own choice between partnership and corporate taxation, then it will have the advantage of choosing between the one-tier and two-tier treatments in midstream, rather than at the outset when most businesses are forced to gamble on future distributions and tax rates. Given the details of the throwback rule, such midstream choice might well be the most desirable alternative, and a great number of investors could be expected to choose the trust form, even knowing that it will eventually be disallowed, because it would serve as a useful holding pattern. It is therefore no surprise that taxpayers who should select either partnership or corporate treatment but who do not, find that the choice is made for them. Moreover, it is apparent why, for tax purposes, these business trusts are generally reclassified as corporations rather than partnerships. As described earlier, the corporate treatment is a tax bargain ouly when distributions have been deferred and when appreciated property has not been disposed of in a way that triggers dual taxation.[19] It is thus quite likely that an entity that has been managed with the hope of qualifying for trust treatment will not, in retrospect, have been managed in a way that minimizes corporate tax liability. Two-tier taxation now produces a penalty when compared to the liability of a similar entity that chose pass-through, partnership taxation all along.

We would expect that when the "trust" has retained earnings, so that two taxes are cheaper than one and the fisc would be enriched by a recharacterization of the business trust as a partnership rather than

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16 Treas. Reg. § 301.7701-2(a)(1) (as amended in 1983); cases cited supra note 12.

17 See Treas. Reg. § 301.7701-2(g) example (3) (as amended in 1983).

18 See Morrissey v. Commissioner, 296 U.S. 344, 357 (1935); Berry Bros. Trust v. Commissioner, 9 T.C. 71 (1947); Fox & Wilson, Treasury Restrictions Concerning the Tax Classification of Business Entities; Recent Developments, 1 J. Corp. Tax'n 28 (1974) (noting that government has sought to maximize the scope of association classification).

19 See supra text accompanying notes 3-5.

as a corporation, the government will in fact choose to characterize the entity as a partnership.[20] Unfortunately, the reported cases do not provide sufficient information about distribution histories so that it is impossible to determine whether or not classification actually reflects revenue maximization by the government. If it does, or if classification as a corporation generally penalizes business trusts, then, returning to the choice and control theme, we might say that taxpayers who choose at the outset to have more control over the timing of distributions than the law contemplates are penalized later with an additional tax.[21]

It is tempting to circle back to the distinction between trusts and corporations, and to argue that the question of whether there are "voluntary associates" is really about whether or not a trust's owners or beneficiaries arranged either for a flexible or for a deferred distribution policy. After all, if the beneficiaries had arranged for immediate distribution of profits, then whatever they might have enjoyed from trust taxation they could have had by simply reporting as a partnership. A trust that distributes its income receives pass-through treatment and is thus not taxed itself.[22] But when the beneficiaries carefully plan for deferred distributions, and hope meanwhile to enjoy the low trust tax rates (and the fact that the throwback rule does not

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20 For a case that seems to support this conjecture, see Foster v. Commissioner, 80 T.C. 34, 184-91 (1983) (court finds entity to be partnership and not association, and notes that there had been no distributions that could be regarded as taxable dividends), aff'd in part and vacated in part, 756 F.2d 1430 (9th Cir. 1985), cert. denied, 474 U.S. 1055 (1986).

21 The examples provided in Treas. Reg. § 301.7701-4(c)(2) (as amended in 1983) are revealing. In example (3), for instance, a promoter forms a trust in which shareholders may place shares they own in a publicly-traded corporation and receive two separable certificates in return. One certificate represents the right to dividends and the value of the underlying stock up to a specified amount, while the other represents the right to appreciation in the stock's value above the specified amount. The regulation says that this "trust" is either an association or a partnership. It is plain that the division into multiple classes affords control over timing, because shareholders can, in midstream, choose a distribution policy. Indeed, the regulation's unwillingness to announce whether the proper reclassification would be as a corporation or as a partnership might be understood as reflecting the fact that the government may wish to wait and see whether classification as a partnership or as a corporation yields greater revenue (and penalizes the strategic taxpayer). See supra note 17 and accompanying text; see also Rev. Rul. 78-371, 1978-2 C.B. 344 (real estate investment trust reclassified as an association where trustees could apparently control distributions by deciding when to invest in properties (and government obligations) that would yield regular income (all of which they were required to distribute quarterly) and when to invest in properties that sacrificed income for longer term appreciation).

22 I.R.C. §§ 651, 661 (1988).

incorporate an interest component), they should be penalized for trying to avoid the terms of the two-tier tax.

Similarly, when beneficiaries plan to wait and see whether the one-tier or two-tier rules would prove more to their benefit, they should be penalized for trying to improve upon the terms of the choice that the tax system offers. As such, the law could probably focus less on the operating decisions of beneficiaries, or associates, and more on the likelihood that they sought to go beyond the terms of the choice offered to them by tax law. Without belaboring the point, we would argue that as a positive matter a respectable case could be made for the proposition that the decisions in this area reflect a determination of whether the associates (beneficiaries) had the power to control distribution decisions, either directly or by replacing the decisionmaker (their "trustee").[23] Of course, when they decide to distribute presently, beneficiaries essentially receive partnership treatment. By contrast, when they defer distributions, they may be able, depending upon the amount of income,[24] to do better than one-tier, pass-through taxation. Control, or the power to time distributions, is thus the critical element.

[23] If this is so, it is despite the fact that some cases insist that control by the beneficiaries over the trust is not essential to association status. See, e.g., Morrissey v. Commissioner, 296 U.S. 344, 354-56 (1935); Howard v. United States, 5 Cl. Ct. 334, 342 (1984), aff'd, 770 F.2d 178 (Fed. Cir. 1985). Still, a fair number of cases support the suggestion that control over timing plays a role in classification. See, e.g., National Sav. & Trust Co. v. United States, 285 F. Supp. 325, 330-31 (D.D.C. 1968) (reclassification from trust to corporation where beneficiaries were "bondholders" who controlled trustees by majority vote); Continental Bank & Trust Co. v. United States, 19 F. Supp. 15, 17 (S.D.N.Y. 1937) (finding an association where beneficiaries could surrender certificates at any time for cash and thus postpone the automatic termination of the entity and the distribution of its income); Hynes v. Commissioner, 74 T.C. 1266, 1280 (1980) (finding a corporation where sole beneficiary was one of three trustees and where court notes control over distributions); Magoon Trust, 11 B.T.A.M. 42,406 (1942) (finding a trust rather than an association where beneficiaries did not control distributions). But see Blair v. Wilson Syndicate Trust, 39 F.2d 43, 46 (5th Cir. 1930) (finding trust where beneficiaries had substantial power to remove and restrict trustees); Bedell Trust v. Commissioner, 86 T.C. 1207, 1219-21 (1986) (finding trust where beneficiaries had substantial power to remove and to restrict trustees and to influence timing of distributions, court emphasizing that beneficiaries did not voluntarily associate).

[24] Within a range, taxpayers will be able to take advantage of the separate progressive rate structure applicable to trusts and of the absence of an interest component in the throwback rule. See supra note 7.

C. Debt

Our discussion of the tax treatment of debt, and the current debate regarding highly leveraged corporations, is best left to follow our introduction of agency cost considerations in Part II.[25] One obvious distinction between debt and equity stands out, however, as soon as attention is paid to the matter of control over the timing of taxes. In a corporation it is quite plain that the holders of equity are those with control over the timing of some tax liability because they control (or ultimately control those who have control over) the distribution of dividends as well as decisions regarding redemptions and liquidations. In contrast, creditors, by and large, are parties to fixed contracts that set forth the size and timing of distributions or interest payments. The deductibility of interest but not dividend (or redemption or liquidation) payments, and the consequent potential reduction in the entity's overall tax burden to the extent that debt rather than equity is employed, thus fits the control theme rather nicely.[26] The corporate gamble, as it were, involves two-tier taxation for those in control of timing and taxes. But there may be some choice even within the corporate form between one- and two-tier taxation. The choice comes partly in the form of a decision about the firm's mix of debt and equity; relief may be available for those participants who are subject to fixed contracts and who do not have control over the timing of their taxes.

D. Stock Dividends

The basic theme is also apparent in the treatment of stock dividends under section 305. Historically, if a corporation distributes a pure stock dividend, so that each shareholder receives new equity in pro-rata fashion, no tax is due.[27] The value (and basis) of each shareholder's stock is simply reallocated from a smaller to a greater absolute number of shares.[28] If, however, shareholders are individually

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[25] See infra notes 62-63 and accompanying text.

[26] The deductibility of interest is sometimes offset by the fact that interest income is taxable to creditors who may in fact be subject to higher marginal rates than corporate borrowers. The overall tax burden is, however, probably reduced through debt because many of the corporation's lenders are tax-exempt entities. See Canellos, The Over-Leveraged Acquisition, 39 Tax Law. 91, 100-01 (1985).

[27] I.R.C. § 305 (1988).

[28] Id. § 307. See generally B. Bittker & J. Eustice, supra note 2, ¶ 7.41-.44.

able to choose between stock dividends and cash (or other, obviously taxable) dividends, then section 305 dictates that all shareholders be taxed at the time of the distribution—including those shareholders receiving stock dividends.[29] On its face, the rule reflects the control theme quite neatly. As soon as shareholders are presented with some choice and control over the timing of their taxes, deferral advantages are withdrawn. Once again, control over timing comes at the price of extra, or at least more immediate, tax.

There is, however, a well-known means by which shareholders may choose between immediate and deferred taxation without bringing on this rule regarding choice as to stock dividends.[30] A corporation might distribute stock dividends—or simply retain earnings, distribute no dividends at all, and allow share prices to rise—and allow shareholders who want cash to sell their own shares and pay tax on the appreciation in their shares. And if the corporation stands ready to redeem shares, the shareholders can have choice and control over their own taxes, and the corporation can shrink through redemption exactly as it would have through a dividend distribution. The generous treatment of (non pro-rata) redemptions thus affords taxpayers a means of exercising control over the timing of their taxes without any tax cost falling on those who choose deferral.[31]

In short, although it remains true that more control is correlated with more tax, the rule pertaining to stock dividends (under which the mere possibility of control generates a tax) is more striking as a matter of theory and drafting than as a matter of practice. Section 305 is noteworthy, in other words, because it so plainly codifies the connection between taxes and control. Moreover, even as a practical matter, inasmuch as corporate insiders may fear that redemptions will generate fiduciary suits and insider trading suits by investors who exit and then observe an increase in share price, the rules regarding stock dividends may be important because the choice that can be offered through stock dividends cannot in fact be precisely duplicated through other means.

29 I.R.C. § 305(b) (1988).

30 Chirelstein, Optional Redemptions and Optional Dividends: Taxing the Repurchase of Common Shares, 78 Yale L.J. 739 (1969).

31 Of course, those who sell shares will find their ownership fractions reduced. If all shareholders attempt to sell in proportionate fashion, dividend treatment will be imposed under I.R.C. § 302 (1988).

E. Intercorporate Dividends

One feature of the two-tier tax system appears to contradict the control theme stressed in Part I of this Article. When one corporation owns stock in another corporation, a seventy percent deduction for dividends received is available to the first corporation; the deduction is eighty percent if the first corporation owns more than twenty percent of the stock of the other; and it is one-hundred percent for a parent corporation receiving dividends from its affiliated, eighty to one-hundred percent owned, subsidiary.[32] Thus, in the context of intercorporate dividends, increased control is associated with less rather than more taxation.

We return to these intercorporate dividends in Part II.C., but meanwhile it is useful to see that if there were no intercorporate deduction, then a corporation that had business reasons for acquiring some control over another corporation would be forced to merge with this target corporation in order to avoid *three*-tier taxation. After all, if there were no intercorporate deduction, then a tax would be due from the corporation that earns money, another would be due on the receipt of dividends by its parent corporation, and a third tax would be levied on the individual shareholders who eventually receive distributions from the corporate parent. In short, the traditional explanation for the intercorporate dividend deduction, that it is a provision that prevents triple (or even greater) taxation, is powerful and overwhelms any inclination to tie taxation directly to the degree of control a taxpayer exercises.[33]

In summary, we are not the first to emphasize that taxpayers can choose between two-tier and pass-through treatment, and that this

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[32] I.R.C. § 243 (1988).

[33] Schaffer, The Income Tax on Intercorporate Dividends, 33 Tax Law. 161, 163-65 (1979) (noting that as far back as 1909, corporations not taxed on intercorporate dividends so as to avoid multiple taxation; partial inclusion introduced in 1935 to encourage simplification of corporate structures).

A "newer view" of dividends, and of corporate dividends in particular, stresses the point that to the extent shareholders bought stock of an ongoing corporation, the price of that stock already reflected the future tax bite of two-tier—or even three-tier—taxation. See Mundstock, Taxation of Intercorporate Dividends Under an Unintegrated Regime, 44 Tax L. Rev. 1 (1988) (providing history of intercorporate dividend taxation and emphasizing windfalls to parent corporations from further intercorporate dividend relief). The point in the text regarding the alternative strategy available to an acquirer is not much changed by this view, but the rationale for the intercorporate deduction must be slightly reformulated.

choice involves something of a gamble about the unknown. And the suggestion that passivity is correlated with the ability to enjoy single, pass-through tax treatment will not seem startling.[34] But it is noteworthy that the idea that taxation is a function of control provides a means of thinking not only about two-tier corporate taxation, but also about such matters as the treatment of corporate debt, the rules pertaining to stock dividends, and the taxation of business trusts. We turn to other applications in Part III, but for the present it is sufficient to see simply that there are a number of areas in which the ability to control the timing of taxes is associated with heavier taxation.

But this theme standing alone is at best a synthetic positive success because it ignores the fundamental question of *why* taxpayers should be allowed to control the timing of their taxes by choosing one form of organization rather than another. And from a different perspective the fundamental question is why taxpayers who choose the corporate form for organizational reasons, and who do not wish to retain earnings and gain deferral advantages, should be penalized with two-tier treatment. We turn, therefore, to the question of two-tier taxation itself.

II. Agency Costs and the Two-Tier Corporate Tax

A. The Role of the Corporate Tax in Reducing Agency Costs

Generally speaking, the tax policy literature has favored some form of integration, or elimination of two-tier taxation, and has been hostile to the separate tax levied on corporate profits.[35] When the two-tier tax system has real bite, so that a corporation pays taxes on its earn-

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[34] Passivity alone is, of course, not much of a predictor. Many shareholders are passive, but their corporations' earnings are taxed twice; and many proprietors and partners are active, but their entity's earnings are taxed only once.

[35] See, e.g., C. McLure, Must Corporate Income Be Taxed Twice? (1979) (discussing the benefits, detriments, and feasibility of integration); R. Musgrave & P. Musgrave, Public Finance in Theory and Practice 291-301 (2d ed. 1976) (positing that integration of corporate source income with the individual income tax may be more in keeping with the progressive nature of the federal tax structure); Feldstein, The Welfare Cost of Capital Income Taxation, 86 J. Pol. Econ. S29, S46-S50 (1978) (arguing that the separate corporate income tax results in a higher tax rate on capital income at every level, causing efficiency losses and welfare costs redeemable only by elimination of the corporate tax); Klein, Income Taxation and Legal Entities, 20 UCLA L. Rev. 13, 43-51 (1972) (pointing out that the concept of the corporation as a separate entity, a concept often promulgated as a justification for a separate tax on corporate profits, is a legal fiction that at best provides only a hollow justification for the two-tiered structure); McLure, supra note 4, at 534-49 (stating that separate taxation of

ings and enjoys no deduction for the dividends it pays, its shareholders pay taxes on the dividends and other distributions they receive and obtain no credit for the taxes paid by their corporation, and these two taxes are at rates and times such that, when combined, they exceed the tax bill paid by similarly profitable businesses that are not in corporate form, it is easy to understand the hostility. The extra tax penalizes and discourages an organizational form that may be quite efficient; savings may also be discouraged because of the surcharge; and even those businesses that find it worthwhile to choose the corporate form will be encouraged to inefficiently retain earnings and delay distributions in order to reduce their shareholders' tax burdens.[36] When the two-tier tax can be turned to advantage, as when the corporate tax rate is lower than the individual rate, and distributions are sufficiently delayed (and even, perhaps, taxed at lower capital gain rates) so that the combined "double" tax is less painful than an immediate tax on earnings levied at individual rates, the complaints about the two-tier tax are obviously somewhat different. Now one objection is that there is a distorting *subsidy* to businesses in the corporate form, and there remains the problem of encouraging the inefficient retention of corporate earnings.[37]

The two-tier tax on corporate profits is thus objectionable because it distorts distribution decisions and because it drives a wedge between corporate and other forms of organization, such as partnerships. Ideally, taxes ought not to affect and distort real decisions (except in a manner that is thought desirable), and it is plain that the two-tier corporate tax affects corporate distribution decisions and, more fundamentally, the incorporation decision itself. Thus, in the current climate, where (quite unusually) the corporate tax rate exceeds the individual tax rate, there is a strong incentive to abandon the corporate form in favor of the partnership alternative, because the latter generates only a single tax at the lower individual rates. Not surpris-

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corporations cannot be justified under commonly accepted canons of taxation as it directly conflicts with the vertical equity and ability-to-pay principles of taxation).

[36] See, e.g., Feldstein, supra note 35, at S46-S48; McLure, supra note 4, at 540-41.

[37] There is some debate, however, as to whether the incentive to retain earnings generates inferior investment decisions. See Friend & Husic, Efficiency of Corporate Investment, 55 Rev. Econ. Statistics 122 (1973); Whittington, The Profitability of Retained Earnings, 54 Rev. Econ. Statistics 152 (1972).

ingly, this migration has triggered renewed interest in integrating the corporate and individual taxes.[38]

Arguments in *favor* of the two-tier tax system are few and far between. Some of the academic proponents of a separate corporate tax are simply hostile to corporations, or at least to large corporations, while others posit that integration of the corporate and individual taxes would diminish the progressivity of the tax system, that the corporate tax amounts to a reasonable user fee for services provided by the government to corporations, that the tax allows the government a partial return on its implicit partnership investment in risk taking, or that the corporate tax offers a way of offsetting the social costs imposed by corporations because of their limited liability.[39] There is also the view that a separate corporate tax exists because it is largely invisible to the electorate.[40] But, as indicated earlier, the overwhelming force of the academic commentary is in favor of some form of integration. Indeed, the academic debate has focused not on the wisdom of integration but rather on the surprisingly difficult question of how exactly to integrate the corporate and individual taxes into a one-tax system.[41]

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[38] See, e.g., Ad Hoc Comm. on Tax Reform, Tax Reform: The Business Perspective, 41 Bus. Law. 907 (1986) (arguing that full integration too complex but dividends-paid reduction favored because integration is fair, efficient, and advisable in order to reduce incentives for leveraged financing); Kahn, Should *General Utilities* Be Reinstated to Provide Partial Integration of Corporate and Personal Income—Is Half a Loaf Better than None?, 13 J. Corp. L. 953 (1988) (stating that, as a matter of good tax policy, the *General Utilities* doctrine should be restored, and personal and corporate income taxes integrated).

[39] For some discussion of these defenses of the separate tax on corporate profits, see R. Goode, The Corporation Income Tax 26-40 (1951) (surveying arguments); C. McLure, supra note 35, at 28-38; Lee, Entity Classification and Integration: Publicly Traded Partnerships, Personal Service Corporations, and the Tax Legislative Process, 8 Va. Tax Rev. 57, 97 n.152 (1988) (viewing corporate tax as appropriate user fee because corporations exploit foreign markets and therefore rely on the country's (expensive) military might in order to ensure stability in those markets); Stiglitz, The Corporation Tax, 5 J. Pub. Econ. 303 (1976) (regarding tax as levy on pure profits and entrepreneurship, and as partial return on an implicit government partnership in risk taking); Studenski, Toward a Theory of Business Taxation, 48 J. Pol. Econ. 621 (1940) (surveying justifications); K. John, L. Senbet & A. Sundaram, Corporate Limited Liability and the Design of Corporate Taxation (forthcoming paper on corporate tax (with carefully designed depreciation deductions) as means of internalizing social costs imposed by limited liability rules).

[40] J. Ballentine, Equity, Efficiency, and the U.S. Corporation Income Tax 7 (1980).

[41] A seminal work on the subject is Warren, The Relation and Integration of Individual and Corporate Income Taxes, 94 Harv. L. Rev. 717 (1981). For an excellent introduction to the problem, see H. Abrams & R. Doernberg, Federal Corporate Taxation ¶ 1.04 (1987).

Our argument in "defense" of, or by way of explaining, the distinct tax on corporations is based on agency cost considerations and might be thought of as a cousin of the well-known theory advanced by Professors Jensen and Meckling in which the coordinated use of debt and equity minimizes the agency costs of the firm.[42] Consider the situation in which a number of investors pool capital, as shareholders in a corporation, and entrust a manager, *M*, to run the enterprise. Assume that *M* is also a shareholder of the firm—and indeed there is reason to think that agency costs are reduced when a firm's manager has a substantial personal stake in the firm's equity.[43] Finally, in order to highlight the role of the corporate tax, imagine first a world of pass-through taxation, in which corporations are *not* separately taxed, but rather where shareholders are taxed each year, at their respective individual rates, on their imputed shares of the firm's income. Our argument focuses on the fact that *M*'s individual tax rate will often be different from that of other shareholders, or principals. It is perhaps easiest to think of a situation in which *M* (and a fair number of other shareholders) faces the highest individual rate; a large proportion of shares is held by tax exempt shareholders, such as pension funds, universities, and the like; some shares are held by corporate investors, who currently enjoy a substantial intercorporate dividend deduction and would surely be entitled to similar or better treatment in a single-tax, integrated system; and the remaining substantial proportion of the stock is held by individual shareholders who are subject to a marginal tax rate that is also lower than *M*'s. Inasmuch as the argument in this Part hinges on the notion that a corporation's shareholders will often be in different tax circumstances and therefore in occasional conflict with one another, it may be useful to concede at the outset that much of what follows depends on the existence of rate progressivity—including that generated by the presence of some tax-exempt shareholders—and an incomplete "clientele

42 Jensen and Meckling emphasize the role of debt in facilitating greater insider ownership of firm equity. With greater ownership, insiders care more about the firm's performance. At the same time, too much debt (too little "outside" equity) encourages too much risk alteration, or gambling, on the part of insiders who profit when the firm has earnings in excess of its obligations to debtholders. See Jensen & Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 J. Fin. Econ. 305 (1976).

43 See id. at 312-13.

effect," so that heavily-taxed and lightly-taxed investors do not gravitate to entirely different investments.[44]

This depiction of *M*'s role as the agent of disparate shareholders in a corporation that (hypothetically) enjoys pass-through tax treatment hints strongly at an unrecognized agency problem. The insider, *M*, will want to make corporate decisions that benefit *M*'s own tax situation. *M*'s self-interest is likely to involve retaining appreciated assets (inside the corporation) in order to postpone recognizing gain, when lower-taxed shareholders would prefer that the corporation sell these assets and perhaps invest in other assets.[45] *M* may also have a personal interest in the firm's decision whether to buy or lease equipment, in the matter of what kind of mergers to pursue, and in the more general question of the firm's overall investment and operations strategy.[46] But for the sake of argument (and brevity) it is useful to limit discussion to the most important areas in which *M*'s self-interest may not be aligned with the interests of other shareholders: the timing of the disposition of assets and, in tax terms, the recognition of gains and losses.

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[44] The phenomenon known as the "clientele effect" begins with the idea that for any given financial policy adopted by a firm, there are likely to be investors who prefer that policy. See generally Auerbach, Stockholder Tax Rates and Firm Attributes, 21 J. Pub. Econ. 107 (1983) (examining empirical results for the period 1962-1977 and finding the existence of investor clienteles differentiated by tax rates). Further, "[e]ach corporation would tend to attract to itself a 'clientele' consisting of those preferring its particular payout ratio." For example, high tax-bracket individuals would prefer investments in low-payout growth stocks, whereas tax-exempt investors would prefer high-payout investments. Miller & Modigliani, Dividend Policy, Growth and the Valuation of Shares, 34 J. Bus. 411, 431 (1961).

[45] Imagine that *M*'s corporation holds an asset, *X*, that has appreciated from 50 to 100, but that as far as production efficiency is concerned, another asset, *Y*, available in the market at a price of 90, substitutes perfectly for *X*. Setting aside recapture provisions and other possible complications, it is apparent that if *X* is sold and the firm is treated as a pass-through entity, *M* must recognize *M*'s proportionate share of the gain of 50. The tax due on the present disposition of *X* (compared to the present value of paying the tax many years in the future when *X* would otherwise be sold) is likely to exceed the gain (derivatively enjoyed by *M*) from deploying *Y* at the present time. Other shareholders, in lower (or even zero) tax brackets, may well prefer that the firm substitute *Y* for *X* as soon as possible.

In a world without transaction costs, *M* could have it both ways by deploying *Y* while leasing *X* to another user. Thus, *Y* could be purchased or leased by *M* and put to use in the firm *M* manages. Put differently, in the absence of transaction costs, the realization requirement of the tax system produces no lock-in effect. In the balance of this Article, we assume that transaction costs interfere with such perfect substitution through leasing.

[46] See Jensen & Meckling, supra note 42, at 313.

If *M* selfishly personalizes the lock-in effect of the recognition rules, so that *M* causes the corporation to retain assets that other shareholders, or the majority of shareholders, would have preferred to sell, it will be virtually impossible for injured shareholders to succeed in bringing a fiduciary suit against *M*. Although it may be true that *M* has failed to maximize the firm's well-being, and has instead managed things in order to suit *M*'s own tax circumstances, such self-dealing is almost invulnerable to attack. *M* will insist that transactions were undertaken or the decision to hold assets and avoid the recognition of gain was made in the best interests of the corporation, and these decisions will accordingly be protected by the business judgment rule. This is especially true because virtually all of *M*'s decisions will be objected to only after the fact. When an asset that was held back from sale rises greatly in value, no shareholder can complain of injury. When a retained, appreciated asset decreases in value after the date a plaintiff says *M* should have sold it, *M*'s defense will be that the thought was that it would rise in value and that the claim against *M* is nothing more than an exercise in perfect hindsight, with strategic delay thrown in for good measure. Moreover, *M*'s self-interested decisions will favor not only *M* but also other shareholders whose tax circumstances resemble *M*'s. The fact that *any* decision made by *M* could be objected to by some shareholders, who would have preferred different timing decisions, adds to the conclusion that such fiduciary suits, however meritorious they may seem to an omniscient observer who can divine *M*'s motivations, are bound to fail. Although there are corporate law cases where plaintiffs point to the self-interested, tax-motivated decisions of fiduciaries, not one of these cases suggests that *M*'s self-interested tax decisions will be controlled by fiduciary suits.[47]

Investors who are eager to use the corporate form may try to avoid this agency problem by pooling capital with other investors who are in the same tax bracket and, therefore, like-minded. And such inves-

[47] There are a few cases that come close to supporting the idea that a controlling shareholder must not selfishly promote his or her own tax objectives. See, e.g., Berwald v. Mission Dev. Co., 40 Del. Ch. 509, 185 A.2d 480 (1962); Smith v. Atlantic Properties, Inc., 12 Mass. App. Ct. 201, 422 N.E.2d 798 (1981). This is not the place to analyze these cases in detail, but a fair interpretation suggests that even these decisions do not stand for the general proposition that fiduciaries whose decisions appear more appropriate for their own tax circumstances than for those of fellow shareholders need fear lawsuits.

tors may then try to employ managers who share these tax circumstances. But this "solution" is expensive. A more promising strategy is to try to control the manager, *M*, (and, of course, *M* may try to bond managerial performance in similar fashion) by contracting for and specifying certain behavior on *M*'s part.[48] But such contractual arrangements can be difficult to design because, ultimately, one disposes of assets based on technological realities and market expectations, rather than tax considerations alone, and these are variables that are not easily sorted out long in advance. Still, the more investors anticipate conflicts, such as those involving the disposition of a firm's assets, the more we should expect to see contracts that reduce *M*'s self-serving flexibility.[49] Thus, investors could try to control the conflict with *M* by denying *M* the right to hold any equity in the firm. Similarly, they may choose to constrain *M* by imposing the ready-made legal construct of a trust. But these are costly solutions that generate other agency costs. The more likely approach, especially in relatively closely-held firms, is for investors to retain the ability to dismiss *M*, to monitor closely the firm's activities (including its dispositions), and to delegate less authority to *M* than they otherwise might. In some circumstances these contractual strategies will succeed in mitigating the agency problem created by the fact that *M* and other investors are in different tax brackets. In other settings, however, investors will surely find that they cannot control this problem at reasonable cost. In large publicly-held corporations, in particular, it is surely the case that shareholders are in dissimilar tax brackets—so that there will be conflicts among the shareholders as to how to control *M*—and that contractual arrangements will fail to completely anticipate and fully control self-interested decisions by *M*. In public corporations, as well as in some closely-held corporations, there is therefore an agency problem when management decisions, such as those involved in the sale of assets, affect the tax liabilities of shareholders in individualized fashion.

A rather remarkable feature of the separate tax on corporate income is that it solves this agency problem. The corporate tax rate can be thought of as a great equalizer that offers *M* and all *M*'s principals a common goal. By rejecting single, pass-through tax treatment,

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48 See Jensen & Meckling, supra note 42, at 349-50.

49 Id.

and taxing a corporation as a distinct entity, tax law causes all shareholders to agree (at least in tax terms) on timing questions. It is in *M*'s interest and in the interest of all the other shareholders for the corporation to be as profitable as possible regardless of their individual tax rates. With a corporate tax in effect, management decisions do *not* affect shareholders differently depending on their individual tax circumstances. Individual tax rates may affect shareholders' tastes for *distributions* from the corporation—a conflict we will turn to shortly (in Subpart B)—but as for "in-corporate" decisions, such as the question of when to sell assets and recognize gains, all shareholders face the same corporate tax. Much as there would be no agency problem of the kind just described if there were pass-through taxation, with a flat rather than progressive rate structure, with no tax-exempt shareholders, and with no corporate investors that enjoyed deductions for intercorporate distributions, so too there is no problem with progressive rates and with some tax-exempt shareholders *if* the corporation itself is taxed, and if this taxation does not depend (as it does not in our tax system) on the identity and tax circumstances of the corporation's shareholders.

Let us postpone discussion of conflicts among shareholders as to the firm's *distribution* policy, and continue to focus on the firm's "in-corporate *disposition* policy," by considering the size of the corporate tax within a two-tier, agency-cost-reducing, tax system. If the corporate tax rate is greater than most individual (or other investors') tax rates, investors will often find it worthwhile to absorb the increased agency costs associated with single, pass-through taxation. Tax law (and its rates) will have "caused" the proliferation of proprietorships and partnerships; it will discourage the efficient pooling of capital and the reduction of agency costs (at least insofar as the corporate form, and the separate corporate tax, eliminates concerns that insiders will adopt self-interested, in-corporate disposition policies). If, on the other hand, the corporate tax rate is low enough so that the combined burden of the tax on corporate earnings and the tax eventually paid by shareholders upon receiving corporate distributions is less than the toll that would be exacted by an immediate (pass-through) shareholder tax on corporate earnings, then entrepreneurs will be induced to choose the corporate form. This will be so even when the corporate form does not fit their needs, with the result that they incur unnecessary transaction costs in opting out of the default rules of corporate governance. It would seem that in terms of reducing agency costs the ideal two-tier tax would be one that simply matched the (individual or other) tax bill paid by proprietors or partners. But it should be apparent that this is an elusive match because the burden of the two-tier tax depends on the timing of distributions, and firms exhibit great variance in their distribution patterns. We return to this ideal two-tier tax in Section C below.

B. Conflicts Regarding a Firm's Distribution Policies

Our emphasis on the role of the corporate tax in avoiding conflicts among investors as to a firm's dispositions draws attention to the fact that a two-tier tax creates conflicts as to a firm's distributions. Highly taxed shareholders may well prefer that a firm retain earnings, even when the firm's best use for these earnings is inferior to investments available elsewhere, because retention postpones the recognition of gain at the shareholder level. Similarly, shareholders in different tax circumstances may disagree about the relative desirability of various mergers or acquisitions, because they attach different importance to the receipt of consideration that qualifies for tax-deferred, or reorganization, treatment.[50] These conflicts can easily translate into a fiduciary problem when insiders face tax circumstances different from those confronted by the majority of the firm's shareholders. Conversely, an advantage of some forms of pass-through taxation or, in particular, of the partnership form of organization, is the reduction in the agency costs associated with distribution decisions. When a firm's earnings are immediately imputed to its ultimate owners, an individual owner's tax situation does not much affect the owner's taste for distributions;

[50] It is also noteworthy that the rules regarding intercorporate dividends exacerbate conflicts regarding distributions. As noted in Part I.E., § 243 allows a generous deduction for intercorporate dividends but allows no deduction for other intercorporate distributions. I.R.C. § 243 (1988). There is, therefore, conflict among corporate and noncorporate shareholders regarding not only overall distribution policy (because corporate shareholders find dividends relatively painless, while individual shareholders will often prefer the retention of earnings), but also regarding the form of distributions. Individual shareholders, for example, may prefer redemptions (which often generate exchange treatment under § 302) while corporate shareholders may prefer dividends. Levmore, Recharacterizations and the Nature of Theory in Corporate Tax Law, 136 U. Pa. L. Rev. 1019, 1043 n.77, 1045 n.84 (1988). Nevertheless, it bears repeating that the separate corporate tax serves as an equalizer. Corporate and noncorporate shareholders may disagree over the form and timing of distributions but they will generally agree about in-firm dispositions.

tax is due regardless of the timing of distributions so that there is no tension in this regard between high and low bracket owners.

It is tempting to stop here and claim that, other things being equal, firms will be organized along corporate or partnership lines depending on whether the potential agency costs associated with dispositions (or other in-corporate decisions) or with distributions are greater and, therefore, more profitably avoided. Such a conclusion would parallel Jensen and Meckling's result that a firm's debt-equity mix reflects an optimal, cost-reducing combination of the different agency costs associated with the two sources of capital.[51] Indeed, it is possible that the claim that an assessment of agency costs associated with disposition and distribution decisions is an important determinant of organizational form captures a great deal about the form in which business is done and about the role of the two-tier tax. It suggests that as a normative matter it could be a mistake to integrate the corporate and individual taxes, as it is almost surely bad policy to legislate higher corporate tax rates than individual tax rates, because investors (especially in a publicly-held corporation) are unable to avoid the agency costs associated with in-corporate decisions as easily as they can with the traditional two-tier tax. When there is a distinct corporate tax, and its rate structure is neither such a bargain that businesses necessarily opt for the corporate form nor so burdensome that they opt out of the corporate form, it becomes possible to think of the choice between forms as a choice about the elimination of one set of agency costs or another. Investors who organize as a corporation will need to think about distribution decisions; those who choose the partnership form will focus instead on disposition conflicts.

Our argument, however, is stronger and more complex than the above discussion might suggest. The preceding discussion implicitly assumed that conflicts over distribution and disposition policies are equally serious because each conflict is a function of the different tax rates faced by shareholders and insiders. Whenever outside shareholders worry that insiders subject to pass-through taxation will cause the firm to hold on to appreciated assets it should sell, they will be equally concerned that insiders, if subject to personal tax when distributions are received, will cause the firm to retain rather than distribute earnings. Some firms, notably those that hold assets of greatly

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[51] See Jensen & Meckling, supra note 42, at 349-50.

fluctuating worth, may encounter especially strong conflicts over disposition policies such that the corporate form seems a particularly appropriate means of avoiding conflicts of interest between fiduciaries and their principals. But, by and large, because different tax circumstances cause both distribution and disposition conflicts, it may seem that agency costs of the sort described thus far are *not* important determinants of organizational form because the advantage of each form offsets exactly the advantage of the other.

In fact, however, there is reason to think that the agency costs associated with dispositions, or with in-corporate decisions in general, are greater and socially more important than those associated with distribution policies. First, with respect to most firms there is no real conflict as to distributions of the kind discussed here, because if the insiders selfishly retain earnings, disappointed investors can simply sell some of their shares—which will have appreciated as a result of the retention of earnings. There may on occasion be a conflict, perhaps because real voting power is lost or because there is a very thin market for these shares, but to the extent that we seek a general explanation of the two-tier tax it seems appropriate to reason that the agency costs associated with (in-corporate) disposition decisions dominate those associated with decisions about distributions.

A somewhat different way of thinking about this is that as a matter of both investor preferences and economic policy, fiduciary problems regarding dispositions are more important than those concerning distributions. The argument is that when an insider, such as *M*, selfishly refrains from selling assets, because under the terms of a pass-through tax system gain will be imputed to *M* on the individual level (with *M* feeling the bite more than other shareholders), a seriously inefficient act has taken place. Assets that would otherwise move to higher valued uses will not be so moved because of *M*'s self-interested behavior. By contrast, when *M* selfishly retains earnings, because under the terms of a two-tier tax system retention is more attractive than distribution, there is not yet a "real" inefficiency, because it is actual investment decisions rather than financing decisions that matter.

This argument resembles one in the insider trading literature regarding the relative importance of quick price adjustments in "real" markets for goods and services as compared to securities markets, which in some sense are one step removed from real economic activity.[52] In terms of the well-known Miller-Modigliani "irrelevance" thesis,[53] a firm's dividend policy—as opposed to its actual earnings—does not affect the value of the firm.[54] If, for example, instead of investing retained earnings, a firm pays out dividends and then sells new stock in the amount of these dividends to finance new investments, the stock held by an old shareholder ought to decline in value (because of the diluting effect of the new stock) precisely by the amount the shareholder is personally enriched upon receipt of the dividend (which could be used, of course, to buy some of the new stock).[55] The selfish deferral of distributions thus seems less troubling than the selfish deferral of dispositions of assets within the firm because the latter locks real assets into suboptimal uses while the former withholds only money—which can be sold and borrowed against in a substitute paper transaction. It *will*, however, matter if the insider retains earnings and then makes suboptimal investments.[56] But it is also possible that the retained earnings will be invested by the firm in another firm, which invests in real projects optimally, or in a financial intermediary, so that the conflict over distribution policy is both personally (to the shareholders) and socially irrelevant.

There will surely be some firms for which distribution conflicts are more serious than disposition conflicts, as a result of the particnlar transaction costs involved and because, as mentioned above, some firms will invest in suboptimal projects with their retained earnings. But overall it is likely that conflicts over distribution policies are both individually and socially less important than are conflicts over in-corporate dispositions. To the extent that the two-tier corporate tax introduces conflicts associated with distribution policies, these con-

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[52] See Levmore, Securities and Seerets: Insider Trading and the Law of Contracts, 68 Va. L. Rev. 117, 155-56 (1982).

[53] Miller & Modigliani, supra note 44.

[54] Id. at 414.

[55] This irrelevance may survive the introduction of taxes because investors can transform capital gains into dividends by borrowing to buy new stock—and enjoying the deductibility of interest expenses. See Miller & Scholes, Dividends and Taxes, *in* The Theory of Business Finance: A Book of Readings 663 (3d ed. 1983).

[56] It should be noted that even when *M*'s selfishness is not socially undesirable, as when *M* is in a relatively low tax bracket and not inclined to lock in assets (but rather to sell when an outsider seems to attach greater value to the assets in question), it is still the case that with pass-through taxation other higher-bracket shareholders will seek to constrain *M*'s behavior through contractual arrangements. A separate corporate-level tax may usefully economize on these transaction costs, even though there is a sense in which it promotes a disappointing end.

flicts are relatively minor because those shareholders who are disappointed with their firms' distribution policies often have homemade alternatives with which to accomplish their goals. Moreover, from a social point of view, self-interested dispositions (or delayed dispositions) of real assets probably represent a more serious efficiency problem than do self-interested distribution strategies.[57]

C. Alternative Routes to Reducing Agency Costs

The discussion up to this point raises several questions about prevailing tax rules and about the range of tax treatments that would successfully reduce the agency costs associated with in-corporate dispositions. First, why is the two-tier treatment, if it is indeed such an elegant means of reducing agency costs, neither the only one made available under tax law nor the treatment chosen voluntarily by all enterprises? Second, could the corporate tax be reduced just as well by deductions for dividends paid? Somewhat similarly, would agency problems be solved just as well by a form of tax integration, where there were two taxes, with the corporate tax paid allowed as a credit against the individual tax due on distribution? The answers to these questions clarify, we think, the positive and normative reach of the theory proposed in this Part.

1. The Availability of One-Tier Taxation

So long as sole proprietors are singly taxed under the terms of the individual rate structure, much harm would be done by a system that forced firms with multiple owners to be subject to a two-tier tax. If the two-tier tax bill were even slightly higher than the single tax, investors who pooled capital would be at a substantial disadvantage compared to proprietors. Inasmuch as a recurring theme of tax law, corporate law, and economic development is the importance of facili-

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[57] Tax lawyers will note that several tax rules promote a kind of disposition neutrality. For example, § 382(h) provides rules that seek to discourage a company with net operating losses, that is about to combine with another company, from rushing to sell appreciated assets. E.g., I.R.C. § 382(h)(3)(B) (1988). Without § 382(h) there would be an incentive to dispose of such assets before the combination because the gain could then be enjoyed tax-free (inasmuch as there are offsetting losses). Also, under the anti-trafficking rules of § 382, once the combination takes place, old losses will be available only to the post-combination entity at a slow and steady rate. Similarly, § 382(h) attempts to eliminate the incentive for the old loss company to delay the disposition of assets with "built-in losses." I.R.C. § 382(h)(1)(B)(i) (1988).

tating pooled investments, it is likely that multiple owners of an enterprise will be offered a means of being taxed as a competing sole proprietor would be taxed. And it is difficult to imagine a tax system successfully forcing all businesses, including sole proprietorships, into a two-tier regime. Tremendous pressure would be put on the distinction between businesses and passive investments, and businesses and hobbies, and the administrative and other transaction costs involved in such a system would surely be prohibitive.

Nor is it surprising that those who pool capital do not all choose the corporate form and the two-tier tax—even in periods during which the corporate tax rate is lower than most individual rates. Our argument suggests that so long as the corporate tax rate is not prohibitive, investors who face different individual rates may best reduce their agency costs by agreeing on a form of organization in which their individual tax circumstances will not color decisions regarding the purchase and sale of assets. We expect that firms with large numbers of investors will minimize agency costs in this way, and that some closely held firms, where circumstances make careful contracting and monitoring difficult, will do the same. For these firms, the added costs of the second tax on distributions out of the corporate form—and the agency costs associated with conflicts as to the timing of these distributions—are mitigated by deferring distributions (and thus lowering the present value of the cost of the second tax) and by making homemade adjustments along the lines suggested by Miller-Modigliani's irrelevance thesis.

But, as implied earlier, some groups of investors will prefer the partnership form of organization, and its single, pass-through tax treatment, even when the corporate tax rate is very low. Some of these groups will consist of investors who are in similar tax circumstances (and have little fear of managerial self-interest as to dispositions); some will be made up of investors who expect to encounter particularly high transaction costs in undoing (as Miller and Modigliani suggest) the distribution policy of the firm; some will prefer to precommit to a distribution policy that does not defer distributions and lower the effective two-tier tax rate, but rather extracts earnings from the firm on a current basis; and some will engage in enterprises where the immediate interest is in the passing through of losses for tax purposes.

The more interesting cases, however, are those where the choice between tax treatments is coordinated with other decisions about agency costs. In particular, some investors will successfully control the agency costs associated with in-corporate dispositions by a governance structure that makes it difficult for insiders to behave selfishly. Changes in disposition policy may require votes or supermajority agreement, the insiders' compensation packages may be structured in ways that encourage the disposition policy that appeals to passive partners, or threats of withdrawal by partners may be sufficient to encourage the disposition policy favored by some or most investors (as opposed to that favored by insiders). This last set of possibilities is likely to capture the reality of most partnerships, or at least those involving partners in different tax circumstances, for the few partners involved in most enterprises will often all be involved in deciding upon asset dispositions, will have bonded together because of their similar preferences, or will have ensured that some decisions require supermajority or even unanimous consent.

It is unfortunate, perhaps, that tax law cannot afford to allow entities to switch back and forth between pass-through and two-tier treatment. This rigidity is unfortunate because, from an agency cost perspective, it is possible that at various points in the life of an entity conflicts over dispositions will be more or less serious than conflicts over distributions. Ideally, the entity could switch back and forth in order to enjoy the equalizing affect of the separate corporate tax each time it was thought to be more efficient than particularized contractual arrangements. But because it is difficult to design throwback rules that would keep the overall tax burden the same regardless of the timing and frequency of changes from one tax regime to another, there must be some constraints on switching, or taxpayers will switch to reduce their taxes even when such switches *increase* agency costs.

2. *Forms of Integration*

If the tax system provided for a deduction by corporations for dividends paid out, the corporate tax owed would decline toward zero the more a corporation distributed its earnings. A low-bracket insider, *M*, such as a parent corporation or an individual with substantial losses from other investments, would be tempted to accelerate the corporation's recognition and distribution of gains. Essentially, *M*'s self-interest pertains to distributions, but one way to enjoy these distributions is to rush in-corporate dispositions. Without a deduction for dividends paid, the incentive to dispose in order to distribute is taken away by the separate corporate tax; when there is a dividends-paid deduction, however, *M*'s own tax rate affects *M*'s taste for in-corporate dispositions. Put differently, a separate tax on corporate earnings can serve to equalize the tastes of disparate shareholders for in-corporate dispositions, but the introduction of a deduction at the corporate level for dividends paid works to undo this corporate tax and to cause shareholders' individual tax circumstances to affect their attitudes toward both dispositions and distributions.

Integration (of the corporate and individual taxes) might instead be accomplished by taxing corporations but allowing corresponding credits against individual (and other distributee) taxes. When *M*'s tax rate is lower than the corporate tax rate, some of the credit *M* could use will be wasted. In such situations, *M* will be inclined to postpone in-corporate dispositions of appreciated assets if there is likely to be a later year in which *M* will be in a higher bracket (and if the credit is passed through on a current basis). And when *M*'s tax rate is high, *M* will have an incentive to rush in-firm dispositions in order to enjoy a credit sooner rather than later.

But our aim in this Article is neither to argue against all forms of integration nor to favor one plan of tax integration over another.[58] Rather, we aim to show that a separate tax on corporate profits (with or without some relief in the taxation of distributees) offers a powerful means of reducing a set of agency costs. Insofar as integration is concerned, it is surely the case that if the two-tax bite is an expensive one, investors will steer clear of the corporate form even though that form and the two-tier tax is most efficient in agency cost terms. There is something to be said for ensuring that no penalty tax is associated with incorporation and that any relief from the two-tax bite is delivered in a manner that makes the profitability of disposition decisions independent of individual tax circumstances.

It is noteworthy that a form of integration was available for many years through the operation of the *General Utilities* rule,[59] which excused a corporation from recognizing gain on the distribution of

[58] Nor do we explore the administrative advantages of various plans of tax integration.

[59] The *General Utilities* rule has its origin in General Utils. & Operating Co. v. Helvering, 296 U.S. 200, 206 (1935).

appreciated assets. The rule thus offered pass-through, rather than two-tier, taxation on in-firm appreciation (but not on corporate earnings) because when distributing appreciated assets to their shareholders, firms were not treated as if they sold the assets, and only the distributees, or shareholders, were taxed on the appreciation. This forgiveness or integration is subject to many interpretations, but for our present purposes what is striking is that small, closely-held corporations were the primary beneficiaries of the *General Utilities* rule.[60] A large publicly owned corporation could hardly manage to distribute appreciated assets, in lieu of cash proceeds, to its many shareholders in pro-rata fashion. A smaller corporation, on the other hand, could more easily distribute an appreciated building here and a machine there in a way that left shareholders satisfied and that made use of the forgiveness, or pass-through, provisions. Moreover, as already noted, it is small, closely-held corporations that least need the separate corporate tax as a means of reducing the agency costs associated with in-firm dispositions. Whatever else might be said in favor of a two-tier tax on earnings alone and not on in-firm appreciation, it is at least noteworthy that the *General Utilities* rule operated precisely where the agency problem was a small one.[61]

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[60] For the idea that large, public corporations rarely benefited from the *General Utilities* rule, see Reform of Corporate Taxation: Hearing Before the Senate Comm. on Finance, 98th Cong., 1st Sess. 148 (1983).

[61] See supra note 1 for a discussion of the *General Utilities* rule and its repeal; B. Bittker & J. Eustice, supra note 2, ¶¶ 7.20-.21, 11.06. The text does not imply that the repeal of the *General Utilities* rule was (or was not) efficiency enhancing. With the rule in effect, ongoing firms preferred to distribute assets inefficiently rather than to sell them to the highest bidder, for a sale to an outsider generated a corporate level tax while an in-kind distribution to shareholders did not, and there was a conflict among shareholders as to when such distributions should be made. Moreover, this conflict over distribution and disposition policy was not one step removed from real economic activity, see supra note 52 and accompanying text, because the rule pertained only to real assets distributed to shareholders. To the extent that firms able to use the rule to their benefit were relatively closely-held, we might assume that they largely controlled these distribution conflicts through contractual arrangements. The inefficiencies generated by the rule were, therefore, those related to the incentive to distribute appreciated assets rather than to sell them to outsiders.

In the absence of the *General Utilities* rule, there is no incentive to distribute rather than to dispose (in a sale to an outsider), and disposition conflicts are eliminated by the presence of the corporate tax. Insofar as the ongoing operations of the firm are concerned, the repeal of the *General Utilities* rule was, therefore, probably a good thing. On the other hand, the repeal of the rule surely increases the two-tier tax burden on small firms, and investors on the margin will therefore prefer to avoid the corporate form of organization in favor of the proprietorship or partnership form even when the corporate form provides efficiency advantages. In the face

Finally, it is significant that tax relief for intercorporate ownership comes in the form of the intercorporate dividend rules, discussed in Part I.E., rather than through some provision lowering the corporate tax liability of the distributing corporation. The manager of a parent corporation may well be inclined to cause an eighty percent subsidiary to pay dividends, when other shareholders of the subsidiary would prefer retention. But inasmuch as relief is offered to the recipient parent corporation, so that the subsidiary's tax rate is unchanged, the corporate level tax continues to serve its equalizing function. The conflict is about distributions and not real in-firm dispositions. Moreover, because the manager's own individual taxes are unaffected by the intercorporate dividend deduction, there may not even be much of a conflict regarding distributions.

D. The Tax Treatment of Corporate Debt

In Part I.C. we showed that the treatment of corporate debt is consistent with the idea that there is a connection between heavier taxes and the ability to control the timing of taxes. The deductibility of interest as opposed to dividend payments was thus linked to the fact that bondholders and other creditors do not normally control the timing of their receipts, but rather receive interest payments according to a prearranged schedule. The introduction of agency cost considerations, and the role of the corporate tax in eliminating conflicts over in-corporate disposition decisions, suggests a still richer explanation for the tax treatment of debt. In terms of agency costs, the critical point is that there is no conflict between an insider, such as *M*, and *M*'s firm's bondholders as to the in-corporate disposition of assets. There remains, of course, the familiar problem of *M* (with the support of fellow shareholders) engaging in risk alteration, or gambling,[62] to the consternation of the firm's creditors. But insofar as the agency problems associated with dispositions and distributions are concerned, there is no conflict between bondholders and insiders. Bondholders simply do not much care about the debtor firm's disposition policy. Distributions are fixed by prior arrangement and dispositions are of little interest to the bondholders. Thus, a single tax is appropri-

of these conflicting effects it is difficult to say whether the rule's repeal was efficiency enhancing.

62 See generally R. Brealey & S. Myers, Principles of Corporate Finance 421-31 (3d ed. 1988) (discussing risk alteration).

ate because anything more would force investors, or at least investors who intend to borrow, away from the corporate form or away from the efficient use of collateral; and there is nothing gained by an equalizing, separate entity tax, because there are no agency problems for such a tax to solve.

Indeed, the only questions appear to be, first, whether interest expenses should be deductible to the corporate borrower or rather excluded from the income of creditors and, second, if interest income is to be taxed, what ought to be done when the bondholders are otherwise tax-exempt entities. The second question is outside the scope of this Article, and is instead an important part of the debate over whether corporations are too highly leveraged.[63] As for the first question, the treatment of debt must be consistent with the treatment of proprietorships or it will bias the decision as to organizational form or as to pooling itself. Moreover, we have already seen that over the long run the corporate tax rate must be lower than most individual rates—or investors will steer clear of the corporate form even though it offers a valuable means of reducing the agency costs associated with in-corporate dispositions—and if interest payments were made nondeductible but excludable, there would be more serious rate shopping problems than at present. Corporations that borrowed from bondholders would become intermediaries capable of earning money at a low rate and turning it over to individuals (who would otherwise be taxed at a higher rate) on a tax-free basis. In short, there are arguments to be made for treating debt as we do, but it is noteworthy that the role of the separate corporate tax in reducing the agency costs associated with in-corporate dispositions neither influences nor is influenced by the treatment of debt.

III. Special Entities

We turn now to special entities, singled out by tax law for their conduit qualities. The Code offers special pass-through rules for cer-

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[63] See supra note 26; see also I.R.C. §§ 246A, 279 (1988) (providing examples of limitations on tax advantages of debt-financed investments).

The idea that leverage may discipline managers, who must produce and distribute the cash flow necessary to pay interest obligations, is associated with Jensen, Eclipse of the Public Corporation, Harv. Bus. Rev., Sept.-Oct. 1989, at 61. The implication is that the deductibility of interest payments is a good thing because it encourages such disciplining, debt-heavy arrangements relative to (nondeductible) dividend distributions.

tain pooled investment schemes such as mutual funds, Real Estate Investment Trusts ("REITs"), and Real Estate Mortgage Investment Conduits ("REMICs"). With regard to these entities, the Code modifies the rules governing the familiar choice between one- and two-tier taxation. Our goal in this Part is to explore these special rules in light of the themes offered in this Article. Similarly, we examine the rules concerning Master Limited Partnerships ("MLPs") and tax exempt organizations ("TEOs"). Inasmuch as our goal is to extend the arguments about control and taxation as means of solving agency cost problems, our discussion of entities, or conduits,[64] in this Part is illustrative rather than exhaustive.[65]

A. Mutual Funds, REITs, and REMICs

Subject to specified conditions, mutual funds, REITs, and REMICs can be organized in the corporate form and yet excused from the separate tax normally levied on corporations.[66] These special corporations thus enjoy one-tier taxation at the investor level. This treatment has traditionally been understood as promoting a kind of horizontal equity, or neutrality. A wealthy investor can assemble a diversified portfolio singlehandedly, and enjoy one-tier taxation on interest and dividend income; more modestly situated investors would be penalized if, when they pooled capital in imitation of their wealthier counterparts, they faced a two-tier tax.[67] Pass-through entities such as mutual funds might therefore be understood as the means by which all investors can assemble portfolios subject to (horizontally) similar

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64 The entities discussed in this Part may all be regarded as conduits of one kind or another. Even charitable organizations can be seen as conduits between donors and beneficiaries. See Hansmann, The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation, 91 Yale L.J. 54, 64-66 (1981).

It should be noted that REITs, REMICs, and mutual funds are "modified conduits" because only gains—and not losses—can be passed through to their investors. Partnerships (including MLPs not reclassified as associations), on the other hand, are "full conduits" because losses can be passed through.

65 For details of the current rules, see Rocap & Waimon, Passthrough Rules for Financial Intermediaries: Different Routes to a Single Tax, 67 Taxes 1025 (1989). The best theoretical analysis is Clark, The Federal Income Taxation of Financial Intermediaries, 84 Yale L.J. 1603 (1975).

66 See I.R.C. §§ 851-855, 860 (1988) (mutual funds that qualify as regulated investment companies); id. §§ 856-860 (REITs); id. §§ 860A-860G (REMICs).

67 See, e.g., Adler, Master Limited Partnerships, 40 U. Fla. L. Rev. 755, 756-57 (1988) (noting that early MLPs were formed by "rolling up" several smaller partnerships into one larger partnership).

taxation. One problem with this explanation is that it is contradicted by the current rules' insistence that these special pass-through entities limit themselves to passive investment activities.[68] Inasmuch as wealthy investors can include real factories and other active businesses in their portfolios, the neutrality argument would suggest that all investors be permitted to do the same through intermediaries. Moreover, it would seem that investors in a mutual fund or similar entity (unlike a single, wealthy investor) face the agency problem discussed in Part II, that managers will make selfish in-firm disposition decisions, and inasmuch as many of these special entities are far from closely held, it is somewhat surprising that small investors are not herded into (or do not themselves select) a form of organization that is subject to a separate, "equalizing," tax.

On closer inspection, however, the rules affecting these special entities are quite explicable. Roughly speaking, the Code imposes two conditions, one on distributions and one on the nature of investment activities. First, income earned at the corporate level must be distributed to shareholders, or investors, in the year it is earned.[69] Second, the business or investment activity carried on in these singly-taxed entities must be passive.[70] In addition, most—but not all—of the corporate entities that qualify for special one-tier taxation will be specially regulated.[71]

These conditions, or characteristics, of the specially taxed entities suggest the explanation for their special treatment. The requirement of immediate distribution of income works to deny control over the timing of taxes. Shareholders in most corporations enjoy such control (directly or derivatively) and, as discussed in Part I, the extra corpo-

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[68] See infra note 70.

[69] See I.R.C. § 852(a)(1) (1988) (allowing conduit treatment for Regulated Investment Company only if it distributes 90% of its net income in the taxable year); id. § 857(a) (stating that to qualify as a REIT, trust's deduction for dividends paid must equal or exceed 95% of its taxable income); id. § 860C(a); Rocap & Waimon, supra note 65, at 1027 (noting that REMIC limited to holding fixed portfolio of real estate mortgages, receiving payments on mortgages, and distributing payments to owners of REMIC on an ongoing basis).

[70] Id. § 851(b) (demanding that 90% of Regulated Investment Company's income be derived from dividends, interest, and other sources related to investments in seeurities or foreigu currencies); id. § 856(c)(3) (stating that REIT must derive 75% of its gross income from dividends, interest, rents, and other sources related to investments in real estate); id. § 860D(a)(4) (stating that substantially all assets of a REMIC must consist of qualified mortgages and permitted investments).

[71] See infra text accompanying notes 74, 82, 83.

rate tax can be understood as the price of this control.[72] It is therefore fitting that the price of forgiveness of this tax is the denial of control. Moreover, there are several reasons why the agency problem that can often be solved with the introduction of a separate corporate tax is much less serious for these special entities than for businesses in general. First, these special entities are investment vehicles and cannot invest in "real" or active businesses and, as argued earlier, there is less of an efficiency problem when disposition decisions concern financial rather than "real" assets.[73] Second, most of these special entities are regulated in ways that constrain managers' behavior so that there is less room than in most corporations for conflicts to develop among investors regarding in-corporate decisions. Third, to the extent that some of these special entities are restricted in scope to real estate investments, disposition decisions may all be of a kind and may be relatively easy to observe and to control through shareholder votes or contractual agreements, even though the number of investors is large. Serious managerial misbehavior will generally be linked to specific real properties, and suspicious, sophisticated investors can often readily detect such misbehavior by tracing real estate transactions. Finally, and perhaps most important, it is noteworthy that the requirement that income earned by these special entities be distributed on a current basis ensures that investors in these entities will not confront conflicts of interest over distribution policies. In short, the corporate form normally allows investors to trade disposition conflicts for distribution conflicts; by contrast, the rules regarding these special entities do away with the separate corporate tax but also diminish room for conflict over dispositions and distributions.

1. Mutual Funds

A mutual fund is a pooled investment scheme through which managers invest in securities with funds contributed by public investors. If the fund qualifies as a Regulated Investment Company ("RIC"), then one-tier, pass-through taxation is available even though the fund is organized as a corporation. To qualify as a RIC, the entity must be registered under the Investment Company Act of 1940, and must sat-

72 See supra notes 4-5 and accompanying text.

73 See supra note 52 and accompanying text.

isfy restrictive conditions on investment and distribution.[74] At least ninety percent of the gross income of a RIC must be derived from investment in securities, and a RIC must distribute annually to its shareholders at least ninety percent of its net income (other than its net capital gain).[75]

This constraint on distribution policy denies investors control over the timing of their taxes, and is therefore easily associated with the availability of one-tier taxation. And the constraint on permissible investments means that the overwhelming share of managerial disposition decisions concerns the purchase and sale of securities. As emphasized earlier, selfish (and even suboptimal) decisions regarding financial assets are relatively unimportant in resource allocation terms and, to the extent that these decisions do matter, some managerial misbehavior will be controlled by the regulation called for in the Investment Company Act of 1940.[76] At best, a RIC can offer some choice to its investors, by deciding whether to invest in stocks that strive for income production or capital appreciation (much as a corporation may not distribute dividends but may provide a ready market for those who wish to sell shares[77]). In short, it appears that the agency problem associated with in-firm dispositions is much less serious for corporations that qualify as RICs than it is for corporations in general, and there is therefore less of a need for a separate corporate tax.

2. *REITs and REMICs*

REITs and REMICs can be thought of as mutual funds that invest in real estate. In the case of REITs, the Code limits investment activity by requiring that seventy-five percent of a REIT's income must be derived from investments in real estate, and forces ongoing distributions of income by requiring that ninety-five percent of taxable income, without regard to net capital gain, be distributed.[78] With

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[74] 15 U.S.C. § 80a-1 to a-64 (1988). Certain common trust funds need not be registered with the Securities and Exchange Commission in order to qualify for pass-through tax treatment. I.R.C. §§ 584(a)-(b), 851(a)(2) (1988); see R. Pozen, Financial Institutions 513-49 (1978).

[75] I.R.C. §§ 851(b), 852(a) (1988).

[76] See generally T. Frankel, The Regulation of Money Managers (1978 & Supp. 1990).

[77] See supra note 28 and accompanying text.

[78] I.R.C. §§ 856(c), 857(a) (1988).

respect to REMICs, a substantial part of a REMIC's assets must be invested in mortgage obligations acquired by the REMIC before its "startup day" or within three months thereafter. Conflicts over in-firm dispositions are thus largely avoided because each REMIC will distribute its income on an ongoing basis.[79]

Conflicts are also avoided because of the requirement that REITs and REMICs invest passively in real estate. This limitation on the entity's activities limits the scope of the enterprise and probably makes it easier for investors to anticipate future problems and to reduce (through contractual arrangements regarding managerial behavior) the agency costs associated with in-firm dispositions. In turn, these constraints and contracts are relatively easy to monitor because suspicious investors can trace real estate transactions.

It is noteworthy that the manager of a REIT enjoys greater discretion and flexibility than does the manager of a REMIC. A REMIC's ongoing investments are limited to mortgages, while a REIT's can include mortgages, government securities, interests in mortgages, and shares of other REITs.[80] This difference in scope can be understood from an agency cost perspective. REMICs deal in complicated collateralized mortgage obligations, or with slices of a portfolio of real estate mortgages that is divided into securities with differing maturities and payment priorities.[81] The idea is to devise slices such that the sum of what investors will pay for the parts (depending on their own preferences for different maturities and priorities) is greater than what investors would pay for the undivided whole. In short, a REMIC is essentially a complex repackaging of mortgages. If other investments were permitted to be included in these schemes it is likely that there would be greatly increased opportunities for managerial misbehavior.

A more straightforward way to associate lower agency costs with REITs rather than with REMICs is to note that state regulatory regimes, comparable to the Investment Company Act of 1940, govern REITs but not REMICs.[82] Thus, a REIT must have at least three

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79 See supra note 69.

80 See Rocap & Waimon, supra note 65, at 1027, 1039 (REMICs limited to fixed portfolio of mortgages whereas REITs have latitude to invest in real estate and securities).

81 See id. at 1027.

82 See North Am. Secs. Adm'rs. Ass'n ("NASAA"), Statement of Policy Regarding Real Estate Investment Trusts (Oct. 2, 1985). Some states have enacted regulations that include provisions similar to those drafted by NASAA.

trustees, more than half of whom are independent of the investment advisor. The trustees are responsible for a variety of monitoring tasks, including that of reviewing the compensation paid to the investment advisor. Conflicts are further controlled by a prohibition on transactions between a REIT and its investment adviser, and by state law constraints on the portfolio of a REIT.[83]

In summary, current tax law permits mutual funds, REITs, and REMICs to escape taxation at the entity level—but the price of this relief is easily understood to be the inability to control the timing of distributions and, therefore, of investor taxation. Moreover, limitations on the scope of each of these special entities reduce the very agency costs that a separate entity tax might otherwise eliminate. With the agency problem out of the way, neutrality, or horizontal equity, arguments dominate. These special entities can indeed be understood as placing the average investor on the same footing as the wealthy investor.

A remaining puzzle is why tax law does not offer small investors a *choice* between one-tier and two-tier taxation, but rather mandates pass-through taxation for special entities such as REITs. Neutrality (and, given some residual agency costs, perhaps efficiency) presumably would be furthered by allowing investors to choose a two-tier tax structure. The quick answer to this puzzle is that, in practice, current law does offer such a choice; it is easy to fail (intentionally) one of the requirements set out for these special pass-through entities. In reality, then, current tax law strongly reflects both the idea that control over timing is associated with extra taxation and the notion that a separate entity tax is a useful way of eliminating conflicts among investors over the disposition decisions in their enterprise.

B. Master Limited Partnerships

The term Master Limited Partnership (MLP) normally refers to an entity with numerous limited partners whose interests are traded in an active secondary market, such as a stock exchange.[84] Section 7704, added in 1987 in response to the sudden introduction and growth of

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[83] See id. § 3 (prohibition on self-dealing); id. § 14 (regulation of operating expenses); id. § 16 (initial capitalization); id. § 19 (investment restrictions). The trend is for states to regulate REMICs, but the regulation of REITs is more substantial. See NASAA, Real Estate Programs (1987).

[84] On the emergence of MLPs, see Adler, supra note 67, at 756-58.

MLPs, imposes corporate treatment (and therefore two-tier taxation) on Publicly Traded Partnerships ("PTPs").[85] Pass-through taxation remains available, however, for MLPs if they are engaged in passive investment activities in real estate or certain natural resources.[86] Section 7704 quite plainly stands in the way, however, of any plan by a large, widely-traded corporation to migrate from two-tier to one-tier taxation even while its shares (which become partnership interests) continue to be traded as before, because a PTP is defined in a way that includes most such large, widely-traded entities.[87]

What is interesting from the perspective of the control theme emphasized in Part I, however, is that new businesses are obviously also constrained by section 7704's rule regarding PTPs. This is at first quite puzzling because it is hard to see why investors in new businesses should not enjoy the familiar choice between one-tier taxation—with no control over timing—and two-tier treatment. Congressional antipathy toward PTPs may stem either from the abnormal inversion of individual and corporate rates since the tax reform of 1986[88] or, more simply, from a desire to avoid tax revenue losses. Congress may not only have sought to prevent the migration of business taxpayers from corporate to pass-through form but also may have wished to capture as many businesses as possible (whether old or new) in the higher rates.[89]

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[85] I.R.C. § 7704(a) (1988). Prior to the introduction of § 7704, some partnerships were reclassified as associations under Treas. Reg. § 301.7701 (as amended in 1983). See Adler, supra note 67, at 763-64 & nn.57-59; see also Peel, Definition of a Partnership: New Suggestions on an Old Issue, 1979 Wis. L. Rev. 989 (detailing the history of Treasury Regulation § 301.7701 from its inception in 1960 to 1977).

Some of Adler's criticism of the reclassification rules is softened by pointing out that REITs and REMICs, for instance, are corporations seeking one-tax treatment while MLPs might be understood as avoiding a gamble from the outset by choosing partnership taxation.

[86] I.R.C. § 7704 (c)-(d) (1988). Even if this provision is not applied, a partnership might still be reclassified as an association. Treas. Reg. § 301.7701-2 (as amended in 1983).

[87] According to § 7704(b), the term "PTP" means "any partnership if (1) interests in such partnership are traded on an established securities market, or (2) interests in such partnership are readily tradable on a secondary market (or the substantial equivalent thereof)." Section 7704(c) provides certain exceptions for partnerships with passive-type income.

[88] Cf. Peel, supra note 85, at 1003-04 (describing congressional refusal to grant partnership tax treatment to those entities that incorporated for reasons of convenience or business efficiency, and refusal to treat as corporations those partnerships that organized for tax shelter reasons).

[89] See McKee, Master Limited Partnerships, 45 N.Y.U. Inst. on Fed. Tax'n. § 23.06 (1987) (corporate taxation of MLPs would be triumph of revenue raising over sound tax policy).

From the perspective of the control theme advanced in this Article, it is noteworthy that section 7704 works to prevent "de-incorporation" and therefore prevents taxpayers, who had chosen two-tier treatment with control over the timing of the second tax, from withdrawing their gamble in midstream. Moreover, it is significant that partners continue to enjoy one-tier treatment if their interests are not freely transferable.[90] It is also arguable that transferability permits a degree of control because a taxpayer can trigger recognition by selling a partnership interest at a price that will reflect the unrecognized gains and losses associated with the partnership's assets. And from an agency cost perspective, it is striking that the Code insists on a separate entity tax for a PTP where there is an active business, investors with limited liability, highly liquid (publicly-traded) investment interests, and numerous dispersed investors. It is precisely in these circumstances that investors—who face a serious agency problem regarding in-firm dispositions and who will find it impractical to reach a contractual solution—can use an entity-level, flat, equalizing tax to solve their agency problem. Such a tax mirrors the hypothetical bargain that investors and managers might make in order to reduce agency costs. It is thus arguable that the remaining loss to investors associated with the inability to choose one-tier taxation is quite small and is, therefore, outweighed by the system's gain in preventing rate shopping.

C. *Tax Exempt Entities*

Tax exempt organizations are not taxed on in-entity dispositions, and neither their beneficiaries nor their contributors are taxed on normal distributions. The scope of these exemptions and the treatment of "unrelated business income" is far beyond the range of the present

[90] Adler, supra note 67, at 783-84, criticizes the rule that permits one-tier taxation so long as partnership interests, however numerous or limited, are not freely transferable. As noted in the text, the rule reflects the fact that without transferability there is less control. From an agency-cost perspective, it is tempting to argue that with free transferability there is less of an agency problem because there is more market discipline over managers. On the other hand, it is arguable that investors (with no power to transfer) should be able simply to choose at the outset whether to opt for one or two-tier taxation. In short, it is arguable that the control and agency-cost perspectives lead to different conclusions; this difference might be seen as the real source of the disagreement as to the effect transferability ought to have on PTP classification.

Article,[91] but it is useful to comment briefly on the rules concerning a TEO's use of debt, because these rules suggest an even richer relationship between agency costs and entity taxation. Generally speaking, a TEO is taxed on its income to the extent that the TEO actively engages in business activities unrelated to its tax-favored mission, or to the extent that it engages in passive investment activity with borrowed funds.[92] There are powerful incentive-based and competition-preserving explanations for the constraints on unrelated business activity, but because these explanations are far removed from our aims in the present Article, we pursue no further the subject of TEO involvement in active businesses.[93]

The relative penalty associated with a TEO's use of debt to invest passively in securities or real estate is quite puzzling. The rules provide that a TEO has nonexempt, unrelated income to the degree that its passive income-producing assets are acquired with borrowed funds[94] and a TEO cannot avoid these rules simply by investing through an intermediary. If a TEO has an interest in a partnership that borrows and engages in passive investments, the exemption from taxation is again proportionally forfeited.[95] By contrast, however, nothing stops or taxes a TEO that simply invests in the stock of a corporation that is itself highly leveraged. Similarly, a TEO is free to invest in a partnership—that is not an MLP—that does not simply invest in passive activities, but rather engages in a real business with borrowed funds.

It goes almost without saying that it is hard to see why (contrary to the spirit of Modigliani and Miller's insight regarding the irrelevance of a corporation's debt-equity ratio) a TEO that invests in the stock of a highly leveraged corporation is treated differently from a TEO that

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91 For a discussion of the TEO exemption and the tax on its "unrelated business income," see generally Hansmann, Unfair Competition and the Unrelated Business Income Tax, 75 Va. L. Rev. 605 (1989).

92 I.R.C. §§ 511-514 (1988).

93 For a discussion of this issue, see Hansmann, supra note 91; Rose-Ackerman, Unfair Competition and Corporate Income Taxation, 34 Stan. L. Rev. 1017 (1982).

94 I.R.C. §§ 512(b)(4), 514(a) (1988).

95 Id. § 514(c)(9)(B); see Beers, Real Estate Transactions and the Unrelated Business Income Tax: An Overview and Look at Current Developments, 5 Tax Mgmt. Real Est. J. 31, 38 (1989); Feder & Scharfstein, Leveraged Investment in Real Property Through Partnerships by Tax Exempt Organizations After the Revenue Act of 1987—A Lesson in How the Legislative Process Should Not Work, 42 Tax Law. 55-59 (1988).

borrows heavily in order to invest in an unleveraged corporation. Some aspects of these rules, however, may be explained from an agency cost perspective. The beneficiaries and contributors to many TEOs are very much like the creditors of a corporation in that they expect and hope for a relatively fixed and certain return over a long time period. Thus, contributors to a pension fund very much hope for stability and solvency. Even alumni who contribute to a university surely want their university to be managed in a way that ensures its long term survival. These groups, like familiar creditors of a business enterprise, will surely disapprove of (and fear) any plans by their TEO's managers to engage in risk alteration—that is, to gamble with the available funds on a risky project. It is thus possible that TEOs are discouraged by tax law from taking on debt because the contractual rule favored by their beneficiaries or contributors (who are often too dispersed to bargain about these matters) is one that limits such debt. After all, if the business or investment activity engaged in by a leveraged TEO performs below expectations, the debt obligation will need to be satisfied before funds can be applied to the purposes favored by the contributors or beneficiaries (or legislators who granted the tax-exempt status in the first place). In short, the tax law rules can be understood as discouraging an ongoing tax-exempt entity from taking on obligations that will subordinate the original "creditors" of the organization. The imposition of an entity tax is thus again associated with the reduction of agency costs.

It remains true, of course, that a TEO can effectively subordinate its beneficiaries by investing in the stock of a highly leveraged corporation. When a TEO takes on debt in this manner, however, it will usually be the case that other investors—the preexisting creditors of the corporation—will monitor the managers, object to risk alteration, and in general have preferences that match those of the TEO's dispersed beneficiaries. It is also the case that as an administrative and practical matter it would be quite difficnlt to discourage TEOs from investing in leveraged corporations. Given the emphasis in this Article on the relationship between entity taxation and agency costs we prefer to focus on the agency-cost explanation for the treatment of TEO income.

Finally, TEOs cannot retain their exemption when they use borrowed money to invest; by contrast, mutual funds, REITs, and REMICs can use borrowed money to invest while retaining their pass-through advantages. One might simply repeat the observation that a TEO's beneficiaries and donors are concerned about risk alteration, while the same cannot be said about investors in mutual funds and other special pass-through entities. But it is tempting to extend the argument about the monitoring needs of dispersed investors, and to note that REITs, REMICs, and mutual funds are limited to investments in securities *or* in real estate and that none of these entities can invest in both securities and real estate. By contrast, TEOs operate under no such constraint so that it may be that a TEO's manager would have too much room to maneuver, from the point of view of beneficiaries and donors, if uninhibited borrowing were also permitted. And in the case of pension funds and some charitable organizations, as opposed to mutual funds, REITs, and REMICs, it is possible that an insider's personal plans and tastes (regarding retirement or the TEO's goals, for instance) could create conflicts as to in-firm dispositions.

Conclusion

It is easy to see how the first descriptive theme advanced in this Article, that taxation is correlated with taxpayer control over the timing of taxes, might be coordinated with an evolutionary theory of tax law. Political and economic pressures may work to equalize the effective tax rates applied to a variety of activities and forms of organization, and taxpayers who can reduce their liabilities by controlling the timing of taxable events may find themselves facing additional taxes. It is far more difficult, however, to see how the second theme advanced here, that a separate tax on corporations is a useful tool in reducing agency costs, has become part of the law. The most promising evolutionary argument hinges on the idea that investors neither abandon the corporate form nor join academic commentators in lobbying for the repeal of the corporate tax because investors somehow believe or understand that the separate tax on corporations, if applied at modest rates, is a small price to pay for the elimination of conflicts regarding in-firm dispositions. This idea extends the reach of the invisible hand further than we are inclined to stretch it.

Even if the origin and survival of the separate corporate tax has everything to do with politics, legal fictions, the need for revenue, and other considerations far removed from agency problems, there is no reason to ignore the fact that the two-tier tax system, whatever its origins, has a desirable effect on the agency problems associated with the pooling of capital. There is therefore a case to be made for offering investors a choice between one- and two-tier taxation (although it is difficult to set forth tax rates that will cause investors to choose on the basis of agency costs alone[96]), and there is also an argument for insisting on two-tier taxation for some entities—especially when dispersed investors might be exploited by a switch to pass-through taxation.[97] At the very least, it is clear that the efficiency cost of the separate corporate tax (and the potential gains from tax integration) is much less than generally thought. But our aim, at least for now, has not been to argue for a given level of corporate taxation, for a given range of choice, for particular treatments of debt, or for other complicating claims. Instead, we have drawn attention both to the contours of the choice that is currently available and to the equalizing effect of the separate corporate tax. We have tried to reorient the path of tax reform and to show that there is more elegance to tax law than first meets the eye.

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[96] See supra Part I.C.

[97] If a publicly held corporation, with dispersed investors, switches to the MLP form in the quest to reduce tax liability, investors may face increased agency costs because of the sudden need for concern about in-firm dispositions. One argument against allowing such switches, or against allowing such firms to enjoy partnership tax treatment, is, therefore, that agency costs will be redueed by such a rule discouraging switching. Investors may vote for the change, but the argument that such a vote may not be efficient is a strong one. See, e.g., Gordon, Ties that Bond: Dual Class Common Stock and the Problem of Shareholder Choice, 76 Calif. L. Rev. 1 (1988) (arguing against relying on midstream votes as guides to desirable, efficient transactions). There remains, of course, the question of why new entities should be unable to choose one-tier taxation. See I.R.C. § 7704(a)-(b) (1988) (widely-traded partnerships treated as corporations—with no distinction between new entities and those switching from the corporate form). A plausible normative argument is that it is too difficult to police the problem of liquidations followed by reincorporations and the further problem of purchases by "new" partnerships of all the assets or stock of preexisting corporations. In short, PTPs may be discouraged because dispersed shareholders may be better off paying a price, in the form of a greater two-tier tax bite, for the agency cost advantages of a separate corporate tax.