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WHO SHOULD PAY THE CORPORATE TAX IN A FLAT TAX WORLD?

Rebecca S. Rudnick*

This article reviews the corporate tax system within the context of the historical bias and current effects of the current system of taxation of corporations and shareholders. Drawing on public finance theory, financial markets microstructure research, and perspectives on corporate governance, Professor Rudnick proposes a profits tax on the liquid equity of firms. She finds this to be a normative rationale for a double tax system under opti-
mal tax principles due to the inelasticity of demand for and supply of liquidity and the economic rent it produces. The value of liquidity in different capital markets is the crucial determinate. Under traditional tax policy criteria of horizontal and vertical equity and efficiency, this approach correctly classifies those firms that can normatively be included in a double tax system after an interest return on equity is deducted. Drawing the line at liquidity allows the fullest expansion of passthrough regimes such as Subchapter S and partnership taxation as well as other forms of integration.

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THIS ARTICLE attempts to answer the question: "Who should pay the corporate tax?" It formulates a defensible, normative rationale for a classical corporate income tax or a profits tax on firm income after allowance is made for interest on firm capital, and then uses that rationale to distinguish firms to which a two-tier double tax system should apply from firms to which a pass-through system of taxation should apply. The approach taken is catholic in its outlook, drawing freely from traditions in neoclassical economics, financial markets microstructure, and perspectives on corporate governance, as well as traditional and non-traditional public finance theory.

Under the classical corporate tax system, the profits of a firm are taxed to the firm and dividends are independently taxed as personal income to the recipient with no

1. Normative principles seek equity, efficiency, and neutrality. They are based, at least in the equitable taxation tradition, on a general ability to pay. Taxation, however, also causes economic responses that affect the efficiency of the economy and the ultimate welfare of its participants. With respect to the double tax system, normative policies suggest strongly that no form of income should receive discriminatory taxation at the expense of long-term efficiency and the appropriate accounting for the cost of capital. See Warren, The Corporate Interest Deduction: A Policy Evaluation, 83 YALE L.J. 1585, 1597 (1974) [hereinafter Warren, Interest] (noting some reasons for not deducting payments to the firm's labor, supplier, and especially debt capital providers under the structure of an income tax and specifically recommending nondeductibility of corporate interest). But see Warren, The Relation and Integration of Individual and Corporate Income Taxes, 94 HARV. L. REV. 717, 734 n.43 (1981) [hereinafter Warren, Integration] (retracting suggestion of nondeductibility of corporate interest on efficiency grounds). If efficiency is too difficult to model, then the best the tax system can do is to promote neutrality. The correct response to the normative form of the double tax system also depends upon the assumptions about the form that system ought to take and the transactions that can be viewed as circumventing the proper formulation of the system. See Warren, Recent Corporate Restructuring and the Corporate Tax System, 42 TAX NOTES 715 (1989) [hereinafter Warren, Restructuring] (detailing the countervailing corporate and legislative cures for the apparent defects in the preference for debt, the tax disadvantage of equity, and the proper taxation of distributions to shareholders). See also Mundstock, Taxation of Business Intangible Capital, 135 U. PA. L. REV. 1179, 1183 n.14 (1987). I readily acknowledge the tensions between policy goals of income-tax structure and long-term social-welfare concerns.

A short version of this Article appeared as Rudnick, Corporate Integration and Investment Liquidity, 42 TAX NOTES 1107 (1989).


3. For a description of the classical system, see Organization for Econ. Co-operation and Dev., Theoretical and Empirical Aspects of Corporate Taxation 13 (1974) [hereinafter O.E.C.D.] (Under the classical system corporate profits are taxed to the firm and dividends are independently taxed as personal income to the recipient with no
firm, including those used to pay interest-like returns on equity capital, are taxed at the firm level and again when distributed to the owners. Thus, a classical corporate tax may operate as a tax on corporate capital as well as on profits. By contrast, under integrated taxation regimes, only one level of tax is paid on the income generated by the firm’s activity. Under one kind of interplay between these two levels of taxation,); Sato & Bird, International Aspects of the Taxation of Corporations and Shareholders, 22 INT’L MONETARY FUND STAFF PAPERS 384, 387-88 (1975) (The “corporation is recognized as a separate entity for income tax purposes, and virtually no relief is provided to shareholders for further personal income taxes levied on distributed corporate earnings.”); A. van den Tempel, Corporation Tax and Individual Income Tax in the European Communities 7 (1970) (The classical system accomplishes double taxation by using a corporation tax plus a second and independent individual income tax.).

4. Variations on the classical system include differentiating at the shareholder level the tax consequences of distributions of earnings from those of sales of stock and, under split-rate systems for all or only certain corporations, taxing undistributed earnings differently from distributed earnings at the firm level. O.E.C.D., supra note 3, at 13-14 (noting number of O.E.C.D. countries that had adopted split-rate systems); Sato & Bird, supra note 3, at 389-90 (describing Germany’s then split-rate system); A. van den Tempel, supra note 3, at 7. Split-rate systems can also operate under integrated systems, See Staff of the Jt. Comm. on Tax’n, 101st Cong., 1st Sess., Federal Income Tax Aspects of Corporate Financial Structures 89 (Comm. Print 1989) [hereinafter Corporate Financial Structures] (noting current German system taxing retained earnings at 56%, distributed earnings at 36% and a full credit for the 36% corporate tax).

5. This is a very traditional view under the assumption that marginal investment is made with equity. See A. Atkinson & J. Stiglitz, Lectures on Public Economics 129 (1980) (“If there are constant returns to scale, and hence no ‘pure’ profits; and if interest is not deductible, then it seems clear that the corporate profits tax ought to be viewed [as a tax on the return to capital.]”); Comm. on Ways and Means, 86th Cong., 1st Sess., Tax Revision Compendium: Compendium of Papers on Broadening the Tax Base, pt. 1, 231, 241 (Comm. Print 1959) [hereinafter Tax Revision Compendium] (paper submitted to the committee by Arnold C. Harberger entitled the Corporation Income Tax: An Empirical Appraisal) (“[T]he [corporate] tax will necessarily be borne out of the earnings of fixed capital equipment . . . .”). For other views, see infra notes 60-69.

6. Passthrough systems occur in one of three basic types: (1) one that “causes losses and undistributed income to pass through to the owners;” (2) one that causes undistributed income to pass through but not losses; and (3) one that “taxes the owners on distributed income and allows the entity to deduct the distributions,” but does not allow the losses to pass through. See J. Eustice & J. Kuntz, Federal Income Taxation of S Corporations ¶ 1.03[2][a], at 1-40 to 1-42 (1985).


Similarly, the Code contains at least five examples of the second type. See I.R.C. §§ 551-558 (West 1988 & Supp. 1989) (foreign personal holding companies); I.R.C. §§ 991-
grated system, generally designated full integration, the income of the firm is allocated and taxed only to the owners; under another, denominated an imputation system, the firm pays the tax and the owners receive credit for the firm taxes paid; under a third, the firm gets a deduction for distributions of earnings. These latter two systems give a credit or deduction for all or part of the tax or distribution at the firm level.

There is a strong body of opinion, in which I generally join, that if we could deal adequately with all windfall gains and losses.

7. Integration systems, and particularly the method by which the shareholders receive a credit for firm-level taxes paid, are referred to as "imputation" systems in foreign and some United States discussions of corporate taxation. For a comprehensive discussion of various integration techniques, see R. Musgrave & P. Musgrave, Public Finance in Theory and Practice 395-400 (4th ed. 1984); Warren, Integration, supra note 1; Sato & Bird, supra note 3, at 384-95; O.E.C.D., supra note 3, at 13-16; Corporate Financial Structures, supra note 4, at 86-89. For a comprehensive view of the classical, split-rate, or dividend deduction, and imputation systems of company taxation in a multinational context, see J. Alworth, The Finance, Investment and Taxation Decisions of Multinationals 38-66 (1988).

8. The previous integration proposals, beginning in 1975, have foundered at least in part on the problem of the undesirable windfall gains for existing shareholders. See infra note 11. Windfall gains arise because "[m]ost current owners of corporate shares acquired their shares at [a discount because of the] expected double tax." 2 Dept't Treasury, Tax Reform For Fairness, Simplicity, and Econ. Growth 143-44 (1984)[Volumes 1 and 2 are hereinafter Treasury I Study]. The extent of this windfall depends on how the corporate tax rate, or alternatively the shareholder level tax on distributions, is capitalized into the value of shares. See infra notes 60-71 and accompanying text. Nonetheless, the debate over retroactivity begins with the assumption that the likelihood of future tax changes has been capitalized by the market. Compare Graetz, Legal Transitions: The Case of Retroactivity in Income Tax Revision, 126 U. Pa. L. Rev. 47, 57-58 (1977)(arguing that the market assesses all positive and negative probabilities of future events in setting prices and opposing all but delayed or phase-in relief for transitions) and Kaplow, An Economic Analysis of Legal Transitions, 99 Harv. L. Rev. 509 (1986)(opposing all transitional relief) with Shachar, From Income to Consumption Tax: Criteria for Rules of Transition, 97
Harv. L. Rev. 1581 (1984) (supporting transition rules to place burden on superior risk bearers) and Ramseyer & Nakazato, Tax Transitions and the Protection Racket: A Reply to Professors Graetz and Kaplow, 75 Va. L. Rev. 1155 (1989) (arguing that Graetz and Kaplow fail to take the political context of tax reform into account, thereby overlooking why Congress will reject grandfather clauses and instead concentrating on why Congress should reject transitional relief). Much of the economic literature assumes that the problem created by windfall gains is the result of at least a portion of the corporate tax being capitalized into the value of the shares. See, e.g., M. Feldstein, Capital Taxation 156, 176-77 (1983) (equity owners bear a portion of the corporate tax burden); Head & Bird, Tax Policy Options in the 1980s, in Comparative Tax Studies 3, 16-17 (S. Crossen ed. 1983) (abolition of the corporate profits tax would generate windfall gains for shareholders). Because of windfall from capitalization of the firm-level tax, integration "would be an extremely inefficient way of achieving the benefits of increased equity finance or improved resource allocation associated with de novo enactment of an integrated corporate-personal income tax." See McLure & Zodrow, Treasury I and the Tax Reform Act of 1986: The Economics and Politics of Tax Reform, J. Econ. Persp., Summer 1987, at 37, 53 (cost in fiscal 1990 of full integration $31 billion, "and this revenue loss would represent windfall gains to present owners of corporate shares."). Accord Summers, Taxation and Corporate Investment: A Q-Theory Approach, 1 Brookings Papers on Econ. Activity 67, 105 (1981) (integrating old equity is a disfavored strategy for encouraging capital formation).

Not all experts believe that windfall gains would occur. See Sheppard, Corporate Tax Integration, the Proper Way to Eliminate the Corporate Tax, 27 Tax Notes 637, 640 & n.7 (1985) (summarizing the contrasting viewpoints of Professors Warren and Andrews). Not all agree that there is sufficient empirical evidence of capitalization of the firm level tax. See infra notes 66-69; see also infra note 127.

The Treasury Department accepted the existence of the threat of windfall gains and stated that "any relief from the double taxation of corporate earnings distributed to shareholders should be phased in over time." 2 Treasury I Study, supra, at 143-44. A phase-in period could eliminate the presumed windfall effect for old equity by allowing the market to readjust and could be accompanied by a compensatory tax on distributions of retained earnings.

Proposals to compensate for a perceived windfall gain include:

(1) Institute a firm-level deduction or a shareholder-level credit for dividends paid, and combine it with a firm-level tax on accumulated earnings and profits (perhaps payable over several years). See Senate LBO Hearings, infra note 16, at 62 (prepared statement of Alan J. Auerbach). This option is similar to the 1985 proposal on reducing windfalls from corporate rate reduction. See Office of the President, The President's Tax Proposals to the Congress for Fairness, Growth and Simplicity 120-23 (1985) [hereinafter President's Study];

(2) Grant dividend relief only for new equity issues and subjecting old equity issues to a firm-level tax on nondividend corporate distributions withheld at the corporate level and creditable at the shareholder level, see Senate LBO Hearings, pt. 2, infra note 16, at 62-64 (prepared statement of Alan J. Auerbach) (discussing the approach taken by the American Law Institute Reporter in Group Draft No. 18, infra note 54, and noting distortions in share repurchases, leveraged buyouts and cash acquisitions and noting further that this proposal is complex but politically palatable);

(3) Equalize tax treatment of debt and equity either (a) by combining a dividends paid deduction with a partial denial of the interest deduction, see Senate LBO Hearings, pt. 2, infra note 16, at 64 (prepared statement of Alan J. Auerbach) (noting that its cost of discouraging corporate investment could outweigh the benefit of neutrality between corporate financing decisions), or (b) by allowing a credit for a portion of the dividends paid to shareholders equal to a disallowed portion of firm level interest payments and a credit to
and with the treatment of tax preferences, we would only need to tax corporate income once at the appropriate rate. In the United States, integrating firm and shareholder taxes has received considerable attention, as it has abroad especially as the European bondholders, see id. at 73-76 (prepared statement of Michael J. Graetz)(The proposal is structurally revenue neutral since the bondholder tax credit would not be refundable for tax exempt and foreign bondholders. Furthermore, the windfall gain enjoyed by shareholders is exactly offset by the burden placed on these tax exempt and foreign bondholders.).

Even without direct transitional relief, a form of integration is preferred. See House LBO Hearings I, infra note 16, at 404 (prepared statement of Alvin Warren)(best solution is to begin integration, perhaps coupled with a limit on interest deductibility in certain cases involving substitution of debt for equity). For the view that integration is both desirable and essential, see Warren, Integration, supra note 1, at 744-53.

9. See, e.g., C. McLure, Must Corporate Income Be Taxed Twice? 217 (1979)(Under an integrated system tax preferences would necessitate keeping "accounts for accumulated and current taxable income and for accumulated and current preference income" where now it is only necessary to keep accounts for "current and accumulated earnings and profits."). See also Popkin, Correspondence, 87 Yale L.J. 1319, 1323-25 (1978). This issue has become less important after 1986.


11. As capital markets become more perfect, following trading partners with integrated systems may be the preferred approach. See Senate LBO Hearings, pt. 2, infra note 16, at 199-200 (prepared statement of Lawrence Summers). The Administration has recently viewed the issue of corporate-shareholder taxation as follows:

Our trading partners also have the advantage when it comes to tax treatment of corporate earnings. They all, to some extent, integrate individual and corporate taxes to prevent fully taxing the same income twice. . . . Changing the policy of double taxation would provide an incentive for long-term growth by lowering the overall cost of capital . . . [and] removing the double taxation of dividends would eliminate the bias towards debt without raising the cost of capital.

Economic Community seeks to harmonize the taxation of corporations under a system of integration and a shareholder credit for firm taxes paid. This body of opinion maintains that given an

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13. For a recent summary, see Bird, Corporate-Personal Tax Integration, in Tax Coordination in the European Community 227 (S. Cnossen ed. 1987). Studies following the adoption of an integrated system by the Common Market countries in their company tax harmonization efforts have questioned the efficacy of the imputation system in raising or accumulating additional capital by business and have suggested that the inefficiency costs of the classical system were exaggerated, see Gourevitch, Corporate Tax Integration: The European Experience, 31 Tax Law. 65, 79-84 (1977)(citing O.E.C.D., supra note 3, at 20, Wiseman and Davenport's 1974 O.E.C.D. study, and Severiens's study of the French stock market after enactment of the avoir fiscal system). For a report on harmonization, see Chown, Company Tax Harmonization in the EEC: A Progress Report, Tax Planning Int'l Rev., Nov. 1988, at 3 (detailing issues to be faced in harmonization including borrowing, capital gains, foreign tax and imputation credits, and capital neutrality). The integrated tax system of the EEC includes double taxation of corporate income and a preference for unincorporated entities. See Commission of the European Communities, Report on the Scope for Convergence of Tax Systems in the Community 46-47 (Bulletin of the European Communities — Supplement 1/80, 1980)(demonstrating a difference between the credits as a percentage of gross dividend and as a percentage of the corporate tax (100% of the tax in Germany, 25.5% of the tax in Denmark, with no tax credit in Luxembourg or the Netherlands)). The preferred system would only allow a 45-55% credit for firm taxes paid. For a discussion of the taxation of partnerships and the difficulty in harmonizing the systems and closer alignment of rates, see id. at 60-62. See also Corporate Financial Structures, supra note 4, at 89 (noting current levels of elimination of the double tax by United States trading partners). For the view that the U.S. should follow the European lead, see A.B.A. Section of Taxation/N.Y. State Bar
income tax on individuals, a corporate tax is needed only to assure that undistributed corporate income does not escape taxation.\textsuperscript{14} On the other hand, integration is not mandated if, as I propose in this Article, a normative model for a classical corporate tax or a profits tax can be designed. The pressures for the migration of firms to a noncorporate status outside of the classical corporate tax regime\textsuperscript{15} and the continued concerns over high leveraging of United States corporations\textsuperscript{16} are symptoms of the failure to implement a nondistortionary normative policy of taxation of corporate profits.

The influential Canadian Carter Commission Report,\textsuperscript{17} issued in 1966, stated that a similar rate structure for corporate income and individual income is a prerequisite to an integrated tax system

\textsuperscript{14} Graetz, \textit{Can the Income Tax Continue to Be the Main Revenue Source?}, in \textit{Options for Tax Reform} 39, 53 (J. Pechman ed. 1984). Under this view, the firm is an accrual-basis proxy for the individual tax. See Committee on Taxation of the Twentieth Century Fund, \textit{Facing the Tax Problem} 414 (1937)(hereinafter Twentieth Century Fund Report)(the corporate tax should be used as a means of collecting at the source and in advance a personal income tax on resident holders of corporate stock and as the only means of collecting tax on nonresident holders); Bradford, \textit{The Choice Between Income and Consumption Taxes}, in \textit{New Directions in Federal Tax Policy for the 1980's}, at 229, 241-42 (C. Walker & M. Bloomfeld eds. 1983)(noting that "the double taxation of dividends as practiced in the United States [is] hard to justify").

\textsuperscript{15} See infra notes 30, 133-35, 139-57 and accompanying text.


for the taxation of corporations and their shareholders. Similarity in rate structure would allow the firm level tax to operate as a withholding tax. Under such a view, now would be an opportune time to pursue integration in the United States. With some differences, rates are now virtually the same for corporations and individuals, and distortions from a preferential capital gains rate are not present. But so far Congress clings to the notion of a separate corporate tax on income as a part of its tax theology and as a revenue source. While the initial Treasury study and the President's study leading to the Tax Reform Act of 1986 proposed forms of integration that generated somewhat more support

18. Id. at 7, 35, 267-76.
19. The Carter Commission proposed setting a withholding rate on corporate earnings at the top individual marginal tax rate and then allowing corporations to allocate retained profits to shareholders for tax purposes. This would be done by sending each shareholder a statement indicating his or her pro rata share of retained profits together with the tax withheld on that share. The total sum would then be included on the shareholder's return and the withheld tax credited, with refunds to individuals in lower tax brackets. Id. at 83-84. Canada did not adopt the proposal but it did adopt distinctions between public and private firms. See Bird, supra note 13, at 236-38. The Carter Commission Report is a useful guide in a flat-tax world. For a description of the proposal, see Break & Pechman, Relationship Between the Corporation and Individual Income Taxes, 28 NAT'L TAX J. 341, 347-48 (1975).
20. SUBCHAPTER C CONFERENCE, supra note 13, at 178 (participant noting that Carter Commission direct tax to shareholders on retained corporate earnings was "particularly attractive now in the U.S. with an individual rate that is lower than the corporate rate" and that the system would be simpler than Subchapter C). Integration could be accomplished either with a refundable credit upon distribution of earnings or no credit except for individuals taxed at the 15% rate. This low tax bracket exception could be justified on the theory that the disparity between 34% and 15% is simply too large. Cf. McNulty, supra note 12, at 670-71 (noting that the 1981 rates fulfilled the Carter Commission parity requirement, although the effective corporate rate was in fact much lower). The present debate is the same as it was prior to 1981. Is the corporate tax an adjunct to the individual income tax base or is it a separate tax on corporate profits? See Warren, The Relationship Between the Corporate and Individual Federal Income Taxes After the Economic Recovery Tax Act of 1981, 1981 PROC. NAT'L TAX ASS'N 27, 30 [hereinafter Warren, Relationship].
21. The present differences between corporations and individuals include a higher corporate rate (34% versus 33% or 28% at the top), graduated corporate rates for smaller firms which place the highest marginal rate at 39% for the phase-out of the graduated rates, see infra note 77, and limited graduation for individuals. Capital gains distributions and sales have been viewed as eliminating the simplicity of integration. See Popkin, supra note 9, at 1321-25. Even without a capital gains distortion, nondividend distributions to shareholders by repurchases and substitution of debt for equity continue a distortion within the classical corporate tax system.
22. 2 TREASURY I STUDY, supra note 8, at 134-44.
23. PRESIDENT'S STUDY, supra note 8, at 120-29. The administration proposal with some modifications was passed by the House. See supra note 11.
in the business community than prior proposals,\textsuperscript{25} the final Act both reaffirmed the classical system\textsuperscript{26} and increased incentives to earn business income as a passthrough entity.\textsuperscript{27} Treasury studies on the corporate and passthrough tax regimes have been mandated by Congress but have not yet been reported, while the study on integration should be reported in 1990.\textsuperscript{28}

In 1987, Congress expanded the scope of the corporate tax system by including publicly traded partnerships\textsuperscript{29} among the firms taxed as corporations, in order to relieve the presumed pressure to disincorporate.\textsuperscript{30} In September of 1988, the Internal Reve-

\footnotesize{25. Previous proposals lacked business community support and managers preferred retained earning financing. \textit{See} Sheppard, \textit{supra} note 8, at 645. Firm managers still may not want pressure to pay out earnings and only want tax reductions on retained, as opposed to distributed, earnings. \textit{See} \textsc{Subchapter C Conference}, \textit{supra} note 13, at 161 (statement of Michael Graetz).


29. These were also known as master limited partnerships ("MLPs"). The term "master" referred to a two-tiered structure that was used to satisfy the laws of many states governing limited liability. Many states required that the names of the limited partners be stated, an impossible task for a publicly traded partnership. Thus, the requirement was satisfied by "making the parent 'master' partnership whose units were traded the sole limited partner of [the] subsidiary limited partnership formed in the state," with the master partnership organized in the state that did not require a filing of the names of the limited partners. McKee, \textit{Master Limited Partnerships}, 45 \textsc{N.Y.U. Inst. on Fed. Tax'n} § 23.01, at 23-1 n.1 (1987).

The Service completed a six-year study of the *Morrissey*\(^3\) resemblance test for classification of unincorporated entities as "associations" taxable as corporations.\(^3\) Upon completion of this study, the Service issued a ruling\(^3\) that nominally applied *Morrissey* as interpreted in the *Kintner* regulations,\(^4\) but that unofficially resolves the characterization question based on the public-trading standard of I.R.C. section 7704.\(^5\)

The 1986 legislation exacerbated two of the three most prominent distortions of the old classical corporate tax regime — the bias toward unincorporated firms and the preference for debt rather than equity financing. The first of these was tempered by the third distortion — the bias toward retention of earnings — but this third distortion was largely eliminated by the 1986 Act's inverted rate structure that unmistakably tipped the scales in favor of pass-through taxation. The bias toward retained earnings\(^6\)

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33. Rev. Rul. 88-76, 1988-38 I.R.B. 14. Applying the four-factor association test — limited liability, centralized management, continuity of life and free transferability of interests — the Service ruled that the presence of limited liability for all firm members in combination with representative corporate management for a real estate firm of 25 members formed under the Wyoming Limited Liability Company Act, Wyo. Stat. §§ 17-15-101 to -136 (1977), will not result in association status if the firm technically dissolves under state law by membership changes and it limits the right to transfer an interest entitled to management participation, but not profit participation, only by unanimous consent. Neither the number of members nor the type of property was determinative and the Wyoming Act is not limited in either respect. *See* Wyo. Stat. § 17-15-103 (1977)(limited liability companies may be organized for any purpose except banking or insurance). Assuming that state law fills the breach by adopting acts such as the Wyoming Act or the Georgia Uniform Limited Partnership Act, Ga. Code Ann. §§ 14-9A-1 to -130 (Supp. 1988), for unlimited numbers of participants and purposes and for new firms, especially where control is not greatly valued, the operative test for corporate production will be the publicly traded standard. The existence of the Service's position on the Wyoming Act provides planning opportunities and raises the question of whether for tax and nontax purposes the characterization of the firm as a limited liability company and a tax partnership will prevail if used by non-Wyoming residents in their home states.
36. *See* M. Fox, *FINANCE AND INDUSTRIAL PERFORMANCE IN A DYNAMIC ECONOMY* 233-34 (1987)(1961 study indicating a strong preference for internal financing was updated by Fox with a similar result for 20 randomly selected Fortune 500 firms during the years 1977-1981); *see also* Greenwald, Stiglitz & Weiss, *Informational Imperfections in Capital Markets in Macroeconomic Fluctuations*, 74 AM. ECON. REV. 194 (1984)(the fact that only 3.9% of the funding sources for 799 industrial firms reported on the Value Line database in 1984 were common or preferred stock issues explained on a theory of capital
arose from the desire to defer shareholder taxes into the future, and it gave rise to the 1984 American Law Institute (ALI) view of the classification issue, which presumed equivalence between the corporate and passthrough tax regimes.\textsuperscript{37} Today, very few firms are able to take advantage of the deferral of shareholder tax because, except for firms able to utilize the graduated corporate rate structure, corporate rates are higher than individual rates. Accumulations no longer enjoy lower taxes than if the income had been taxed directly to the owner.\textsuperscript{38} In a flat tax world without a capital gains preference and with the repeal of the General Utilities doctrine — which now requires taxation of corporate asset appreciation at the firm level upon liquidation — the corporate strategies of earnings retention and bailout are rarely advantageous.\textsuperscript{39} Even if preferential treatment for capital gains were reintroduced, a corporate rate that is higher than the individual rate eliminates the deferral value of corporate retention. However, the capital gains preference would create a bias against dividend distributions of earnings and would further favor redemptions.

The distinctly increased bias toward corporate debt financing that began in 1981 continues,\textsuperscript{40} despite the increased relative tax cost of debt financing (in 1989 relative to 1985) and the decline in the individual marginal rate on interest income below the corpo-

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\item[39.] Timing of the second tax and the occurrence of full double taxation has always been subject to deferral. See W. Vickrey, Agenda For Progressive Taxation 155-56 (1947)(deferral is equivalent to an interest-free loan from the government). See also infra note 106. The double tax can be avoided through use of the stepped-up basis at death. See I.R.C. § 1014(a) (West 1988). Furthermore, its effects can be mitigated through the purchase of debt that generates deductible interest, a form of tax arbitrage now covered by I.R.C. § 163(d) (West 1988 & Supp. 1989), see 1987 Senate MLP Hearing, supra note 30, at 62 (statement of J. Roger Mentz), or other deductible rent and salary payments to owners. Moreover, prior to the 1986 Tax Act, such major capital transactions as a liquidating distribution and the sale of appreciated assets incident to liquidation were exempted from the corporate level tax. \textit{Id}.
\end{itemize}
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rate rate. However, the bias toward debt financing relative to retained earnings financing for individual firms depends on the change in their marginal tax rates and the marginal rates of their investors. A consequence of equity retirements through corporate repurchases of equity and debt replacing equity, an increased level of new borrowing, and new equity issues amounting to less than one third of equity retirements has been "negative financing" by new equity beginning in 1984. Also beginning in 1984, the value of stock repurchases and cash distributions to shareholders through acquisitions now surpasses the value of dividend distributions for the major public corporations. Indeed, mergers and ac-

41. See Hausman & Poterba, Household Behavior and the Tax Reform Act of 1986, J. Econ. Persp., Summer 1987, at 101, 110 (The marginal tax rate on interest income has fallen by just over 4% under the 1986 Tax Act. This decline is much less than the decline in the corporate tax rate. Debt-financed investment may have been discouraged in significant measure by this new development.). In fact, it has not. See infra notes 158-74 and accompanying text. The particular firm leverage incentive after 1986 depends upon whether the firm's tax rate increased or decreased after 1986 and whether its investors are taxable at the top marginal rates, the middle income level, or are tax exempt. See Poterba, Tax Policy and Corporate Saving, 2 Brookings Papers on Economic Activity 455, 489-91 (1987)(demonstrating that debt finance is only preferable for existing firms where the firm and shareholders are taxed at the highest rates both before and after 1986, or for all shareholder clienteles where the firm's tax rate increased after 1986).

42. Corporate Financial Structures, supra note 4, at 7-8 (Table I-A). Corporate debt borrowing rose from $54.4 billion in 1983 to $170.3 billion in 1984 and has remained and was $132.4 billion in 1985, $173.8 billion in 1986, and $136.8 billion in 1987. Id. Retirement of equity securities were $118.6 billion in 1986 and $112 billion in 1987. Id. The excess of equity retirements over new equity issues was $80.8 billion in 1986 and $76.5 billion in 1987, resulting in negative financing by new equity in the respective amounts. Id.

43. See Corporate Financial Structures, supra note 4, at 9-10 (Table I-B)(discussing data from Bagwell & Shoven, Cash Distributions to Shareholders, J. Econ. Persp., Summer 1989, at 129, and noting that dividends were 80 percent of distributions in 1977 and only 40 percent in 1986). See also Shoven, The Tax Consequences of Share Repurchases and Other Non-Dividend Cash Payments to Equity Owners, in TAX POLICY AND THE ECONOMY 29, 37-44 (L. Summers ed. 1987)(increase in repurchases beginning in the 1970s). The repurchase strategy has been widely noted. See, e.g., Bernheim & Shoven, Taxation and the Cost of Capital: An International Comparison, in THE CONSUMPTION TAX: A BETTER ALTERNATIVE? 61, 74-75 (C. Walker & M. Bloomfield eds. 1987)(corporate buyback of shares provides preferred tax treatment for shareholders, compared to dividends). Notwithstanding these increases in repurchases, other evidence suggests that dividends per unit of equity have not fallen and that stock repurchases and acquisition of shares in other companies have allowed firms to retain relatively constant debt to equity ratios. Recent criticisms focus on the ability of shareholders to realize corporate value in a capital (sale or exchange) transaction rather than a dividend distribution. See Bryan, Leveraged Buyouts and Tax Policy, 65 N.C.L. REV. 1039, 1071 (1987). Even if the gain is not taxed at a preferential capital gains rate, the ability to offset basis in nondividend distributions arguably creates a bias that should be compensated. Id. at 1072-74. The increase in repurchases occurs for many reasons, many of which are defensive measures
acquisitions, including leveraged buyouts and debt for equity recapitalizations in which the loss in future corporate tax revenue is

against hostile acquisition. See Bradley & Rosenzweig, Defensive Stock Repurchases, 99 HARY. L. REV. 1377 (1986).

The rise in stock prices effects an automatic unleveraging of the firm as the market value of debt to equity decreases. Share repurchases are a mechanism by which the firm's leverage increases. Shoven, supra, at 34. The same occurs if the firm buys the stock of another corporation which works as an investment in-equity. Id. at 35. Shoven demonstrates the near equivalence of cash acquisitions (purchases of outstanding corporate equity of another corporation) and the effect of a share repurchase (the cash acquisition of a firm's own shares). Id. at 34-36. These forms of repayment began to exceed dividends for New York Stock Exchange firms in 1984, see id. at 38 (table 2), but the dividend payout did not decrease (perhaps due to the discipline of market expectations as to dividends), which "weakly supports the hypothesis that firms are repurchasing equity with debt-financed funds to achieve their target leverage ratios [within the rising stock market]." Id. at 46-47 (noting that the United States corporations have been issuing debt and absorbing equity with a relatively constant leverage ratio). Furthermore, by choosing to absorb equity and issue debt while holding leverage constant, firms have saved large amounts of taxes. Shoven, supra, at 46. Another way to view the tax savings and revenue loss is through the interest expense as a percentage of taxable income before interest. This percentage has increased from 24.01 percent in 1976 to 47.05 percent in 1985. CORPORATE FINANCIAL STRUCTURES, supra note 4, at 80 (Table IV-F). See, e.g. Canellos, supra note 27 (arguing that tax incentives for highly leveraged acquisitions threaten to undermine the corporate income tax). This results in an increasing loss of revenue in the corporate tax base as the firms avoid the future imposition of the corporate tax, even though there is a present tax increase due to the realizations at the shareholder level. Id. at 48-49. The value of the offsetting tax gain is hotly debated. See infra note 45. Obviously, there are arbitrage incentives for the lowest taxed shareholders to accept the repurchase offer, and the fact that there is no capital gains preference limits the arbitrage possibility for shareholders in the highest brackets to a recovery of basis. However, whether there is a benefit for the continuing shareholders, even though the firm has fewer assets and has merely adjusted its financial claims from equity to debt, is the issue. Since the value of leverage inures to the continuing shareholders, see infra notes 211, 215, 230 and accompanying text, the use of leverage, as opposed to the mere transference of corporate capital to shareholders in repurchases, argues that the correct response is to limit the interest deduction for these restructuring transactions. This argument is not new, but the linkage to the value of leverage to the continuing shareholders, as distinguished from the value of a repurchase to the continuing shareholders, is new.

44. The value of mergers and acquisitions also dramatically increased beginning in 1984, corresponding to the increased percentage of LBOs as a percentage of mergers and acquisitions. See CORPORATE FINANCIAL STRUCTURES, supra note 4, at 10-11. LBOs and hostile acquisitions have received ample academic attention. Much of the commentary focuses on the fairness to shareholders, the economic efficiency of these transactions, and the tax policy implications. See Booth, Management Buyouts, Shareholder Welfare, and the Limits of Fiduciary Duty, 60 N.Y.U. L. REV. 630 (1985); Lowenstein, Management Buyouts, 85 COLUM. L. REV. 730 (1985); Kraakman, Taking Discounts Seriously: The Implications of "Discounted" Share Prices as an Acquisition Motive, 88 COLUM. L. REV. 891 (1988); Knights, RAIDERS AND TARGETS (J. Coffee, L. Lowenstein & S. Rose-Ackerman eds. 1988); S. Kaplan, Management Buyouts: Efficiency Gains or Value Transfers (University of Chicago Working Paper No. 244, 1988) [hereinafter S. Kaplan, Efficiency] (no underpricing of management buyouts); Canellos, The Over-Leveraged Acquisition, 39 TAX LAW. 91 (1985); M. Fox, supra note 36, at 369-70; Kaplan, Management Buyouts:
not fully compensated by current taxation on the restructuring transaction, have generated great interest and led to proposals prior to 1989 to reduce the tax attractiveness of replacing equity with debt. They have also led to renewed calls for congressional study, recent hearings, and proposals contained in the Omni-

Evidence on Taxes as a Source of Value, 44 J. Fin. 611 (1989) (taxes as a source of value includes new depreciation, asset basis step ups, ESOPs and interest deductibility, with gains from debt-financed depreciation totaling 21.1% to 142.6% of the gains in sample group to public shareholders with this gain offsetting the cost of the capital gains tax to buyout shareholders); Bryan, supra note 43, at 1040-42. Another important focus is the debate over the risk of bankruptcy and costs of financial distress inherent in the use of leverage. See infra notes 905, 909-10, 913, 916-25 and accompanying text.

45. Various studies attempt to demonstrate that there is a gain to the Treasury through the capital gain of shareholders in restructuring transactions. See, e.g., Jensen, Kaplan & Stiglin, The Effects of LBOs on Tax Revenues, 42 Tax Notes 727 (1989); Newport, Why the IRS Might Love Those LBOs, FORTUNE, Dec. 5, 1988, at 145. However, the classical corporate tax regime requires that tax be collected on the entire amount distributed and not merely the gain on the transactions after a recovery of basis. See House LBO Hearings I, supra note 16, at 393 (statement of Alvin Warren).

46. See Staff of JT Comm. on Tax with Staff of House Comm. on Ways & Means, 100th Cong., 1st Sess., Description of Possible Options to Increase Revenues 171-74 (Comm. Print 1987) [hereinafter 1987 Revenue Options]; House Comm. on the Budget Omnibus Budget Reconciliation Act of 1987, H.R. Rep. No. 391, 100th Cong., 1st Sess. pt. 2, at 1085 (1987) [hereinafter 1987 House Report] (proposing I.R.C. § 279A, that would disallow deduction of acquisition indebtedness in excess of $5 million a year if the debt is substantially subordinated, carries equity participation and the issuer is thinly capitalized or projected earnings do not exceed three times annual interests costs). Further, the committee expressed:

concern that the excessive leveraging that has manifested itself in recent years reduces the corporate income tax base by replacing corporate equity with debt, particularly in circumstances where no corporate-level tax has been paid on appreciated assets and the earnings derived from these assets are sheltered by post-acquisition interest deductions . . . and that such leveraging may be particularly likely to occur in the context of an acquisition or significant redemption and may threaten the health of the corporate sector and the economy in general.


Other proposals are listed in Subchapter C Conference, supra note 13, at 164-65 (statement of Michael Graetz) (limit the interest deduction to a percentage of capital including debt and equity and finance lease transactions). See also id. at 246 (debt and equity can be distinguished on the basis of their relative market yields).

47. The fact of increased debt and leverage through going private transactions spurred by the proposed $25 billion leveraged buyout of RJR Nabisco, Inc. by Kohlberg, Kravis, Roberts & Co. prompted the Federal Reserve Chairman, Alan Greenspan, to propose to the Senate a change of the tax laws to discourage borrowing to finance takeovers. See Kilborn, Greenspan Hints of Need to Curb Debt, N.Y. Times, Oct. 27, 1988, at D1, col. 6. The insolvency risk of savings and loans is also cited as an impetus for change. Id.
bus Budget Reconciliation Act of 1989, which mark the begin-
ing of an exploration of options related to debt and equity fi-
ance under the current system and of the desirability of
integrating the corporate and shareholder taxes. It has also be-
come increasingly clear that not even a single tax is collected on
corporate debt owned by tax-exempt institutions and foreigners
enjoying tax-exempt status.

48. For the 1989 hearings, see Senate LBO Hearings, supra note 16; House LBO
Hearings, supra note 16.

49. See The Revenue Reconciliation Act of 1989, (Title VII of the Omnibus
1st Sess. (1989) [hereinafter OBRA]. Portions of this legislation are directly relevant to
this Article. First, it amends I.R.C. § 385 to allow the Treasury Department to character-
ize an instrument having significant debt and equity characteristics as part debt and part
equity. Id. at § 7208(a). Such characterization would represent a major change in the way
the law is applied. Second, it adds I.R.C. § 163(e)(5) to provide for bifurcated treatment of
certain high yield OID obligations. This treatment provides that the yield on these “appli-
cable high yield discount obligations” with maturities in excess of five years will be treated
as an interest cost up to six percent over the applicable federal rate and will be deductible
only when paid in cash, and that the yield above such amount will be treated as a dividend
when paid for which no interest deduction is allowed but a dividends received deduction
can be used. Id. at § 7202; see also infra note 186. Third, it adds I.R.C. § 163(j) to
disallow the deduction for payments of interest to foreign related persons that are not sub-
ject to United States tax on such receipts to the extent that the excess of the payor's total
interest expense over interest income is greater than 50 percent of the corporation's taxable
income, where the corporation has a debt-equity ratio exceeding 1.5 to 1. Id. at § 7210. In
other proposed legislation by Senator Bensten, see S. 1506, 101st Cong., 1st Sess. (1989),
135 CONG. REC. 9935 (daily ed. Aug. 3, 1989), a limitation would be imposed on corpora-
tions seeking to obtain a refund of taxes by carrying back net operating losses arising from
excess interest deductions allocable to transactions reducing corporate equity. This provi-
sion was added by OBRA, supra, § 7211, which added § 172(b)(1)(M) to the I.R.C.

50. In addition to the 1989 legislation, options include other forms of limitations on
interest deductibility, taxes upon corporate restructurings, and forms of equalization of
debt and equity financing, and limitations on the use of Employee Stock Ownership Plans
(“ESOPs”) and pension funds in corporate financing. For options and the context in which
they exist, see CORPORATE FINANCIAL STRUCTURES, supra note 4, at 82-124.

51. In 1987, only 8 percent of corporate bonds were owned by the taxable household
sector. Foreigners held 13 percent and the tax preferred life insurance companies, and tax
exempt pension funds held 57 percent and other financial intermediaries held the remain-
der. CORPORATE FINANCIAL STRUCTURES, supra note 4, at 13. See also Jacobs & Rud-
nick, ABA Tax Section Task Force Looks at Passthrough Entities, 42 TAX NOTES 607,
608 (1989)[hereinafter ABA Passthrough Report](report of the ABA Tax Section Task
Force on Passthrough Entities). The weighted average tax rate paid on interest receipts in
1988 is estimated at 7.3 percent. See Senate LBO Hearings, pt. 2, supra note 16, at 196
(prepared statement of Lawrence Summers) (Table 1). For a discussion of the tax treat-
mant of foreigners and tax-exempt entities, see infra note 147-48. Partnerships do not pro-
vide the same benefits as interest receipts. Partnership income from operations triggers the
unrelated business income provisions for tax-exempt entity partners and results in taxation
of gross income from MLP equity that is not allocable to dividends, interest, royalties, and
capital gains. I.R.C. § 512(a) & (c) (West 1988 & Supp. 1989); Turlington & Beeson,
While there is a need to study the deductibility of interest under the present system, there is also an increasingly widespread view that the problem with the corporate tax system may be the treatment of equity capital, rather than the allowance of the interest deduction.\textsuperscript{2} My conclusion following recent hearings is that for the foreseeable future study should focus on not only whether we will have the classical double tax as it presently exists, or as reinforced by provisions to limit interest deductibility and the tax favoritism for nondividend distributions, but also to which firms should it apply.

Limited attention has been given to the effect of double taxation of the equity return if a deduction for an interest return on new or existing equity is allowed to neutralize the debt-equity choice and to lessen the risks of bankruptcy and financial distress through equity rather than debt financing. For a number of years the ALI has been studying Subchapter C.\textsuperscript{3} Sensitive to both a


\textsuperscript{52} All of the major speakers at the Senate LBO Hearings testified to the distortion that disfavors equity finance. See Hershey, \textit{Greenspan Shuns Curb on Buyouts, N.Y. Times}, Jan. 27, 1989, at 25, col. 6 (Federal Reserve Chair Alan Greenspan testified that the best legislative measure would be to reduce or eliminate the corporate tax or offer a form of relief from double taxation of dividends); Nash, \textit{Dividend Tax Cut Is Favored}, N.Y. Times, Jan. 26, 1989, at 25, col. 6 (S.E.C. Chair David Ruder favored equal treatment of dividends and interest); Kilborn, \textit{Brady Voices Concern Over Takeover Debts}, N.Y. Times, Jan. 25, 1989, at 23, col. 4, & at 30, col. 2 (Treasury Secretary Nicholas Brady testified to “over taxation of corporate equity”). See also Bierman, \textit{Debt, Stock, and Junk Bonds, 41 TAX NOTES} 1237, 1238 (1988). In the Senate hearings, both Alan Auerbach and Lawrence Summers expressed their concern over the need for neutrality between debt and equity financing. See \textit{Senate LBO Hearings}, pt. 2, supra note 16, at 29-30 (prepared statement of Alan Auerbach); \textit{id.} at 20 (prepared statement of Lawrence Summers). The same concern was shared in the House. See \textit{House LBO Hearings I, supra note 16, at 227-28 (prepared statement of Benjamin Friedman) (any policy that is adopted should “correct the nonneutrality of the tax code between debt and equity financing”); \textit{id.} at 216-17 (prepared statement of Martin Feldstein) (proposal for a cash flow business tax that besides leveling distinctions between depreciation of investment assets would “eliminate the current tax bias to use excessive debt”); \textit{id.} at 359-60 (prepared statement of Michael Blumenthal) (neutrality between debt and equity is a necessary “first step”); \textit{id.} at 204 (prepared statement of Felix Rohatyn).

\textsuperscript{53} The current version of the ALI focus on acquisitions and distributions is \textit{AM. LAW INST., FEDERAL INCOME TAX PROJECT: SUBCHAPTER C (SUPPLEMENTAL STUDY), REPORTER'S STUDY DRAFT} (June 1, 1989) [supplemental study] [hereinafter REPORTER'S STUDY DRAFT]. The prior version of this supplemental study was contained in \textit{AM. LAW INST., FEDERAL INCOME TAX PROJECT: SUBCHAPTER C (SUPPLEMENTAL STUDY), TAX AD-
perceived windfall-gain problem and the known distortions of the double-tax regime for new investment, the ALI Reporter's Study of 1982 included a proposal, recently revived, to limit the distortion between debt and equity financing caused by the classical corporate tax regime. Under this proposal, a firm-level deduction for an interest-like return to new equity would be allowed, so that only the return in excess of that interest-like return would be taxed twice. That proposal recasts the tax on corporate equity capital as a tax on corporate equity profit.

This Article argues that liquidity of ownership interests should be the bright-line distinction that justifies a double tax of equity under equitable taxation, optimal taxation, and neutrality.
principles: Any double tax on business enterprises faces many critics, but one may be justified for firms in which liquid equity ownership interests are present. While the proposal advanced in this Article is descriptive of the current system with the migration of firms from the public market, the proliferation of S corporations and partnerships, and the increase in the use of debt financing, the proposal is not drawn from a description of the current regime but is based on a normative foundation. It is not a proposal advanced under a populist or small business notion that large corporations should pay a tax, an argument generally made under a mistaken notion of incidence analysis. The liquidity standard is also not a convenient proxy for taxing large firms, but is based upon the emerging research in financial economics as to the value of liquidity in pricing residual claims. It is the value of liquid equity as perceived by the market that justifies a double tax. Liquidity attracts investors who value the exit rights or the financial strategies that can be pursued with liquid equity ownership. It also attracts investors who, due to fiduciary limitations, must invest their portfolios substantially in firms in which a measure of liquidity is provided. A double tax can reasonably and equitably be applied to firms with liquid equity without economic distortion and violation of neutrality principles.

There are three ways in which a tax is a profits tax. The first refers to profits in the accounting sense, which are the difference between revenues and the corresponding historic costs including any returns treated as interest costs. 57 This Article uses the term "profits tax" in two ways other than the accounting sense. The profits referred to in this Article are (1) the return to equity capital after a deduction is allowed for the interest component either directly or through the financing of marginal investment with debt and (2) profits in an economic sense as an excess return or pure profit, which is an economic rent that exists only due to market imperfections such as market power and is in excess of what would be required to attract capital. 58 Interest has two components: (1) the time value of money component which is made up of the real rate of interest plus inflation and a term liquidity pre-

58. For a discussion of the return to equity capital after a deduction for interest, see infra notes 728 & 749. For a discussion of the financing of marginal investment with debt, see infra notes 63-64. For a discussion of profits as economic rents, see infra notes 729-32 and accompanying text.
mium and (2) the risk premium component which is based on the issuer's default risk. The view of liquidity advanced here justifies a profits tax on the return to liquid equity; it does not justify a classical corporate tax on corporate equity capital. It is a proposal for a tax on the value of liquidity as an economic rent referred to as excess profits, pure profits, and profits-as-surplus and for a computation of the tax base for the double tax after a deduction for the time value of money component on equity capital is made. The proposal also leaves open the question of whether profit is appropriately defined as a part of the total economic income of the firm by limiting the interest deduction on interest-denominated debt. In support of my profits view of the corporate tax, several assumptions about firm financing decisions and the capitalization of taxes must be made. Financial theory demonstrates the irrelevance of debt and equity financing on firm financial structure in a no-tax world. Financial theory also holds that even if taxes are imposed on the firm and its shareholders, firm level leverage can offset the effects of the corporate tax on at least the interest return on equity and shareholder leverage can offset limits in firm level lever-

59. See infra notes 219 & 482.
60. The Miller-Modigliani view of corporate financial structure is that absent taxes, "the value of the firm is independent of its capital structure and is determined . . . solely by capitalizing the expected stream of operating income at a discount rate appropriate to the company's business risk." V. BRUDNEY & M. CHIRELSTEIN, CORPORATE FINANCE 372-73 (3d ed. 1987). The Miller-Modigliani view, which was spelled out in their historic 1958 article, Modigliani & Miller, The Cost of Capital, Corporation Finance and the Theory of Investment, 48 AM. ECON. REV. 261 (1958) (Proposition I) [hereinafter Modigliani & Miller I], and then later refined, see Miller & Modigliani, Dividend Policy, Growth, and the Valuation of Shares, 34 J. Bus. 411 (1961); Modigliani & Miller, Corporate Income Taxes and the Cost of Capital: A Correction, 53 AM. ECON. REV. 433 (1963) [hereinafter Modigliani & Miller II], rests on the notions of perfect capital markets, perfect categorization of firms into risk categories, and the same probability of distributions for all investors. While the propositions have been under attack, see V. BRUDNEY & M. CHIRELSTEIN, supra at 372-73, they are generally accepted, see CORPORATE FINANCIAL STRUCTURES, supra note 4, at 53 & n.88 (accepting the Miller-Modigliani view of the irrelevance of capital structure in a no tax world and noting that the only required update of the proposition is that there be no unexplored arbitrage positions, see Ross, Comment on the Miller-Modigliani Propositions, J. ECON. PERSP., Fall 1988, at 127 (1988)). Both debt and equity merely represent financial claims and the right to future ownership of the firm's income.

61. If firms finance their marginal investments with debt, the effect of the corporate level tax is eliminated if interest payments are deductible. Even if firms are not fully leveraged, the favorable taxation of retained earnings distributed as capital gains and the deferral of the shareholder level tax on capital gains produce value, at least where the corporate rate is lower than the individual tax rate on dividends. See Miller, Debt and Taxes, 32 J. FIN. 261 (1977). Currently, this is not the case.
age and the effects of a tax on dividends. If so, the corporate tax is at most a single level profits tax. The unlimited firm level debt finance hypothesis reflects the Stiglitz view of the corporate tax as a tax on profits to the extent that all marginal investment is funded by debt.

62. Shareholder "homemade" leverage exists when the shareholders undo the effects of the firm to change its debt-equity ratio through sale of new equity by their own personal borrowing. See Gordon & Malkiel, Corporation Finance, in How Taxes Affect Economic Behavior 131, 133 (H. Aaron & J. Pechman eds. 1981). In a world without taxes and bankruptcy costs, the result is that "since personal borrowing is a perfect substitute for corporate borrowing, the firm cannot profit from additional leverage, and since individuals can undo any degree of corporate leverage by buying bonds and shares of the levered company, the firm is not hurt by a capital structure that is more levered than investors desire. In fact, not only is any one firm's financial policy irrelevant, but the aggregate financial policy of the corporate sector is too." Id. See also W. Klein & J. Coffee, supra note 40, at 296-97. The proposition that the shareholders can undermine firm level leverage in a taxable world is the same and leads to the Miller-Modigliani argument of capital structure irrelevance. See R. Brealey & S. Myers, Principles of Corporate Finance 383-401 (1988). Shareholder leverage is not unlimited as margin limitations, see infra note 319, and other restrictions on borrowing would suggest.

63. Under the argument advanced by Miller and Scholes, homemade leverage can also avoid the tax on dividends. See Miller & Scholes, Dividends and Taxes, 6 J. Fin. Econ. 333 (1978)(both (1) investment in high dividend stocks, borrowing with interest equal to the dividend, and investing proceeds in a tax deferred account and (2) the investing in high dividend paying stocks to offset interest deductions limited by the investment interest deduction limitations can avoid the shareholder level tax on dividends). But see Poterba, How Burdensome are Capital Gains Taxes?, 33 J. Pub. Econ. 157, 158 & 164-69 (1987)(unlikely that individual taxpayers were sophisticated enough to use these strategies). Extended to its logical outcome, it means that all taxes can be "laundered." The existence of individual taxes on dividends, see Poterba & Summers, infra note 66, at 235-37, and limitations on the actual usage of the strategies advanced by Miller and Scholes demonstrate that dividends taxes are not irrelevant. See Peterson, Peterson & Ang, Direct Evidence on the Marginal Rate of Taxation on Dividend Income, 14 J. Fin. Econ. 272-80 (1985)(demonstrating that the marginal and effective rate of tax for dividends, 40% and 30%, respectively, are greater than the capital gains tax, and supporting the premise of the Feenburg results that only a small portion of taxpayers, 0.4%, receiving a small portion of the dividends, 2.5%, are actually utilizing the provisions outlined by Miller and Scholes to reduce their marginal rate on dividend income less than their marginal rate on capital gain). This argument may be more plausible given the limitations on consumer interest deductions after 1986, even though the limitation on investment interest deductibility was of little interest to individual investors in devising strategies to obtain dividends to offset unused investment interest expense. See Corporate Financial Structures, supra note 4, at 55 n.89. This is also related to the manner in which the market values retained earnings (capital gains) and dividends. See infra note 106.

To the extent that these assumptions do not hold (and to assume unlimited debt is unrealistic), the corporate tax is a tax on pure economic profits. Under this view, the corporate tax is nondistortionary since firms that can resort to debt financing will under marginal production theory invest to the point where the marginal revenue is equal to the interest cost. Stiglitz then viewed the corporate tax in each of its roles with the incidence on the owners of the firm or the entrepreneur incorporating a firm as a tax on capital in the corporate sector, if there is economic depreciation and is a tax on imputed interest income; a tax on pure profits, if there is immediate write off of capital expenditures; a tax on entrepreneurship; and a tax on risk taking. See Stiglitz, *The Corporation Tax*, supra.

65. The fact that firms do not borrow to make all investments is explained in many ways: (1) the existence of tax clienteles which may have favored taxation of equity rather than debt, such as prior to the 1986 Act when individuals were taxed higher on interest income than on capital gains from stock and currently where capital gains can be deferred, (2) the declining value of leverage due to less than perfect loss offsets at the firm level, and (3) the increased cost of debt related to the cost of bankruptcy and moral hazard risks. See Auerbach, *Taxes, Firm Financial Policy, and the Cost of Capital: An Empirical Analysis*, 23 J. PUB. ECON. 27, 28 (1984)[hereinafter Auerbach, *Empirical Analysis*]; see also Auerbach, *Real Determinants of Corporate Leverage*, in *CORPORATE CAPITAL STRUCTURES IN THE UNITED STATES* 301 (B. Friedman ed. 1985)(empirical analysis of bankruptcy/agency cost, tax shield, and tax clientele models with assumption of borrowing as a continuous process and variables corrected for inflation). The traditional view is that the marginal source of equity financing in the corporate sector is the issuing of new shares, whereas another view holds that the marginal source of equity financing is retained earnings. See Poterba & Summers, *Dividends, Taxes, Corporate Investment, and “Q”*, 22 J. PUB. ECON. 135, 137-40 (1983). Still a third view regards debt as the marginal source of funds for investment. See Stiglitz, *Taxation*, supra note 64, at 18. Newer models show that at least where retained earnings are taxed more favorably than distributions, marginal investment is made first with retained earnings, then debt, as compared with new equity. See Auerbach, *Empirical Analysis*, supra, at 27, 32-33. Neutrality between debt and retained earnings financing also exists, although the rate of return required for retained earnings financing may be lower if the firm level tax is lower than the personal income tax rate on dividends. See Bradford, supra note 66; Zolt, supra note 27, at 843 (detailing limitations on the unlimited debt hypothesis). A weighted cost of capital approach counters the Miller-Modigliani model and holds that the risk level in firms increases by the amount of debt outstanding, and that the cost of capital will be adjusted to reflect the increased risk and thereby limit the amount of the firm's leverage See R. Brealey & S. Myers, supra note 62, at 383-402. Finance theory and empirical evidence also find that the issuance of new equity is at the cost of negative signalling to the market due to the market's presumption that managers possess asymmetric information about the firm. See R. Korajczyk, D. Lucas & R. McDonald, *UNDERSTANDING STOCK PRICE BEHAVIOR AROUND THE TIME OF NEW ISSUES* (National Bureau of Economic Research Working Paper No. 3170, 1989)(supporting the asymmetric information theory and evaluating the good project and naive trading theories to explain the rise in equity value before equity announcement and the drop thereafter); see also Myers & Majluf, *Corporate Financing and Investment Decisions When Firms Have Information that Investors Do Not Have*, 13 J. FIN. ECON. 187 (1984)(model predicts that firms will refuse to issue stock and rely on the stronger signal of debt issuance or retained earnings finance to avoid the negative signal of new equity); Greenwald, Stiglitz & Weiss, *Informational Imperfections in the Capital Market and Macroeconomic Fluctuations*, 74 AM. ECON. REV. 194 (1984)(debt commitments as a higher level of signalling and equity issues as negative signals). Nonetheless, many firms
equity capital at the firm level and has a double tax effect on distributions to the shareholder. Enter the economists who proclaim, not unanimously, that investors invest on an after tax basis, that the value of the publicly traded shares reflects a discount for capitalization of the corporate tax, and that shareholder taxes on distributions may also have an effect on share prices. If the capitalization of the firm level tax hypothesis holds, then the original entrepreneur sees the return on her investment lowered upon incorporation by the firm level tax on all or part of the return to equity capital. Alternatively, some economists proclaim that for mature companies that can invest out of retained earnings and view investment decisions as a reflection of the cost of the investment relative to the replacement cost of capital, the appropriate

must rely on equity offerings. See Masulis & Korwar, Seasoned Equity Offerings, 15 J. Fin. Econ. 91 (1986) (empirical study of firms issuing new equity).

66. The traditional view is that the firm level tax is capitalized into the value of equity shares. The value of corporate equity is determined under this traditional view by the tax rate on corporate retentions relative to the shareholder tax rate on retained earnings if earned directly and also by the shareholder tax rate on distributions. See Bradford, The Incidence and Allocation Effects of a Tax on Corporate Distributions, 15 J. Pub. Econ. 1, 2-5, 21-22 (1981). A change in the tax rate on both corporate earnings and distributions will change the value of the firm; and since the firm's capital will be discounted by both, the change in either will produce a windfall gain for the equity holders who may not be those who originally bore the burden of any capitalized tax. Under this view, dividend taxes affect the value of the firm as additional taxes on corporate profits which lower the return to existing shareholders relative to capital gains. Dividend taxes also affect the firm's marginal investment decision between retained earning financing and new equity issues by requiring the firm to view the investment choice from both the corporate and personal level of taxation. Under this view, a reduction in dividend taxes will raise share values and increase incentives for capital investment precisely because the firm's financing view is based on the corporate and individual tax effects. See Poterba & Summers, The Economic Effects of Dividend Taxation, in Recent Advances in Corporate Finance 227, 231, 240-44 (E. Altman & M. Subrahmanyam eds. 1985) (model using British time series data to establish the empirical validity of the traditional view). See also infra note 127.

For evidence of the effect of shareholder level taxes, see Brinner & Brooks, infra note 100, at 201-02 (Using a model that values the after-tax dividend earnings and the after-tax proceeds for the sale of stock by discounting each by the relevant tax rate, their principal finding relative to taxes was that "if one makes fairly simply assumptions about the formation of expectations, stock prices are highly correlated with the expected present value of returns from equity investment. Roughly 70 percent of the variation in actual share prices can be explained by the variation in a present value of future post-tax dividends and capital gains.").

67. See supra note 66 and accompanying text.

68. Q theory helps predict firm valuation after the firm makes an investment. It "posits that there are adjustment costs in changing the capital stock and derives a one-to-one relationship between investment and the variable called (marginal) q (the incremental market value of a firm at the margin of new investment minus the price of investment
view of capitalization is not the capitalization of the firm level tax but capitalization of the burden of shareholder taxes on distributed earnings (dividends) and capital gains taxes on retained earnings.\textsuperscript{69} Under this view of these companies, a change in the corporate level tax will not change share values.

These complex questions permeate the formulation of any normative view of the corporate tax. For purposes of this analysis, I accept the following views: (1) the firm level tax is generally capitalized into corporate equities but may not be fully capitalized into public share prices since there is no effective and full substitute for the financial assets of public corporate equities; (2) while mature firms can resort to leverage or retained earnings (presently a more costly route increasing the required return on these retained earnings) to finance their marginal investment decisions, they are not fully leveraged; (3) taxable shareholders are not fully leveraged and cannot and do not avoid all dividend taxes; (4) when a firm finds it necessary to issue new equity, the incidence of
the tax is on the existing shareholders of that firm regardless of whether it is the firm level or shareholder level tax that is capitalized; (5) the incidence of a profits tax that excludes the interest return on capital from the tax base is determined under the Stiglitz assumptions set forth above, and to the extent that the "profit" taxed is not pure or economic profit, the tax creates a long-run shift of capital which places the ultimate incidence of the tax on capital under the traditional Harberger closed economy model; and (6) even if the firm level tax is written as a profits tax allowing an interest deduction, it is not "shifted" to consumers in the form of higher prices or to labor in the form of lower wages.  

70. While the foregoing are apparent from the previous discussion, the assumption of lack of capitalization for public equities and the assumptions of tax incidence are not. The public market for equity offers an efficient means for an equity return relative to an equity risk in a manner that, through the application of portfolio theory, can be efficiently diversified. Cf. Auerbach, Corporate Taxation in the United States, 2 BROOKINGS PAPERS ON ECONOMIC ACTIVITY 451, 482 (1983)("One of the fundamental reasons for the existence of public corporations is to allow risks to be efficiently diversified through the stock market."). The characteristics of the value of public equities in some way are unique and their value as an investment may mean that the full tax cost, under any view of tax capitalization, are not borne for that reason. The argument draws from the view over the mobility of corporate capital through a fluidity of investment choice and the properties of common stock as a unique financial investment. See infra note 474 and accompanying text.  

The issue of incidence is an important one. Under the profits tax advanced in this Article, liquidity is viewed as a quality in the nature of "pure" economic profit for entrepreneurs and shareholders in firms that resort to new equity financing and as an excess return for those firms. See infra notes 460-531 & 757-83 and accompanying text. In the closed economy model, taxing excess profits and allowing a firm level deduction for the interest component of the cost of capital will produce an incidence on the entrepreneur who takes her firm public by causing it to issue liquid equity or the residual equity holder in a firm that issues new equity to the extent that the demand for liquidity is inelastic, but will not produce an allocation of capital to the illiquid sector. To the extent that such an allocation does occur, however, it may have a beneficial effect by freeing capital for risky and start-up firms. See infra notes 729-83, 791 & 897 and accompanying text. In other words, the incidence of any profits tax will be borne by residual equity holders and entrepreneurs, and in the long run assets will move in and out of firms, industries, and economic sectors in response to after tax rates of return resulting in the equalization of after tax returns in all sectors. However, capital will not necessarily migrate from the taxed sector to the untaxed sector if the double tax is based on liquidity, since there will exist through the market's valuation of liquidity a superior return in the taxed sector.  

If firms produce to the point where marginal cost equals marginal revenue, a profits tax lowers the profit to the firm but does not affect price or output since a net profits tax is a marginal cost only so long as the good produced is profitable. Therefore, we should assume that the incidence of the income tax is not shifted. See J. DODGE, THE LOGIC OF TAX 282-83 (1989). While it is argued that the corporate tax is shifted to labor or consumers, the ability to shift a profits tax belongs to all firms that possess economic power or choose
I also accept that for mature firms, there may be as recently suggested a “bifurcated view” of the capitalization of shareholder taxes together with the firm level tax.\textsuperscript{71}
Based on the foregoing assumptions, I propose that all firms with liquid ownership interests, which are generally publicly traded, should be subject to the double tax,^7^ and firms with illiquid ownership interests, which are generally nonpublic firms, should have their income taxed directly to their owners unless for administrative reasons the firm is substituted as a collection agent.\(^{78}\) The logic of the proposal dictates that returns on the new equity of these existing firms should be deductible or creditable, and that the Subchapter S corporation regime should be available to the fullest extent possible.\(^{74}\) Firms that want a more complex capital structure than that allowed by Subchapter S could elect to be taxed at the entity level with a deduction for distribution of earnings to owners or a credit for taxes paid. The proposal could also be the basis for integrating existing corporate capital with appropriate transitional relief. The proposal made here is not the same as for a securities transfer tax.\(^{75}\)

under an integrated tax system. Put simply, investors would receive a small cut in their marginal tax rates and a large windfall, equal to the present value of the capitalized taxes on distributions forgiven. This would include distributions from all net assets, equal to returns to existing capital plus economic rents less interest payments on preexisting debt." (emphasis in original)).

72. The capitalization argument suggests that the double tax is not a double tax in the sense of two overlapping jurisdictions. Nonetheless, it is a useful shorthand for the two-tier or classical taxation of corporate income.

73. Gene Steurele's simplified integrated tax ("SIT") is in this model. It applies Subchapter S to a growing number of corporations that are "just beyond the boundaries" for current Subchapter S and new venture firms, with the additional feature of corporate based withholding at the highest rate of tax for individuals. See Steurele, A Simplified Integrated Tax, 44 Tax Notes 335, 336 (1989).

74. See infra notes 1050-64 and accompanying text.

75. See Brockway, Joint Committee Outlines Securities Transfer Tax Issues, 35 Tax Notes 595 (1987); Keifer, A Stock Transfer Tax: Preliminary Economic Analysis, 35 Tax Notes 595 (1987). The argument is made that a securities transfer tax encourages economic efficiency by curbing excesses associated with short term speculation including the diversion of resources away from production into financial speculation and promotes a longer corporate managerial horizon. See L. Summers & V. Summers, When Financial Markets Work Too Well: A Cautious Case for a Securities Transfer Tax 29-30 (Working Paper presented at the Annenberg Conference on Technology and Financial Markets, 1989)(concluding that the argument that the tax would reduce the role of the U.S. securities industry, would not be enforceable, and would move the U.S. financial markets offshore are unfounded given possible approaches to the problems and possible harmonization of securities transfer taxation worldwide). The securities transfer tax is aimed at producing revenue and discouraging short run trading strategies, although for long-term investors it has the impact of increasing their transaction costs associated with holding a security and is a tax to discount to the present. With that as a policy, the proposal is to exempt debt and equity of privately held firms which are not readily tradable. Id. at 25-26. At issue is also whether to exempt debt securities or to tax them at a different rate. Id. at 26-27. The
The first step should be to abolish the graduated rate structure since it deviates from the flat tax perspective, creates a third category of firms, and grants a significant but decreasing tax subsidy to those firms to which it applies. In a flat tax world, the inquiry is not whether graduated rates should be used as a

imposition of a firm level tax on liquidity may have the same incidence as an excise tax but since it is on the anticipated yearly stream of income, it has its incidence on the entrepreneur rather than the purchaser of the discounted earnings stream. The tax on liquidity is less well targeted to speculative trading activity since it affects both traders and fundamental value investors the same.

76. The Treasury was concerned with the categorization of firms. It sought the elimination of graduated corporate rates by proposing a flat tax on all corporate income and a modified flat tax on all passthrough income. See 1 Treasury I Study, supra note 8, at 97; 2 Treasury I Study, supra note 8, at 127-29. For the case against the graduated rates, see Brooks, Taxation of Closely-Held Corporations: The Partnership Option and the Lower Rate of Tax, 3 Austl. Tax Forum 381, 471-509 (1986)(advocating mandatory passthrough for closely held firms regardless of form and arguing against a lower rate of corporate tax); 1987 House MLP Hearings, supra note 30, at 343-52 (statement of John W. Lee)(mandatory passthrough of income and loss for closely held C corporations). The case for graduated tax rates for small firms was set forth in J. Butters & J. Lintner, Effects of Federal Taxes on Growing Enterprises (1945). The rationale for the graduated rates is to allow firms to compete more effectively with larger businesses. If risky business is not encouraged, specifically targeted incentives should be preferred to capital accumulation through inside shelter. Harold Groves captured the unfocused nature of the graduated corporate rates:

Extended consideration cannot be given here to the use of business taxes for social control. The graduated corporate tax may, through its differentials, aid small business. Because of their importance in small communities and because of their possible value as a check upon monopoly, small companies have claim to special attention. However, small business should not be confused with new business, competitive business, or business developing new products, all of which are the proper objects of social concern. Moreover, the graduated corporate tax aids not only small business but also large business with a small income. . . .

H. Groves, Postwar Taxation and Economic Progress 26-27 (1946). For a further discussion, see infra text at notes 1065-69.

77. For estimates of the revenue loss associated with the new corporate graduated rates, see supra note 38. Presently under the flat tax, graduated rates are provided and then phased-out for firms with greater than $100,000 of taxable income. I.R.C. § 11(b) (West 1988 & Supp. 1989). Under prior law, the benefits of graduated rates were phased-out for corporations with more than $1,000,000 of taxable income. See The Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 66(a), 98 Stat. 494, 585. The subsidy is now not available for personal service corporations. See I.R.C. §§ 11(b)(2), 448(d)(2) (West 1988 & Supp. 1989).

78. The individual tax base is actually a form of a regressive tax since it has both an exemption amount through the personal exemptions, and a single rate for middle class taxpayers through the phase out of the 15 percent rate to equalize the rate to a proportionate 28 percent rate. For the highest income taxpayers, the tax is a true flat tax because both the personal exemptions and the lower rate as completely phased out. For the contrast between the regressive rate and the progressive income tax, see Kornhauser, The Rhetoric of the Anti-Progressive Income Tax Movement: A Typical Male Reaction, 86 Mich. L. Rev. 465, 470-71 (1987).
subsidy for small business or whether small business should be forced to be part of a pure passthrough regime, but whether double taxation of an equity return from any firm is justified on any grounds. This Article sets forth a justification for the ALI new equity proposal to redraft the corporate tax as a profits tax, but goes beyond the ALI proposal by providing a normative rationale for some instances of double taxation.\textsuperscript{79} The proposed profits tax is coupled with an explicit liquid equity ownership standard to determine the firms subject to a double tax.

The Article is organized into seven parts. Part I considers the historical and current setting for the classical corporate tax regime and the relevant biases of that system compared to those of the passthrough system. It takes into account the theory of an income tax as applied to individuals and legal intermediaries, and criticizes the current system for its inability to articulate a valid basis for distinguishing between twice-taxed entities and single-taxed entities. Part I demonstrates that the resemblance test is an ineffective means of distinguishing between single-taxed and double-taxed entities, notwithstanding nontax differences between closely held and public firms that are suggestive of tax consequences. I include in Part I a discussion of the evolution of the classical system, its place in firm financing decisions, and the pressures existing before and after 1986 to set the stage for the search for a normative standard for double taxation of an equity return. I include a discussion of the theory of the income tax and the taxable unit in Part I to place firm level taxation within the tradition of the income tax. Finally, I critique the resemblance test for the distortion that a legal test focusing on "resemblance" creates in the policy debate on the United States classical corporate tax regime. Readers familiar with these issues may wish to read briskly.

\textsuperscript{79} In reviewing the work of the A.L.I. Subchapter C project and in particular the proposals related to corporate distributions, Renato Beghe noted that the fundamental question is who should be subject to the corporate tax regime:

The scheme envisioned by Draft No. 2 would drastically alter the tax burdens of investors who chose to conduct business using an entity subject to the corporate income tax. Until we have identified the entities that ought to be subject to that tax, it is impossible to decide whether the increased burden would be justified. The history of the differences in the effective overall rates of taxation on public and private corporations and their shareholders underscores the importance of these questions.

Beghe, \textit{The American Law Institute Subchapter C Study: Acquisitions and Distributions}, 33 Tax Law. 743, 773 (1980)(crediting Professor Blum with this insight and noting reliance of closely held firms on deductible payments and nondividend distributions).
through Part I to obtain my focus on these issues.

Part II sets forth the separate justification for a double tax regime. It also briefly considers and rejects four other plausible rationales for the double tax regime. Part III presents a proposal for reforming the current system by confining the double tax regime to firms that produce business income for which the owners have liquid ownership interests. It demonstrates that liquidity has value that is susceptible to taxation. It then sets forth a definition of liquidity that does not wholly depend on stock being traded in a public marketplace, but would include liquidity granted by a private contract if the indices of the value of liquidity in a public market were sufficiently present. Part IV considers other tax proposals that would impose double taxation based on public trading. Part V considers and rejects various other rationales for a double tax.

Part VI tests the liquidity proposal against the traditional tax policy criteria of fairness, efficiency, neutrality, simplicity, and revenue. Part VII sets forth an agenda for inquiry concerning the implementation of a liquidity based system. The Article concludes that drawing the double tax line at liquid equity and as a profits tax is the best rationale under benefits, equity, and optimal taxation theories for an arguably inefficient tax. Furthermore, the scope of Subchapter S corporations and any future fully integrated system should be expanded significantly given the other safeguards in the law for eliminating the passthrough of tax losses.

I. THE SETTING

A. Historical Background

1. The Classical Corporate Tax System

To understand the source for a normative basis for a double tax, it is helpful to review where the classical corporate tax system began, its relationship to firm-financing decisions, and the threads holding it together that began to break before 1986. I do not undertake a comprehensive analysis of all the policy considerations behind the tax treatment of corporate financial structures; an analysis that is finally possible in 1989 in conjunction with the hearings on leveraged buyouts. Nonetheless, it is important in

80. See CORPORATE FINANCIAL STRUCTURES, supra note 4.
advocating the normative view of a double tax on equity returns to examine the structural biases of the classical corporate tax regime both before and after 1986.

The 1909 corporation income tax,\(^8\) denominated an excise tax to avoid perceived constitutional limitations,\(^8\) was constitutionally upheld under the *Flint v. Stone Tracy Co.*\(^8\) benefits analysis. After ratification of the sixteenth amendment\(^8\) in 1913, a general income tax was adopted.\(^8\) The statute created a normal tax and a surtax on individuals\(^8\) and left in place the normal tax on corporations. It imposed a tax on dividends received by individuals and corporations,\(^8\) although dividends received by individuals were exempt from the normal tax.\(^8\) Until the 1986 Act, the cor-

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81. Tariff Act of 1909, ch. 6, 36 Stat. 11, *repealed by* Tariff Act of 1913, ch. 16, § 4(S), 38 Stat. 201. The statute did not apply to partnerships, since it required that the firm be organized for profit and “have a capital stock represented by shares.” *Id.* at § 38. Modern PTPs have “shares” in the form of depository receipts.


83. 220 U.S. 107 (1911). The benefit of utilizing the corporate franchise was a rationale for imposing an entity-level tax. The corporate income tax did not provide the same problem according to the Court that an individual income tax would have prior to the adoption of the Sixteenth Amendment. See *id.* at 148-58.

84. U.S. CONST. amend. XVI (granting Congress power to collect taxes on income “from whatever source derived” without apportionment).


86. *Id.* at § II(A)(1), (2).

87. *Id.* at § II B.

88. *Id.* at § II D. The result was that, subject only to deferral of the second tax, corporate income bore the individual tax rate and the corporation acted as a withholding agent. This was so even though the Act contained a provision for taxing shareholders on profits improperly accumulated regardless of whether distribution actually took place. *Id.* at § II(A)(2). The scope of this provision was, in any case, less than clear from the colloquies. See Seidman’s Legislative History of Fed. Income Tax Laws 1938-1861, 984-86 (1938).

A short-lived retained earnings tax on undistributed income not “actually invested and employed in the business or retained for employment in the reasonable requirements of the business” was adopted in 1917. Revenue Act of 1917, ch. 63, § 1206(2), 40 Stat. 300. This provision was later replaced with a provision to tax shareholders directly on the retained profits of firms, which represented a departure from the legal entity view. See Revenue Act of 1918, ch. 18, § 220, 40 Stat. 1057 (1919). At the same time, the corporate rate became greater than the individual normal tax rate available to dividend credit, but not greater than the combined normal tax and surtax. See Revenue Act of 1918, ch. 18, tit. II, §§ 210-241, 40 Stat. 1058-1082 (1919)(compare Parts II and III). Neither capital stock taxes nor excess profits taxes were creditable. Revenue Act of 1918, ch. 18, § 222(a), 40 Stat. 1073 (1919); see also Brooks, *supra* note 76, at 403.
Corporate rate remained lower than the highest individual rates. Until 1936, the corporate tax was partially creditable against the individual tax on distributions and then not at all. Additionally, prior to and immediately after 1936, undistributed profits (retained earnings) were generally not taxed separately. Beginning in 1921, proceeds from sales and redemptions of shares were taxed at a preferential capital gains rate. The fact that for many years dividends were exempt from taxation under the normal tax meant that the classical corporate tax regime operated as a progressive element in the tax base — only individuals with higher levels of income actually paid a second level tax on dividends received.

This double tax regime, known as the classical corporate tax system and typified by both deferral and double taxation of prof-

89. Excess profits taxes may have briefly pushed it higher. See Reporter's Study Draft, supra note 54, at 48 n.43. It has been argued that incorporated businesses bore a higher tax burden than did unincorporated businesses from 1919 until the mid-1930s, when the federal corporation rates began to be higher than the individual normal rates. See Twentieth Century Fund Report, supra note 14, at 159 (arguing that in 1935 the greatest discrepancy occurred when the highest individual normal passthrough rate was 4% and the corporation rate was graduated to 15% while the individual surtax rate was 75%). Surtax rates, however, caused the highest individual rate to be higher than the corporate rate. By the 1930s, the disparity in rates was considerable for individuals subject to the surtax rates. See J. Eustice, J. Kuntz, C. Lewis & T. Deering, Tax Reform Act of 1986: Analysis and Commentary § 2.02[b][a], at 2-8 (1986)(table). The excess of the corporate rate over the individual normal rate was disadvantageous to incorporated businesses since stockholders receiving dividends were subject to a higher total of taxes than were investors in unincorporated businesses. See Twentieth Century Fund Report, supra note 14, at 160.

90. Brooks, supra note 76, at 403.

91. The short-lived undistributed profits tax of 1936, the repeal of which was urged by the Twentieth Century Fund, is the exception. Its enactment demonstrated the view that the accumulation of undistributed profits in reserves was undesirable and should be discouraged, in part, due to the belief that excessive saving by corporations and individuals from 1923 to 1929 was a cause of the stock market crash. See J. Stamp, The Fundamental Principles of Taxation 213-14 (rev. ed. 1936). Its actual effect was limited. Compare G. Lint, The Impact of the Undistributed Profits Tax, 1936-1937, at 33-34 (1948)(33 percent increased dividend payout) with R. Hubbard & P. Reiss, Corporate Payouts and the Tax Price of Corporate Retentions: Evidence from the Undistributed Profits Tax of 1936-1938 (National Bureau of Economic Research Working Paper No. 3111, 1989)(effect only in 1936 as managers found ways to retain "free cash flow"). This form of split-rate system, which had an increasing tax rate based on the decreasing ratio of dividends to income, was repealed based on the belief that it discouraged business expansion. See Corporate Financial Structures, supra note 4, at 88.


93. This assumes incidence of the tax on shareholders or owners of capital. See infra text accompanying note 351.

94. The first usage of the term may be in A. Van den Tempel, supra note 3, at 7. See also Phelps, Profits Theory and Profits Taxation, 34 Int'l Monetary Fund Staff
its, came into the world without any apparent legislative discussion of policy or economic considerations. The effects of the double tax have depended upon the relationship between the firm level rates (for both large and small corporations) and the individual rates. The corporate tax prior to the 1986 Act can generally be viewed as an inefficient single tax system rather than a


95. See Clark, The Morphogenesis of Subchapter C: An Essay in Statutory Evolution and Reform, 87 Yale L.J. 90, 109 (1977) [hereinafter Clark, Morphogenesis]. The excise tax requirement under the 1909 Act that the organization be formed for “doing business” was used by the courts when they construed the income tax. See McKee, Problems of the Unintentional Corporation: The Association Taxable as a Corporation, 29 Inst. on Fed. Tax'n 853, 865 (1971). The courts blindly adopted the “doing business” requirement without a discussion of the purpose of the excise tax as a privilege tax and the purpose of the income tax as a tax on net income. See Brooks, supra note 76, at 402 n.71 (no separate taxpaying ability implied because 1909 Act denominated an excise tax for constitutional reasons). Phelps summarizes the problem:

What was the antecedent wisdom on profits taxation prior to the criticisms of such a tax made by Harberger? A number of countries have chosen the system of corporate taxation introduced by the United States in 1909. In broad outline, the corporation pays a flat tax rate on all taxable profits without any tax credit going to the shareowner for his share of the profits tax paid. The shareowners are liable for the personal income tax, if any, on their dividends or capital gains. Finally, on the principle that only income, not gross receipts, should be taxable, the corporations (and thus, indirectly, their owners) are permitted to deduct interest expense in the calculation of taxable profit income. The economic historian is left to infer the intended “economics” of this legislation. There was no formal defense of it using recognizable economic theory.

Phelps, supra note 94, at 680-81 (footnote omitted). The classical system continued without a thought-out basis, perhaps impelled by considerations of revenue and prevention of tax avoidance through the use of corporations. Brooks, supra note 76, at 405 n.82 (quoting Shoup, infra note 125, at 137)(the extra taxation “was almost a by-product of the confusion that arose over the issue of taxing undistributed profits”).

96. For a review of these relationships in the United States, the United Kingdom, Canada, and Australia, see Brooks, supra note 76, at 386-458.

97. Even if capital gains are subject to full taxation only when realized, an unintegrated corporate tax will be neutral with respect to the payout decision, provided that the capital gains rate is equal to the marginal personal tax rate of shareholders. See Warren, Integration, supra note 1, at 731-37 (higher tax bracket individuals prefer equity investments if retained earnings and capital gains are possible); Warren, The Timing of Taxes, 39 Nat'l Tax J. 499, 501 (1986) [hereinafter Warren, Timing] (tax on dividends would not necessarily encourage retention of dividends). Nonetheless, prior to the 1986 changes, viewing corporate financing strategies solely in light of the applicable corporate and individual rates, a retained earnings strategy produced a higher after-tax valuation for the firm than did immediate distribution of firm earnings, financing by new equity, or increasing leverage by distributing earnings and reloaning the distribution to the corporation. See Zolt, supra note 27, at 864-68. This relationship was even more pronounced prior to the reduction of the individual marginal rate on unearned income to 50 percent from 70 percent. See Warren, Integration, supra note 1, at 719-33. The value of the deferral for
double tax system, for both public and private firms retaining earnings rather than paying dividends although even that view can be contradicted by evidence of the effective tax rates for corporations and shareholders. Nonetheless, the traditional tax clientele retained earnings was recognized early on. See Twentieth Century Fund Report, supra note 14, at 161-62 (withholding dividends postpones, rather than avoids, payment of income tax). This concept was apparently forgotten by economists. See Klein, Incidence, supra note 2, at 585-86 (advantages of the corporate form to individuals has largely been ignored). See also R. Musgrave & P. Musgrave, supra note 7, at 394 (comparing present double tax with what tax would be under an integrated system). The characterization of the corporate tax as a double tax system has persisted despite the obvious deferral advantages in the corporate form. See Beghe, supra note 79, at 769 (discussing ALI proposed draft of Subchapter C).

The distortion between retention of earnings and payment of earnings is witnessed by the aborted 1936 undistributed profits tax. See R. Blakely & G. Blakely, The Federal Income Tax 401-27. This view continues in repeated proposals to increase the scope of the accumulated earnings tax. See Cohen, Taxing Stock Dividends and Economic Theory, 1974 Wis. L. Rev. 142, 174. Taxing only distributed profits favors retained earnings as a source for corporate finance. The advice to managers relative to using retained earnings has been long-standing. See J. Dean, Capital Budgeting 39-42 (1951)(offering guidelines on dividing profits between retained earnings and dividends).

A related concern is the appropriate timing of the tax on dividend distributions. It places newer businesses at a competitive disadvantage in the capital markets compared with established businesses able to finance with lower taxed retained earnings. W. Vickrey, supra note 39, at 162-63. Since World War II the tax rates for currently distributed earnings have been much higher than the pass-through rate. See J. Eustice, J. Kuntz, C. Lewis & T. Deering, supra note 89, at ¶ 2.02(1)(c), at 2-8 (table 2-1)(both public companies and closely held C corporations have not distributed all earnings currently but rather have used retained earnings to finance corporate expansion); see also Clark, Morphogenesis, supra note 95, at 102-03 (retained earnings avoids double taxation of shareholders and provides higher after-tax returns than can be obtained by partnerships and sole proprietors).

98. The criticism that the corporate tax is a single tax system stems from the belief and data that regardless of the deferral advantages of the corporate form, in the aggregate there was double taxation at the corporate and individual ordinary rate that far exceeded the deferral opportunities. The historical rate relationship leading to the retained versus distributed earnings distortion may be somewhat overstated as actual dividends received were taxed at rates lower than the highest individual marginal rate and close to the highest corporate marginal rate. Evidence on individual effective tax rates provided by Brinner & Brooks, Stock Prices, in Brookings Institution, How Taxes Affect Economic Behavior 199 (H. Aaron & J. Pecharman eds. 1981), suggests that recipients of dividends were taxed at lower marginal tax rates than the marginal tax rate applicable to the tax on the earnings at the corporate level. Studying the historical patterns of taxation of corporate capital from 1955 to 1978 they find a dividends tax rate, based on a weighted average of people who reported dividends in adjusted gross income, of between 5 and 10 percentage points less than the corporate profits tax rate until about 1974. The rate differential then began moving towards parity. By 1978 the dividend rate was less than one percentage point below the corporate rate. Brinner & Brooks, supra, at 226-27. Accord Peterson, Peterson & Ang, supra note 63, at 280 (dividends taxed at an average marginal rate of 40% for taxable recipients). Viewing the issue from an effective tax rate perspective leads to a different conclusion. The Brinner and Brooks data was updated in Feldstein & Jun, The Ef-
factors of Tax Rates on Nonresidential Fixed Income: Some Preliminary Evidence from the 1980s, in The Effects of Taxation on Capital Accumulation 101, 137-51 (M. Feldstein ed. 1987). Feldstein and Jun demonstrate that the effective federal income tax rate of individual dividend recipients was, beginning in 1958, always higher than the effective federal corporate tax rate. See Feldstein, Corporate Tax Integration: The Estimated Effects on Capital Accumulation and Tax Distribution of Two Integration Proposals, 30 Nat’l Tax J. 37, 38-39 (1977)(noting estimates of waste by Harberger and Shoven). The advantages of equity relative to debt lead to arguments under the prior rate relationships that the individual tax burden on equity is lower than debt. See Miller, supra note 61. Whether that is true depends upon whether the taxes on dividends are capitalized by the market, see supra notes 66-69 and accompanying text. If not, the corporate tax on equity plus the individual level tax on dividends is higher. A model by Marcus, Palmon and Yaari argues that where both the dividend tax has been capitalized and where cash flow can be realized by stock trading among shareholders which does not transfer corporate cash out of the firm, the tax effect of the retention followed by a capital transaction through a sale on the market or a corporate repurchase is at a higher tax cost than if the firm distributes income currently: “By depriving shareholders of a cash flow, retention induces trading at appreciated prices causing an immediate tax payment on realized gains over and above any tax that must be paid on incremental future distribution.” Marcus, Palmon & Yaari, Growth and the Decision to Incorporate: A Financial Theory of the U.S. Tax System, 6 Rev. Fin. 29, 36-37 (1986)(taxation of distributions should favor distribution of earnings rather than the commonly accepted retention of earnings since the deferral period is unknown under the assumption of capitalization of the dividend tax and the actual capital gains tax). Even if deferral is advantageous vis a vis investment in a proprietorship, the period for evaluating that deferral remains imprecise despite numerous studies attesting to its beneficial effects. See id. at 39-43.

99. The tax clientele view reflects the belief that investors diversify their ownership interests in a firm by the type of security that provides the desired tax preferred return — debt, preferred stock, or common stock. It also reflects the belief that with respect to common stock, firms with high payout ratios are owned by shareholders in lower tax brackets. See infra notes 100 & 189. This relationship has been tested with ex-dividend day data which finds that the expected ex-dividend day relationship of a drop in the value of the stock by the exact amount of the dividend is not present due to the fact that there are taxpayers holding the stock for whom dividends are more favorably taxed than capital gains. See Elton & Gruber, Marginal Stockholder Tax Rate and the Clientele Effect, 52 Rev. Econ. & Stat. 68, 71-73 (1970). This data also supports the view that dividend taxes are not avoided. See Peterba & Summers, supra note 66, at 252-53. Ex-dividend day returns have been used to predict marginal stockholder tax rates. See Elton & Gruber, supra. These tests have been controversial in establishing a clientele effect. Compare Elton & Gruber, supra, at 71-73 (Ex-dividend day behavior shows that differential rates of taxation cause investors to discount the value of taxable cash dividends relative to capital gains. This creates a tax clientele effect in which investors with high marginal tax rates hold stocks yielding low dividends and vice-versa.) and Litzenberger & Ramaswamy, The Effect of Personal Taxes and Dividends on Capital Asset Prices, 7 J. Fin. Econ. 163, 189 (1979) and Barclay, The Ex-Dividend Day Behavior of Common Stock Prices Before the Income Tax, 19 J. Fin. Econ. 31, 32 (1988)(finding that investors in the pre-tax period value dividends and capital gains as perfect substitutes and that differential taxation of dividends
deferral opportunities for high bracket investors and owners investing in low-payout, high-retention firms allowed these individuals to reduce their personal marginal tax rates and reduced the progressivity of the income tax system.\textsuperscript{100} Penalty taxes were the statutory answer to deferral.\textsuperscript{101} While deferral was advantageous and capital gains has since caused investors to discount the value of taxable cash dividends) with Kalay, \textit{The Ex-Dividend Day Behavior of Stock Prices: A Re-examination of the Clientele Effect}, 37 J. Fin. 1059 (1984)(rejecting prior studies showing ex-dividend day price drops by less than the amount of the dividend and demonstrating a positive correlation between relative price drops and dividend yields indicating that dividends are taxed more heavily than capital gains) and Eades, Hess & Kim, \textit{On Interpreting Security Returns During the Ex-Dividend Period}, 13 J. Fin. Econ. 3 (1984) and Grinblatt, Massulis & Titman, \textit{The Valuation Effects of Stock Splits and Stock Dividends}, 13 J. Fin. Econ. 461 (1984)(Finding abnormal ex-dividend day returns for a variety of non-taxable distributions including stock dividends, stock splits, and nontradable cash distributions. This raises the possibility that ex-dividend day stock returns do not reflect marginal stock holder tax rates, but are instead related to transaction costs or to a larger ex-dividend day anomaly.). \textit{See also} R. Michael E, \textit{EX-DIVIDEND DAY STOCK PRICE BEHAVIOR: THE CASE OF THE 1986 TAX REFORM ACT} 20 (Salomon Brothers Center for the Study of Financial Institutions, Working Paper No. 472, June 1988)(Corporate traders dominate trading in the high yield groups. This finding is consistent with the favorable tax treatment of dividends for corporate investors through the dividends received deduction. It also acts as a rejection of the tax clientele hypothesis for other groups such as short-term traders and it shows how corporate traders dominate the price determination. The adverse effect of dividends for long-term individual investors has no significant effect on ex-dividend day stock price behavior.).

Depending on how shares are priced, tax clienteles can create both shareholder value and a windfall under the view that the extra burden of dividend taxes is capitalized by the market or just shareholder value under the traditional view of the role of shareholder taxes on distributions. \textit{See} Mundstock, \textit{ supra} note 70, at 29 (capitalization view); Miller, \textit{ supra} note 63, at 270 (traditional view with high bracket shareholders holding low payout shares for extra value).

100. \textit{See} Klein, \textit{Incidence}, \textit{ supra} note 2, at 585-86.


The accumulated-earnings tax provisions impose a penalty tax on a corporation "formed or availed of for the purpose of avoiding the income tax with respect to its shareholders ... by permitting earnings and profits to accumulate instead of being divided or distributed." I.R.C. § 532(a) (West 1988). The provision applies to accumulations "beyond the reasonable needs of the business," I.R.C. § 533(a) (West 1988), subject to a $250,000 credit, was originally intended to prevent accumulations at corporate rates lower than the individual tax rates and is argued to be inapplicable after the 1986 rate inversion. \textit{See} Kwall, \textit{Subchapter G of the Internal Revenue Code: Crusade Without a Cause?}, 5 VA. Tax Rev. 223 (1985); J. Eustice, J. Kuntz, C. Lewis & T. Deering, \textit{ supra} note 89, at 2-11. The provision has been expanded statutorily to public corporations, thus reversing Golfonda Mining Corp. v. Commissioner, 58 T.C. 139, 58 T.C. 736 (1972), \textit{rev'd on other grounds}, 507 F.2d 594 (9th Cir. 1974). \textit{See} I.R.C. § 532(c) (West 1988). The extension to widely held corporations was based on the ability to convert the distribution from ordinary income to capital gain. \textit{See} H.R. Rep. No. 432, 98th Cong., 1st Sess., pt. 2, at 1039 (1984).
for many firms and was the operative pattern for closely held corporations, the net result of the classical corporate tax is maintained to be a higher rate of taxation for corporate as compared to noncorporate profits.102

Despite this double taxation of dividend paying firms, the ranks of public companies continued to grow.103 Assuming that taxes on dividends do matter to investors, under what has been termed a "traditional view,"104 many studies have been under-

Such a premise has limited validity in a flat tax world, other than its utility in accomplishing the recovery of basis. If the accumulated earnings tax continues for earnings earned in 1988 and beyond, it will amount merely to a tax on the deferral of the dividend tax. On the other hand, Treasury may take the suggestion offered by numerous sources and recommend repeal of this penalty tax at least for post-1987 earnings. See, e.g., Wolfman, Subchapter C and the 100th Congress, 33 TAX NOTES 669, 674 (1986); J. Eustice, J. Kuntz, C. Lewis & T. Deering, supra note 89, at 2-12 (suggesting that the only real target of these taxes is a corporation with large earnings and profits accumulated in prior years).

The personal holding company and foreign personal holding company taxes do not require a showing of a tax avoidance purpose. They impose a penalty on undistributed personal holding company income from passive investments and personal services of a closely held corporation owned by five or fewer shareholders. See I.R.C. §§ 541-547 (West 1988 & Supp. 1989)(personal holding company) and §§ 551-558 (West 1988 & Supp. 1989)(foreign personal holding company). For a discussion of the need for the provisions in a post-1986 Tax Act world, see Wolfman, supra at 674. The Treasury study will also comment on these taxes.

102. See R. Musgrave & P. Musgrave, supra note 7, at 392-95 (demonstrating that the extra burden of the corporate tax is progressive if distribution-to-retained earnings ratios were high, but as the distribution ratios decline, the extra burden ratio turns negative for high income taxpayers and the burden distribution becomes negative). See McLure, The Case for Integrating the Income Taxes, 28 NAT'L TAX J. 257, 260 (1975)(Overtaxation of distributed corporate-source income considerably outweighs the undertaxation of retained income, resulting in debt financing being favored relative to equity finance, and investment in the corporate sector being discouraged relative to that in the noncorporate sector. The end result is capital shortages in the corporate sector and unnecessarily low national output.).

103. J. Pechman, Federal Tax Policy 145 (5th ed. 1987)(attributing growth to many factors such as the advantages offered by the corporate form, the lesser non-tax sophistication of the passthrough entities, general economic prosperity, and efficient use of capital by corporations). The growth might also be explained on the grounds that the effective tax rate of corporations was lower than the effective tax rate of individuals and noncorporate businesses. Agency cost economics also supports the value of the public firm despite higher levels of taxation. See Jensen & Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure 3 J. FIN. ECON. 305, 330-43 (1976).

104. An alternative "tax irrelevance" view, the basic premise of which is disputed, see supra note 63, is based on the Miller and Scholes contention that investors can avoid all personal taxes on interest, dividends, and partnership income. This view creates a before tax equilibrium for firm financing decisions, including the choice between debt and equity finance, the payment of dividends, and the funding of pensions based on the irrelevancy of the tax effects on dividends. See Hamada & Scholes, Taxes and Corporate Financial Management, in Recent Advances in Corporate Finance 187, 197-201, 203, 205, 208 (E. Altman & M. Subrahmanyam eds. 1983).
taken to explain why public firms continued to pay dividends in the face of the double tax.\textsuperscript{106} There is evidence that dividends and retentions were valued equally by investors in large public firms due to the presence of many tax-exempt and tax-preferred investors,\textsuperscript{108} which provides support for a "tax capitalization" view of

\textsuperscript{105} For an overview of the basic theories, see J. \textsc{Ang}, Do Dividends Matter? A Review of Corporate Dividend Theories and Evidence (Salomon Brothers Center for the Study of Financial Institutions Monograph Series No. 1987-2, 1987). The various explanations include: different tax clientele for different firms, see S. \textsc{Ross} \& R. \textsc{Westerfield}, Corporate Finance 418-19 (1988); an irrational preference for dividends, see Black, The Dividend Puzzle, 2 J. Portfolio Mgmt. 5 (1976); a signalling function concerning the future profitability of the firm, see Bhattacharya, Imperfect Information, Dividend Policy and "the Bird in the Hand" Fallacy, 10 Bell J. Econ. 259 (1979); Miller \& Rock, Dividend Policy Under Asymmetric Information, 40 J. Fin. 1031 (1985); Asquith \& Mullins, The Impact of Initiating Dividend Payments on Shareholders' Wealth, 56 J. Bus. 77 (1983); the reduction of agency costs by the payment of dividends restricting the actions of management, see Jensen \& Meckling, supra note 103, at 312; Rozell, How Companies Set Their Dividend Payout Ratios in The Revolution in Corporate Finance 320 (J. Stern \& D. Chew eds. 1986); if the distribution tax on retained earnings is capitalized by the market, payment of dividends merely reflects the market's prior expectation of payment, see supra note 69; conflicting preferences of shareholders in different tax brackets and their desire for portfolio diversification causes firms to pay dividends, see Feldstein \& Green, Why Do Companies Pay Dividends?, 73 Am. Econ. Rev. 17 (1983), reprinted in M. \textsc{Feldstein}, Capital Taxation 69 (1983); growth of the firm makes it riskier and reduces the market value of the shares and therefore the firm will pay dividends to avoid growing faster than the economy's natural rate, see Feldstein, Green \& Sheshinski, Corporate Financial Policy and Taxation in a Growing Economy, 93 Q. J. Econ. 411 (1979), reprinted in M. \textsc{Feldstein}, Capital Taxation 427 (1983); behavioral/cognitive elements contributing to decisions to issue dividends, see Miller, Behavioral Rationality in Finance: The Case of Dividends, 59 J. Bus. S451, S467 (1986) (the cash preference allusions of \textsc{Shefrin} \& \textsc{Statman}, Explaining Investor Preference for Cash Dividends, 13 J. Fin. Econ. 253 (1984), may "loom larger for individual investors who hold modest amounts of stock directly and who, unlike institutional and other large investors, do not rely heavily on professional portfolio advisers"); tax clienteles that prefer dividends to capital gains, see infra note 106; the positive reaction that a dividend announcement may provide, see Eades, Hess \& Kim, Market Rationality and Dividend Announcements, 14 J. Fin. Econ. 581 (1985); the use of dividends to fund consumption in a more preferable manner than capital gains transactions through lower transaction costs or lower risk than violating legal structures against the spending of capital, see Gordon \& Malkiel, supra note 62, at 131, 152-53, 175; and an overlapping generation of investors model to predict the undervaluation of firms and dividends as a means to realize value, see \textsc{Auerbach}, Share Valuation and Corporate Equity Policy, 11 J. Pub. Econ. 291 (1979) (corporations distribute dividends despite their disadvantageous tax treatment because corporate capital may be undervalued in the market place and dividends represent the best means to allow shareholders to recognize value in their investment).


\textsuperscript{106} This valuation can be calculated through use of the capital asset pricing model. See Gordon \& Bradford, Taxation and the Stock Market Valuation of Capital Gains and
Dividend taxes do not affect firm value under either view if debt and retained earnings financing, rather than new equity, dominate capital financing choices.\textsuperscript{108} However, for many investors, deferral of distributions\textsuperscript{109} coupled with share repurchase strategies\textsuperscript{110} created value which may not have been capitalized by returning cash to stockholders subject to lower tax rates than were dividends.\textsuperscript{111} Indeed, it is surprising that such strategies were not more heavily used\textsuperscript{112} prior to 1984, when debt

\textit{Dividends}, 14 J. PUB. ECON. 109, 110 (1980) (demonstrating that “asset market equilibrium will generate a \textit{single} rate of exchange between dividends and capital gains” due to the presence of individual investors for whom capital gains are an advantage and institutional investors with no tax on dividends or a reduced tax on dividends but with that relative value fluctuating). The data is interpreted as consistent with the view of the firm as maximizing share value and making decisions about dividend policy, real investment and financial structure, with an implication that the increase in value from a dividend and capital gain are estimates of the value in the market of incremental real investment. \textit{Id.} at 134. It also reflects the fact that there are tax clienteles for both dividends and capital gains. \textit{See} Gordon \& Malkiel, \textit{supra} note 62, at 152-53. This fact coupled with the repeal of the capital gains preference should change the capitalization mix.

\textsuperscript{107} \textit{See supra} notes 67-69 and accompanying text.

\textsuperscript{108} \textit{See supra} note 66. Debt and retained earnings finance dominate corporate capital structure, as illustrated by the allocations of 34\% by debt, 62\% by retained earnings, and 5\% by new equity. \textit{See} D. Fullerton \& J. Mackie, \textit{supra} note 98, at 8-9 \& n.7 (noting also that the noncorporate sector is financed one-third by debt and two-thirds by equity). Under the capitalization view the cost of capital is higher in 1989 than in 1980 but under the traditional view it is lower. \textit{See id.} at 11.

\textsuperscript{109} \textit{See supra} notes 96-102 and accompanying text.

\textsuperscript{110} \textit{See supra} note 43.

\textsuperscript{111} \textit{See} Gordon, \textit{The Savings Investment in Valuation of Corporations}, 45 REV. ECON. \& STAT. 37 (1962). A future second tax at the same rate as the initial corporate tax with the second tax not offset by a return of basis (in situations where there are earnings and profits) is equivalent to the result of an immediate distribution of earnings. \textit{See} Warren, \textit{Timing}, \textit{supra} note 102, at 501; Bryan, \textit{supra} note 44, at 1054-55, 1057-58. A future distribution at a lower rate is not and creates value for the shareholder.

\textsuperscript{112} \textit{See} Auerbach, \textit{The Tax Reform Act of 1986 and the Cost of Capital}, J. ECON. PERSP., Summer 1987, at 73, 75-76 (When dividends were less attractive than share repurchases under prior law a significant amount of money was distributed as dividends. This unexplained phenomenon leads to the conclusion that “[u]ntil economists have an adequate theory of what determines firms’ financial structure, we cannot be sure either of the effect of the new tax law on financial structure, or more importantly, on investment.”). \textit{ Accord Corporate Financial Structures, supra} note 4, at 58 (current understanding of corporate distribution policy leaves uncertain “the total impact of policies designed to reduce the bias between debt and equity”). On the value of repurchases versus dividends and the effects of the personal income tax structure relevant to the valuation of the corporation, see Brennan, \textit{Taxes, Market Valuation and Corporate Financial Policy}, 23 NAT’L TAX J. 417, 425-26 (1970).
replacing equity led to negative equity financing. Nonetheless, deferral strategies and the firm level lower cost of capital through retained earnings arguably led to an inefficient allocation of resources. Firm managers preferred retained earnings financing over debt and new equity financing, both of which require more extensive disclosure of information about firm uses of funds. Retained earning financing without a required dividend payout is argued to have maximized corporate wealth rather than profits, led to the funding of inferior projects, and created a negative im-

113. See supra note 43.

114. Merritt Fox argues and demonstrates by empirical evidence that firm efficiency as measured by production efficiency, output choice efficiency, and dynamic efficiency (the search for new goods to produce and new production techniques) is limited where firms rely on retained earnings finance where managers are not subject to the discipline of expressly interested capital providers and under the check of explicit financial constraints in capital structure through required interest payments or required to disclose information about projects and where projects are generated internally rather than externally. See M. Fox, supra note 36, at 337-39. This argument is at the core of the belief that increased debt finance results in greater efficiency. Internal cash flow after payment of dividends has in recent years been sufficient to fund an average of close to 90% of the real investment of the largest 100 United States industrial corporations. Id. at 337. There is growing evidence of the inefficiency of retained earnings financing. See id. at 201-09 (discussing "internal" financing and adoption of a "low payout ratio" and advocating a mandatory dividend payout); Baumol, Heim, Malkiel & Quandt, Earnings Retention, New Capital and the Growth of the Firm, 52 REV. ECON. & STAT. 345 (1970); see also Brumbaugh & Gravelle, The Corporate Income Tax and the U.S. Economy, 25 TAX NOTES 576 (1984); Heaton, On the Bias of the Corporate Tax Against High-Risk Projects, 22 J. FIN. & QUANT. ANALYSIS 365 (1987) (corporate tax leads to misallocation of resources because firms are reluctant to undertake high-risk ventures). But see Racette, Earnings Retention, New Capital and the Growth of the Firm: A Comment, 55 REV. ECON. & STAT. 127 (1973)(suggesting that Baumol, Heim, Malkiel & Quandt used an unsatisfactory assumption about the importance of transaction costs and that their conclusion is therefore suspect).


116. See M. Fox, supra note 36, at 247-331 (demonstrating theory by application to the semiconductor industry). See also Jensen, Takeovers: Their Causes and Consequences, J. ECON. PERSP., Winter 1988, at 21, 28 & n.6 [hereinafter Jensen, Takeovers] (discussing the importance of agency costs associated with conflicts between managers and shareholders over dividends). See also Sheppard, supra note 8, at 646 ("[T]he combination of the double taxation of dividends and the capital gains exclusion . . . has resulted in entrenched management acting as investment bankers for their shareholders . . . ."). This observation is not new. See Twentieth Century Fund Report, supra note 14, at 169 (retained earnings results in two kinds of misapplication of funds: the firm invests without consulting the individual stockholders who might spend the dividend instead of investing it, and the firm is likely to reinvest the funds in the firm's business while the shareholders might invest
pact on saving. The reverse is argued to be true for highly leveraged corporate structures.

2. The Impact of the 1986 Act

Proceeds from the corporate tax declined from 21.6% of federal tax receipts in 1959 to 6.2% in 1985. The explanation for this decline is twofold. First, legislative changes reduced the corporate tax base; and second, economic conditions reduced corporate profitability. The 1986 Tax Act reversed the decline by looking toward the business sector as a whole, and particularly corporations, for increased taxes.

The 1986 Act eliminated most of the tax advantages of the classical corporate tax system. While nominally lowering the tax rate, the 1986 Act broadened the corporate tax base. In reduct-
ing the maximum effective individual rate to 28%\(^{123}\) and setting the corporate rate at 34%\(^ {124}\), the 1986 Act inverted the long-standing relationship between the individual and corporate rates which had existed under the classical corporate tax system\(^ {125}\). The 1986 Act also eliminated the preferential capital gains rate. Although the bases are somewhat different, the minimum tax rates for individuals and corporations\(^ {126}\) are almost at parity. The as-
sumption of capitalization of firm level taxes argues that the rate changes produced a tax-related gain in old corporate equity by causing an increase in the value of corporate shares. However, the 1986 Act left the classical corporate tax regime intact and therefore perpetuated the tax bias against new corporate equity.

As a result of these changes, the 1986 legislation exacerbated two prominent distortions of the old classical corporate tax re-


One would expect a reduction in the corporation tax to cause capital gains on equity, but if the amount of equity outstanding is initially in equilibrium, this may not be the case. In the new equilibrium, equity holders will still value the returns (after the corporation tax) from a dollar of marginal real investment at a dollar. The price of equity may rise immediately, but firms will expand the supply of equity capital, cutting back the supply of bonds, until the price falls toward its original level. Anticipation of this eventual drop may restrain the initial rise. Even though in equilibrium the new marginal holder of equity values the return from a dollar of real investment at a dollar, the increased inframarginal holdings of equity will be valued at more than a dollar, so consumer surplus will have increased. Although price may not change significantly, there will be windfall gains in utility. Since those in the higher tax brackets have relatively stronger preferences for equity rather than for bonds [due in part to the tax benefits for equity income rather than interest and the risk aversion of upper income investors], this group would capture most of these windfall gains in utility. And existing bondholders, having a lower probability of bankruptcy, would also receive windfalls.

Gordon & Malkiel, supra note 62, at 179.

128. The impact of these two distortions was moderated by a third distortion, the retained earnings versus distributed earnings bias. The new tax law, however, has now largely eliminated this third distortion, thereby unmistakably tipping the scales in favor of pass-through taxation. The retained earnings bias, or reward for a deferred future shareholder tax, was the basis of the 1984 ALI view of the classification issue that presumed the equivalence between the corporate and pass-through regimes:

There is ample evidence that a broad section of the tax community views these two systems of taxation [the corporation tax regime and the pass-through regime], at least when applied to entities economically similar to limited partnerships, as tradeoffs. For entities that are economically similar to partnerships, a direct tax on the owners of the entity is considered an adequate substitute for the combined corporate and shareholder level tax applied to corporations.
gime — the bias in favor of unincorporated firms and the preference for debt financing. Tax planning since the 1986 Tax Act has tried to ensure the "disincorporation of America" in three ways. The first, or "nonincorporation" prong of disincorporation, encourages firms to earn business income in the first in-

For the most profitable entities, the 50 percent tax paid immediately by a partner produces revenue that compares favorably with the amount realized from the lower corporate tax rate and a deferred tax at the shareholder level. However, even for less profitable enterprises, this type of tradeoff also exists. Of course, for particular businesses the decision to operate as a partnership or a corporation can have important tax consequences. Nevertheless, there is ample evidence that Congress has been willing to accept pass-through taxation for limited partnerships and the entities most similar to them.

The American Law Institute's view of the actual effective taxation of profitable enterprises was presumably colored by the reduction in effective corporate tax rates created through the enactment of the accelerated cost recovery system and the investment tax credit as well as through self-help of closely held corporations. Accord Fredrich, The Unincorporation of America?, 12 J. Corp. Tax'n 3, 12 (1987). Moreover, it assumed that the issue was the treatment of limited partnerships only. Its impression of the tradeoff between the two taxing regimes appears to adequately reflect economic reality. For an overview of the posture of the present corporate tax system, see LeDuc & Gordon, Two Visions of Subchapter C: Understanding the 1986 Tax Reform Act and the 1987 Revenue Act and Predicting the Near Future, 42 Inst. on Fed. Tax'n § 13.01, at 37-1 (1988) (describing orthodox and radical views of the classical corporate tax system in the context of specific legislation).

129. See infra notes 139-57 and accompanying text.

130. See infra notes 158-74 and accompanying text.

131. No definition of disincorporation has been offered to date but the term was first coined in a 1983 article. See Mack, Disincorporating America, Forbes, Aug. 1, 1983, at 76. Use of the term continued in subsequent years. See, e.g., Saunders, America Disincorporated?, Forbes, June 16, 1986, at 74; Saunders, Tax Reform's Tax Dodge, Forbes, Oct. 20, 1986, at 103.

132. Empirical evidence of the erosion of the corporate tax base by the nonincorporation and freezing strategies is difficult to obtain. The best evidence on nonincorporation to date is the great increase in S corporation elections following the 1986 Tax Act, and the increasing number of S returns. In 1986, 811,987 Forms 1120S were filed, 892,376 were filed in 1987, and 917,800 were projected to be filed in 1988. 7 Statistics of Income Bull. 3 Winter 1987-88, at 100 (Table 20). This increase was substantial, although less than the increase in the reported number of S elections made after the 1986 Tax Act. Reports of S elections were 220,000 for 1986 (although some may have only been effective for 1987). See Brooks, A Proposal to Avert the Revenue Loss from "Disincorporation," 36 Tax Notes 425 n.1 (1987). S elections totalled 329,000 for January 1, 1987 through May 1987. See 1987 Senate MLP Hearing, supra note 30, at 63 (statement of J. Roger Mentz). The incentives to adopt passthrough taxation have been increased by the lack of economic size limitations imposed upon S corporations.

The problem of avoidance of the corporate tax through unincorporated entities is not confined to the United States. See White Paper, supra note 12, at 195 (prior to adoption of an imputation system in 1987, Australia feared "de facto abolition of the company tax
stance in a passthrough entity. The second, or “freezing” prong of disincorporation, encourages firms to restructure themselves as partnerships or as S corporations entitled to passthrough taxation so that asset appreciation and future income from assets presently in entities subject to the classical corporate tax regime will be earned by the present owners outside of the corporate entity and thus be subject to single level taxation. The third, or “debt finance” prong of disincorporation, encourages firms to increase leverage and substitute debt for equity in leveraged buyouts or leveraged recapitalizations. These strategies have


134. Liebtag, Capital Formation by Small Business, J. Acct., June, 1987, at 82, 86 (citing study of 400 small business owners where 25% of the owners of firms structured as corporations are giving serious thought to changing to an alternate business form).


136. After 1986, debt finance replaces retained earnings finance as the tax preferred form of capital structure. For a comprehensive view of the value of deferral, redemptions, and retained earnings, debt finance, and debt replacing equity strategies in 1988, see Zolt, supra note 27, at 858-68 (finding that 100% dividend payout strategy is the preferred dividend strategy and that debt finance initially or by replacing equity with debt provide the highest after-tax future value of the financing alternatives). Accord Corporate Financial Structures, supra note 4, at 38-54, 82-84 (debt structure increases returns on equity and distributions favored over retention). Leverage increases the after-tax return to equity if interest is deductible. See infra note 230 and accompanying text. Debt-finance preference is caused by the tax advantage to the firm relative to recipient tax rates and the double taxation of corporate equity. See Senate LBO Hearings, pt. 2, supra note 16, at 195-96 (prepared statement of Lawrence Summers). Debt finance with interest deductibility also allows tax arbitrage by “increasing the transfer of low effective tax rate assets to high bracket taxpayers” through leveraged purchases of assets and shifting income inclusions to low bracket taxpayers. See Corporate Financial Structures, supra note 4, at 78-79. All prongs, however, increase the transaction costs.

137. Corporate spin-offs followed by S elections were a favored technique. See Simon & Simmons, The Future of Section 355, 40 Tax Notes 291, 295-96 (1988). Corporations that decide to use a spin off to elect subchapter S will not qualify for the federal tax savings available under I.R.C. § 355 because the reorganization will lack the required valid business purpose. See Treas. Reg. § 1.355-2(b)(3) (1989). Certain plans to use partner-
been attacked but not eliminated, and no solution to the revenue loss through interest payments to tax exempt recipients has been accepted.\textsuperscript{138}

Private ordering in partnerships, limited partnerships, and trusts can accomplish many of the same results as incorporation,\textsuperscript{139} although there are differences. In the case of a limited partnership, equity participants sacrifice some management rights. However, the significance of these rights under earlier versions of the limited partnership acts, and especially the more liberal recent versions,\textsuperscript{140} is debatable. To achieve limited partnership status and

ships to circumvent the repeal of \textit{General Utilities} will be attacked under I.R.C. § 337(d) (1986). See I.R.S. Notice 89-37, 1989-13 I.R.B. 7 (corporate-level gain recognized to the extent corporate contributing partner receives a partnership distribution of its stock or stock of an affiliate); see also Sheppard, \textit{Curbing General Utilities Abuses; The Scope of Notice 89-37}, 42 \textit{TAX NOTES} 1433 (1989)(counteracts May Department stores transaction). No consensus has yet been reached on the appropriate treatment of corporate debt and the interest deduction in restructuring transactions or for all taxpayers.

138. See supra notes 47-50 & 56 and accompanying text. The obvious solution is to treat interest paid by corporations that are entitled to a deduction as unrelated business income in the hands of tax exempt recipients and as taxable to foreign holders. A limited provision with respect to foreign holders is contained in I.R.C. § 163(j) as amended by the OBRA, \textit{supra} note 49, § 7210, which denies the interest deduction for earnings stripping transactions where debt has replaced equity in a leveraged buyout resulting in a higher debt-equity ratio than 1.5 to 1 and the payment is made to a related party.

139. See Anthoine, \textit{Federal Tax Legislation of 1958: The Corporate Election and Collapsible Amendment}, 58 COLUM. L. REV. 1146, 1175 (1958)("[L]imited partnership is well suited to most of the ventures that subchapter S seems designed to serve . . . . [Therefore,] subchapter S is bound to be a 'gimmick' section."). For considerations in organizational choice, see \textit{infra} note 279. The state law characteristics of limited partnerships have also undergone significant change. See \textit{infra} note 140.

140. The Uniform Limited Partnership Act was drafted in 1916. \textit{Unif. LIMITED PARTNERSHIP ACT}, 6 U.L.A. 561-619 (1969)[hereinafter ULPA]. Creation of the ULPA was intended to resolve the liability issues and to encourage the wider use of limited partnerships. \textit{See id.} at 562-65 (official comment). The Revised Uniform Limited Partnership Act was promulgated in 1976. \textit{Rev. UNIF. LIMITED PARTNERSHIP ACT}, 6 U.L.A. 220-385 (pocket part 1989)[hereinafter RULPA]. Its purpose was to "modernize the prior uniform law while retaining the special character of the limited partnerships . . . ."). \textit{See id.} at 221 (prefatory note). The limited partner's right to information was increased. \textit{Id.}, § 105, at 265; \textit{id.} § 305, at 314. The ability to have a limited input into basic policy was clarified with the imposition of several corporate law concepts. \textit{Id.}, §§ 301-05, at 298-316.

The limited partnerships formed under RULPA temporarily raised questions as to whether they would be treated as partnerships or associations for tax purposes. \textit{See Comment, An Analysis of the Revised Uniform Partnership Act}, 18 AM. BUS. L.J. 399, 400 (1980). However, the Treasury eventually ruled that limited partnerships formed under RULPA would be treated the same as ULPA partnerships. \textit{See Treas. Reg.} § 301.7701-2(a)(5)(1983). Forty-two jurisdictions have now adopted RULPA. \textit{Id.} at 220-21 (table of jurisdictions). The 1985 amendments to RULPA streamlined the procedural requirements for creating and operating limited partnerships and modified the test for liability to third parties. The 1985 amendments also further clarified safe-harbor activities for a limited
for tax and market signalling purposes,\textsuperscript{141} some public corporations liquidated entirely or transferred significant business divisions\textsuperscript{142} into publicly traded limited partnerships while continuing their businesses and substituting limited-partnership equity for corporate equity or debt.\textsuperscript{143} These corporations were generally but not always in industries with a history of limited partnership use and with returns mirroring high yield debt returns.\textsuperscript{144} It had been

partner. See id. at 221-23 (prefatory note).

The theory that a limited partner is not entitled to participate in management while retaining limited liability derives from the fact that the limited partner is allowed to be treated as a partner rather than a debt holder. She does have, however, debt-like characteristics. This was recognized from the adoption of ULPA and is grounded in creditor reliance upon the activities of a limited partner in determining status as a general or a limited partner. See infra notes 286-94 (discussion of limited partners' debt-like and equity-like characteristics and the difficulty in distinguishing debt from equity). RULPA imposes liability when third parties have actual knowledge of the limited partner's participation in control. See Note, \textit{Limited Partnership Control: A Reexamination of Creditor Reliance}, 60 Ind. L.J. 515, 524 (1985). Notwithstanding the control restrictions inherent in the limited partnership model, publicly traded partnerships had been substituted for corporations. See, e.g., \textit{ServiceMaster Industries, Proxy Statement/Prospectus} (Nov. 28, 1986).

Other quirks of partnership law may make private ordering less flexible than one would otherwise believe. For instance, there are restrictions limiting the right of a general partner to have a return of capital before the limited partner. \textit{But see} Lanier v. Bowdoin, 282 N.Y. 32, 38, 24 N.E.2d 732, 735 (1939)("In the absence of prohibitory provisions of . . . statutes or . . . rules of common law . . ., the partners . . . may include . . . any agreement they wish . . ."); Riviera Congress Associates v. Yassky, 18 N.Y.2d 540, 548, 223 N.E.2d 876, 880, 277 N.Y.S.2d 386, 392 (1966)(self-dealing can be validated by partnership agreement — "if the asserted self-dealing was actually contemplated and authorized, it would not, ipso facto, be impermissible").

141. These transfers created wealth for the corporation upon conversion to limited partnership status, rollouts of assets and distributions to shareholders, reductions in free cash flow, information signalling, reductions of information asymmetries, and improved asset management. See Moore, Christensen & Roenfeldt, \textit{Equity Valuation Effects of Forming Master Limited Partnerships}, 24 J. Fin. Econ. 107 (1989).

142. See, e.g., exhibit III of Turlington & Beeson, \textit{supra} note 51, at 309-12 (listing twelve liquidation MLPs and 23 drop down MLPs).

143. See \textit{1987 Senate MLP Hearing, supra} note 30, at 145-46, 163-68, (statements of John E. Chapoton and Barry R. Miller). These transactions are illuminating. For example, Bordon Chemical rolled out its developed basic chemical and polyvinyl chloride resin business and assets into a publicly traded limited partnership under the grandfathering provisions of the 1987 legislation, retaining a 25% interest. Capital expansion was not contemplated and the return generally mirrored a high-yield return (12% on $10.50 unit) with a put or call right prior to conversion to a corporation at $10 per unit or 125% of the actual trading price. See \textit{Borden Chemicals and Plastics Ltd. Partnership, Prospectus} 3-11 (Dec. 10, 1987).

144. Most MLPs operated in the debt-substitute mode because of market perceptions as to their use. The few offerings of MLPs that failed to offer the current cash flow or security that investors think of as essentially a substitute for debt (such as DeLaurentis, which offered investors long-run appreciation) do not sell well. The market looked for current yield rather than \textit{General Utilities}-type gain and sponsors adapted to that. MLP eq-
argued that the pressure to disincorporate by forming a publicly traded limited partnership, would be mitigated by at least four countervailing forces: (1) the relative expense of establishing and administering partnerships,\(^{146}\) (2) the tendency of management to retain rather than distribute earnings,\(^{146}\) (3) disadvantageous tax consequences for tax-exempt equity holders\(^ {147}\) and foreigners,\(^ {148}\) and (4) the relative nontax advantages of the corporate form.\(^ {149}\)

A transaction cost view may be used to explain why PTPs held assets of an identifiable, generic type and were redeployable. See Williamson, Corporate Finance and Corporate Governance, 43 J. Fin. 567, 581 (1988). Williamson first notes that the key governance structural differences between debt and equity are that debt has numerous contractual restraints, is a preemptive security, and does not intrude into firm governance, whereas equity has no contractual restraints, bears residual claimant status, and intrudes extensively into management. Id. at 579-81. Williamson then surmises as follows:

> [T]he TCE [transaction cost] approach maintains that some projects are easy to finance by debt and ought to be financed by debt. These are projects for which physical asset specificity is low to moderate. As asset specificity becomes great, however, the preemptive claims of the bondholders against the investment afford limited protection—because the assets in question have limited redeployability. Not only does the cost of debt financing therefore increase, but the benefits of closer oversight also grow. The upshot is that equity finance, which affords more intrusive oversight and involvement through the board of directors (and, in publicly held firms, permits share ownership to be concentrated), is the preferred financial instrument for projects where asset specificity is great.

Id. at 589. Williamson speculates that debt will be substituted for equity for redeployable assets and that the shift in focus for lenders in leveraged buyouts from a cash-flow analysis to an asset-based analysis is consistent with his transaction-cost hypothesis. Id. at 581, 585-87.

145. See McKee, supra note 29, at 23-8; 1987 Senate MLP Hearing, supra note 30, at 172 (statement of Barry R. Miller).

146. See McKee, supra note 29, at 23-9.

147. Tax-exempt equity holders are subject to tax on unrelated business income which was not triggered by dividend payments. See McKee, supra note 29, at 23-9, 23-10; see also I.R.C. §§ 511-514 (West 1988 & Supp. 1989).

148. Foreigners are taxed on a withholding basis on partnership equity income but are not taxed on "portfolio interest" or treaty preferred interest. See McKee, supra note 29, at 23-10; see also I.R.C. §§ 871(b), 871(h), 875, 881(c), 882(c), 1446 & 6012 (West 1988 & Supp. 1989). Foreigners receive dividend and interest payments subject to 30% withholding unless reduced by treaty, but since 1984 a broad category of "portfolio" interest is tax-free to foreigners. See I.R.C. § 871(b) (West 1988 & Supp. 1989).

149. Examples of non-tax advantages of the corporate form of organization include perpetual life of the organization, general freedom from liability for the investors and principals, and greater control over management by investors through the ability to elect directors. See 1987 Senate MLP Hearing, supra note 30, at 103 (statement of Lewis Sandler).

A corporate governance preference for corporations over limited partnerships has also been observed. Writing after the decision in Larson v. Commissioner, Gabinet and Coffey,
While these four arguments leveled against MLPs as general business vehicles failed to persuade Congress, they may be borne out by subsequent developments.\textsuperscript{150}

Pressures to disincorporate existed before 1986.\textsuperscript{161} The increase in S elections from 1981 to 1985\textsuperscript{152} provided evidence of the increased desirability of passthrough entities compared to that of the traditional corporate form. This increase was enhanced by

observe that contract-risk attributes of corporate equity are not the same as limited partnership interests because of the limited supervisory prerogatives of limited partners and the relative illiquidity of their interests relative to publicly traded but not closely held equity. Even if they had the same contract risks, firms that require substantial equity investment must tap investors with lower levels of absolute risk aversion who would not enter limited partnerships as managers because the managers of a limited partnership have unlimited personal liability for the acts of the firm. They assert that certain production activities may only be undertaken through the corporate form, if "[b]usiness association's law . . . disallow[s], outside the framework of the corporate form, the packaging of total firm risk so as to construct an equity investment that meets the risk tolerance of [potential investors]."


150. The problems of high administrative costs, suitability for investment by pension funds, IRAs and mutual funds, stability of the ownership base, and limitations on the use of suspended losses-by partners are all reasons that several publicly traded limited partnerships with qualifying income have considered reincorporation. See Shearson Lehman Hutton, \textit{The "Recorporatizing" of MLPs: Devon Resources and Apache Petroleum Lead the Way}, \textit{TAX AND ACCOUNTING ISSUES}, vol. 1, issue 33, Dec. 12, 1988, at 1 (Devon Resources and Apache Petroleum abandon MLP status and convert to the corporate form).

151. For some, disincorporation only began in 1986. See Zolt, supra note 27, at 870.

152. S elections for the years 1983, 1984, 1985, and 1986 numbered 147,000, 187,000, 133,000, and 174,000, respectively. 1987 Senate MLP Hearing, supra note 30, at 19 (statement of J. Roger Mentz). The number of S returns increased from 541,489 in 1981, to 564,219 in 1982 (the first effective year for new firms), and to 648,267 in 1983 (the first year effective for all firms). \textit{INTERNAL REVENUE SERVICE, Corporation Income Tax Returns: Selected Balance Sheet, Income Statement, and Tax Items for Selected Years, 1970-1983}, 5 \textit{STATISTICS OF INCOME BULL.}, no. 4, at 108 (Spring 1986)(Table 8); \textit{INTERNAL REVENUE SERVICE, Corporation Income Tax Returns: Balance Sheet, Income Statement, and Tax Items for Selected Income Years, 1970-1985}, 7 \textit{STATISTICS OF INCOME BULL.} no. 3, at 92 (Winter 1987/1988)(Table 13). The percentage increase was less significant than one would otherwise have believed. The 61\% increase for 1981-1984 must be discounted somewhat because there was a corresponding 12\% increase in all corporate returns during that same period. Since 1983, S corporations have continued to increase in number. In 1984, 701,339 S corporations filed tax returns and in 1985, they increased to 725,021. \textit{Id.}

There is also an increase from 1982 in the proportion of total S corporation income over total net income. The value was 0.88\% in 1981, 1.97\% in 1982, 2.70\% in 1983, 2.97\% in 1984, and 3.17\% in 1985. See \textit{INTERNAL REVENUE SERVICE, SOURCE BOOK: CORPORATION INCOME TAX RETURNS (1981, 1982, 1983, 1984, 1985)}[hereinafter \textit{SOURCE BOOK}](compiled from table called "all industries returns with and without net income" by comparing the following two entries: (1) Total net income (less deficit) and (2) Net income (less deficit) for firms using form 1120S). However, S corporations generated a very small percentage of the total net income in the larger asset groups.
the extremely favorable 1986 legislation enabling certain corporations, not limited by economic size, to elect S corporation pass-through taxation without liquidating or making taxable distributions. The only restriction was a future tax cost that may in whole or part be eliminated.\textsuperscript{153} Between 1981 and 1985, the number of publicly offered limited partnerships, including publicly traded partnerships, also increased.\textsuperscript{154} The best evidence of the increased

153. Under the legislation, firms eligible for the election can elect Subchapter S status without a taxable liquidation to the corporation (or to the shareholders who would recognize a tax on the unrealized appreciation in corporate assets) and can avoid entirely the corporate tax on appreciated assets if the election was made before 1987, if the firm liquidated after the election before January 1, 1989 and was eligible for the General Utilities repeal transitional rules, or if the election was made after 1986 and the corporation retains the appreciated assets more than ten years after the Subchapter S election. For firms electing S and continuing to operate, the resulting single taxation may be a great deferral benefit. See Yin, Taxing Corporate Liquidations (and Related Matters) After the Tax Reform Act of 1986, 42 Tax L. Rev. 573, 681-86 & n.459 (1987). The built-in gain tax can also be eliminated or minimized with careful planning even where the transitional rules could not be utilized to avoid the tax. See Billings & Ryan, Making the S Election with Built-in Gain, 14 J. Corp. Tax'n 283, 297-98 (1988)(noting importance of carry-forward losses offsetting unrealized gain, ten-year holding period, disposal of gain assets at the same time as losses assets, and timing of losses). See generally Smith, S Corporation Built-in Gains: An Analysis of Section 1374 After the Tax Reform Act of 1986, 39 U. Fla. L. Rev. 1117 (1987). An alternative could have been a toll-charge spread over a reasonable period. See Yin, supra at 686 n.459 (citing Senate Finance Committee Staff Report). For an earlier view of the appropriate S toll charge recognizing gain in excess of shareholder basis, see Ginsburg, Subchapter S and Accumulated E & P: A Different View, 17 Tax Notes 571 (1982). The extent to which the failure to tax appreciation at the firm level, the individual shareholder level, or both at the time of the election is subject to debate. The answer to this question depends largely upon assumptions made regarding the role of double taxation in the classical regime. See infra notes 298-446 and accompanying text. The LIFO benefit recapture that triggers upon the making of an S election is one form of toll charge. I.R.C. § 1363(d) (West 1988 & Supp. 1989). For a further discussion of S corporations, see infra notes 1049-60 and accompanying text.

154. In 1985, 28 MLPs were formed (10 roll-up, 7 liquidation, 7 roll-out, and 4 acquisition) as compared with 6 in 1984 (4 roll-up, 1 roll-out, and 1 acquisition). In 1986, 38 MLPs were formed, and 40 were formed in 1987, through June 29 of that year. 1987 Senate MLP Hearing, supra note 30, at 77 (table 2)(statement of J. Roger Mentz). While estimates vary, the Treasury Department placed the number of exchange-trade MLPs in existence at approximately 126. Id. at 65. The Coalition of Publicly-Traded Partnerships estimated this number at 100. See Chambers Associates, An Overview of the Origin and Tax Treatment of Publicly-Traded ("Master") Limited Partnerships 2 (Oct. 1987) reprinted in Tax Notes Microfiche Database Doc. 87-6812. The 1988 estimate is 140. NEW YORK STATE BAR ASS'N TAX SECTION, REPORT ON ISSUES CONCERNING THE DEFINITION OF PUBLICLY TRADED PARTNERSHIPS 14 (June 15, 1988)(found in full text in Tax Notes Microfiche Database Doc. No. 88-5534). The gross proceeds from public limited partnership offerings were $16.395 billion in 1985, $23.140 billion in 1986, and $22.963 billion in 1987. S.E.C., Gross Proceeds From Limited Partnership Offerings, By Industry 1985-1988, S.E.C. MONTHLY STATISTICAL REV., vol. 47, no. 11, at 19 (Nov. 1988). The value of limited partnership offerings in
use of passthrough taxation prior to the 1986 Tax Act was the emergence of net income in the partnership sector in 1985, reversing a four-year loss trend. In reaction to the presumed effects of the 1986 Act, which drove firms to disincorporate, the 1987 legislation included certain publicly traded partnerships within the scope of the classical corporate tax system and proposed broad limitations on debt financing. Debt financing also increased significantly prior to 1986, due to the tax advantages of debt, a high real rate of interest, and development of the high yield debt market. Restrictions prohibiting certain financial intermediaries


The increase in debt finance beginning in 1981 is considered by some to contradict the belief that the change in the rate structure in 1986 was the primary impetus for higher leverage.

Some believe that, because the top personal tax rate was reduced below the top corporate tax rate in the 1986 Act and because the share of wealth held by tax-exempt entities is substantial, the tax advantage of debt at the corporate level outweighs its disadvantages to investors [who are taxed currently on interest income]. They would argue that changes in tax law have provided the motive force in the drive toward higher leverage. However, given that the observed changes in corporate financial behavior began well before 1986, the changes due to the 1986 Act may have been of relatively little importance in determining changes in leverage and acquisition behavior. The individual rate reductions in the Economic Recovery Tax Act of 1981, some respond, started the shift toward more debt in corporate structures and the 1986 Act merely provided another push in that direction.

The theory that the high real rate of interest caused the increase in debt financing in
from holding equity also contributed to this increase by encouraging these capital providers to hold riskier debt in search of higher rates of return on their invested capital.

The net new borrowing figures show a dramatic increase in the amount of corporate debt beginning in 1981, a reduction during the recession of 1982-1983, and an increase in 1984. Debt-equity ratios also demonstrate an increase in 1986-1988 relative to 1981-1985, although the implications for the risk involved in such leveraging and the relationship between interest deductibility and investment choices remain unclear. The growth in corporate debt is correlated with an increase in leveraged buyouts


159. CORPORATE FINANCIAL STRUCTURES, supra note 4, at 8 (Table I-A). Accord Jensen, supra note 116, at 37-39 (the dramatically increased bias toward corporate debt finance began in 1981). The increase continues despite the increased cost of debt financing in 1989, relative to 1985. See Hausman & Poterba, supra note 41, at 110.

160. CORPORATE FINANCIAL STRUCTURES, supra note 4, at 64-66 (Table IV-B). For 1981-1985, the ratio of debt to equity based on book value averaged 33.1 percent and 62.5 percent based on market value. Id. For 1986-1988, the average was 44.4 percent based on book value and 65.6 percent based on market value. Id. Other measures of the difference in the debt-equity ratios show higher debt-equity ratios in the years 1900 to 1958 than in 1985, even though there is a trend in the nonfinancial corporate sector toward increased debt-equity ratios beginning in 1946. See M. Schapiro, THE STABILIZATION OF THE U.S. ECONOMY: EVIDENCE FROM THE STOCK MARKET 20 (National Bureau of Economic Research Working Paper No. 2645, 1988).

161. While the average based on book value has exceeded the previous peak in the 1970s, see supra note 160, "book values of equity do not embody expectations about future profitability, and therefore do not take into account the stock market's evaluation of the corporate sector's ability to repay debt . . . ." and the ratio based on market value was not significantly higher than the immediate and other past periods, "because the recent increase in the market value of stock has paralleled the increase in corporate debt insurance . . . [there is] some comfort for those concerned about the increase in corporate debt, but only to the extent it is believed the stock market is a reliable predictor of future ability to repay debt." CORPORATE FINANCIAL STRUCTURES, supra note 4, at 64 & 66 (footnote omitted). See also infra note 909 and accompanying text.

162. Tax shields such as depreciation and the investment tax credit lower a firm's need to issue debt since they decrease the value of interest deductibility. See J. MACKIE-MASON, DO TAXES AFFECT CORPORATE FINANCING DECISIONS? 1-2 (National Bureau of Economic Research Working Paper No. 2632, 1988). Empirical data seems to suggest that the reduction of tax shields as occurred in 1986 will increase the value of other deductions such as the interest deduction and will cause firms to increase debt-equity ratios. Id. See also CORPORATE FINANCIAL STRUCTURES, supra note 4, at 81 ("[R]ising interest deductions might cause corporations to reduce tax-preferred investments (because there is less income to shelter from tax).").
and other acquisitions\textsuperscript{163} and the view of the firm as a cash flow\textsuperscript{164} (possibly allocating capital to industries that can be highly leveraged and away from start-up firms and more risky investment).\textsuperscript{165} It also arguably leads in restructuring transactions to a weakening of the debt coverage ratios.\textsuperscript{166} The reduction in other tax preferences in the 1986 Act may also be resulting in increased debt finance.\textsuperscript{167} The characteristics of that debt have changed over time.

\textsuperscript{163} See Corporate Financial Structures, supra note 4, at 11 (Table I-C) (for example, while the $4.5 billion in value of LBOs was 6.2 percent of the $73.1 total value of mergers and acquisitions in 1983, LBOs rose to $18.8 billion in 1984 or 15.4 percent of the $122.2 billion value of all mergers and acquisitions and the $14.3 billion increase in LBO transactions in 1984 relative to 1983 was 29 percent of the total $49.1 billion increase in mergers and acquisitions between 1983 and 1984).


\textsuperscript{165} Most of the leveraged buyout and acquisition candidates are firms with cash flows — "cash cows" — argued to support the leveraged structure. See Corporate Financial Structures, supra note 4, at 62. This may impact other firms:

"The development of highly leveraged firms may shift the allocation of capital toward firms which can be more cheaply leveraged. It is often assumed that desirable leveraged buyout candidates are stable firms with a reliable cash flow available to meet the required interest payments. As funds shift toward these firms, capital may be allocated away from riskier investments. Indeed, if debt is truly tax advantaged, then the cost of funds may be reduced for industries which can support high leverage. Less stable industries then would face a relatively higher cost of capital."

\textsuperscript{166} Id.

\textsuperscript{166} Interest coverage ratios — the ratio of interest payments to cash flow — are used to evaluate the risk of bankruptcy since a high interest coverage ratio suggests a decreased ability of the firm to meet interest payments with current cash flow. Interest coverage ratios are rising regardless of whether they are measured as a ratio of net interest to cash flow or the ratio of net interest to capital income plus economic depreciation. See M. Scholes & M. Wolfson Corporate Financial Structures, supra note 4, at 66-67 (Table IV-C). "Both measures indicate that current levels of interest coverage are higher than in the past, especially for a period of economic expansion with relatively low rates of interest. This may explain why, unlike in other expansions, bankruptcies and defaults are increasing." Id. at 66.

\textsuperscript{167} See supra note 162. The 1986 Act may also increase debt finance by increasing the attractiveness of acquisitions by foreign investors. See M. Scholes & M. Wolfson The Effects of Changes in Tax Laws on Corporate Reorganization Activity
with less-than-investment-grade debt, much of which is argued to be a disguised form of equity finance, increasing from 14.9 percent of corporate debt issued in 1983 to 23.9 percent in 1988.168 These high yield issues range in form from conventional high yield bonds to the deferred coupon structures used in leveraged buyouts which increase the options for the firm to realize cash from asset sales before paying back the subordinated debt holders.169 These issues also provide a current interest deduction for the payment of interest or for the accrual of interest on discount obligations, although legislation has now limited the interest deduction and has reclassified a portion of certain interest as preferred stock. The risks relative to the returns from using either default ratios or mortality ratios are monitored170 and are argued to present posi-

168. CORPORATE FINANCIAL STRUCTURES, supra note 4, at 69 (Table IV-E). For the view that junk bond financing is not the reason for takeovers and merely reflects forces generally increasing competition in capital markets, see Taggart, The Growth of the "Junk" Bond Market and Its Role in Financing Takeovers, in MERGERS AND ACQUISITIONS 5 (A. Auerbach ed. 1988).

169. L. Goodman, High Yield Default Rates: Is There Cause for Concern? 12 (Goldman Sachs Fixed Income Research Apr. 1989). For a description of these bonds, see infra note 817. For the basis of the interest deduction, see infra note 183 and accompanying text.

170. The Altman-Namacher zeta index which evaluates junk bond defaults has long suggested that the risks of junk bonds are overcompensated relative to the default rate. See E. ALTMAN & S. NAMACHER, INVESTING IN JUNK BONDS: INSIDE THE HIGH YIELD DEBT M.RKET 148-49 (1987). Using the entire population of junk bonds outstanding as the denominator, but excluding the 1987 Texaco default, the 1988 default rate has increased from 1.34 percent to 2.48 percent and the weighted default loss increased from 0.89 percent to 1.54 percent. Both the weighted default loss and the default rate is lower in 1988 than in both 1986 and 1987 if the Texaco default is included. The 1989 data shows a 4.035 percent default rate which does not include the defaults of the Allied and Federated stores. Data from calculations by Edward Altman on file with the Case Western Reserve Law Review. The zeta index predicts that the risks are overcompensated and that the risks, while higher than investment grade bonds, can be offset if the holders of the bonds invest in them the way they would with traditional loans by setting up reserves against default based on individual issue mortality rates. See Altman, Should We Regulate Junk Bonds?, FIN. ANALYSTS J., Jan.-Feb. 1989, at 8, 9.

Focusing on individual issue mortality rates, however, increases the "default rate." Altman's bond mortality rate study finds higher rates of default ranging from 31.17% to 36.4%. See Altman, Measuring Corporate Bond Mortality and Performance, 44 J. Fin. 909 (1989)[hereinafter Altman, Mortality]. Other studies based on mortality figures find similarly high rates of mortality. Asquith, Mullins & Wolff, Original Issue High Yield Bonds: Aging Analysis of Defaults, Exchanges, and Calls, 44 J. Fin. 923 (1989)(also noting high rate of exchanges and low rate of payoff through sinking funds or at maturity). While there was controversy over the zeta approach and the mortality approach to measuring risk, see Winkler, Junk Bonds Are Taking Their Lumps: Harvard Study Notes Defaults, Wall St. J., Apr. 14, 1989, at C1, col. 3, the difference reflects the difference be-
tive returns for investors, especially those who can invest on a portfolio basis, but the changing market creates additional risks.\textsuperscript{171} There is also a growing presence of tax-exempt investors in these leveraging transactions.\textsuperscript{172}

While leveraged structures are argued to induce firm managers to become more efficient,\textsuperscript{173} especially when coupled with the

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2. While leveraged structures are argued to induce firm managers to become more efficient, especially when coupled with the

171. The financial predictions in 1989 for the risk-return ratio have become increasingly cautious based on default and mortality data:

What are the lessons of this for the future? The market is so different from a decade ago that it is hard to draw firm conclusions. The issuers have changed, the issue size has changed, the capital structures of the issuers have changed, and the bond structures have changed. Thus, while returns have more than compensated for the risks in the past, there is obviously no guarantee they will continue to be attractive in the future. Money managers must continue to evaluate each investment opportunity on its merits, while considering the effects of diversification. They should bear in mind that a high yield portfolio can sustain a fairly high proportion of defaulting bonds, given the high initial issue spreads and normal recovery rates.

L. Goodman, supra note 169, at 13. The turmoil in the high yield debt market in 1989 and the increasing default rate, see supra note 170, highlight these issues. See Wallace, Riding the "Junk" Whirlwind, N.Y. Times, Feb. 18, 1990, § 3, at 12, col. 3; Bartlett, Life in the Executive Suite After Drexel, N.Y. Times, Feb. 18, 1990, § 3, at 1, col. 6 (detailing the changing market).

172. See Corporate Financial Structures, supra note 4, at 76. Proposals directed at these investors and the erosion of the tax base are repeatedly made. See supra note 49 and infra notes 825 & 1023.

173. There are many theories that include efficiency gains as a result of restructurings. Under the "free cash flow" hypothesis, target firms are those that have positive cash flows in excess of their net present value investment projects. Since a manager's compensation is often based on the size of the firm, managers will use this cash flow to invest in zero or negative net value projects rather than distribute funds to shareholders. See Jensen, Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers, 76 AM. ECON. REV. 323 (1986). Other efficiency gain theories focus on lowering transaction costs, better use of tax shields and leverage, wealth transfers, defenses against takeovers, lowering agency costs and monitoring by concentrating ownership in fewer hands, bonding managers through compensation tied more clearly to the firm's performance, and risky arbitrage through re-structuring the firm's assets-project composition in a more efficient manner. See Kieschnick, Management Buyouts of Public Corporations: An Analysis of Prior Characteristics, in LEVERAGED MANAGEMENT BUYOUTS: CAUSES AND CONSEQUENCES 35, 36-41, 59-60 (Y. Amihud ed. 1989)(detailing these hypotheses, rejecting the free cash flow hypothesis on data, and accepting the risky arbitrage view). Other studies find efficiency gains based on a combination of debt and managerial incentives. See Kaplan, Efficiency, supra
Restructuring of financial incentives for managers supervised by interested residual shareholders, there currently is no consensus on this view and there is a concern over the macroeconomic and firm-specific risks of leverage. Increased leveraging in public firms through the use of subordinated issues has reduced the creditworthiness of these firms and has caused a decline in the value of their senior debt. This loss in value has been the subject of litigation by senior bondholders against the management of these firms and has led to changes in covenants in the bond indentures of current senior issues.

Note 44; C. Muscarella & M. Vetsuypens, Efficiency and Organizational Structure: A Study of Reverse LBOs (Southern Methodist University Working Paper, July 1989). For a summary of the efficiency claims and debt risks, see KKR Hearing, supra note 16 (Securities Industry Association Position Paper on Leveraged Buyouts attached to the prepared statement of Hardwick Simmons). Efficiency arguments for leveraged structures include: (1) aligning interest of managers and shareholders more closely, (2) increasing the management supervision by shareholders, (3) a reduction in the ability to managers to squander cash flow on pet projects, (4) sales of under-performing divisions to those who can make a better use of the assets, as contrasted with the view of the sales as a fire sale to support the transaction, and (5) a sum of the parts is greater than the whole effect for broken up firms. Corporate Financial Structures, supra note 4, at 60-61. The managerial efficiency strategy of structuring management compensation to more clearly reflect the profitability of the firm, concentrating equity ownership in a few active investors, and bonding managers through debt creation and servicing has recently been characterized as a higher level of firm than the public corporation and a management-investment structure that will eclipse public ownership. See Jensen, Eclipse of the Public Corporation, Harv. Bus. Rev., Sept. - Oct. 1989, at 61 [hereinafter Jensen, Eclipse]. Evidence on efficiency is mixed. Compare S. Kaplan, Efficiency, supra note 44 (finding efficiency gains in LBOs for both selling and buying shareholders) with D. Ravenscraft & F.M. Scherer, Mergers, Sell-OFFS, and Economic Efficiency 1-19, 192-215 (1987) (no increase in profitability for acquired businesses but LBOs not included since study was based on older data).

174. The debate over the efficiency gains moved to the congressional stage in the leveraged buyout hearings. Compare House LBO Hearings I, supra note 16, at 225 (prepared statement of Benjamin M. Friedman) (noting the increased risk of financial distress relative to efficiency gains since "the principal basis for the optimism about corporations' debt burdens in relation to likely future earnings that was often expressed just a brief time ago has now disappeared") with id. at 408-14 (prepared statement of Michael C. Jensen) (new organizational management gains from leveraged buyouts and leveraged structures mirror Japanese groups of companies and the risks of bankruptcy have been privatized). See Hearing on Kohlberg Kravis Roberts & Co. Leveraged Buyouts Before the House Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce, supra note 16 (examining the conflicting views of efficiency gains in response to a KKR study claiming efficiency). See also Corporate Financial Structures, supra note 4, at 63 ("However, increased corporate indebtedness and even increased risk are not necessarily adverse developments, and there is by no means consensus among experts about the significance of increased debt. Some consider it to be just one more aspect of financial innovation; yet others consider it as ultimately improving economic efficiency.").

175. The senior bondholders of RJR Nabisco have engaged in litigation which has so
The financial claims of the firm's capital suppliers are denominated debt and equity. Equity is what remains after the claims of all of the firm's claimants are paid. It includes the right to the profits of the firm only after the claims of the creditors of the firm are paid. Ultimately, equity "connotes an unlimited claim to the residual benefits of ownership and an equally unlimited subjection to the burdens thereof." For voting issues, equity carries the control rights over the management of the firm. Debt, on the other hand, is traditionally viewed as a fixed claim to the repayment of principal and the payment of interest on that principal, with interest reflecting the return for the use of the principal based on the time value of its use. In other words, debt is an "unqualified obligation to pay a sum certain at a reasonably close fixed maturity date along with a fixed percentage in interest payable regardless of the debtor's income or lack thereof." Although the debtor gives up the right to control the management of the firm, she exercises control over the management of the firm through the terms of the indenture. These terms encompass numerous covenants and representations by the firm including the establishment of priorities of creditors and sinking funds for repayment of senior debt, the use of borrowed proceeds, and the important right to declare the bankruptcy of the firm if those promises are not kept.

See Metropolitan Life Ins. Co. v. RJR Nabisco, Inc., No. 88-8266 (S.D.N.Y. June 1, 1989) (granting motion to dismiss claims based on implied agreement not to restructure and leaving claims based on bond covenants). There is growth in the use of new forms of bond indentures with contractual provisions — "poison puts" — which shift event risk to the issuer by creating a right to compel a bond's redemption if a significant increase in debt lowers the issuer's credit rating. See Sec. Reg. & L. Rep. (BNA), Apr. 14, 1989, at 551. The ultimate issues in this area are the basis of the claim against management, whether creditor protection statutes are necessary in a free market, and whether bondholders have a duty to protect themselves through prior negotiations. See Bratton, Corporate Debt Relationships: Legal Theory in a Time of Restructuring, 1989 Duke L. J. 92 [hereinafter Bratton, Restructuring].

176. B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 4.02, at 4-7 (5th ed. 1987). See W. KLEIN & J. COFFEE, supra note 40, at 230-38; CORPORATE FINANCIAL STRUCTURES, supra note 4, at 35 ("[A] pure equity interest is generally understood as an investment which places the funds contributed by the investor at the risk of the enterprise, provides for a share of any future profits, and carries with it rights to control or manage the enterprise.").

177. Gilbert v. Commissioner, 248 F.2d 399, 402 (2d Cir. 1957). See W. KLEIN & J. COFFEE, supra note 40, at 216-30. The tax law has adopted this view of pure debt from which gradations in risk and return are tested. See CORPORATE FINANCIAL STRUCTURES, supra note 4, at 35 ("It is generally understood that a pure debt instrument is ordinarily represented by a written, unconditional promise to pay a principal sum certain, on demand or before a fixed maturity date not unreasonably far in the future, with interest payable in all events and not later than maturity.").
The factors used to classify debt and equity claims are drawn from case law which generally involves closely held corporations. These classification factors were reflected in section 385 of the Internal Revenue Code which authorized the Treasury to prescribe regulations, according to a number of enumerated factors, to determine whether a debtor-creditor or a corporation-shareholder relationship exists. The Treasury withdrew the section 385 regulations because of the ease with which the factors were manipulated involving the all or nothing classification of hybrid instruments — instruments with both debt and equity characteristics. In 1989, the Treasury was granted explicit authority to split the characterization, although this authority previously may have been implicit. New financial instruments created to achieve optimal capital structures and to accommodate investor demand for a variety of financial instruments are (like more

178. See B. BITTKER & J. EUSTICE, supra note 176, ¶¶ 4.02-04, at 4-6 to 4-27; see also CORPORATE FINANCIAL STRUCTURES, supra note 4, at 35-36 (listing judicially formulated factors to distinguish debt from equity which were codified in part in I.R.C. § 385); Comment, The Intractable Debt/Equity Problem: A New Structure for Analyzing Shareholder Advances, 81 NW. U.L. REV. 452 (1987) (applying these factors in a closely held context). For early consideration of debt and equity distinctions, see Commissioner v. O.P.P. Holding Corp., 76 F.2d 11, 12 (2d Cir. 1935) (creditor is to be paid “independently of the risk of success” whereas the stockholder “takes the risks and profits from success”).

179. The factors include the existence of “a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money’s worth, and to pay a fixed rate of interest,” the subordination of preference of the promise over any indebtedness, the ratio of debt and equity in the corporation, any conversion feature of the instrument into stock, and the proportionality of the stock holdings to the ownership of the interest in question. See I.R.C. § 385(b) (West 1988). See also B. BITTKER & J. EUSTICE, supra note 176, ¶ 4.02, at 4-11 to 4-12 (detailing the failure to implement regulations under I.R.C. § 385 which codifies the judicially formulated categories for distinguishing debt from equity); CORPORATE FINANCIAL STRUCTURES, supra note 4, at 35-37. Under H.R. 3299, supra note 49, the Treasury would be permitted to treat a hybrid instrument as part debt and part stock. For a view of the classification problem as a subset of the problems of tax avoidance and income measurement, see Rosenberg, Tax Avoidance and Income Measurement, 87 Mich. L. Rev. 365, 437-39, 462, 474-84 (1988).

180. For a discussion of the ruling on adjustable rate convertible notes, see infra note 205 and accompanying text.

181. The Senate Report accompanying § 7208 of the OBRA, supra note 49, states that it is not intended to reflect that the Treasury did not have implicit prior authority to split the characterization of an instrument under both I.R.C. § 385 and several case law precedents.

182. New financial products strain both the classification tests and the appropriate view of the accrual of interest on discount obligations. See, e.g., Canellos, New Financial Products, 63 TAXES 970 (1985) (discussing instruments including subsidiary tracking stock or debt, convertible stock, debt with interest rate caps, payment in kind debentures with mini-bonds, and S & P index subordinated notes (SPINs)); PRACTISING LAW INST., NEW
traditional instruments) tested under the facts and circumstances test of current law. This test requires an inquiry into the capitalization of the firm (the “thin incorporation” problem), the subordination of the claim to creditors, and the reference point for the right to payments.

When dealing with highly subordinated issues, the dividing line between preferred stock and debt is murky at best. Preferred stock is defined as stock with a term for mandatory redemption at a specific price and a fixed return if earned. It is traditionally issued without voting rights. A deduction for interest is allowed if the interest is “paid or accrued,” allowing firms to issue discounted debt obligations which accrue interest under the original issue discount rules and are either not paid until maturity or are paid on a sliding scale. Discounted debt provides the ongoing reinvestment in the firm of the foregone interest payment. This suggests that the interest deduction should not be allowed until actual payment. Discounted debt, carrying a high interest rate that reflects its subordination in the firm’s capital structure and its increased default risk for which the coupon premium is compensation, is closer to an instrument with a cumulative right to fixed payments out of retained earnings (like preferred stock) than it is to an instrument with the right to payment regardless of the income of the firm. In highly leveraged structures where there is

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FINANCIAL PRODUCTS (1988) (discussing portfolio income notes, auction rates, and remarketed preferred stock); Hariton, The Taxation of Complex Financial Instruments, 43 TAX L. REV. 731 (1988) (advocating accrual of interest on the revised issue price of any financial instrument that provides for variable payments at the stated rate or the applicable federal rate (whichever is greater) including the accrual of interest on zero coupon convertible debt contrary to the holding in Scott Paper Co. v. Commissioner, 74 T.C. 137 (1980)).

183. I.R.C. § 163(a) (West 1988 & Supp. 1989) provides for an interest deduction if interest is paid or accrued. Accrual of interest income and interest deductions on discount obligations are mandated under the original issue discount rules. See I.R.C. §§ 1272-1275 (West 1988 & Supp. 1989). Proposed regulations help differentiate between promised payments meeting the “all events” test of accrual accounting and rights to contingent payments that do not. See Prop. Treas. Reg. § 1.1275 (Apr. 8, 1986). Accrual deductions strain the traditional view of interest as the denominated right to payment. Cf. Old Colony Railroad v. Commissioner, 284 U.S. 552, 561 (1932) (interest is the amount of the payment in the coupon and not the amount with reference to the issue price when issued at a premium). Payment-in-kind debt for which a separate “baby bond” is issued has a variety of possible tax treatments under the original issue discount rules, but the general consensus is that the bond should not be treated as payment and that the value of the baby bond should be included in the stated redemption price upon maturity of the parent bond upon which original issue discount is computed. See Levin & Gallagher, Proposed Code Section 386 Treating OID and PIK Debentures as Preferred Stock, 45 TAX NOTES 87, 88 (1989).

184. Stated differently, if the instrument meets the capitalization tests for debt clas-
an increasingly high premium paid over the riskless rate of interest to reflect firm specific default risks, subordinated debt holders apparently take on the increased risks of equity holders. The fixed claims of these subordinated debt holders to current or deferred interest payments and the ultimate return of their principal are highly exposed to the risks of the business. The question is whether the manner in which the holder's risk is compensated by the market turns it into an equity risk that is taxed as a debt risk.\textsuperscript{185}

Classification of debt and equity is important in determining the appropriate taxable income of the firm since distributions on equity are nondeductible and distributions on debt are deductible as a cost of producing income. The foregoing characteristics have led to the current debate over whether the interest deduction for deep discount bonds and certain hybrid instruments should be deferred until the time of payment or whether these instruments should be recharacterized as equity. Current law bifurcates the treatment of these instruments and creates a deferred interest deduction for certain discount obligations until the payment of cash and a nondeductible dividend for interest in excess of six percent over the applicable federal rate.\textsuperscript{186} For those viewing these instruments as equity risks based on the rate of return indicating an equity premium, deferring the interest deduction until the time of payment would create a further form of integration of the corporate-shareholder tax.

\textsuperscript{185} Outside of tax policy considerations, the repackaging of equity risks as debt has been labeled a deceptive alchemy. See House Protection Hearings, supra note 16, prepared statement of Louis Lowenstein, at 13-18 (reporting preliminary data from study of high yield portfolios of median coverage ratios of 1.04:1 and other features of the funds investing in high yield securities that arguably understate the equity risk).

\textsuperscript{186} The current provisions of I.R.C. § 163(e)(5) & (i) defer the deduction on certain high yield OIDs and PIKs and disallow the interest deduction entirely for OID and PIK features in excess of the applicable federal rate plus six percent. See Levin & Gallagher, \textit{New Code Section 163(e)(5) Limiting Deductibility of Interest on OID and PIK Debentures}, 46 TAX NOTES 555 (1990). This should be contrasted with the House provision which, using a five percent benchmark, treated the entire payment as a nondeductible dividend, see H.R. 3299, § 11202, 101st Cong., 1st Sess. (1989), and the Senate provision which provided for deferral of the deduction until payment and no recharacterization of any portion of the yield on the instrument as a dividend, see H.R. 3299, § 6202, 101st Cong., 1st Sess. (1989)(as passed by the Senate).
For the foreseeable future, the double tax on new and existing corporate investment is subject to deferral only through the use of tax-exempt entities (mainly pension funds) for ownership of corporate equities or through the elimination of the second tax by holding equity securities until death or otherwise timing the realization of capital gains and losses to take into account favorable rates. Both of these strategies may be significant from the investor's perspective when compared with other investment choices. Nonetheless, the deferral strategy under the classical corporate tax regime, unless coupled with repurchase strategies, no longer presents the same tax advantages as single-level taxation when viewed from both the taxable shareholder's and the firm's perspective.\textsuperscript{187} Debt is tax preferable for raising firm capital, although for a variety of reasons some firms do not resort to debt financing.\textsuperscript{188} Assuming taxes on dividends and interest are an important consideration, tax clientele with a demand for new financial instruments, the value of deferral for outstanding equity, and the existence of higher rates of return on investment counter to some degree the bias against equity in public firms.\textsuperscript{189} The erosion of


For both public and private corporations a retained-earnings strategy cannot be justified by the present rate structure. For firms not subject to the graduated corporate rates, the Warren formula indicates that the firm should distribute all earnings. Warren, Timing, supra note 97, at 501; Ben Horim, Hochman & Palmon, The Impact of the 1986 Tax Reform Act on Corporate Financial Policy, 16 FIN. MGMT. 29, 35 (1987)(predicting increased dividend payout ratios and a shift to debt financing using analysis of tax changes on corporations and their security holders).

\textsuperscript{188} See, e.g., Long & Malitz, Investment Patterns and Financial Leverage, in CORPORATE CAPITAL STRUCTURES IN THE UNITED STATES 325 (B. Friedman ed. 1985)(detailing agency cost and other limitations that limit firm debt financing and testing the hypothesis against data in different industries). The Long and Malitz data validates the "pecking order" view of corporate finance — firms prefer internal funds, adjust dividend payouts for investment requirements, and if external finance is required, firms choose the safest security first. Long and Malitz support the conclusion that the greater the availability of internal funds, the less the use of leverage. They also support the "static trade-off" view of financial structure choice since they find that firms with investment in intangibles have a lower market imposed debt capacity than firms investing in tangible assets. Id. at 345. For a critique of the Long and Malitz model, see id. at 348-51 (comments of Stewart Myers). Other industry data is consistent with the view that leverage is not uniform. See Taggart, Secular Patterns in the Financing of U.S. Corporations, in CORPORATE CAPITAL STRUCTURES IN THE UNITED STATES 13 (B. Friedman ed. 1985).

\textsuperscript{189} Preferred stock has always been used to exploit the clientele effect based on the
For new investment the choice is clearly biased against the corporate form. A consensus of tax planners after the 1986 Tax Act is that "noncorporate forms of business organization may come to dominate corporate forms." And if a corporate form is chosen

...
or maintained, high leverage is tax preferred even if the market demands a higher rate of return.

Whether a change in business forms in response to tax incentives should be viewed as beneficial depends to a large degree upon the normative basis for a double tax that allows an interest return to the firm that is taxed only once and that subjects the remainder of the firm's profit to double taxation. While debt finance creates this form of a profits tax, it may have other consequences such as increased monitoring and agency costs as well as macroeconomic disadvantages. Private ordering outside of the capital markets as S corporations and partnerships in order to obtain passthrough status also distorts financing incentives if these alternate business forms are chosen for tax consequences alone.

B. Income Tax Theory

1. The Taxable Unit

The Haig-Simons definition of income includes in income a taxable unit’s increase in net wealth (property rights) from the beginning to the end of the period in question, plus all rights which might be exercised in consumption.\[192\] The income tax system requires a current payment from a taxable unit based on ability to pay tax in the year in which income is earned.\[193\] The cur-
rent version of the income tax functions like a consumption tax since savings are not taxed until they are realized. However, neither the Haig-Simons definition of income nor the current income tax system adequately addresses the selection of the appropriate taxable unit. In the case of business firms, the selection

present statutory scope for installment sales); Cain, Installment Sales by Retailers: A Case for Repeal of Section 453(a) of the Internal Revenue Code, 1978 Wis. L. Rev. 1; Note, Fairness and Tax Avoidance in the Taxation of Installment Sales, 100 Harv. L. Rev. 403 (1986).


195. Eisner v. Macomber, 252 U.S. 189 (1920). The realization requirement is relaxed in circumstances in which a taxpayer could either take riskless income, I.R.C. § 1272 (West 1988), or could choose to realize it, I.R.C. §§ 1092, 1256 (West 1988 & Supp. 1989), or is given a choice either to realize income or leave appreciation as unrealized, I.R.C. § 305(b)(1) (West 1988)(choice between stock dividend and cash dividend); cf. I.R.C. § 305(b)(3) (West 1988). On a continuum of opportunities to save or consume, the existence of an opportunity to choose becomes a taxable event. The lack of a realization to continuing shareholders on the implicit increase in wealth upon redemption of other shareholders which currently falls outside of this continuum is an example of tensions in the realization concept. Even in the absence of choice, a clearly received right that is nonforfeitable and noncontingent, even though not immediately exercisable, is income. Cf. Drescher v. Commissioner, 179 F.2d 863 (2d Cir. 1950)(employer purchased annuity which could not be borrowed against directly in the plan, had a spend-thrift provision, but was nonforfeitable was included in income).


The tax system has difficulty identifying the appropriate taxable unit when a unit other than an individual is involved. Non-human taxable entities present unique problems. There is a question, for instance, about when a firm ceases to exist. See I.R.C. §§ 362(a)(1), 708 (West 1988). Another issue is the permissible splitting of income between related taxable units. "Business purpose" tests derive from two different legal bases: (1) direct statutory requirements, see, e.g., I.R.C. § 355 (West 1988 & Supp. 1989)(divisive reorganizations); and (2) implied statutory requirements, see, e.g., I.R.C. § 368(a) (West
of the appropriate taxable unit is complicated because incidence and distributional analysis of taxes indicates that they fall upon individuals rather than entities.\textsuperscript{197} Thus, one may argue that entities should only be taxed as withholding or surrogate agents for the ultimate owners.\textsuperscript{198} Nonetheless, while some legal entities have been given transparent status for tax purposes, corporations, "associations," cooperatives distributing earnings to non-members, and trusts not distributing income are treated by the income tax system as separate taxable units.\textsuperscript{199}

## 2. Single-Taxed Income

The income tax system has identified certain returns that will generally be taxed only once — namely, returns that are funneled to outsiders in exchange for their labor or capital before the firm's taxable income is calculated. This treatment is consistent with the single-tax character of income that is the direct product of labor or capital.\textsuperscript{200} Elaborate statutory steps\textsuperscript{201} are sometimes taken to

\textsuperscript{198} This is a major thrust of the integration debate, at least in the past. See supra notes 8-10.

\textsuperscript{199} See supra note 6. Distributions of earnings in the first three situations are taxed again under the classical corporate tax system. \textit{Id}.

\textsuperscript{200} Income as a product also dictates that the tax system should not tax in a manner that would distort the production of wealth by society. See Warren, \textit{Interest}, supra note 1, at 1596-97. Theory demonstrates that income that is the direct product of one's labor or capital, including salary, rents, interest, royalties, or income from financial intermediaries, should be taxed as income from single-tax items. While distortions such as unreasonable salary or debt-depreciation mismatches may exist, income tax theory proceeds from the assumption that direct income from capital or labor is a single-tax item.
This view of income as product underlies the personal income tax base. See Warren, supra note 194, at 1085-90.

Specialized forms of creating income as a product and defining financial intermediaries include employee stock ownership plans ("ESOPs"). An ESOP allows a company to give employees ownership through repurchases of existing stock, benefitting the employee trust, or purchases of treasury stock, allowing the firm additional investment capital. In addition, if the ESOP leverages by borrowing at the favorable rates provided by the tax law, which exempts 50% of the interest income of the lender, the firm which funds the payments receives a deduction for both interest and principal. See I.R.C. §§ 133, 409, 4975d(3), e(7)(West 1988 & Supp. 1989). Other than the rate of interest, the use of an ESOP for the purchase of existing equity does not create a benefit for the firm that would be absent if compensation deductible at the firm level was paid directly to the employees and the employees purchased the equity from a third party equity holder. The use of an ESOP to finance purchases of outstanding stock does not, however, accomplish a leveraging effect for the firm other than increasing the tax deferral options for the ESOP equity beneficiaries. On the other hand, where the equity contributed by the ESOP is used by the firm to purchase business assets, the ESOP creates a pure financing effect analogous to debt financing with deductible principal payments. However, since the increased value of the firm inures to the ESOP which must invest primarily in employer common or convertible preferred stock, the ability of the other firm shareholders to appropriate the benefit is somewhat tempered. See M. Scholes & M. Wolfson, Employee Stock Ownership Plans and Corporate Restructuring: Myths and Realities 17-24 (National Bureau of Economic Research Working Paper No. 3094, 1989). For the use of the ESOP as a financing technique in leveraged buyouts and stock or asset acquisitions, see Corporate Financial Structures, supra note 4, at 50-52. The OBRA, supra note 49, contains provisions (§§ 7301-7303) which would limit the partial exclusion for interest received with respect to a securities acquisition loan used to acquire employer securities for an ESOP and the dividend deduction with respect to employer securities held by an ESOP, repeal the estate tax, and impose a three year holding period requirement on rollover sales.

The evidence as to an ESOP's success in increasing employee ownership is mixed. The GAO Study finds no significant resulting increase in employee ownership. General Accounting Office, Employee Stock Ownership Plans: Little Evidence of Effects on Corporate Performance, GAO/PEMD-88-1, (Dec. 14, 1987)(While ESOPs have broadened the base of stock ownership somewhat, they do so at a relatively high cost in foregone tax revenue. The 1986 tax legislation on ESOPs may undercut this observation but it is still too early to tell.).

201. Canada has taken such steps in its tax law. It provides a very elaborate imputation system for private corporations designed to preserve single taxation of investment income (capital gains, dividends, interest, and rents). Its fully integrated system achieves current taxation of these items through a withholding system whose safeguards prevent deferral advantages for shareholders. See Boadway, Bruce & Mintz, Corporate Taxation in Canada: Toward an Efficient System, in Tax Policy Options in the 1980s, at 171, 178 (W. Thirsk & J. Whalley eds. 1982). Canadian controlled private corporations receive a refund of the tax on income from certain specified investment businesses. The principal purpose of such a business must be to gain income from property (interest, dividends, rents, or royalties) unless it employs more than 5 full-time employees or uses an affiliated corporation to provide the services that these employees would otherwise provide. See Income Tax Act §§ 125(7)(b), 125(7)(e) & 129, reprinted in 9 Can. Tax Rep. (CCH) §§ 125(7)(b), 125(7)(e) & 129 (1988). For a discussion of these statutory provisions, see 4 Can. Tax Rep. (CCH) ¶¶ 19,559a, d, e & 19,562 (1989).
funneled through firms and financial intermediaries.\textsuperscript{202} Debt and equity are labels on the financial claims to a firm's assets. Traditionally, in a corporation, equity is the common stock with the lowest residual claim, i.e. a contingent return of unlimited duration; and senior debt is the highest financial claim with a denominated return of fixed duration.\textsuperscript{203} The changing nature of financial structures including high yield subordinated debt paid on a cash or an accrual basis in leveraged buyouts,\textsuperscript{204} adjustable rate convertible "debt,"\textsuperscript{205} and various forms of participating and variable rate debt\textsuperscript{206} continues to raise questions about the significance of the labels attached to these financial claims. Legislation aimed at the hybrid character of debt and bifurcated treatment thereof realistically addresses these financial structures.\textsuperscript{207}

The Modigliani-Miller capital structure irrelevance principle separates the production decisions and financial decisions of the firm by demonstrating that in perfect capital markets and in a no tax world "the market value of any firm is independent of its capital structure and is given by capitalizing its expected return at the

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204. See \textit{supra} note 169 and infra note 817 and accompanying text.

205. Debt that has a return adjusted to the earnings of the firm was classified as stock under the proposed \$ 385 regulations, see \textit{Prop. Treas. Reg.} \$ 1.385-5, 47 \textit{Fed. Reg.} 164 (1982)(withdrawn by T.D. 7920, 1983-2 C.B. 69), if on the date of issue the fair market value of the straight debt payments was less than 50\% of the fair market value of the instrument. Adjustable rate convertible notes ("ARCNs") were classified as equity when the notes had the right to be converted into common equity in a transaction that was structured to cause investors to exercise the conversion privileges. See \textit{Rev. Rul.} 83-98, 1983-2 C.B. 40. The ruling on ARCNs has been criticized for failing to address the main issue of whether the fact that the notes are convertible, the fact that the instrument is traded in line with the firm's stock, or the fact that the notes guarantee a specific return which operates like a stop-loss provision was the key factor. See Hariton, \textit{supra} note 182, at 778-80; accord Madison, \textit{The Deductibility of "Interest" on Hybrid Securities}, 39 \textit{Tax Law.} 465, 492-94 (1986)(criticizing the all or nothing approach to debt classification, arguing for bifurcation, and applying contingent claims analysis to value the option and debt components of ARCNs).

206. Participating forms of debt that provide equity returns ought not be classified as debt if they are subject to a risk of loss of capital similar to that facing equity participants. \textit{But see Prop. Treas. Reg.} \$ 1.385-6(d)(3), 47 \textit{Fed. Reg.} 164 (1982)(withdrawn by T.D. 7920, 1983-2 C.B. 69)(pro rata participating debt may be treated as debt if 20\% held by third parties). Variable rate debt raises the issue of whether payment should float with interest rates or other factors. See Hariton, \textit{supra} note 182, at 753-58.

207. See \textit{supra} note 49.
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rate . . . appropriate to its class [of risk]."208 Similarly, the average cost of capital of the firm does not change since shareholders have the opportunity to undo any leveraging decision of the firm by putting leverage into or out of their own personal accounts.209 Leverage does increase the expected return on the equity of the firm in proportion to the debt-equity ratio expressed in market values, with the rate of increase depending upon the spread between the expected rate of return on the portfolio of all of the firm's securities and the expected return on the debt.210 In the real taxable and financial worlds, the form of capital structure can make a difference because with interest deductibility at the firm level, leverage creates value up to the point that it increases the risk of bankruptcy and other costs of financial distress (the existence, definition, and magnitude of which is debated) beyond the discounted present value of the tax savings.211 A later model by Miller posits that there is no optimal capital structure for the firm but only an optimal capital structure for all corporations, and that under existing law and existing tax clienteles, the tax benefits of equity finance due to low taxation of unrealized appreciation for individuals offset the higher taxation of interest payments.212

208. Modigliani & Miller I, supra note 60 (Proposition I).
209. Id. at 269-70.
210. Id. at 271 (Proposition II). With leverage, the total value of the firm remains still the value of its discounted cash flows but the gains of leverage which will accrue to the shareholders if the project financed are successful are matched by an enhanced risk of a decline in operating income; thus, while the issuance of debt increases the expected returns to shareholders, it is exactly offset by the rate at which the earnings are capitalized. M. BREALEY & S. MYERS, supra note 62, at 390-93.
211. Under the Modigliani-Miller approach, the costs of bankruptcy are insignificant, see Modigliani & Miller II, supra note 60 at 433, 435-39 (value enhancement is discounted present value of tax savings), but that approach is not universally followed. See, e.g., Litzenberger, Some Observations on Capital Structure and the Impact of Recent Recapitalizations on Share Prices, 21 J. FIN. & QUANT. ANAL. 59, 66 (1986)(estimated costs of bankruptcy and financial distress need to be considered); DeAngelo & Masulis, Optimal Capital Structure Under Corporate and Personal Taxation, 8 J. FIN. ECON. 3 (1980)(same); S. ROSS & R. WESTERFIELD, supra note 105, at 363, 373-75. See infra notes 904-21 and accompanying text.
212. Miller, supra note 61. Nonetheless, finance theory does search for the optimal capital structure for the firm. See, e.g., Titman & Wessels, The Determinants of Capital Structure Choice, 48 J. FIN. 1 (1988)(testing theory of capital structure choice based on collateral value of assets, non-debt tax shields, growth, uniqueness, industry classification, size, volatility and profitability and finding a positive correlation for uniqueness explained under the view that firms that can impose costs on suppliers and customers in bankruptcy have a lower debt ratio and importance of transaction costs); Choi, Fabozzi & Yaari, Optimum Corporate Leverage with Risky Debt: A Demand Approach, 12 J. FIN. RES. 129 (1989)(investigating the Modigliani-Miller theorem on optimal capital structure in an im-
Challenges have been made to Miller’s view that there is not an optimal capital structure for the firm. The challengers posit that for a given firm there is a credit rationing effect beyond the risk/return rationale. They contend that, in a world where bankruptcy is possible and in which there is asymmetric information, (1) debt and equity differ in the amount of monitoring required, (2) the concentration of debt holders and the dispersion of equity holders have effects on the firm, and (3) debt and equity provide different incentives for managerial risk taking. In addition, in a world of less than perfect markets, individual borrowing may be credit constrained, and therefore homemade leverage is not a perfect substitute for firm level leverage, which may also be credit constrained by limitations such as the 1989 legislation restricting savings and loan portfolios to investment grade debt. The recent trend in higher firm leverage through internal firm leverage rather than external personal leverage is “just MM leverage arbitrage, but channeled through the raider’s corporate, rather than personal, investment account.” In these restructurings, the tax arbitrage value of debt brings with it additional agency costs which are offset by aligning the interest of the debtholders with the residual equity claim. The theory that both debt and equity securities may provide a more stable financial structure and forestall bankruptcy raises questions as to the appropriate classification of perfect capital market and finding that bankruptcy risk has an ambiguous effect on the value of the firm and its optimal leverage). Finance theory also finds capital structure decisions to be based on both agency theory and a signaling and asymmetric information approach to indicate value to the firm of different capital structure choices. See S. Ross & R. Westerfield, supra note 105, at 377-79.


216. Id. at 114 (“The debtor/creditor incentive and agency problems that might be expected under such high leverage ratios have been kept manageable partly by immediate asset sales, but over the longer term by “strip financing”—trendy investment-banker argot for the old device of giving the control, and most of the ownership of the equity (except for the management incentive shares) to those providing the risky debt (or to the investment bankers they have designated as monitors). The same hold-both-securities approach . . . has long been the standard one in Japan . . . “).
these intertwined financial structures.\footnote{Proportionately held debt is a classic problem for the tax classification of debt and equity in closely held firms. See B. BITTKER & J. EUSTICE, supra note 176, ¶ 4.04, at 4-22 to 4-23; Comment, supra note 178; see also Prop. Treas. Reg. §§ 1.385-2 & -6, 47 Fed. Reg. 164 (1982)(withdrawn by T.D. 7920, 1983-2 C.B. 69)(testing hybrid and straight debt instruments based on proportionality of holding, debt-equity ratio, and the existence of holdings by independent creditors for hybrid instruments, and asserting the inapplicability of the proportionality rules if both the corporation's stock and debt is widely held and the instruments are separately traded and readily marketable). In LBOs, equity may be held through a partnership and the debt held separately. Furthermore, investors may invest on a portfolio basis which further complicates the question of the appropriate view of a firm's proportionate holdings of debt and equity.}

As recently pointed out, debt and equity exist in three modes in the corporation: a legal mode where debt supplies capital to equity owners, an investment mode where debt and equity depend on managers for their returns from the firm, and an agency/financial economics mode where debt and equity are traded securities with different risk variances.\footnote{Under a legal mode, debt suppliers are contractual suppliers of capital not tied to the firm and the equity holders are the owner-managers facing the highest entrepreneurial risk and reward and retain control. Under an investment concept, the debt holders like equity are dependent upon the performance of managers for the return on and a "refund" of their investment, with both lacking the power of managers within the firm. Under an agency-financial economics approach applicable so firms with traded securities, debt like equity is a traded security with debt-equity relationships in the firm determined through the relationship of underinvestment costs (the requirement of the equity holders to invest in high return high variance projects to increase the return to equity higher than the cost of the project and the face amount of the debt), asset substitution costs (equities represent options to buy and sell the firm's assets with an incentive to increase the value of the firm by increasing the volatility of the firm's earnings), and out-of-pocket bankruptcy costs. Bratton, Restructuring, supra note 175, at 101-33.}

As financial claims, the value of both debt and equity is based in part on their relative risks and variances and on the probability that they will bear returns in excess of the risk-free rate of return measured by the rate of interest on Treasury bills.\footnote{The riskless rate of return is not the real interest rate equating the supply of and demand for capital, see I. FISHER, THE THEORY OF INTEREST (1930), but also includes the inflationary component of interest. The default premium for bonds over the riskless rate of return is correlated with the market risk of the firm in a recession which includes the debt-equity ratio of the firm, the variability of the firm's income, the size of the issue, and the duration of the bonds and thus is calculated with reference to the firm relative to the entire market. See R. BREALEY & S. MYERS, supra note 62, at 562-66. The value of the bond can also be derived under option pricing theory. Id. at 564-65. Equity premia are related to the market risk of the firm, which is measured by beta under the capital asset pricing model (CAPM), which includes the factors of debt-equity ratio and flow of income relative to the market portfolio. Id. at 136-44. In both cases, the risk of the firm relative to the market sets the debt and equity premia over the riskless rate of return. The ultimate market is the market for all investments, which is the problem with the empirical proof of the CAPM. Viewing equity as a risk-return investment for securities}
greater variance and can command a greater return than "debt." The increased return to equity is a mixture of the riskless rate of return and of the profit of the firm that is demanded by risk adverse capital suppliers as to particular firms in a particular risk class. Financial theory does not make a case for a principled definition of debt or equity because the capital structure of the firm is irrelevant in perfect capital markets in a no tax world; it only becomes relevant in a world in which taxes are imposed at the firm level and the existence of tax clienteles at the investor level produces a demand for and gives value to different financial claims.  

While financial theory generally lends great support to the theory of single taxed income, or analogous treatment of debt and equity in all firms including corporations, and supports the economic concept of an interest return to all capital supplied to the firm, it fails to make out a case for the double taxation of returns from financial claims on firms. Financial theory does support a view that risk variances between "debt" and "equity" claims can be used to measure the cost of production from a profit and to differentiate an equity cost of capital from a debt cost, so that the tax system by allowing interest as a deductible cost does not subsidize the creation of debt to replace equity returns.  

traded in a market and priced under the CAPM, arbitrage pricing theory, or option pricing theory, see infra notes 538-43, also has application to viewing the claims in all firms — sole proprietorships, partnerships, limited partnerships, cooperatives and the like.

220. This neutrality view of finance theory was also made in Comment, Hybrid Instruments and the Debt-Equity Distinction in Corporate Taxation, 52 U. CHI. L. REV. 118, 140 (1985)(proposing debt classification only for straight debt). The Comment does not deal with the further question as to how finance theory and the recognition that variance of returns is also a basis for determining when debt is effectively equity.

221. For a recent exposition of this view in a cost-of-capital allowance system, see Kleinbard, Beyond Good and Evil Debt (and Debt Hedges): A Cost of Capital Allowance System, 67 TAXES 943 (1989).

222. Variance between the movement of the instrument and the systemic risk of the market under the capital asset pricing model differentiates and values different instruments issued by a particular firm. R. BREALEY & S. MYERS, supra note 62, at 136-40, 173-85. Contingent claims analysis derived from the option pricing model also prices contingent instruments based on relative variance. See Mason & Merton, The Role of Contingent Claims Analysis in Corporate Finance, in RECENT ADVANCES IN CORPORATE FINANCE 7, 16-17, 25-32 (E. Altman & M. Subrahmanym eds. 1985). Financial theory also demonstrates that differences in the rates of return of firms cause differences in the market value of the firm's equity and debt, and that the variance between debt and equity is lowered by a decline in the debt-equity ratio. See Galai & Masulis, The Option Pricing Model and the Risk Factor of Stock, 3 J. Fin. Econ. 53, 62-66 (1976). This suggests particularized debt and equity risks for each firm. This is a similar argument to the rationale for the passage of I.R.C. § 279 (West 1988) in 1969 which denied interest deductibility for certain subordinated debt convertible into equity in leveraged corporate structures. See H.R. 91-413 (Part
It has been maintained that, under the income tax, the income of a corporation or firm other than a sole proprietorship includes profits used to pay all financial claims of the firm, and therefore a deduction for interest is not required since it is not a special category of "expense." It is a stronger argument when applied to firms that are clearly separate economic entities made up of managers and financial investors. While the income tax has generally denominated claims to firm level profits by debt capital, labor, and product suppliers as costs of doing business, it has been demonstrated that there is no theoretical requirement to so denominate such claims. There is a rationale for the single taxation of individual income and for the pooling of financial resources


223. See Corporate Financial Structures, supra note 4, at 79-80. This position was maintained in Warren Interest, supra note 1, at 1594-98, drawing from accounting concepts of income and a view of income as product as elaborated by Seligman, see E. SELIGMAN, THE INCOME TAX 12-13, 19, 685 (2d ed. 1914); E. SELIGMAN, ESSAYS IN TAXATION 246 (9th ed. 1921). Seligman's view of the nondeductibility of interest on corporate debt comes from the belief that the corporation has an ability to pay tax on that debt "is in reality an integral and constituent part of the capital." E. SELIGMAN, ESSAYS IN TAXATION 106-07, 272-73 (8th ed. 1913)("Taxation of income on corporate debt is not double taxation, because the coupons, like the dividends, are integral parts of the income; because both bonds and stock together form what is really the working capital from which the income is derived."). See supra note 200.

224. Warren, Interest, supra note 1, at 1588. For recognition of this view of corporate capital structure and the ambiguous result from its application, see Corporate Financial Structures, supra note 4, at 79-80:

Under one view, the corporation earns income not for the benefit of its own consumption, but for the benefit of its owners. In such a case, it is not clear what the appropriate calculation of income is for the separate corporate entity or how interest should enter into it. Indeed, much of modern corporate financial analysis is based on the premise that debt and equity both represent ownership claims on the future earnings and assets of the corporation. Within this framework it may be more plausible to treat corporate debt just like equity and permit no deduction at the corporate level for interest. Yet such treatment would create additional distortions between corporate and noncorporate forms of business and among various investment activities that may be viewed as more undesirable than the problems caused by debt finance.

The same type of analysis, however, leads one to question the justification for a separate, unintegrated tax on corporate income; the corporation could be viewed as a partnership between all debt and equity holders. Some believe, however, that the large corporate enterprise often possesses significant economic resources and acts to some degree, for its own benefit and not necessarily for the benefit of its creditors or shareholders. They would argue, therefore, that a separate corporate level tax is appropriate. (Emphasis in original).
for passive investment. For a firm generating business income
within a structure that provides for multiple suppliers of labor and capital, however, the single-taxed income rationale breaks down since within the firm all are at a multiple risk of loss. If neither income-as-product nor accounting income rationales compel a tax distinction between debt and equity capital providers and if financial claims in the form of both debt and equity can be double taxed, any failure of the income tax to distinguish debt from equity is irrelevant. On the other hand, Henry Simons and others have argued that a generalized principle of single taxation of all income is mandated by the theory of an income tax. Income tax theory could thus be viewed, without appeal to other considerations, as supporting on the one hand the double taxation of the returns to all firm capital suppliers and, on the other, the single

leverage by substituting a public-equity buyout or repaid existing corporate debt through a public-equity buyout. Support for this proposition is gathered from the offering prospectuses, the returns offered by the transactions, and the use of the proceeds raised from the public. See Chambers Associates Inc., An Overview of the Origin and Tax Treatment of Publicly Traded ("Master") Limited Partnerships 1-17 (Oct. 1987), reprinted in Tax Notes Microfiche Database Doc. No. 87-6812; Kraakman, supra note 44, at 916-17 n.89. Cf. 1987 Senate MLP Hearing, supra note 30, at 67-70 (statement of J. Roger Mentz)(absent tax considerations, a subsidiary corporation would be as effective). The debt-substitute argument was enlarged to note that corporate expansion could be undertaken in a single tax form through the use of investments financed by debt, by retained earnings, or by an MLP. See 1987 Senate MLP Hearing, supra note 30, at 142, 145-60 (statement of John E. Chapoton); id. at 179 (statement of Richard G. Cohen)(If MLPs are debt substitutes, then the question whether MLP equity should be single-taxed should be considered in conjunction with the question of whether interest on corporate debt should be deductible.). The debt-substitute argument was made frequently by industry representatives. See 1987 Senate MLP Hearing, supra note 30, at 102, 133, 167 (statements of Lewis H. Sandler, John P. Neafsey, Barry R. Miller). The fact that MLPs themselves contained debt financing was not lost on the Treasury. See 1987 Senate MLP Hearing, supra note 30, at 52 (statement of J. Roger Mentz)(noting capitalization of MLPs with debt and the use of debt in MLPs to raise capital from tax exempt and foreign investors). This was disputed by industry representatives. See Id. at 162, 165-66 (statement of Barry R. Miller). The effect of debt on MLP yield was also noted. Id. at 197 (statement of Barry R. Miller)(MLPs are market-driven by the yield requirement not to have significant amounts of debt and they do not use debt in any way comparable to the historic use of debt by corporations). One can imagine many reasons, including administrative ones, why transactional parity for the taxpayer should not have been maintained since arguably PTPs, which trade on the "junk bond" return and offer a contingent return, provide a riskier return than ought to be allowed under the classification of debt. Congress failed to articulate a rationale for not pursuing that line of reasoning.

226. H. SIMONS, FEDERAL TAX REFORM 22-25 (1950); TWENTIETH CENTURY FUND REPORT, supra note 14, at 155-87, 397-400. This argument would also be applicable to a view of income as product in the personal tax base, see supra note 200, to the extent that double taxation reduces social product. This fact suggests that the tax must be structured as a profits tax.

227. See infra notes 364-77 and accompanying text.
taxation of the returns to all firm capital.\textsuperscript{228}

Depending upon assumptions as to the form of financing by the firm and setting aside considerations of tax incidence, any firm level tax capitalized by the market is a flat tax in the sense that when it occurs it lowers the rate of return to the residual equity holder.\textsuperscript{228} Since finance theory demonstrates that the value of firm leverage in a world with an income tax inures to the benefit of the residual equity claimants,\textsuperscript{230} a corollary tax policy, holding that at

\begin{itemize}
\item \textsuperscript{228}One explanation for the failure of the 1986 general inquiry on the tax treatment of passthrough entities and an inquiry on pending legislation dealing with RICs and REITs to generate momentum is that they asked the wrong question. The Staff of the Joint Committee in framing the issues for the hearings was correct to review the structures of each of the entity's and then examine the factors that lead both to taxation of the entity as a separate entity and also the taxation of that entity's earnings twice. \textit{Staff of the Jt. Comm. on Tax'n, supra} note 30, at 1. It focused on the arguments for separate taxation when the entity is not the alter ego of the owner as both a reason for separate taxpayer status in conjunction with factors of the firm such as centralized management, limited liability, and free transferability of interest, the administrative case for entity level taxation, and the neutrality issue of taxation of like firms alike, but then devoted little space to the two key issues — the rationale for the treatment of income generated through financial intermediaries and passive income funneled through firms as single taxed income regardless of how collected and the question of "whether income should be taxed both at the entity level when earned and at the owner level when distributed." \textit{Id.} at 13-19. Review of the structure of and classification tests for the passthrough regimes is useful, but as a normative point of view, the normative value of passthrough taxation cannot be addressed without making the question of who should pay the corporate or a firm level tax the first level inquiry. The 1986 inquiry mixed the question of the positive and normative structure of passthrough taxation with the normative issue of when passthrough taxation is correct.
\item \textsuperscript{229}See supra notes 60-67 and accompanying text.
\item \textsuperscript{230}Leverage is the mechanism by which the yield on an investment including an equity investment in a corporation is increased. See R. Brealey & S. Myers, \textit{supra} note 62, at 390-93. Just as a leveraged purchase increases the yield on an out of pocket investment in an asset, leverage in the classical corporate tax system up to the point that leverage is too expensive as a cost of capital increases the yield on invested equity relative to the risk. See \textit{id.} at 393-401. If interest on firm debt is deductible, a leveraged financial structure increases the return on the equity. See R. Hamilton, \textit{Corporation Finance} 484-525 (2d ed. 1989). For a demonstration of this result consider the example used in \textit{Corporate Financial Structures, supra} note 4, at 53-54:
\end{itemize}

Assume a corporation in the 34 percent tax bracket with after tax earnings of $990,000 on income of $1.5 million. It has 99,000 shares outstanding, earnings per share of $10, and trades on the market at 8 times earnings, or $80 a share for a market value of $7,920,000. A repurchase of the 91,667 shares at 12 times earnings can be made for $11 million. If the firm finances this totally with debt borrowed at 12 percent interest, it will have an interest cost of $1.32 million, which if deductible will leave before tax earnings at $180,000 and after tax earnings of $118,000 ($180,000 minus taxes of $61,200). Earnings per the remaining 7,333 shares are now $16.20. For the remaining shares, while the amount of after-tax income of the corporation has decreased, the earnings per share have increased on account of leverage, which is the normal phenomenon of leverage in capital structure, so that even if the firm still sells for 8 times earn-
the individual level income from capital representing merely the

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the time value of its use and the return from one's labor should be
subject to only one level of tax, supports the view of the firm level
tax as a profits tax — a tax after the return to capital suppliers of
the time value of their money. This would mean a profits tax
computed by determining the tax base from the income of the
firm less a deduction at the risk-free rate of interest on the value

ings, the stock value for the remaining shareholders will increase from $80 per
share to $129.60.

Id. "More generally, the return on equity rises with increasing debt capitalization so long
as the interest rate is less than the pre-tax rate of return on corporate assets. This suggests
that the Code creates an incentive to raise the debt-equity ratio to the point where the

The existing corporate tax mismatches the taxation of the return for the time
value of money. In the argument for inclusion of the interest on corporate debt in the

corporate income tax base, it was noted that:

Even assuming that the relevant increment in value accrues to the corporate
enterprise generally, and not solely to shareholder equity, there is a final argu-
ment that some interest should be excluded from the ideal corporate income tax
base . . . . The cost of capital can be conceptualized as the sum of (1) the cost
of using assets in a riskless enterprise, i.e., what it is worth to have something
now instead of in the future, plus (2) a premium for the risk entailed . . . .

Since even a riskless enterprise would necessarily incur the time preference com-
ponent of the cost of capital in order to effect production, it might be concluded
that payments for the time preference reduce increment as much as payment for
real, as opposed to financial, assets or services. That argument is, of course, in-
appropriate with regard to the existing corporate income tax since the cost of equity
capital also includes a payment for the riskless use of capital, but no deduction is
permitted for any part of dividends paid. Moreover, interest on debt cannot be
regarded as the rough equivalent of the cost of using assets in a riskless enter-
prise nor dividends on equity as a rough equivalent of a risk premium since

equity instruments can be purchased independently of debt instruments. Thus,
the return on equity instruments must include a pure time component as well as
a risk premium.

Warren Interest, supra note 1, at 1593-94 n.34. The efficiency response is that to the ex-
tent that there is double taxation of an interest return, the interest rate either increases if
in an open economy or the cost of capital generally increases in the closed economy model.
of all financial claims. It does not say anything about the risk element of that return, but suggests that the normative view of the rate is that of a risk-free rate of return. The obvious benchmark for this riskless rate is the applicable federal rate for issues of comparable term. It is on this premise of the income tax that the argument is made in Part III of this Article to rewrite the corporate tax as a profits tax on firms with liquid equity, leaving to the agenda for inquiry consideration of the appropriate interest rate and the limitation of interest deductions on debt capital.

232. Finance theory generally defines risk which commands a risk premium as against a return merely for the passage of time by reference to the returns on the risk free portfolio of Treasury bills. R. Brealey & S. Myers, supra note 62, at 126-27. A further refinement on risk and the risk premium is made by portfolio theory which assumes that the unique risk of a particular investment can be avoided by diversification such that the market will not reward that risk with a risk premium and that the only remaining risk which is rewarded with a risk premium is the systematic risk, the risk of the market. Id. at 128-65. The importance of determining the appropriate risk measure for debt instruments (which any return above a Treasury instrument of comparable term reflects risk) and equity is, as set forth in the Staff discussion of the theory of the disallowance of a portion of the interest on debt, a question of finding the appropriate rate in an attempt to define economic income:

[T]o the extent the rate selected reflects a measurement of “risk”, this approach also might be described as an attempt to properly measure economic income. If one accepts the premise that all interest on debt is properly deductible without regard to whether the debt supports an asset that produces taxable income, and the further premise that the most fundamental basis for distinguishing debt from equity is the degree of investor risk, this approach seeks to deny a deduction for the “risk” element of stated interest on the theory it more nearly resembles a dividend distribution, while continuing to permit the nonrisk portion to be fully deductible.

A primary issue with respect to this type of approach is the selection of the permitted deductible interest rate. To the extent that rate is selected in an attempt to identify excessive risk, the questions may be raised regarding the accuracy of a risk analysis based solely on interest rate. On the other hand, to the extent the proposal is viewed as one of administrative convenience, designed to address revenue concerns and avoid the need to distinguish between debt and equity, the accuracy of any risk analysis may be considered less important.


234. See infra notes 447-59 and accompanying text.
to appropriately compute the firm's profit.

C. The Resemblance Test

Since 1909, corporations and associations have been subject to an entity-level tax on income while unincorporated businesses, with the exception of those publicly traded partnerships covered by the 1987 Act, have not. From its inception, the tax was viewed as a tax on the legal personality of the corporation, and not as a tax on the production of business income. The decision to impose a corporate tax on "associations" and the lack of a statutory definition led to administrative definitions of "association." A 1916 regulation included all limited partnerships as taxable associations based on the limited liability afforded their owners, a position that was reversed in 1918 in a definition that relied in part on a weighing of resemblance factors to the characteristics of a corporation and was an early formulation of a resemblance test.

While the regulations gave the test its administrative scope, Morrissey v. Commissioner gave it the judicial imprimatur to find "resemblance and not identity." According to the courts, the test was designed to include a common law association, de-

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235. The revenue acts of 1913 (Act of Oct. 3, 1913, ch. 16, 38 Stat. 114, 166-81), and 1916 (Revenue Act, 1916, ch. 463, 39 Stat. 765) specifically excluded "partnerships" from the "associations" and "corporations" that were subject to the corporate tax, again without definition, and "partners" were held individually liable for tax. See Sexton & Osteen, Classification as a Partnership or an Association Taxable as a Corporation, 24 Tul. Tax Inst. 95, 99 (1975). The reason for the statutory exclusion was thought to be a desire to preserve harmony between federal tax law and general principles of state law. See United States v. Coulby, 251 F. 982, 984 (N.D. Ohio 1918), aff'd, 258 F. 27 (6th Cir. 1919)(noting that the reason Congress and consequently "the law" ignored the partnership for taxing purposes was that "[u]nlke a corporation, a partnership has no legal existence aside from the members who compose it").

236. See infra notes 640-71 and accompanying text.

237. The definition of a "corporation," which survives in I.R.C. § 7701(a)(3) (West 1988), was incorporated into the tax law in 1918. Revenue Act of 1918, ch. 18, § 1, 40 Stat. 1057 (1919). Personal service corporations were excluded from the corporate tax from 1918-1921. Sexton & Osteen, supra note 235, at 100.


239. Id. at 106-07.

240. For a review of the resemblance test from the revenue acts of 1894 to 1975, see Sexton & Osteen, supra note 235. For additional history, see Scallen, Federal Income Taxation of Professional Associations and Corporations, 49 Minn. L. Rev. 603, 611-14 (1965).


242. Id. at 357.
fined as “a body of persons united without a charter ‘but upon
the methods and forms used by incorporated bodies for the prose-
cution of some common enterprise.’”243 For fifty years the tax sys-
tem has gone back and forth with less than coherent formalistic
rules based on the resemblance test.244 The present regulatory re-
semblance test is based on four elements: limited liability for cor-
porate debts, centralized management, continuity of life, and free
transferability of ownership interests. The *Kintner* regulations245

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243. *Id.* at 358 (citing Hecht v. Malley, 265 U.S. 144, 157 (1924)). After *Morris-
sey*, the bundle-of-rights “resemblance” test would tip the balance to association status, the
predictability of which, even by regulation, was unclear. See Sneed, *More About Associations
in the Oil and Gas Industry*, 33 Tex. L. Rev. 168, 185-90 (1954). The constitutional-
ity of distinguishing between unincorporated and incorporated firms was based on a ben-
efits recognition of the corporate form. See Flint v. Stone Tracy Co., 220 U.S. 107, 111,
151-52 (1911)(benefit of corporate form is different). Until 1987, the core of the current
system tested unincorporated firms solely for resemblance to that form. Although Congress
did reconsider the classical corporate double-tax-single tax line when it enacted Subchapter
S in 1958, as well as when it expanded it in subsequent years, the basic rationale which
drew firms into the double-tax world was never fully articulated.

244. See Scallen, *infra* note 240, at 605-07 n.6 (listing a comprehensive biography); Sexton & Osteen, *infra* note 235 (discussing the evolution of the resemblance test). Con-
sideration of the resemblance test occurred before *Morrissey*. See, e.g., Pierson, *The Cor-
porate Tax Decision*, 20 Yale L.J. 636 (1911); Pond, *The Taxation of Corporations*, 24
282 (1921); Robinson, *Taxability of Unincorporated Organizations as Corporations for
decision as well. See, e.g., Flagg, *Associations Taxable as Corporations*, 13 Taxes 589
(1935); Smith, *Associations Classified As Corporations Under the Internal Revenue Code*,
34 Calif. L. Rev. 461 (1946); Brabson, *What Constitutes an Association Taxable as a
Corporation*, 7 Inst. on Fed. Tax'n 1282 (1949). For a detailed critique of “association
status,” see Sneed, *infra* note 243. For a discussion of the *Kintner* regulations, see Lyons,
*Comments on the New Regulations on Associations*, 16 Tax L. Rev. 441 (1961); Scallen,
*infra* note 240. The proposed 1977 draft regulations are found at 42 Fed. Reg. 1038 (to be
1489 (withdrawn Jan. 7, 1977). They would have applied more functional considerations and
taxed large limited partnerships as corporations, with the application of the functional
analysis also bringing large general partnerships in the service industries close to the line.
See Note, *Tax Classification of Limited Partnerships*, 90 Harv. L. Rev. 745 (1977);
Note, *Tax Classification of Limited Partnerships: The IRS Bombs the Tax Shelters*,
52 N.Y.U. L. Rev. 408 (1977) [hereinafter Note, *Shelters*]. Some offer the well-worn view
that the *Kintner* regulations allowed tax shelters to exist. See, e.g., R. Doernberg, H.
Abrams, B. Bittker & L. Stone, *Federal Income Taxation of Corporations and

245. With the adoption of the *Kintner* regulations (Treas. Reg. § 301.7701-2
(1960)), the resemblance test became a mechanical test that treated any firm which had
more than two of the above factors as an association. The elements of “associates” and
“objective to carry on business for profit,” however, are considered essential and an associa-
tion will not be classified as such if either of these elements is absent. See W. McKee, W.
Nelson & R. Whitmire, *Federal Taxation of Partnerships and Partners* § 3.06
[2], at 3-41 (1987). These authors argue that the regulations are:
convert the test into a stylized formula under which only three of the elements need to be present before association status exists. The regulations list "other factors" which, if applied, should cause publicly traded limited partnerships to be taxed as associations, but since these are not incorporated into the main test the courts have disregarded them.\textsuperscript{246}

1. Legal Personality and the Resemblance Test

The resemblance test looks for a resemblance between the characteristics of the entity tested and the legal characteristics of corporations and stems from a fictional legal personality of the corporation that existed at the turn of the century. According to this fiction, the corporate form has certain unique attributes,\textsuperscript{247} including limited liability which was heralded by Nicholas Murray Butler as "the greatest single discovery of modern times."\textsuperscript{248}

\begin{footnotesize}
\begin{itemize}
\item composed of a series of sentences which, though not directly contradictory, are not entirely consistent. This tendency probably resulted in most cases from an effort to resolve most questions against the [corporation] classification and to insure that every general partnership subject to the Uniform Partnership Act, and most limited partnerships subject to the Uniform Limited Partnership Act, will not be classified as [corporations], while paying lip service to the theoretical considerations.
\end{itemize}
\end{footnotesize}

\textit{Id.} at 3-42.

\textsuperscript{246} Larson v. Commissioner, 66 T.C. 159 (1976), acq. 1979-1 C.B. 1 (reaffirms adherence to the four factor balancing test). But see Outlaw v. United States, 494 F.2d 1376, 1385 (Ct. Cl.), cert. denied, 419 U.S. 844 (1974)("other factors" such as the use of a securities offering to achieve financing are "significant"). Treasury then issued proposed regulations on limited liability companies that required personal liability for at least one member in the firm as a pre-condition to application of the four factor balancing test. Prop. Treas. Reg. § 301.7701(a)(2) - (a)(4) & (g), 45 Fed. Reg. 75709 (1980). These proposed regulations were later withdrawn in order for the Service to "undertake a study of the rules for classification of entities for federal tax purposes with special focus on the significance of the characteristic of limited liability . . ., with the possible application of the minimum capitalization requirement of Revenue Procedure 72-13, 1972-1 C.B. 735, to all entities seeking classification of partnerships for federal tax purposes." I.R.S. News Release IR-82-145 (Dec. 17, 1982)(discussing whether Revenue Procedure 72-13 must remain an advance ruling position or instead be elevated to a rule of substantive law). At the same time, the acquiescence to \textit{Larson} was withdrawn to the extent that it was inconsistent with the minimum capitalization requirement. \textit{Id.} The \textit{Larson} approach was followed for foreign entities where there was beneficial joint ownership by "separate and distinct economic interests." See MCA, Inc. v. United States, 685 F.2d 1099, 1103 (9th Cir. 1982).

\textsuperscript{247} See Cleary, \textit{The Corporate Entity in Tax Cases}, 1 TAX L. REV. 3 (1945)(This theory presumes that corporations have separate identities, much like individual personalities, regardless of the number of stockholders. This "identity" is what is generally considered for tax purposes and it cannot be ignored by the courts, except in unusual circumstances.).

\textsuperscript{248} 1 \textit{W. Fletcher}, \textit{Cyclopedia of the Law of Private Corporations} § 21, at
Historical research has yielded conflicting views as to both the uniqueness and importance of limited liability as a corporate attribute. While noting that limited liability economizes on transaction costs and the cost of internalizing externalities, commentators debate its importance to the firm as a whole.

249. Limited liability in a corporation was not considered a unique attribute 150 years ago although 300 years ago monopoly probably would have been thought unique. H. Dougan, The History of the Taxation of Associations, at 17-18 (1962)(unpublished manuscript on file at Columbia Law Library).

250. While the importance of limited liability is debatable, the majority of writers consider it a "landmark institution." But see Meiners, Mofsky & Tollison, Piercing the Veil of Limited Liability, 4 Del. J. Corp. L. 351, 357 (1979)(since the number of incorporations in Massachusetts did not increase after introduction of limited liability, limited liability did not promote incorporation).


252. Limited liability has no allocative effects even if significant transaction costs are present. This is true due to the downside that limited liability brings. Although limited liability may make it cheaper to raise equity capital, this is offset by a higher cost of debt capital. See Forbes, supra note 251, at 164 n.1 (citing Ekelund & Tollison, Mercantilist Origins of the Corporation, 11 Bell J. Econ. 715, 719 (1980)). Under this view, limited liability for nonconsensual claims on firm assets, by tort or otherwise, serves as a substitute for insurance coverage for those third-party claims that exceed firm assets. Limited liability merely reduces the cost of this insurance. Forbes, supra note 251, at 165 & n.5. Insurers are risk averse when they face uncertainty and unpredictable probability of loss, rather than with risk and predictable probabilities. See F. Knight, Risk, Uncertainty and Profit 197-263 (1921 & reprint 1971). The argument that the cost of insurance is identical to the cost of limited liability by statute breaks down. The two present different monitoring costs. Further, limited liability avoids the costs associated with diversifying the risk through pooling. These factors suggest that limited liability is advantageous. See Abraham, Environmental Liability and the Limits of Insurance, 88 Colum. L. Rev. 942, 945-49 (1988).

Limited liability impacts the monitoring activities within the firm. Several reasons suggest why transaction costs make limited liability attractive for consensual parties. First, it permits efficient risk-sharing between shareholders and bondholders, since the value that shareholders place on the reduced exposure to risk will be positively related to the claims of creditors relative to the size of the firm's assets. "In this sense limited liability is a substitute for an insurance policy that covers the claims of creditors in excess of the firm's assets." See Forbes, supra note 251, at 165. Second, unlimited liability is a costly arrangement since shareholders attempt to escape their liability for firm debts, thus increasing collection costs. This problem can be remedied in part by limited liability because shareholders have no personal liability for firm debts. Id. at 166. Third, only limited liability can permit free transferability of shares, since unlimited liability argues for restrictions on transferability of shares. Id. at 166, citing S. Woodward, On The Economics of Limited Liability (U.C.L.A. Dept. of Econ. Working Paper, 1983).
has generally reduced legal personality and the resemblance test to rhetoric;\textsuperscript{253} however, tax law continues to follow the personality cult.\textsuperscript{254}

Ever-changing state laws make the resemblance test even more suspect as a guardian of federal tax policy. This was demonstrated by the 1976 and 1985 revisions to the Uniform Limited Partnership Act\textsuperscript{255} as well as by state changes in the management

The existence of limited liability favors new firms and those firms that require that the savings of a large number of individuals be pooled. Limited liability is not essential for established firms because they may be able to internally finance their investment. In addition, their reputation for honesty and managerial acumen might be sufficient to overcome investor uncertainty. \textit{Id.} at 174-75.

Limited liability may distort firm behavior, reducing social responsibility. \textit{See} Kraakman, \textit{Corporate Liability Strategies and the Costs of Legal Control}, 93 \textit{Yale L.J.} 857, 858 (1984)(considering when liability rules should hold accountable leading corporate participants for corporate wrongdoing, rather than the firm itself.). Firms may be willing to sacrifice the ability to manage in order to benefit from limited liability laws. \textit{See infra} note 289 and accompanying text.

253. \textit{Comment, The Personification of the Business Corporation in American Law}, 54 \textit{U. Chi. L. Rev.} 1441, 1442, 1478-83 (1987)(discussing the evolution of corporate personality and explaining that all that remains of a corporation as a legal person is rhetoric). For the view that the decision to tax "corporations" was compounded by some basic errors in the fiction of the corporate personality. \textit{See} H. Dougan, \textit{ supra} note 249, at 17-18 (Perhaps the only thing unique about a corporation is that the law has recognized its entity characteristics as conferred by an act of the legislative or executive branches of government rather than by case law or common experience.). For a discussion of contextual views of the firm within society, see R. Clark, \textit{Corporate Law} 1-4, 675-703 (1986).

254. The Commissioner of Internal Revenue declared in 1960 that "[t]he separation of the corporate personality or the corporate entity is one of the cornerstones of our present income tax law." \textit{See} Caplin, \textit{Income Tax Pressures on the Form of Business Organization: Is It Time for a "Doing Business" Tax?}, 47 \textit{Va. L. Rev.} 249, 252-53 (1961)(considering the complexities and inconsistencies in current tax legislation and suggesting a single doing business tax on the taxable income of any enterprise, regardless of its classification under state law). For an example of the strength of this proposition, see Gabinet & Coffey, \textit{ supra} note 149. There, the authors argue that a plan for full imputation of corporate income to shareholders in other than closely held firms would be "a major upheaval in the constitutional meaning of income, a rejection of the narrow holding of \textit{Macomber}, and the abandonment of the dominion and control doctrine, which is simply not likely to happen." \textit{Id.} at 935. Other forms of integration do not have that defect. \textit{Id.} at 935-41. Gabinet and Coffey hypothesize that the lack of a constitutional challenge to Subpart F is explainable on the grounds that the corporations in question are foreign. \textit{Id.} at 928-29. \textit{Compare Powell, The Stock-Dividend Decision and the Corporate Nonentity, 5 Bull. Nat'l Tax Ass'n 201 (1920)(passthrough taxation of all corporations could be upheld despite \textit{Macomber}), with Ballantine, Corporate Personality in Income Taxation, 34 Harv. L. Rev. 573, 586 (1921)(passthrough taxation would not be upheld "at least in the case of large and active business corporations employing large capital since corporations are separate legal personalities").

255. The 1976 proposed revisions to the Revised Uniform Limited Partnership Act were delayed until a "favorable" determination could be made by the Internal Revenue Service. \textit{See generally} T.D. 7889, 1983-1 C.B. 362 (containing regulations relating to the
rights of limited partners. New trends in state laws, like the Georgia Limited Partnership Act which depends on application of the Kintner test for tax classification, highlight the uncertainty arising from reliance on state law.

2. Economic Personality and the Resemblance Test

Since the keys to the resemblance test are characteristics of legal personality, economic aspects such as whether a firm operates in a public or private market and whether its economic role is based on the size of the organization occupy a distinctly secondary status. The resemblance test was developed in the infancy of corporate finance. The large publicly traded firm operating in an efficiently organized and regulated equity market did not come into existence until after the Stock Market Crash of 1929. In 1932, Berle and Means advanced their revolutionary view of the firm as an economic agent rather than as a legal personality. Notwithstanding the Berle and Means insights, the resemblance test arrived at in the Morrissey decision and based on statutory interpretation and longstanding Treasury regulations pointing to formal classification of limited partnerships in light of recent state-law changes allowing the removal of a general partner by the limited partners and for limitation of the liability of a general partner to partnership creditors).

256. See infra note 676.
258. Federal Tax consequences under the resemblance test may be altered by changes in state law. See Ribstein, A Statutory Approach to Partner Dissociation, 65 WASH. U.L.Q. 357 (1987)(proposing statutory provisions limiting a general partner's power to effect a partnership dissolution); Hetherington & Dooley, Illiquidity and Exploitation: A Proposed Statutory Solution to the Remaining Close Corporation Problem, 63 VA. L. REV. 1, 3, 50-59 (1977)(since a closely held corporation is similar to a partnership, a minority shareholder should have a statutory right to have the closely held corporation buy out all his stock and equity). The creation of these state law rights can alter the federal tax treatment accorded the firm. See, e.g., Rev. Rul. 88-76, supra note 33 (determining the status of an unincorporated limited liability firm for tax purposes under the resemblance analysis depends solely on existence of more than two of the corporate factors of continuity of life, centralization of management, limited liability, and free transferability of interests under state law).

259. See generally A. BERLE & G. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (rev. ed. 1968); L. LOWENSTEIN, supra note 164, at 21-30 (discussing changes in corporations after 1929 and how these changes brought about corporations with large numbers of stockholders).
260. A. BERLE & G. MEANS, supra note 259. See also id. at 119-40 (the corporation is itself an economic agent in a financial market). Berle and Means noted the transition of the corporation from a legal entity in which owners controlled their property according to terms in a charter closely supervised by the state, to an arrangement in which many deliver capital into the centralized control of a separate entity. Id. at 127.
characteristics of the entity such as continuity of existence and centralized management, continued to rely heavily on the fiction of legal personality. The struggle to determine the true nature of a corporate entity occupied much of the nontax, but not the tax, considerations in the 1940s and 1950s. While the nontax view of the corporation was becoming more functional, the resemblance test, although not completely mechanical, was only applied by the courts to firms that were not incorporated entities. While resemblance characteristics in a firm also pointed to economic differences, any attention paid to an economic concept of corporate production in determining the appropriate entity to tax was subsumed in the discussion of the resemblance characteristics.

3. The Counter-Productiveness of Resemblance Thinking

Unfortunately, the resemblance conception colored the

261. Subsequent regulations continued adherence to the formal characteristics under state law. See Sexton & Osteen, supra note 235, at 117-20. The Morrissey articulation of resemblance rather than identity did cause the Treasury in 1939 to reverse its earlier position that New York limited partnerships modeled on the ULPA would not be tested for resemblance since they were so like ordinary partnerships "as to render impracticable any differential in their treatment for tax purposes," and to require testing of ULPA limited partnership for resemblance. See Vernon, When Are Partnerships Likely to be Taxed as Associations?, 4 INST. ON FED. TAX'N 489, 499 (1946).

262. See, e.g., Coase, The Nature of the Firm, 4 ECONOMICA 386 (1937), which had its greatest influence later. For a review of the theoretical developments, see Williamson, Th. Modern Corporation: Origins, Evolution, Attributes, 19 J. ECON. LITERATURE 1537, 1537-43 (1981). These conceptions of the theory of the firm as an economic actor, beginning with Coase, had other antecedents ignored by the tax law. See Bratton, The New Economic Theory of the Firm: Critical Perspectives from History, 41 STAN. L. REV. 1471, 1473 (1989) [hereinafter Bratton, Theory] (arguing that theories of the firm as an economic actor presently represented in both the Jensen and Meckling neoclassical and Oliver Williamson institutional nexus of contracts views of the firm "have followed from and responded to economic practice; they have not dominated and determined it"). For a recent set of views on the theory of the firm and contractual arrangements in corporate governance theory, see Contractual Freedom in Corporate Law, 89 COLUM. L. REV. 1395 (1989) (Symposium).

263. See, e.g., Sneed, supra note 243 at 193 (corporate taxes should be applied to business entities depending on limited liability of the owners and centralization of legal title rather than through application of the other classification factors).

264. See, e.g., Glennder Textile Co. v. Commissioner, 46 B.T.A. 176, 187 (1946) (holding a New York limited partnership not taxable as an "association" because "it does not bear such a resemblance to an association or operate effectively as such so as to justify our inclusion of it in that category for tax purposes") (emphasis added); Bert v. Commissioner, 92 F.2d 491, 495 (D.C. Cir. 1937) (holding a stock trading trust an association after weighing the resemblance factors to find the "method, mode, and form of procedure in the conduct of its business") (citing Commissioner v. Brouillard, 70 F.2d 154, 158 (10th Cir. 1934)) (emphasis added).
double-tax debate in a number of ways, foreclosing the development of a reasoned economic rationale for the business tax classifications that exist even today. First, Congress never articulated its reasons for taxing corporations differently from partnerships; consequently, the issues were decided on the basis of entity classification and statutory construction. The policy critiques of the classification issue have generally been interwoven with an analysis of the availability of perceived tax benefits or an analysis of attributes associated with the status of the entity. Second, the resemblance test obscured the legal, if not the economic, debate over the taxation of business entities. Even if the resemblance test made distinctions among co-ownership, corporation, limited partnership, and trust, it failed as a meaningful legal test of the role of entities within the context of the income tax.

The vagueness of the resemblance test and its relationship to the other structural provisions of the income tax left the Treasury open to criticism that its regulations did not establish a policy definition of corporations. The failure of the resemblance test also

265. Some commentators have bemoaned the fact that the classification regulations cannot “be tested against the congressional purpose [because] Congress has never articulated its reasons for taxing corporations differently from partnerships.” Note, Shelters, supra note 244, at 420.

266. When partnerships were used as tax shelters, commentators asked the Treasury and the courts to refrain from judging the classification issue on the ultimate tax consequences, i.e., the passthrough of losses. Instead, they urged that classification under state law should control. See Hyman & Hoffman, Partnerships and “Associations”: A Policy Critique of the Morrissey Regulations, 3 J. REAL EST. TAX’N 377 (1976) (advocating the wholesale adoption of state-law classification as controlling federal tax consequences absent a countervailing federal tax policy). Similarly, commentators urged the Treasury and courts to use state law principles when professional partnerships sought association status to achieve pension and other deferred-compensation benefits available only to corporations and associations. See, e.g., Scallen, supra note 240, at 715 (preferable course was to allow normal federal tax consequences to follow from the local-law form of these professional organizations).

267. See Klein, Legal Entities, supra note 196 (analyzing taxation based on legal status and suggesting a gradual replacement of tax on entities with a more direct tax on “people”); see also Lee, Entity Classification and Integration: Publicly Traded Partnerships, Personal Service Corporations, and the Tax Legislative Process, 8 VA. TAX REV. 57, 83-93, 102-09 (1988) (“deep structure” analysis to determine appropriateness of entity taxation with participation of owners as sine qua non of entity-level taxation, and under separate analysis, the classical corporate tax); Brooks, supra note 132, at 459 (“Entities should be subject to separate-entity taxation only when the administrative reasons for imposing the separate tax are thought to outweigh the economic and equity costs of doing so, irrespective of the legal form of the entity.”). A resemblance test is necessary to draw lines, other than the single-tax/double-tax line, whenever these relationships have a meaning in the tax-collection system for firms and individuals.

268. See, e.g., Hyman & Hoffman, supra note 266.
resulted in the inclusion of clear financial intermediaries within the scope of the double tax.\textsuperscript{269} The resemblance test does not exclude from association status closely held corporations, defined as those firms without a public market for their shares and which may be controlled by their owners, even if such an unincorporated entity would not be an "association" when tested under the criteria.\textsuperscript{270} Nonetheless, legal commentators, including the ALI, have proposed standards based on resemblance criteria\textsuperscript{271} without asking the federal tax-policy questions alluded to in \textit{Flint v. Stone Tracy Co.} — what is the classical corporate tax, who should pay it, and implicitly, why? The ALI’s position on the resemblance test — that the \textit{Kintner} regulations continue and that only publicly traded limited partnerships be taxed as associations — resolves none of these problems.\textsuperscript{272}


\textsuperscript{270} Note, \textit{Close Corporations and the Federal Income Tax Laws — Should the State Label Control?}, 59 Iowa L. Rev. 553, 573-75 (1974) ("[T]he close corporation . . . cannot meet the resemblance test of the 1960 regulations."); see also 1987 House MLP Hearings, supra note 30, at 344 (statement of John W. Lee) ("[M]ost close C corporations exhibit some of Reg. § 301.7701-2(d)’s four corporate characteristics."); Kessler, \textit{With Limited Liability for All: Why Not a Partnership Corporation?}, 36 Fordham L. Rev. 235, 255-58 (1967) ("[A]ny statute designed to benefit close corporations would permit them to mold their mode of operation more or less as they chose, thus making them even more permissive than the ordinary corporation statute.").

\textsuperscript{271} Limited liability seems to be the most popular factor because of its uniqueness to the corporate form and its importance in choosing a corporation as a business entity. See, e.g., Postlewaite, Dutton & Magette, \textit{A Critique of the ALI's Federal Income Tax Project — Subchapter K: Proposals on the Taxation of Partners}, 75 Geo. L.J. 423, 459-60 (1987)(given the deficiencies of other parts of the resemblance test, classification regulations should be changed to focus on limited liability, the only truly distinguishing factor); Leonard, \textit{A Pragmatic View of Corporate Integration}, 35 Tax Notes 889, 897 (1987)(although classification lines are always somewhat arbitrary, limited liability is an important factor); Keyser, \textit{Publicly-Traded Limited Partnerships: The Treasury Fights The Wrong War}, 36 Inst. on Oil & Gas Law & Tax’n 10-1, 10-17 to 10-19 (1985)(a general partner with enough assets to pay all the debts of the partnership is required, and the liability in the partnership must be in the form of recourse obligations for a limited "partnership to enjoy partnership status, since only then will there be unlimited liability"); Note, \textit{Tax Classification of Limited Partnerships}, 90 Harv. L. Rev. 745, 757 (1977)(personal liability is the cleanest distinction between a corporation and a partnership).

Whether the owner’s interests are publicly traded or offered has been also suggested as the determinative factor under a resemblance criteria. See, e.g., ALI Subchapter K Study, supra note 128, at 392 (public trading); Outlaw v. United States, 494 F.2d 1376, 1385 (Cl. Ct.), cert. denied, 419 U.S. 844 (1974)(public offering as another factor that should be considered and generally would be determinative). The public offering standard was also proposed in 1975 as part of anti-tax shelter legislation and was not acted upon. See Lee, supra note 267, at 85 n.114.

\textsuperscript{272} ALI Subchapter K Study, supra note 128, at 383-84. Noting that if a busi-
Other countries have dealt directly with these questions without resemblance criteria and in spite of different corporate and individual rate structures. Although the resemblance test does little to identify which firms should pay a corporate tax, the United States persists in applying resemblance analysis. The 1986 Treasury proposal on a public-trading standard that led to the 1987 legislative change of heart reflects this persistence.

The proposal we make today is not based on the view that publicly traded limited partnerships are different in kind from all other partnerships, but on the view that public trading in the interests of a limited partnership is indicative of the existence of the other, more relevant, classification factors . . . that may, to a lesser extent, be present in many other partnerships.

Thus, the change of heart was based on the resemblance criteria and not on a position that public trading or liquidity in and of itself justified an entity-level tax. The debate over publicly traded limited partnerships was so intertwined with resemblance concerns that it failed to articulate the meaningful differences between private and public firms and the capital markets in which they exist.

The difficulty of using resemblance criteria has not been lost on economists. Their inquiries have generally focused on the al-

ness entity acts like a corporation, presenting the same administrative and audit problems as a corporation, it should be taxed as a corporation the ALI proposed an addition to the resemblance test based on public trading. The "public-trading test is principally intended to exclude from partnership treatment the type of entity that carries on an active business and which, if interests in it were publicly traded, would resemble the publicly-held corporations that carry on most of this country's important industrial enterprises." Id. at 384. That view is known as the duck theory. See, e.g., Partnerships: Ways & Means Chairman Rostenkowski Says Nature of MLP Deals Will Determine Tax Treatment, BNA DAILY TAX REPORT No. 181 at G-6 (Sept. 21, 1987)("To the extent that the deals [the investment community puts] together look more and more like ordinary businesses, the Congress is going to be inclined to tax you as such. In other words, if it looks like a duck, walks like a duck, and sounds like a duck, it ought to be taxed like a duck."). The duck theory is much cited as an explanation of the 1987 legislation. See, e.g., McKee, supra note 29, at 23-11 to 23-13.


274. 1986 House Passthrough Hearings, supra note 30, at 31 (statement of J. Roger Mentz). The concern changed in 1987 to a fear of a start-up MLP. See infra text accompanying note 659.

275. This economists' point of view is encapsulated in Brooks, supra note 76, at 460 ("Of what importance is it in a tax system designed to measure economic power that a person's liability for an investment in an income source is limited, or that the investment has potentially an unlimited life, or that it is freely transferable?").
locative inefficiency of the classical corporate tax, the distortions it creates in the corporate and the noncorporate sectors and in financing decisions, and increasingly, the need to define corporate production. The imposition of a firm-level tax on corporate production has some justification, particularly when there is evidence that a form of business organization produces excess returns that ought to be taxed. Thus, the resemblance test should be directed at the form of production rather than an organization's resemblance to a corporate entity. For example, the ability of residual claims to manage or affect the management structure may not be as highly valued as was once thought, and firm organizational choices reflect control of agency risks, diversification and consumption choices, and production forms. This would belie the

276. See A. Nekam, The Personality Conception of the Legal Entity, in III HARVARD STUDIES IN THE CONFLICT OF LAWS 110-15 (1934). "It would be easy to recall all those formations which are not recognized as corporations yet, nonetheless, have either because of legislative enactment or because of the decision of the courts rights patently acknowledged to them, and which therefore all contradict the theory." Id. at 114.

277. Control is generally valued in the pricing of securities. In addition to the study of market acceptance of dual class common structures, see infra note 683, the value of control has attracted further study. In the study by Lease, McConnell & Mikkelson, The Market Value of Control in Publicly-Traded Corporations, 11 J. FIN. ECON. 439, 441, 466-68 (1983), superior voting rights for identical securities of 26 firms resulted in higher valuation, but superior voting rights in common stock for four firms with voting preferred stock traded at a significant discount. They thus reject in part the Manne, Jensen, and Meckling hypothesis that the source of value is the additional compensation and perquisites the controlling security holders can obtain. They conclude that there is a consistent relationship between security value and corporate control and that the value of control is related to the "incremental positive payoffs" relative to control. Similarly, Swiss studies show there is a value to the vote for public firms. Since capital markets do not reward diversifiable risk, the majority shareholders hold the high-voting-rights stock. Horner, The Value of the Corporate Voting Right: Evidence from Switzerland, 12 J. BANKING & FIN. 69 (1988). Lower valuation for high voting right shares relative to other shares can also be related to the other restrictions of the securities. The Lease, McConnell, and Mikkelson conclusion that control has its costs and benefits is applicable to the argument that the limited partnership form might not replace the corporate form, but that the ability to tailor the agreement to replace the costs of loss of control with other protection will give a positive valuation regardless of the control element. Since limited partners do not work for the firm, the agency explanation is not as compelling. Control is also related to factors involving managers. Cf. R. Morck, A. Shleifer & R. Vishny, ALTERNATIVE MECHANISMS FOR CORPORATE CONTROL 2 (National Bureau of Economic Research Working Paper No. 2532, 1988)("Where the board fails, external control devices come to play a role.").

278. See infra notes 364-77 and accompanying text. Firm-structure choice is much studied, as is firm-capital structure. For example, Jensen and Meckling posit that firms are legal fictions for contractual relations among individuals. This has led to research into contracts and bargains that are struck to minimize risk and agency costs. See Jensen & Meckling, supra note 103, at 310-11; Fellingham & Wolfson, TAXES AND RISK SHARING, 60 ACCT. REV. 10 (1985)(evaluating efficient risk sharing and incentives in joint ownership of
assumption that limited partnerships can never completely replace corporations, and it demonstrates that in many respects the limited partnership is a different organizational form.\(^{279}\) As will be argued shortly,\(^{280}\) there are great difficulties with such a

an income-producing project when part of the income is unavailable for personal consumption); Shevlin, Taxes and Off-Balance-Sheet Financing: Research and Development Limited Partnerships, 62 Acct. Rev. 480, 480-81 (1987)(finding tax and off-balance sheet motivations providing support for agency-model predictions); Harris & Raviv, Optimal Incentive Contracts with Imperfect Information, 20 J. Econ. Theory 231, 233 (1979)(noting that there are potential gains to monitoring individuals when the agent is risk-averse). Drawing on earlier work of Coase (Coase, supra note 262), Oliver Williamson finds that the model is transaction-cost minimizing. Williamson, supra note 144, at 572 (noting that the distinctive orientation of Coase's theory is transaction costs). Theoretical models suggest that there are identifiable rationales for choosing a general partnership, limited partnership or a corporate form. Fama and Jensen provide a theoretical explanation for the existence of various organizational forms such as corporations, professional partnerships, financial mutuals, and non-profit organizations. Fama & Jensen, Agency Problems and Residual Claims, 26 J.L. & Econ. 327 (1983). They conjecture that the larger and more complex the decisionmaking hierarchy in a firm, the greater the need to separate the decision management from the risk-bearing claimants. The more complex the organization, the larger is the number of decisionmakers employed and the more specialized is each of the decisionmaking roles. This complexity rules out the possibility that all decisionmakers may become involved in all relevant decisions. Fama and Jensen explain that this may result in a separation of risk-bearing from decisionmaking, which creates an agency problem. They hypothesize that the separation of the manager's "decision management rights" and executive "decision control rights," as in a corporation, will resolve some of these agency problems by limiting the ability of the individual decisionmakers to force too much risk on the risk-bearing claimants. For smaller and less complex organizations, such as a small partnership, concentrated decisionmaking is efficient and agency costs are low. Thus, there is no need for separation between decisionmakers and risk-bearing claimants. In a further study, Fama and Jensen demonstrate that closed firms trade the loss of optimal portfolio diversification for gains in controlling agency costs, which leads to an undervaluation of their residual equity claims relative to the value of the residual claims of an open firm traded in perfect capital markets. See Fama & Jensen, Organizational Forms and Investment Decisions, 14 J. Fin. Econ. 101, 102, 106-09, 117-19 (1985) [hereinafter Fama & Jensen, Organization]. For a view of other corporate stakeholders, see Cornell & Shapiro, Corporate Stakeholder and Corporate Finance, Fin. Mgmt., Spring 1987, at 5 (claiming that the inclusion of stakeholders other than investors and managers play an important role in financial policy and leads to new interpretations of classical problems in finance). See also Hansmann, Ownership of the Firm, 4 J.L. Econ & Org. 267 (1988)(surveying the reasons for the "dominance of investor-owned firms in market economies").

279. See supra notes 141-50 and accompanying text. One commentator argues that the limited partnership form is chosen for agency savings and an ability to effect management entrenchment, but sometimes an agency cost results when the tax treatment of a corporation causes the form of the transaction to be distorted in favor of a limited partnership. See Ribstein, An Applied Theory of Limited Partnership, 37 Emory L.J. 835 (1988). I do not agree with his assertions (1) that there is no principled reason for distinguishing between publicly traded and nonpublicly traded firms, see id. at 874-76, and (2) that the "resemblance" distinctions he makes ought to be tax significant under a "resemblance" test.

280. See infra notes 409-18 and accompanying text.
4. The *De Facto* Public Trading Test for the Double Tax: Revenue Ruling 88-76

On September 6, 1988, the Service dropped two bombshells. First, it announced that it would no longer apply the net-worth requirements of Revenue Procedure 72-13 to entities seeking partnership classification.\textsuperscript{281} Second, the Service issued Revenue Ruling 88-76\textsuperscript{282} in which it classified a firm formed under the Wyoming Limited Liability Company Act\textsuperscript{283} as a partnership, notwithstanding the fact that all of the participants had limited liability and there was centralized management. The Service substantially altered the normal focus of the resemblance test by basing its ruling on the partnership's lack of free transferability of management rights and absence of continuity of life.\textsuperscript{284} The Service's position was extraordinary, given its previous reading of its own regulations and given prior predictions of a legislative move to include large limited partnerships within the double-tax regime.\textsuperscript{285}

Limited liability within a firm has two functions.\textsuperscript{286} First, it

\textsuperscript{281} Net worth requirements of Rev. Proc. 72-13 are no longer applicable to all entities seeking partnership classification but went on to state that it would prepare a new consolidated revenue procedure that would review net worth requirements. See infra note 297 and accompanying text. The announcement was somewhat cryptic as to whether it would continue to apply to sole corporate general partners. Announcement 88-118, 1988-38 I.R.B. 26. In a subsequent private letter ruling, Private Letter Rul. 8916003 (Dec. 19, 1988), the Service applied only the requirement in the regulations for substantial net worth to a limited partnership with a sole corporate general partner. The announcement closes the study initiated in 1982 of rules for classifying entities which presumably was focusing in large part on the significance of limited liability for federal tax purposes. *Id.* See generally I.R.S. News Release IR-82-145 (Dec. 1982), reprinted in 17 TAX NOTES 998 (1982)(further explanation of the then forthcoming study).

\textsuperscript{282} Rev. Rul. 88-76, 1988-38 I.R.B. 14; see supra note 33 and accompanying text.


\textsuperscript{284} According to Treas. Reg. § 301.7701-2(b)(1), continuity of life is not present if death, bankruptcy, retirement, resignation, or expulsion of any member causes dissolution. Rev. Rul. 88-76, supra note 33. In the event of death or withdrawal of any member, § 301.7701-2(b)(2) provides for continuity of life if all remaining members consent to continue the business by agreement in the articles of incorporation, unless, under state law, death or withdrawal causes dissolution. Rev. Rul. 88-76, supra note 33. Here, the remaining members did not consent to continue the business, so the corporate characteristic of continuity of life did not exist. *Id.*

\textsuperscript{285} M. GRAETZ, FEDERAL INCOME TAXATION 594 (2d ed. 1988) (the dominant motive after the 1986 Tax Act to form large limited partnerships will be avoidance of the double corporate tax.)

\textsuperscript{286} Limited liability as a *Kintner* resemblance factor looks to whether at least one
allows the managers of the firm to engage in decisions or acts that have the potential of bankrupting the firm. Second, it ensures that owners are not liable for the debts of the firm. While limited liability has therefore been argued to lead to excessive risk taking by the firm, the reason why limited liability was included among the resemblance test criteria was essentially unclear. Was the reason related to the reward that equity participants received from the firm engaging in risky behavior, or was the value of the subsidy they received to invest without risk justifiable under the benefits theory? If the latter, the issue was overpayment since under economic theory the risk of limited liability is shifted to the creditors who will demand higher compensation; in the case of involuntary creditors, the firm will have an incentive to purchase insurance at a price that will induce managers and employees to invest human capital in the firm, especially smaller firms investing in risky projects where there is no separation of functions between capital suppliers and decision makers. Limited liability acts as an antecedent to a more important function in the firm — the reduction in costs of trading equity securities under uncertainty of valuation and the reduction in cost of separating management.

member of the organization would have personal liability for the organization’s activities. Treas. Reg. § 301.7701-2(d)(1)(as amended in 1984). However, an impecunious general partner does not preclude limited liability so long as he is not the “dummy” of the limited partners. Presence of a “dummy” may cause general liability for the limiteds under state law. W. MCKEE, W. NELSON & R. WHITMIRE, supra note 245, at ¶ 3.06 [4][c]. The court in Zuckman v. United States, 524 F.2d 729, 741 (Ct. Cl. 1975), paraphrases the regulations, approvingly, as follows:

[P]ersonal liability will exist with respect to a general partners where (1) such general partner is a corporation having substantial assets which can be reached by creditors; (2) the general partner contributes only services, but still has substantial assets; (3) the general partner has substantial assets, although insufficient to satisfy the obligations of an organization engaged in large-scale financial transactions; and (4) the general partner has no substantial assets and is not merely a “dummy” acting as the agent of the limited partners.

Id. The 1977 proposed regulations looked to see if a functional question with respect to liability was actually present. “If the principal activity . . . is acquisition . . . and operation of property,” if ordinary risks are insured or indemnified against, and activity is principally financed by debt to which none are personally liable — then, there is limited liability as to loss of assets not invested. Prop. Reg. § 301.7701-2(f)(2), 42 Fed. Reg. 1038, 1042 (1977)(withdrawn 42 Fed. Reg. 1489 (1977)). In 1980 the centralized management prong was limited. Prop. Reg. § 301.7701-2(c)(4), 45 Fed. Reg. 70,909 (1980). “A substantially restricted right of the limited partners to remove a general partner . . . will not itself cause the partnership to possess centralized management.” Treas. Reg. § 301.7701-2(c)(4)(as adopted in 1984).

287. See Bratton, Restructuring, supra note 175, at 92, 109-10.
288. See Easterbrook & Fischel, supra note 251.
from capital.269 When limited liability is viewed in such a manner, transferability becomes the key issue because limited liability is only its antecedent for which a price is paid by the equity participants in the firm in the form of insurance and higher payments to creditors.280

In a limited partnership, a limited partner is not liable for the debts of the firm; limited partners achieve their limited liability because they are considered lenders to the partnership.291 Tax

289. This view begins with a simple statement of the role of limited liability, and is extended by further analysis, see Easterbrook & Fischel, supra note 251, at 94 (adjunct to separation of management from capital); Halpern, Trebilcock & Turnbull, An Economic Analysis of Limited Liability in Corporation Law, 30 U. TORONTO L.J. 117 (1980)(eliminates valuation uncertainty).

290. See infra note 418.

291. The first limited partnership acts preceded corporate laws by decades. See H. REUSCHLEIN & W. GREGORY, THE LAW OF AGENCY AND PARTNERSHIP § 264, at 434 n.54 (1979)("The first U.S. legislation providing for a limited partnership was adopted in New York in 1822."). Limited liability in limited partnerships were available, however, only for truly passive investors who were not in control of the business. See Weidner, The Existence of State and Tax Partnerships: A Primer, 11 FLA. ST. U. L. REV. 1, 26-40 (1983). "Just as for state law purposes the partnership is seen as a separate entity that owns its own assets and conducts its own business, it is also treated as a separate entity for many federal income tax purposes." Id. at 26-27. While there is no prohibition on control, the loss of limited liability through exercising control is a strong deterrent. J. CRANE & A. BRUMBERG, PARTNERSHIP § 26, at 147 (1968). Drafters of the Uniform Limited Partnership Act considered it to be a codification of a majority judicial rule that "[t]he lender who takes a share of the profits . . . does not by the reason of that fact run the risk of being held as a partner." Lewis, The Uniform Limited Partnership Act, 65 U. PA. L. REV. 715, 719 (1917)(footnote omitted). General partners have a principal-agent relationship with each other as to activities within the enterprise, but someone who supplies additional capital "without forming a corporation or other statutory business association," Id., can keep the limited liability of the lender-debtor relationship inherent in the limited partnership and avoid the principal-agent relationship of a normal partner. See, e.g., Eastman v. Clark, 53 N.H. 276 (1872)(cited with approval in Lewis, supra at 719 n.5). This principle applies so long as she does not "take . . . part in the control of the business." ULPA, supra note 140, at § 7, amended by RULPA, supra note 140, at § 303(b). Apparently some courts have held that a limited partner may act like a shareholder on important issues or an employee as long as she does not function like a corporate director. Kempkin, The Problem of Control in Limited Partnership Law: An Analysis and Recommendation, 22 AM. BUS. L.J. 443, 453-55 (1983)(citing Silioua v. Rowlett, 129 Colo. 552, 272 P.2d 287 (1954); Grainger v. Antoyan, 48 Cal. 2d 805, 313 P.2d 848 (1957); Plasteel Products Corp. v. Helman, 271 F.2d 354 (1st Cir. 1959)). But see Klein, Legal Entities, supra note 197, at 130 ("[T]he relationship of limited partners to the business in which they invest seems even more remote than that of shareholders, since the latter at least retain the legal power of control over the management of the business.").

A similar trend has occurred with respect to creditor control. For example, debt holders can only withhold funds from creditors where they reasonably believe that such action is necessary to protect the creditor's interest. See K.M.C. Co. v. Irving Trust, 757 F.2d 752, 763 (6th Cir. 1985)(decision against the bank); see also Hass, Insights Into Lender Liability: An Argument for Treating Controlling Creditors as Controlling Shareholders,
Commentators frequently view the dominance of limited partners in the capital structure of a firm as a fatal combination of quintessential corporate attributes, notwithstanding the fact that limited partners receive their limited liability for nontax purposes precisely because they are viewed as creditors rather than investors. Furthermore, if they dominate the capital structure but cannot manage the firm, then the organization assumes another corporate characteristic — representative management.

Revenue Ruling 88-76 radically reduces the importance of the resemblance factors of limited liability and centralized management, which were long thought by the Service to carry more weight in the determination of corporate status than the two other characteristics of the resemblance test — continuity of life and free transferability of interests. In addition, the partnership agreement at issue in Revenue Ruling 88-76 limited the transfer of management rights but permitted the transfer of rights to profits. Thus, the ruling embraced a nonfunctional reading of free transferability that was specifically contrary to the view of free transferability taken under the 1977 draft regulations. Those proposed regulations found free transferability to exist if one could transfer the right to profits without consent, notwithstanding the fact that management rights could only be transferred with consent.

This de facto publicly traded standard for double taxation remains the rule in the Service's revised advance ruling position. Al-

135 U. Pa. L. Rev. 1321, 1346-49 (1987)(comparing controlling creditors to controlling shareholders where creditors have the power to use voting control created in debt instruments and the means to signal the market based on the creditor's superior access to information).

292. See Postlewaite, Dutton & Magette, supra note 271, at 458-62 (An entity ought to be treated by the tax law as an "association" if it exhibits any of three important traits: (1) the general partners are all corporations; (2) the general partners are without sufficient assets; or (3) a majority of the equity is limited partner equity.).

293. See Lewis, supra note 291, at 719.

294. Treas. Reg. § 301.7701-2(c)(4)(as amended in 1983). "[L]imited partnerships . . . generally do not have centralized management, but centralized management ordinarily does exist . . . if substantially all the interests . . . are owned by the limited partners." Id.


296. Under the 1977 proposed regulations, free transferability would exist if a member had the power freely to assign her "primary attributes," such as the right to receive capital and the right to share the profits of capital. Prop. Reg. § 301.7701-2(g), 42 Fed. Reg. 1038, 1042 (1977)(withdrawn 42 Fed. Reg. 1489)(1977)).
though not a statement of substantive law, the position permits independent consideration of each of the ruling factors, omits discussion of free transferability, and does not require a corporate general partner to satisfy any particular net worth standard although it does provide a safe harbor.\(^{297}\) The operative test for double taxation will be the publicly traded standard. There is no longer a regulatory uncertainty as to the scope of the application of the resemblance test regulations; they are close to a rubber stamp for "unincorporated" corporations at the state law level.

II. APPROPRIATE NEUTRAL RATIONALE FOR A DOUBLE TAX

A. Distinguishing the Rationale for a Double Tax from the Rationale for a Corporate Tax

Many rationales for a separate corporate tax within the general context of business taxation have been offered.\(^{298}\) A separate


298. See, e.g., R. Musgrave & P. Musgrave, supra note 7, at 387-90 (describing the absolutist view, ability-to-pay, benefit consideration, and regulatory objectives theories); J. Pechman, supra note 103, at 135-37. (It is fair to tax the corporation because it "owes its life, rights, and power to the government"); Warren Interest, supra note 1, at 1598-1603 (noting rationales of (1) adjunct to the personal income tax; (2) charge for benefits granted to corporations; (3) production of revenue; (4) need to control corporate power and monopoly profits; and (5) economic stabilization). For the distortions it produces, see C. Shoup, Public Finance 300-32 (1969). For other early views, see H. Groves, supra note 76, at 20-25 (discussing T.S. Adams, Gerhard Colm, Paul Studenski, and Edwin Seligman). See also Buehler, The Theory of Business Taxation, in Taxation and Business Concentration 231, 235-36 (1952)[hereinafter Buehler, Theory] (citing the discussions of Adam Smith, David Ricardo, John Stuart Mill and Henry Carter Adams). Business taxation was originally defined as a tax whose burden rested largely on the owners of the enterprise but this theory was extended to include the creditors, managers, employees and others associated in a group venture for obtaining income. See Studenski, Toward a Theory of Business Taxation, 48 J. Pol. Econ. 621, 623 (1940). This view of business taxation would extend to all taxes that affect taxpayers in their capacities as producers rather than consumers, and it would be imposed on income where it is earned rather than where it is spent. See Adams, Fundamental Problems of Federal Income Taxation, 35 Q.J. Econ. 541 (1921); Buehler, Theory, supra, at 248, 252-53. The flux in the law resulted from the difficult search for a coherent rationale. See, e.g., Buehler, The Taxation of Business, in Reappraisal of Business Taxation 33, 36 (1962)[hereinafter Buehler, Taxation] ("Each theory falls down on some score, whether one refers to the numerous variations of ability to pay, costs, benefits, neutrality, equality, uniformity, or other bases of taxation. We always arrive at the point where ability, benefits, economic effects, and so on become uncertain and perhaps immeasurable.").
corporate tax may function solely as a collection mechanism for the fisc or as a back-stop to an inadequate tax payable by the taxpayer in the future. Alternatively, it may be used to control or restrict the absolute size of firms (not necessarily monopolies), to tax monopoly profits, or to pay for perceived benefits of the corporate form of business in general or benefits received by corporations as business entities. It may be imposed as a painless source of pure revenue or a revenue and economic

Corporations Be Taxed? 3, 10-11 (1947). See also S. Surrey & W. Warren, Federal Income Taxation 1087-1100 (1953) (discussing the policy debate in the National Tax Association and listing sources); S. Surrey & W. Warren, Federal Income Taxation 1254 (1955) (additional sources). For an early view that only retained or undistributed profits in the hands of the corporation should be taxed, and that distributed profits in the form of dividends as well as interest should be deducted, see Lent, Bond Interest Deduction and the Federal Corporation Income Tax, 2 Nat'l Tax J. 131, 131-33, 140-41 (1949).

299. The use of the firm as a collection agent on current income eliminates the need to trace beneficial ownership of income, particularly when tax liabilities may be adjusted in an audit long after the event. See 1987 Senate MLP Hearing, supra note 30, at 71-72 (statement of J. Roger Mentz).


301. R. Musgrave & P. Musgrave, supra note 7, at 389.

302. Id.

303. A control rationale for the imposition of a firm level tax derives from the idea that extra profitability ought to be taxed as a means of controlling the "persistent monopoly elements in corporate profits." Siltor, The Corporate Income Tax: A Re-Evaluation, 5 Nat'l Tax J. 289, 302 (1952).

304. R. Musgrave & P. Musgrave, supra note 7, at 388-89 (limited liability).

305. See H. Groves, supra note 76, at 23 ("'Business,' says Adams, 'ought to be taxed because it costs money to maintain a market and those costs should in some way be distributed over all the beneficiaries of that market.' The fallacy lies in the fact that everyone is a beneficiary of a well-maintained market and the relative benefits are indeterminate.") (footnote omitted).

306. A. Atkinson & J. Stiglitz, supra note 5, at 131-32 ("Perhaps most important in political terms is the belief, held by many taxpayers, that it is borne by corporations rather than individuals — and is therefore relatively 'painless.'").

307. The cynical view of corporate taxation is that "[t]he tax is well established . . . and . . . produces large amounts of revenue." R. Goode, supra note 10, at 26 (citing Colm, Conflicting Theories of Corporate Income Taxation, 7 Law & Contemp. Probs. 281, 282 (1940)). This appraisal of the corporate tax is offered by Professors Kragen and McNulty:

The federal corporation income tax has been highly successful in the most conspicuous way that a tax can be successful — namely, in raising government revenue. Like the political party that has been in power through a period of continuous high-level prosperity, it is unlikely to be quickly turned out of office by the voters. Nevertheless, it is true that the incidence of the tax is open to serious question, and that insofar as the tax is not shifted it fails to fit neatly with the personal income tax into a logical system of income taxation.

2 A. Kragen & J. McNulty, Federal Income Taxation: Individuals, Corporations,
stabilization measure in times of inflation and recession.\textsuperscript{308} The existence of a corporate tax allows for tax incentives and disincentives to be directed at firms.\textsuperscript{309} For example, if corporate savings are desired, the tax system can be used to make retentions more desirable than distributions.\textsuperscript{310}

Under the corporate double tax system and the theory that the firm level tax is capitalized, the corporate level tax lowers the after tax return on profits to the firm.\textsuperscript{311} Taking into account the relevance of shareholder level taxes, equity investors invest in the firm based on the after tax firm profits available for distribution to them and the alternative after tax investments in the economy with similar risk.\textsuperscript{312} Under this view, the corporate tax is a flat tax that impacts upon the firm’s decision to incorporate or upon the shareholders if the firm issues additional equity.\textsuperscript{313} The decision to incorporate and the subsequent financing choices of the firm dictate the presumed initial incidence of the tax.\textsuperscript{314} For the firm, finance and economic theory holds that given certain assumptions, including perfect capital markets, the effect of the tax is completely avoided if existing firms finance all marginal investment with debt\textsuperscript{315} or if shareholders are able to finance their investment totally with debt.\textsuperscript{316}

The Modigliani-Miller model shows that the choice between debt and equity does not matter absent taxes.\textsuperscript{317} Both firm level\textsuperscript{318} and shareholder level\textsuperscript{319} limitations on debt financing negate these
effects, and the weighted cost of capital in even the most highly leveraged firms includes an equity component. If financing through a noncorporate vehicle in a nonpublic market is limited, the actual effect of the tax will either be on entrepreneurs who must exploit their ideas in the corporate form or on venture capital and leveraged buyout investors who find the public market essential for realizing gains from private ownership. The effect will also fall on existing shareholders if firm financing is not made with debt or retained earnings. While the assumptions of firm finance theory demonstrate the short-term incidence effect of the tax, none of the foregoing provides a rationale for the double taxation of distributed profits. The existence of a high-rate excise tax based on income as a franchise tax on doing business in one form rather than another is difficult to rationalize, especially if the overtaxed form is a socially and economically advantageous form for the activities that are being pursued.

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320. For an example of non-tax factors that led entrepreneurs to choose a public rather than a private market, see infra notes 840-42 and accompanying text. For firms that were not previously subject to the tax, there would be an obvious loss during transition. See McLure & Thirk, A Simplified Exposition of Harberger Model I: Tax Incidence, 28 Nat'L Tax J. 1, 12-13 (1975); McLure & Thirk, The Harberger Model, Reply, 28 Nat'L Tax J. 467 (1975)("[A] loss in production efficiency must be added to the loss in consumers' surplus to arrive at the overall welfare cost.").

321. See infra notes 1039-40; see also L. Lowenstein, supra note 164, at 182-83. "[T]he advantages of private ownership are largely based on, or at least coupled with, a heavily leveraged capital structure, extremely generous but short-term compensation arrangements, tax-sheltering devises of equally short duration and an investor group that in all likelihood will not be content for long with merely paper profits . . . ." Id. at 183. This means that the going private firm "is inherently unstable and will soon metamorphose into something quite different." Id. But see supra note 173 and accompanying text.

322. Flint v. Stone Tracy Co., 220 U.S. 107 (1911) upheld an early form of such an excise tax under a benefits theory.

323. It is anomalous to tax an entity on its savings and its addition to savings and again tax an individual owner of that entity based on the same additions to savings either
If a comprehensive personal income tax with full accrual of capital gains existed, there would be no need for a corporate level tax at all except for the taxation of nonresidents and for division of revenues between source and residence countries. If the tax system could start anew (or ignore or adequately lessen the windfall gains or losses), a single tax on real economic income would be desirable. The tax system might for instance pass en-

(1) when the firm reinvests its profits, (2) when the firm distributes its profits to the owner which allows the owner a consumption or a savings choice, or (3) when the owner realizes such income through a sale of the ownership interest. Under traditional tax policy, this fundamental discontinuity in the income tax system can only be accepted if there is a separate benefit, ability-to-pay, or equitable consideration that has been received by the owners of the firm that is separate and apart from the increase in wealth that is present in the firm itself. Income tax theory suggests that single level taxation of individuals, partnerships, limited partnerships, cooperatives, and financial intermediaries is actually correct. See, e.g., Twentieth Century Fund Report, supra note 14, at 150-52; W. Vickrey, supra note 39, at 456-57. This holds true because all one can expect any tax system to do is tax income from capital once (or in the Irving Fisher or John Stuart Mill sense, twice). See Klein, Legal Entities, supra note 197, at 51-52 (fairness considerations account for the varying treatment of different entities).

324. Without the corporate tax individuals could amass huge amounts of wealth in corporations that either would never be subject to tax or would be taxed preferentially. See Pechman, Another View of the Corporate Income Tax, in New Directions in Federal Tax Policy for the 1980's 177 (C. Walker & M. Bloomfield eds. 1983).

325. See Bird, supra note 13, at 245.

326. See Boadway, Bruce & Mintz, Corporate Taxation in Canada: Toward an Efficient System, in Tax Policy Options in the 1980s (W. Thirsk & J. Whalley eds. 1982); Musgrave, Interjurisdictional Coordination of Taxes on Capital Income, in Tax Coordination in the European Community 197, 200-01 (S. Cnossen ed. 1987) ("lower-level jurisdictions within a federal system usually confine their corporate income taxes to the source principle"). There may be good reasons why a national jurisdiction may want to base a system of income taxes on both the source and residence entitlement concepts. Some source countries, for example, France and West Germany, have extended by treaty the imputation credit to investors from abroad.

327. It has been argued that capitalization of taxes saved through integration would result in a windfall gain to present shareholders who are concentrated in the upper income groups. Others suggest that the adverse effects of resource allocation are not dependent upon whether capitalization has occurred and that even if capitalization does occur the burden of the tax will be shared by owners of noncorporate capital. In the studies of European integration, the question of windfall gains to existing equity holders was not debated, whereas the actual mechanics of the tax credit and the refunds to wealthy shareholders were. See Gourevitch, supra note 13, at 74-77, 107-09 (noting the loss of revenue after integration in France and West Germany, revenue neutrality in the United Kingdom, and the opposition to a tax credit system in the Netherlands on the basis of revenue loss due to refunds to nonresident shareholders).

328. Other problems would still arise. Another significant problem with integration involves treatment of corporate earnings that have not borne corporate tax (tax preference income). The Treasury Department dealt with this problem by allowing only a 50% dividends paid deduction thus leaving much of the tax preference income within the firm and not distributed to the shareholders. The proposal rejected a 100% deduction to prevent
tity income through to owners, as is done now for partnerships and S corporations. On the other hand, as I argue, equity and efficiency goals could also be met through a double tax.

B. Rationales for Double Tax Systems

A double tax system has five possible structural rationales: to tax income that has not been taxed at the appropriate rate, to tax income where the first tax has been shifted to other taxpayers, to tax excess returns from production, to allocate income between jurisdictions for firms that operate internationally, or to tax power over income. This section considers these rationales and examines whether they advance horizontal equity and efficiency. It concludes that only the fifth, the power rationale, is an appropriate neutral rationale from which to design a double tax system that will advance horizontal equity and efficiency.

1. The Inappropriate Corporate Tax Rate Rationale

One justification for a double tax system is that the first level tax may not be assessed at the appropriate marginal effective tax rate. The effective tax rate of corporations began to drop in the 1970s, just as the real tax burden on corporations (as well as excessive revenue loss and to keep the rules simpler since preference income would be presumed to be paid out last under rules governing the order of payout. 2 Treas. I Study, supra note 8, at 136. Those rules would come into play less frequently under a 50% deduction, but would affect many corporations under a 100% deduction. To the extent that corporate preferences have been limited, that concern is less valid. The dividend deduction probably confers a short run benefit on any corporation that can adjust its dividend payout without diminishing its access to capital markets. The question is whether there has been a sufficiently complete overhaul of the tax law to eliminate tax preferences so as to allow integration. Sheppard, supra note 8, at 644-45 (quoting Seymour Fiekowsky, Assistant Director of Business Taxation in Treasury’s Office of Tax Analysis: “you have to have a complete overhaul of the law to get rid of tax preferences to sell integration.”). The economic effects of the choice of mechanism (dividends paid deduction or shareholder credit) for the firm as a withholding agent for the shareholders differ. Under the “managers are reluctant to distribute dividends” view and the question of extending benefits to foreigners, a credit mechanism is preferred.

331. See infra notes 385-446 & 829-928 and accompanying text.
332. See Bird, The Interjurisdictional Allocation of Income, 3 Australian Tax Forum 333 (1986)(a comprehensive discussion describing how income should be allocated among firms that compete internationally); Warren, Integration, supra note 1, at 786-87.
333. J. Pechman, supra note 103, at 150 (Table 5-3). By 1982 the effective tax rate for the average large corporation had dropped to 16%. See Staff of Jt Comm. on Taxation, 98th Cong., 1st Sess., Study of 1982 Effective Tax Rates of Selected Large
other taxpayers) was increasing because of inflation.\textsuperscript{334} The 1986 Tax Act reversed this trend by raising taxes on the corporate sector and by broadening the corporate and business tax base,\textsuperscript{335} but the magnitude of the effective corporate tax rate is still debated.\textsuperscript{336} The ability of firms to avoid taxes is not only suggested by the unusually small difference between taxable and tax-exempt bond yields,\textsuperscript{337} but also by the creativity of large accounting firms.\textsuperscript{338} Recent evidence suggests that the changes in the 1986 Tax Act have been successful in increasing the effective corporate rate,\textsuperscript{339} although it is still not as high as the nominal rate. A view of the corporate tax as a toll charge for the deferral value of the corporate tax system is a subset of this analysis.\textsuperscript{340} If firms are able to use tax preferences to lower their marginal tax rate to a


\textsuperscript{335} The fuller inclusion of corporate source income in the tax base is largely offset by a rate reduction. Nevertheless, the reform increases taxes and should, under traditional incidence analysis, add to the progressivity of the tax system since stock tends to be owned by higher bracket taxpayers. See Musgrave, \textit{Short of Euphoria}, J. Econ. Persp., Summer 1987, at 59, 69.

\textsuperscript{336} \textit{See infra} notes 337-39 and accompanying text.


\textsuperscript{338} \textit{See Berton, Business as Usual: Under New Tax Law, Corporations Still Find Ways to Reduce Rates}, Wall St. J., June 2, 1988, at 1, col. 6 (noting examples of large U.S. corporations paying taxes at "microscopic rates" in a study that did not purport to be an effective tax rate study). For example, firms can achieve a lower effective tax rate by making deductible contributions to pension plans. Benefits are not taxed until they are received by the plan beneficiaries. If plan assets are assets of the firm, overfunded pension plans benefit the firm, creating value and lowering the effective tax rate. See S. Ross & R. Westerfield, supra note 105, at 719-24. For a description of various funding strategies, see Francis & Reiter, \textit{Determinants of Corporate Pension Funding Strategy}, 9 J. Acct. & Econ. 35, 36-7 (1987). The ability of firms to take advantage of tax preferences varies with their size and their ability to make investments. See Brooks, supra note 132, at 482-94 (noting higher cost of capital for small firms and government efforts to intervene in favor of small business). Exemptions for small producers from value added taxation are based on this theory. Imposing a double tax system on firms that take advantage of the existing tax preferences to lower their effective tax rates would reverse such tax expenditures.

\textsuperscript{339} R. McIntyre, \textit{The Corporate Tax Comeback: Corporate Income Taxes After Tax Reform} (1988)(22% overall effective tax rate in 1987 compared to 15% in pre-tax reform years); F. Marovelli, \textit{Effective Corporate Tax Rates — 1987} (1988)(survey of the top 1,000 United States corporations found that they paid taxes at an effective tax rate of 25.54 percent in 1986, with much of the one-year rise attributed to the 1986 Act). \textit{See also} M. Starcher, \textit{The Effect of Tax Reform on Effective Corporate Tax Rates} (1988)(interindustry changes).

\textsuperscript{340} \textit{See supra} note 300.
very low effective tax rate, then the second level tax is necessary to ensure that income will be taxed at the established effective tax rate. Thus, a double tax system should single out for special treatment those firms that are able to lower their effective tax rates through integration of production processes by bypassing otherwise taxable steps in the production of goods and services or through accounting and investment decisions. Untaxed perquisites consumed by managers, owners in owner controlled firms, and employees which are presently deductible under the income tax which has a high tolerance for such consumption items, create a separate ability to pay tax since taxes at the consumer level would lower the ability of the firm to offer tax free consumption. Taxing the firm would be a surrogate for taxing the ultimate beneficiary. Another example would be the use of pension benefits, including the existence of overfunded pension plans. The use of tax preferences, including the use of fringe benefits, may be correlated with size. The effective tax view of the double tax is essentially a tax arbitrage view. Firms that utilize tax arbitrage through the above means, as well as other arbitrage possibilities, should arguably be subject to a second level of tax on either distributed or undistributed earnings since the investment of the residual equity owners is at first subject to a very low level of

342. For example, the Bradley and Mikulski Amendment No. 2390 to S. 1511, 100th Cong., 2d Sess., 134 Cong. Rec. S8028 (daily ed. June 16, 1988), proposed a phase-out of the 80 percent deduction for meals and entertainment expenses by one percentage point for each $1,000 of adjusted gross income over $360,000 with a complete phase-out at $440,000 for individual entrepreneurs and partners but did not apply to C corporations. The rationale for not applying the provision to C corporations was not as clear as it could have been. See 134 Cong. Rec. S7933, 7962-63 (daily ed. June 16, 1988)(colloquy between Sen. Bentsen, Sen. Bradley and Sen. Dole).
343. If plan assets are assets of the firm, see S. Ross & R. Westerfield, supra note 105, at 705, 719-24 (in defined benefit plans where the value of the pension assets is not related to the promised benefits), the excess of pension assets over pension benefits is a corporate surplus that can be controlled by the shareholders and under this interpretation shareholders of a firm could have an incentive to overfund the pension plan because of tax arbitrage. For a view of the funding strategies, see Francis & Reiter, supra note 338.
345. See Koppelman, supra note 337; Shakow, Confronting the Problem of Tax Arbitrage, 43 Tax. L. Rev. 1 (1987). To the extent that tax arbitrage positions are available in all firms through long-term contracts, inventory, self-constructed assets, see Koppelman, supra note 337 (identifies these items), tax depreciation, economic depreciation, interest deduction and income reporting mismatches, and substituting labor for capital subject to tax arbitrage limitations, see Shakow, supra, at 47-48, a double tax system becomes a doing business tax under the effective tax rate view.
The use of effective tax rates to judge tax policy objectives has engendered much debate. This rationale for a double tax is stronger for firms that lower their effective tax rates through integration of production processes and utilization of unrealized appreciation, and it is weaker for firms that lower their effective rates through the use of tax preferences. In that sense, the firm level tax is a tax on supernormal profits that accrue because the firm takes advantage of favorable structural provisions that are applicable in computing the income tax. Treating a double tax as a back stop for the overutilization of tax preferences is more troublesome since these were adopted for all firms. While these difficulties proved insurmountable to integration efforts after the 1981 Tax Act, they are more an explanation of inaction than a reason for taking action in constructing a tax system. The effective tax rate rationale, like the shifting rationale, suggests that the second level tax should be collected on an accrual basis.

2. The Shifting or Incidence Rationale

A second rationale for a double tax system is that a double tax is appropriate when general or partial equilibrium analysis\(^\text{347}\) shows that the firm is able to shift the firm level tax away from the owners who would otherwise bear the incidence of the tax. A firm engaging in profit maximizing behavior will not shift a tax on net profits to labor or consumers, because firms will produce to the point where marginal cost equals marginal revenue. However, firms that fail to profit maximize for a variety of reasons may shift the tax to labor or consumers. The reasons that some firms fail to profit maximize include the exercise of economic power in neither perfectly competitive nor monopolistic markets and the conscious decision of managers to maximize size rather than profits.\(^\text{348}\) Under this controversial view of shifting, the burden of new

\(^{346}\) See Bittker, Effective Tax Rates: Fact or Fancy, 122 U. Pa. L. Rev. 780 (1974)(critiquing the usefulness of effective tax rates as an analytical tool). The effective corporate rate argument is somewhat undercut by the fact that all firms within a particular industry enjoy the same effective tax rate due to similar tax preferences. The effective tax rate argument should, therefore, be made in the context of those firms that are more integrated than others.

\(^{347}\) General equilibrium analysis is a study of the effect of a given policy on all economic factors. Partial equilibrium analysis is a study of the effect of a given policy on only a few factors.

\(^{348}\) These rationales are detailed in Klein, Incidence, supra note 2, and Break,
corporate taxes is passed on to consumers and labor in the form of higher prices or lower wages. This enables corporations to preserve a constant rate of return, and even if the incidence of the corporate tax were on shareholders because of financing decisions of the firm, the corporate level tax would not be capitalized into share prices in efficient capital markets. Thus, shareholders as investors and entrepreneurs would be sheltered from taxes unless a second level tax is applied. Concerns about shifting continue in the debate on integration of the firm level and shareholder level tax. The economic empirical and modeling evidence concerning such shifting and other views of the corporate tax have followed three paths in the analysis of a closed economy. For different reasons, both the classical and neoclassical views suggest that in the short run the tax is borne by shareholders; the Krzyzaniak-Musgrave view adopts one aspect of the shifting hypothesis and suggests that the tax is borne by consumers through higher prices of corporate products; the Harberger view rejects the shifting rationale but demonstrates that capital investment is allocated away from the taxed sector and that the incidence of the tax is borne by owners of capital in general.

The neoclassical view of the tax as solely a tax on corporate profits and based on a view of infinite debt finance must be re-

supra note 70, at 141-46. See also supra note 70.


350. The issue is whether firm managers will behave differently under the various forms of integration relief assuming that the tax will be shifted under the two-tiered system and whether a tax collected at the firm level would be viewed simply as a withholding tax for the shareholders rather than a classical tax on the firm. See C. McLURE, supra note 9, at 41-42 & n.60; see also Mieszkowski, Integration of the Corporate and Personal Income Taxes: The Bogus Issue of Shifting, 19 FINANZARCHIV 285, 290-91 (1972)(arguing that managers will see that integration has increased the after tax yield on corporate income and that connecting the firm with the shareholders' direct after tax interests increases the likelihood of profit maximization).

jected as the complete explanation if debt finance is limited. Models of shifting as the rationale for the tax would have to evaluate more closely the economic power and behavior of the firm within its market, and therefore shifting would not provide a generalized rationale for the imposition of the corporate tax under any form. The classical view of the corporate tax as a tax on equity financed corporate capital must be rejected as a complete explanation of the incidence of the tax if the Harberger model is correct. Harberger posits that capital migrates based on after tax returns and that to the extent that capital in noncorporate sectors is bid up, the incidence of the tax is borne by owners in general depending upon the ratio of labor and capital input in each sector and the structure of demand for corporate and noncorporate goods. These theories are shared by other models that view the corporate tax as an incentive for present rather than future consumption. In a recent criticism of the Harberger model, economists Jane Gravelle and Lawrence Kotlikoff posited a mutual production model that attempts to explain the existence of corporate produc-

352. Harberger, The Incidence of the Corporation Income Tax, in Taxation and Welfare 135 (A. Harberger ed. 1974). In a closed economy, the Harberger model of the incidence of the corporate income tax found that capital in general bears almost the full burden of the corporate tax and that the burden falls on all investors, not merely corporate investors. Harberger, supra note 5, at 215, 236. Harberger's analysis divides the economy into two business sectors — corporate and noncorporate. Harberger concludes that the corporate income tax creates a disequilibrium in the capital markets since the taxed corporate sector achieves a lower rate of return on capital. Id. at 215-16. As illustrated in an earlier work, Harberger concludes that the disequilibrium in capital markets ultimately leads to price differentials between the two sectors that in turn lead to overexpansion of the noncorporate sector at the expense of the corporate sector. See Tax Revision Compendium, supra note 5, at 231-33. For a recent critique of the Harberger model, see infra notes 353 & 369-72 and accompanying text. For earlier modelling of the deadweight loss in lower output due to capital flight to noncorporate producers, see Harberger, Efficiency Effects of Taxes on Income from Capital, in Effects of Corporate Income Taxation (M. Kryzaniak ed. 1966). The preference for consumption over savings demonstrates another distortion. Compare Shoven, The Incidence and Efficiency Effects of Taxes on Income from Capital, 84 J. Pol. Econ. 1261 (1976) and Fullerton, Shoven & Whalley, General Equilibrium Analysis of U.S. Taxation Policy, in Dep't of Treasury, Office of Tax Analysis, Compendium of Tax Research 23, 48-55 (1978)(large excess burden and loss of national income from the tax and preference for present consumption over savings) with Gordon, Taxation of Corporate Capital Income: Tax Revenues versus Tax Distortions, 50 Q.J. Econ 1, 5-6, 22-23 (1985)(setting forth a model where the variance of the return to the individual and the excess return over the market portfolio depends on the level of investment and not on tax rates and includes all sources of risk that the individual investment decisions embody). Gordon argues that the actual effect of the tax is less even though individuals ultimately bear all risk even though the government by taxing away a portion of the return is in effect charging a price for the portion of the risk it bears and that current taxation shifts the burden to future generations. Id.
ers with the same production functions as noncorporate producers producing the same goods. They find an even greater deadweight loss in overtaxing corporate production which in effect allows less efficient noncorporate entrepreneurial producers to compete with respect to the same good.\textsuperscript{355}

If the contours of the Harberger model are accepted as the correct explanation, then a determination of whether the incidence is on capital or labor depends upon whether the capital is located in a substantially closed economy. Traditional analysis has suggested that where the economy is closed (i.e., where neither national savings nor international capital movements are significantly responsive to changes in the domestic rate of return to capital), the corporate tax incidence is borne by capital.\textsuperscript{354} The globalization of the world economy, however, calls into question the traditional assumptions about the closed economy.\textsuperscript{355} In an

\begin{itemize}
  \item Globalization of the world capital markets is a reality. Harberger noted the impact of globalization of economic investment and production: These facts of modern life require a re-examination of the incidence question in the context of an open capital market. . . . [that] dramatically alters the conclusion reached for the case of a substantially closed economy. For if the net rate of return is given in the international market place, the burden of a tax on the income from capital in one country will not . . . end up being borne by capital (which can flee) but by other factors of production (. . . which cannot flee). [Therefore]. . . wages will be driven down.
  \item Harberger, \textit{supra} note 354, at 166. Although Harberger thought that the incentive to save would not be impaired, \textit{id.}, the effect of the tax burden shifting to labor remains unclear. Compare Lintner, \textit{Effects of a Shifted Corporate Income Tax on Real Investment}, 8 Nat'l Tax J. 229, 233-35 (1955) (shifting to labor causes increased liquidity and availability of capital and leads to increased investment), with Bhatia, \textit{Tax Effects, Relative Prices, and Economic Growth}, in \textit{Public Finance and Economic Growth} 349, 361-62 (D. Biehl, K. Roskamp & W. Stolper eds. 1983) (predicting a decline in savings and investment as a result of increased taxes on corporate income). \textit{But cf.} Harberger, \textit{supra} note 354, at 167 (suggesting that all the major trading nations of the world taken together could be characterized as a closed economy).
  \item For the practical implications of shifting, see Bernheim & Shoven, \textit{Taxation and the Cost of Capital: An International Comparison}, in \textit{The Consumption Tax: A Better Alternative} 61, 82-83 (C. Walker & M. Bloomfield eds. 1987) (assuming tax borne half by
open economy, although general incentives to save are not im-
paired, prices for tradable corporate products will not rise to ab-
sorb the corporate tax, wages will be driven down, and labor must
bear the full burden of the tax. Incidence studies that take into
account the globalization of the domestic economy suggest that
the United States should follow the lead of other countries that
have adopted an integrated corporate and individual tax regime.

In an open capital market, the burden of an increase in the
corporate tax would be borne by labor. A complete evaluation of
the corporate income tax will require an understanding of the rel-
ative effect of corporate tax rates on domestic as well as foreign
firms, and an understanding of the impact of dividend relief provi-
sions under existing tax treaties. For example, the second level of
taxation may be less onerous for foreign investors than for domes-
tic shareholders, and a corporate tax may be more regressive do-
merically in an open economy.

In summary, there is a general acceptance that some of the
incidence of the tax is borne by shareholders, at least in the short
term, to the extent that corporate tax is not a profits tax as Stig-
litz has suggested, although evidence also suggests some short-
term shifting to consumers or labor. However, the long-term ef-
fects are more problematic and the ultimate results are incon-
clusive. At the very least, the consumer/labor shifting ration-
ale for both the firm level tax and any tax on the investment
capital and half by labor, and concluding that the 1986 Tax Act increased the cost of
capital by .2 percent). The cost of capital in the United States was the second highest in
the world after West Germany, attributable largely to domestic credit conditions and in
part taxation.

356. See Harberger, supra note 354, at 166; see also Pechman, Another View of the
Corporate Income Tax, in New Directions in Federal Tax Policy for the 1980s, at
177 (C. Walker & M. Bloomfield eds. 1983).
357. See supra note 64.
358. See supra note 351.
359. The most recent evidence suggests that short-run shifting of the tax is not
likely, although most specialists would probably agree that long-range shifting to owners of
capital does occur. See McLure, The Elusive Case of the Corporate Income Tax, the State
Case, 9 PUB. FIN. Q. 395, 397 (1981); see also Solow, Interindustry Flows and the Inci-
dence of the Corporate Income Tax, 30 J. PUB. ECON. 359, 367 (1986)(concluding that
omission of consideration of interindustry flows in general equilibrium tax incidence re-
search has been a serious flaw); Rapanos, Variable Returns to Scale and Tax Incidence, 46
J. ECON. (ZEITSCHRIFT FÜR NATIONALÖKONOMIE) 397 (1986)(concluding that a consider-
ation of variable returns to scale adds a new dimension to tax incidence research).
360. J. Pechman, supra note 103, at 141-46.
361. Concern over shifting suggests that firms of sufficient economic size operating in
neither perfectly competitive nor monopolistic markets, or corporations operating in oligo-
income distributed to shareholders suggests that (1) incidence analysis does not support the use of the double tax system as a backstop to a tax on firm profits that has been shifted to consumers or labor if there is evidence that the shareholder level tax can also be shifted and (2) if investment taxes on shareholders are not shifted, then the second level tax ought to be collected on an accrual basis rather than upon a distribution of income in order to prevent the deferral from undermining the impact of the tax to the extent that the individual rate is higher than the corporate rate. If the Harberger or mutual production model is followed, the tax ought to be applied regardless of whether the firm is incorporated.\textsuperscript{362} It is clear from the foregoing that the issue of corporate tax incidence cannot justify the continuance of the classical double tax system although it points, if not uniformly, to the adoption of a form of integration.\textsuperscript{363} Incidence analysis must be coupled with an analysis of the desirability of the effect and occurrence of tax incidence as well as whether the profit being double taxed is a true "economic profit or rent." Incidence analysis alone does not answer equity or efficiency concerns.

3. The Unique Attributes of Corporate Production Rationale

A double tax system might be justified if it could be demonstrated that corporate producers have unique attributes that generate unique, and therefore arguably excess, profits.\textsuperscript{364} Success

\textsuperscript{362} Unincorporated firms with market power, such as law firms with merger and acquisition specialists or accounting firms with valuable software, should be subject to the tax under this rationale.

\textsuperscript{363} See Bird, supra note 13, at 227, 242-43 ("[I]t hardly follows that the corporation taxes now existing in almost every country should be abolished in whole or part (or integrated with personal income taxes, which amounts to the same thing) for reasons of intellectual tidiness.").

\textsuperscript{364} Others have suggested that "[t]here is an offsetting technological advantage [to corporate economies of scale] and to running an enterprise as a partnership or proprietor-
with such an argument supports the tax on equitable taxation and efficiency grounds.\textsuperscript{365} The incidence of these excess profits, just as with a profits tax on economic rents, suggests that production decisions will not change and the incidence of the tax will be on the owners of corporate capital.\textsuperscript{366} Even the resemblance test attempts to identify enterprises that, because of their form, have the capacity to produce greater returns. However, the resemblance test looks only to legal personality. A correct theory would look to corporate management efficiencies, economic size, and access to capital markets, all of which enable the corporation to produce excess profits.\textsuperscript{367} The argument is that the demand for this form of production is inelastic, and therefore the imposition of a tax will not reduce new equity investment.\textsuperscript{368}

The question is whether economic insights have advanced the concept of corporate production to the point that a meaningful test, apart from a doing business tax on large firms, can be devised. Economic inquiry has recently focused on the nature of corporate production. Gravelle and Kotlikoff use this inquiry to determine which capital is subject to the corporate tax, and to

...
rework assumptions about the lack of competition between corporate and noncorporate firms that underlie the Harberger model.\textsuperscript{369} They note that the government appears to be looking at both the size of the enterprise and diversity of ownership. They conclude that for many producers there are some economies in operating on a large scale, and that the production unit could be owned by a number of individual specialists rather than a very large number of owners.\textsuperscript{370} Furthermore, they conclude that small entrepreneurs

\textsuperscript{369} See Gravelle \& Kotlikoff, \textit{supra} note 353. The Gravelle and Kotlikoff observations on the nature of corporate production are significant. First, they review the problems with even large service firms in which the owners participate, where there may be a less efficient form of production due to the problems of information and control. Second, they determine that liquidity and diversification have much to do with the form of corporate production. Third, they isolate the multiple parts of this view of production: the size of the enterprise, the diversity of ownership, and the management relationships.

Responding to criticisms that corporate and noncorporate firms may produce substitute rather than identical goods, Gravelle and Kotlikoff have calculated the excess burden of the corporate tax under a Differentiated Product Model (DPM) for firms that produce goods with substitute demand under identical production functions. See J. Gravelle \& L. Kotlikoff, \textit{Does the Harberger Model Greatly Understate the Excess Burden of the Corporate Tax? — Another Model Says Yes} 2, 6, 7, 12 \& 17-20 (National Bureau of Economic Research Working Paper No. 2742, 1988)(using 1957 rates, Shoven's data allocating 60\% of capital to the noncorporate and 20\% to the corporate sectors, and the substitution of demand hypotheses, they find excess burden of 102\% of the tax collected under the DPM rather than the 123\% excess burden under the Mutual Production Model (MPM)). Unlike the MPM, the DPM does not treat the supply of entrepreneurs as inelastic, does not seek to explain the size distribution of noncorporate firms, and treats the demands for substitution of corporate and noncorporate goods as highly elastic, which are all reasons that Gravelle and Kotlikoff prefer the MPM model despite the fact that the DPM predicts similar excess burdens. \textit{Id.} at 22 n.8.

\textsuperscript{370} See Gravelle \& Kotlikoff, \textit{supra} note 353, at 756 (“enterprises that both are very large and have a large number of owners appear to be fair game”). Other economists accept the Morrissey view of the resemblance test as indicative of forms of production within firms that cannot take place outside of corporations. See Petruzzi, \textit{Mergers and the Double Taxation of Corporate Income}, 7 J. ACCT. \& PUB. POL'Y 97 (1988)(corporate production involves identifiable Morrissey factors and significant equity financing).

For a discussion of the effects of integration on firm productivity, see Grossman \& Hart, \textit{The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration}, 94 J. POL. ECON. 691, 692 (1986)(“a firm that purchases its supplier, thereby removing residual rights of control from the manager of the supplying company, can distort the manager's incentive sufficiently to make common ownership harmful”). Gravelle and Kotlikoff answer this with the following:

The answer here appears to involve a number of factors: diversification of risk, the desire to limit liability, information costs of becoming fully informed about all the activities of a large enterprise, and liquidity. These reasons for multiple owners are interrelated. For example, it may be very difficult for any one owner to become fully informed about a large firm's activities, but the lack of full information may make investing in a large firm riskier. The limits on full information provide investors with a further interest in reducing their exposure in a particular firm, including limiting their liability.
can compete successfully because the enhanced value of information and control in a small firm offsets any disadvantages of its small size.\textsuperscript{371} In other words, even in large service firms production may be less efficient due to the problems of information and control.\textsuperscript{372} The claimed efficiency gains from undergoing a management or leveraged buyout support the review of the resulting organizational relationship in search of a basis upon which to support the imposition of the tax on forms of production that create excess profits.\textsuperscript{373}

In contrast, the Harberger model presumes that corporate producers and noncorporate producers do not compete. This is an unwarranted assumption. Economic statistics show that there is corporate production in noncorporate sectors and noncorporate production in corporate sectors.\textsuperscript{374} Two economists, Ebrill and

Gravelle & Kotlikoff, supra note 353, at 757.


372. \textit{See} Gravelle & Kotlikoff, supra note 353, at 757 ("Entrepreneurs, with a major stake in their own firm, will have an incentive to stay better informed about their firm's behavior and to control more fully their firm's behavior than will shareholders in large companies.").

373. Michael Jensen has posited the efficiency gains resulting from aligning the firm and its managers in a business form that does not depend on the capital markets, is highly leveraged with placement of these noninvestment grade securities in the diversified portfolios of institutional investors, provides equity stakes for the managers, and is monitored by the ultimate residual institutional owners through delegation of authority to partners of leveraged buyout funds who are themselves motivated by high equity rewards for success. \textit{See} Jensen, \textit{Eclipse}, supra note 173. Others contradict the view that the public market's risk diversification will be replaced by structures which have questionable efficiency with regard to the risk of bankruptcy, and also suggest that management may possibly appropriate shareholder returns in going private transactions. \textit{See Letters to the Editor, Harv. Bus. Rev.}, Nov.-Dec. 1989, at 182; \textit{see also} Kitching, \textit{Early Returns on LBOs}, Harv. Bus. Rev., Nov.-Dec. 1989, at 74.

374. \textit{See} Ebrill & Hartman, \textit{The Corporate Income Tax, Entrepreneurship, and the Noncorporate Sector}, 11 Pub. Fin. Q. 419, 423 (1983)(even if it is empirically possible to maintain a distinction between the sectors, the mere possibility of crossover is sufficient to negate the Harberger modeling hypothesis); \textit{see also} Gravelle, \textit{Effects of the 1981 Depreciation Revisions on the Taxation of Income from Capital}, 35 Nat'l Tax J. 1 (1982)(asso-
Hartman, suggested that the effect of a corporate tax will be to delay incorporation until the benefits of incorporation, particularly access to capital, outweigh the costs. 376 Viewing the firm's decision as a cost of capital choice, they concluded that the corporate tax is merely a tax on size. Other studies argue that large incorporated firms arise because ex ante contracting costs are too great, 376 and that firms strive to achieve overall efficiency by gravitating to the form of organization that best serves their financial and governance needs. 377

Although these theories provide interesting insights into the nature of a firm, it is clear that they do not consistently isolate the uniqueness of corporate production or a view of organizational efficiency as a rationale for a double tax system satisfying equitable taxation or efficiency criteria. At most, these theories would support a doing business tax, or a tax based solely on economic size.

375. Ebrill & Hartman, supra note 374, at 426-27 ("The market for corporate capital is, therefore, viewed here as an institution that processes and disseminates information in an efficient manner."). Ebrill and Hartman conclude that these considerations lead them to modify their analysis in two ways: "First, the technology employed by a firm depends on the firm's inventiveness and may well be related to size . . . Second, the gross cost of raising capital will in general differ between sectors due to differences in the cost of transmitting information to — and thereby influencing — the investors." Id. at 428.

This view of corporate production would encompass a publicly traded limited partnership. It would not encompass a publicly offered limited partnership absent sufficient forms of liquidity. The Ebrill and Hartman analysis placed no particular value on pure liquidity, and viewed the effect of the tax on the mix of goods produced in the economy as uncertain. However, they presumed that noncorporate firms could exist in competition with corporate firms in the same good because of technological innovation. This presumption is supported by empirical data on the coexistence of competitors of very different size. Id. at 428 (citing Stigler).


4. The Allocation of Income Rationale

A fourth rationale for a double tax system is that it will facilitate the allocation and taxation of income to source countries given a less than harmonized international tax system.\(^\text{378}\) The unintegrated corporate tax avoids issues of discrimination between the allowance of distribution or credit relief for distributions to domestic investors and the disallowance of such relief for foreign direct or portfolio investors.\(^\text{378}\) Furthermore, it has been argued that capital importing countries can extend dividend relief to foreign corporations or tax credits to foreign shareholders of domestic companies without an imputation system.\(^\text{380}\) The existence of

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\(^{378}\) The considerations in determining whether to model the corporate tax system as a classical integrated or imputation system are discussed in Musgrave, \textit{supra} note 326. For a discussion of the general lack of coordination in international taxation, see Palmer, \textit{Toward Unilateral Coherence in Determining Jurisdiction to Tax Income}, 30 \textit{Harv. Int'l L.J.} 1 (1989).

\(^{379}\) For that reason, major studies of corporate taxation in the past have recommended the adoption of the unintegrated corporate tax. \textit{See} M. Norr, \textit{supra} note 12, at 158-60 (noting that Van den Tempel, Sato and Bird, and Cardyn all prefer the classical system on neutrality and simplicity grounds). For capital importing countries, the existence of the classical tax results in significant revenue from foreign investors. \textit{See} White Paper, \textit{supra} note 12, at 195. Thus, the preferred choice for integration of the corporate and shareholder level taxes is: (1) an imputation system (as distinguished from full integration systems); and (2) denial of credits on dividends paid to non-residents and imposition of a withholding tax on foreign direct investors. \textit{Id.} at 196-99. These considerations in adopting imputation systems apply also in capital exporting countries. \textit{See}, \textit{e.g.}, Lovisolo, \textit{Italy: The New Imputation System}, \textit{Intertax}, 1979/1, at 10; Reitsma, \textit{Italy: Fundamental Changes in the Imputation System, European Taxation}, Feb. 1985, at 40, 46 (discussions of extending dividend relief to nonresident shareholders). For a discussion of the interrelationship between domestic relief from double taxation and international tax credit relief, see Chown, \textit{Imputation Systems: An Overview}, 4 \textit{J. Strategy in Int'l Tax'n} 1 (1988). On the other hand, the Treasury Study proposed extending dividend relief to distributions to foreign shareholders and not imposing a compensating withholding tax to offset the corporate deduction for tax treaty reasons. \textit{See} 2 \textit{Treasury I Study, supra} note 8, at 139-40 & 142-43 (the denial of a credit refund in credit imputation systems technically does not violate tax treaties); \textit{see also} Ault, \textit{Germany: The New Corporation Tax System, Intertax}, 1976/8, at 262, 273-74 (double taxation to be resolved through treaty negotiation). For views from developing countries, see Lent, \textit{Corporation Income Tax Structure in Developing Countries, 24 Int'l Monetary Fund Staff Papers} 722 (1977).

\(^{380}\) Foreign direct investment may depend on exploitation of economic rents. Therefore deferral advantages for direct investors and creditability of foreign taxes in the home jurisdiction are sufficient incentives to continued investment. \textit{See} Bird, \textit{Imputation and the Foreign Tax Credit: Some Critical Notes from an International Perspective}, 4 \textit{Australian Tax Forum} 1, 7 n.15, 8-11 & 32-34 (1987)(focus should also be on the politics of taxation and not merely economic models). For a discussion of foreign direct investment in the context of international company taxation, see J. Alworth, \textit{supra} note 7, at 16-66, 153-82. For discussions of the taxation of direct investors, see S. Frommel, \textit{Taxation of Branches and Subsidiaries in Western Europe, Canada and the USA} (2d ed. 1978).
the foreign tax credit in the foreign capital supplier's home country shifts the loss of revenue to that treasury. The classical system may also have an impact on investment and savings by influencing returns to capital in the taxing jurisdiction relative to worldwide rates of return.\textsuperscript{381} The open economy model suggests that the classical corporate tax increases the rate of interest worldwide, whereas a profits tax may not.\textsuperscript{382} Successful interjurisdictional allocation also depends on the creditability of the tax in the home country.\textsuperscript{383}

In an open economy, the classical corporate tax raises efficiency concerns even if it is effective in the allocation of income in favor of the host country.\textsuperscript{384} Therefore, the allocation of income rationale has merit, but is not costless. It also does not address by

\textsuperscript{381} It is beyond the scope of this article to incorporate the extensive economic literature on the effects of capital taxation for large and small countries, capital importing and exporting countries, and the effect of that taxation in an open economy of international capital flows. For a discussion of the literature within the context of an open economy model, see Slemrod, \textit{Effect of Taxation with International Capital Mobility}, in \textit{UNEASY COMPROMISE: PROBLEMS OF A HYBRID INCOME-CONSUMPTION TAX} 115 (H. Aaron, H. Galper & J. Pechman eds. 1988). Imposition of a capital tax by a large capital importing country reduces the price of capital as the world rate of return declines. \textit{Id.} at 133. This suggests that taxing returns that are both interest and equity returns will cause a revenue increase to the extent that rates of return in the importing country remain higher than the worldwide level. \textit{Id.} at 124-28. The classical corporate tax is argued not to be this type of tax since its incidence is argued to fall on labor. \textit{See supra} note 357. If this argument is correct then the classical corporate tax is like a wage tax and its effect will be to decrease the availability of the labor supply and also to decrease capital stock. \textit{Id.} at 144 (discussing Roger Gordon model). The Slemrod model, like others, is not without its critics. \textit{Id.} at 148-55 (comments by Lawrence Summers)(\textit{focus should be on the relationship between taxes that tax savings and investment}). This is also not to suggest that there is no rationale for the scope of two-tier taxation of corporations and shareholders in the case of income derived by corporations from foreign sources or the claims of the United States as a capital importing nation to tax U.S. source corporate income distributed to foreign shareholders. \textit{See Roin, The Grand Illusion: A Neutral System for the Taxation of International Transactions, 75 Va. L. Rev. 919, 941-42, 959-60 (1989)}.

\textit{See Phelps, supra} note 94, at 686-91. Where capital is owned by foreigners, the profits tax produces "a 'sitting duck' for the national treasury." \textit{Id.} at 686. There is no increase even if the economy is open, provided that certain assumptions apply.

\textsuperscript{383} If the rate of return is higher on a specific foreign investment because of, for example, lower labor costs, that higher rate of return will be preserved to the investor if the effective foreign tax rate does not exceed the effective domestic tax rate and if the foreign tax is fully credited against the domestic tax. \textit{See Slemrod, supra} note 381, at 130-31; \textit{id.} at 150-51 (comments by Lawrence Summers)(A tax that is "creditable by another country's treasury . . . is desirable [and] will have no distortionary effect at all and is therefore an ideal tax from the point of view of the home country. It is, however, a bad tax from the world's point of view.").

\textsuperscript{384} \textit{See generally} Bird, \textit{supra} note 13 (noting the effectiveness of a firm-level tax in sourcing income but making no claim for the efficiency of the classical corporate tax).
itself the equity or efficiency of a double tax domestically.

5. The Power Rationale

a. The Power Rationale Defined

The income tax is a tax on power.385 "The power to dispose of income is the equivalent of ownership of it."386 To the extent that

385. See Helvering v. Horst, 311 U.S. 112 (1940) (donor of interest coupons taxed on payments made to donee since donor created the right to receive the income); Taft v. Bowers, 278 U.S. 470 (1929) (assignor of right to receive future income taxable on that income). Provisions that tax persons who have power over income have been incorporated into the tax law under assignment of income principles. See, e.g., I.R.C. § 704(e) (West 1988) (family partnerships); see also Commissioner v. Culbertson, 337 U.S. 733 (1949) (the Court recognized the partnership, rejecting the Commissioner's position that all the income should have been taxable to one high-rate taxpayer). In interpreting these provisions the question arises whether the courts, in prior definitions and challenges to power, appropriately drew the line according to the congressional conception of the power doctrine.

Early versions of the power rationale sought to tax improper accumulations of profits in closely held corporations directly to shareholders notwithstanding the legal personality of the firm. Even now power over income has tax consequences in a variety of situations. See, e.g., Rev. Rul. 88-37, 1988-21 I.R.B. 9 ("The owner of a working interest under an oil and gas lease is not entitled to a charitable deduction . . . for the contribution of an overriding royalty interest or a net profit interest."); Rev. Rul 81-282, 1981-2 C.B. 78 (no charitable contribution where owner of stock retains voting rights); Rev. Rul. 76-331, 1976-2 C.B. 52 (no contribution where owner retains mineral rights to donated tract of land).

An analogy can be made between the power rationale and the double taxation of gifts (i.e., gifts taxed both to the donor and the donee even though there is only one level of consumption). See H. SIMONS, supra note 101, at 56-58, 134-35; Dodge, Beyond Estate and Gift Tax Reform: Including Gifts and Bequests in Income, 91 HARV. L. REV. 1177, 1184-88 (1978) (finding that both the consumption tax and Haig-Simons model of an income tax require the inclusion of gifts in the income of the recipient and taxation of the donor on any appreciation with no deduction on the transfer). Several arguments support this double tax of gifts. First, the tax system does not require that all income items have offsetting deductions. See Utz, Taxpayer May Not Always Have Income When Fine or Penalty Paid By Another, 69 J. TAX'N 112 (1988) (discussing situations in which fines paid on behalf of another will not constitute income to the one benefitted by the payment). Second, treatment of a gift as nontaxable corpus has its roots in incorrect views of trust law as applied in several state cases. See J. DODGE, THE LOGIC OF TAX 98 (1989). The better view is that receipts of corpus can in fact be taxable events. See Kwall, The Income Tax Consequences of Sales of Present Interests and Future Interests: Distinguishing Time from Space, 49 OHIO ST. L.J. 1 (1988). Third, mechanical views of ability to pay do not adequately distinguish between separate taxpayers. Dodge, supra, at 1187-88 (ability to pay of donor and donee should be measured separately). Taxation of both the donor and the donee can be explained by viewing the taxed item as shared consumption. (Calvin Johnson illustrates this point with an outrageous necklace that has appreciated in value after it was given to him by a relative). Identification of the correct taxpayer for distributed income in a trust in the well-known series of cases on life estates and remainders proceeds from the same rationale. See M. CHIRELSTEIN, FEDERAL INCOME TAXATION 60-65 (5th ed. 1988) (positing alternatives).

the income tax taxes those persons with power over income,\textsuperscript{387} the choice of a taxable unit is simple — determine who has the ultimate power over any item of income or asset and tax any gains or losses to that person.\textsuperscript{388} A corollary to income taxation based on power is the fact that the right to income implies the right to consume or save — that income carries with it the dual ability to be a liquidator of an investment by consumption or to be a saver by deferring consumption until the future.\textsuperscript{389} When firm managers exercise decision-making power separate from that of the residual owners, control over income is present\textsuperscript{390} and the firm is arguably the appropriate taxpayer in the first instance.

The assertion that this tax should be accompanied by a second tax rests on a separate foundation — the ability of the owner, independent of the firm, to exercise potential consumption-savings choices directly, or where shares are held through a financial intermediary, the ability to exercise savings-consumption decisions with respect to it.\textsuperscript{391} Owners can liquidate their investments with-

\textsuperscript{387} The classic case is Horst, which stands for the proposition that present power over future income makes the income taxable to the donor. See also Iber v. United States, 409 F.2d 1273 (7th Cir. 1969)(owner of real estate can be taxed on the rental proceeds even though those payments were assigned to a trustee and paid to the trustee’s beneficiary); Harrison v. Schaffner, 312 U.S. 579, 580 (1940)(trust payments assigned by beneficiary to her children taxable to beneficiary)(citing, \textit{inter alia}, Lucas v. Earl, 281 U.S. 111 (1930)).

\textsuperscript{388} That view was the rationale for separate income tax returns for married persons based on the separate power that each had over separate assets and the joint power that both had over community assets in a community property state. See Poe v. Seaborn, 282 U.S. 101 (1930). It was also the rationale for viewing dual working spouses as two consumption units. See Felton v. Commissioner, 43 T.C.M. (CCH) 278 (1982), \textit{aff’d}, 723 F.2d 66 (7th Cir. 1983); Hantzis v. Commissioner, 38 T.C.M. (CCH) 1169 (1979), \textit{rev’d}, 638 F.2d 248 (1st Cir.), \textit{cert. denied}, 452 U.S. 962 (1981). But see Popkin, \textit{Deduction of Traveling Expenses by the Two-Worker Family — An Inquiry into the Role of the Courts in Interpreting the Federal Tax Law}, 55 Tex. L. Rev. 645 (1977)(family is the appropriate consumption unit).

\textsuperscript{389} See W. POPKIN, INTRODUCTION TO FEDERAL INCOME TAXATION § 6.04[A] (1987).

\textsuperscript{390} The Fisher separation theorem of financial economics supports the principle of segregating decision-making power from ownership. The theorem states that the potential consumption decision is separate from the firm’s decision to invest rather than distribute retained earnings. See Chang, \textit{Optimal Taxation of Business and Individual Incomes}, 35 J. PUB. ECON. 251, 262-63 (1988) (economic model supporting integration of business and personal taxes based on the firm as the initial taxpayer). Roberta Romano has applied this insight to firm-shareholder relations. See Romano, \textit{Metapolitics and Corporate Law Reform}, 36 Stan. L. Rev. 923, 952-56 (1984).

\textsuperscript{391} The separation theorem has been used to identify firms that exhibit a separation of ownership from control and it provides the tax rationale for the owner level tax. Fama and Jensen have elaborated on this theorem. Assuming that perfect substitute securities for
out regard to the desires of the majority.\textsuperscript{392} It is this ability to liquidate that supports an increased ability to pay at the owner level.\textsuperscript{393} A double tax system is justified where there is both the relinquishment of power over income and the retention of power over income. Power is relinquished by becoming an equity holder in a firm in which one is not a controlling shareholder or a manager. Power is retained by having liquidity; that is, by being able to realize a return through a sale of an interest and obtain the underlying value in firm assets.

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common stock exist that are correctly priced and tradable without transaction costs in a perfect capital market, "the consumption streams that an investor can realize in future periods are constrained only by current wealth, that is, the market value of current and future resources. When the stream of payoffs implied by the wealth or value maximizing investment decisions of an open corporation does not correspond to an investor's optimal consumption stream, the capital market can be used to exchange residual claims in the corporation for other claims with the same market value but with a stream of payoffs that better matches the investor's desired consumption stream." Fama & Jensen, \textit{Organization}, supra note 278, at 102.

\textsuperscript{392} A shareholder must be viewed as both an owner and a risk taker who has a residual claim to the firm. The firm managers are directed to supply her a fair return on her capital; hence the firm should be treated as a unit, separate from the shareholders, with power over income. N. WOLFSON, \textit{THE MODERN CORPORATION} 40-41 (1984)(citing Fama, \textit{Agency Problems and the Theory of the Firm}, 88 J. POL. ECON. 288 (1980)). Public firm shareholders also have the perspective, for better or for worse, of investors. See L. LOWENSTEIN, supra note 164, at 89-118. This has been validated by informal survey evidence. See Soderquist & Vecchio, \textit{Reconciling Shareholders' Rights and Corporate Responsibility: New Guidelines for Management}, 1978 DUKE L.J. 819, 835-40.

\textsuperscript{393} A Berle and Means residual equity claimant who has no management role owns an interest in invested capital that, although not subject to a risk of total loss to the same extent as a gambler, is entirely outside of her direct control. Such residual claimants take their indirect control rights (i.e., voting rights) lightly. Although proposals for corporate and shareholder integration may be advanced on efficiency grounds, the classic formulation of the income tax regards the residual claimant as a risk-taking gambler rather than as an owner.

The teaching embodied in \textit{Taft, Lucas}, and \textit{Horst} is that income is taxed only once and only to one person. However, the notion of a "person" can be split, as in the case of the theoretically correct taxation of a remainderman. See M. CHIRELSTEIN, supra note 385, at 60-65. Just as the single tax system is based on power over income, the double tax system is based on two rightful claims over income. Cf. North American Oil Consol. v. Burnet, 286 U.S. 417 (1932)(profits earned by property in receivership taxed to receiver because corporate owner of property had no claim of right to the profits until the receivership was dissolved). Nevertheless, tax liability can be triggered even in the absence of a claim of right over income. See James v. United States, 366 U.S. 213 (1961)(Embezzled funds are income taxable to the embezzler, although the funds were obtained illegally and the embezzler may be required to repay them.). When assessing the risk associated with an investment the ultimate question is how likely is the investor to get her money back with a return for the time it has been used. The essence of equity participation is residual risk with respect to the ability to recoup capital and to share in profits. See supra note 176 and accompanying text.
It may be argued that a firm must have more than mere control over income to justify taxing it separately. This argument raises the question of whether a firm has its own ability to pay. The answer to this question depends on the way in which ability to pay is defined. \(^{394}\) Under a theory of ability to pay requiring sacrifice \(^{395}\) and the elimination of consumption wants, firms do not have an ability to pay since firms do not consume (apart from perquisites consumed by their managers and employees). \(^{396}\) Thus, an income tax simply cannot be justified on an ability-to-pay rationale. \(^{397}\)

However, under equitable taxation principles, a firm possesses a separate taxpaying ability, even if it is not justified under the traditional ability-to-pay principle, simply because it is perceived as separate from its underlying owners. \(^{398}\) This observation

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394. See Colm, *The Ideal Tax System*, 1 Soc. Res. 319, 326-28 (1934)(a tax based on one's ability to pay is most clearly manifested in a progressive tax system).


396. Under an income tax, entities do not have the choice between present and future consumption. Cf. Kaplow & Warren, *supra* note 192, at 409 n.42 (1986)(income reflects the present value of future cash flows, and the income tax taxes presently, regardless of when consumption takes place). Haig's definition, while not emphasizing the separation of income into the components of consumption and change in wealth, offers the same perspective as Simons: "Income is the *money value of the net accretion to one's economic power between two points of time*." Haig, *supra* note 190, at 1, 7 (emphasis in original). Simons arrives at his concept of income via an "estimate of (a) the amount by which the value of a person's store of property rights would have increased, as between the beginning and the end of the period, if he had consumed (destroyed) nothing, or (b) the value of rights which he might have exercised in consumption without altering the value of his store of rights." H. Simons, *supra* note 101, at 49. This implies that income, while not equalling consumption, is viewed as being part of the ability to consume. The Haig definition emphasizes the power concept without asking whether power includes the power to consume rather than merely the power to save. The result is a defect in the ability to pay rationale for a tax: since firms do not consume, they are inappropriate separate taxpaying entities unless they are a proxy for accrual taxation of their owners on undistributed firm profits. \(^{397}\) See J. Ballentine, *Equity, Efficiency, and the U. S. Corporation Income Tax* 5 (1980)(even though corporations are legal persons, they do not have income since the profits of the firm are owned by the stockholders).

Ability to pay can also be viewed by gauging the social usefulness of corporate profits. R. Goode, *supra* note 10, at 37 ("a large part of corporate profits and dividends has a lower order of social usefulness than the income that would be taken by likely alternative taxes"). For a critique of this approach and the assumptions upon which it is based, see id. at 32-37.


399. See A. Kragen & J. McNulty, *supra* note 308, at 791-92. Other commentators agree:

[t]he earnings of General Motors are plainly not the earnings of its shareholders
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raises the much asked question, "whether it is appropriate to view the corporation as a separate, taxable entity, distinct from its shareholders or, alternatively, as simply a conduit through which all earnings and taxes eventually pass to the owners of the firm." The argument against the conduit view lies in the distinction between the corporation and the shareholder which "include[s] the fact that functions of management and ownership are typically separated, and firm executives may act more in their own interests than those of their shareholders." The agency costs

for many other purposes: unless General Motors declares a dividend the shareholders may not even be enriched by them, for gloomy future prospects may depress the value of General Motors' stock even as the corporation earns income; and the people who eventually get the money that General Motors earns this year will include many who are not now General Motors shareholders. For these and many other reasons, the underlying premise that a corporation is a mere fiction cannot be taken seriously today. Once we discard "sacrifice" notions of ability to pay and recognize that it is the earners of income, not those who "benefit" from income, who pay income tax, taxing corporations seems no more absurd and no more unjust than taxing anyone else.

Gunn, supra note 193, at 395 n.77 (conceding that the separatists' case is weakened for closely held corporations and that in contrast with corporations that have no shareholders such as universities, shareholders in public corporations are somewhere between closely held firms and firms without owners). But see 2 TREASURY I STUDY, supra note 8, at 128.

The progressive rate structure for individuals is premised on the ability-to-pay concept, which in turn reflects an assumption that additional amounts of income are increasingly available for discretionary, nonessential consumption. These concepts have no relevance to corporate income, all of which is either distributed or used to produce additional income.

Id.

400. Auerbach, "New View", supra note 71, at 21. See C. McLure, supra note 9, at 20 n.2 ("[t]he conduit view is most often used to justify full integration, but can be used to argue for dividend relief"). The difference goes beyond the fact that small firms are more-like partnerships. It has long been recognized that close corporations are the functional equivalents of partnerships and are inappropriate for entity level taxation. See Weiner, Legislative Recognition of the Close Corporation, 27 MICH. L. REV. 273, 283 (1929)(noting early Treasury proposal to class small corporations with partnerships for income tax purposes).

401. Auerbach, "New View," supra note 71, at 21 ("corporate taxes may be viewed as affecting the power of managers as well as the wealth of investors").

The argument begins with the recognition of the separate entity relationships of the corporation and its stockholders under state law for financial accounting purposes. See Bryan, Cancellation of Indebtedness by Issuing Stock in Exchange: Challenging the Congressional Solution to Debt-Equity Swaps, 63 TEX. L. REV. 89, 114-20 (1984)(the classical corporate tax base has its roots in financial accounting principles that were traditionally applied to corporations as an entity to distinguish accounts of the entity from the accounts of the owners and creditors). Whether a firm has a separate ability to pay tax under equitable tax policies is a different matter. See, e.g., R. Musgrave & P. Musgrave, supra note 7, at 232-46 (ability to pay is not dispositive). Also a different consideration is whether the income of a large corporation constitutionally can be taxed directly to its owners. See Gabinet & Coffey, supra note 149 (realization requirement is a constitutional
theory is also at the heart of this view of the firm.\footnote{limitation to pure integration or allocation of public corporation's income to its shareholders).} \textit{But see} Cohen, \textit{supra} note 98, at 147-49 n.19 (realization requirement no bar).

\footnote{402. Agency risk describes the situation where managers who are not substantial owners are able to expropriate the firm's assets through perquisites. Agency theory has been elegantly described by Williams:

Stripped to its barest elements, Jensen and Meckling's provocative argument runs roughly as follows. Insiders in firms financed with external debt optimally invest in excessively risky projects, whereas insiders in firms financed with external equity optimally consume excessive perquisites. Because outside investors anticipate these problems when purchasing corporate securities, insiders bear all agency costs in equilibrium. If insiders serve their personal interests, then they select a capital structure that compromises between the corporate agency class of external debt and equity.

Williams, \textit{Perquisites, Risk, and Capital Structure}, 42 J. FIN. 29 (1987). "In short, a theory of optimal corporate securities logically precedes a theory of optimal capital structure." \textit{Id.} at 43. For a detailed application of agency theory, see A. BARNEA, R. HAUGEN \& L. SENBET, \textit{AGENCY PROBLEMS AND FINANCIAL CONTRACTING} (1985)(distinguishing between the economic theory of agency which concerns itself with principal-agent problems in a single-period world and the financial theory of agency that brings financial markets into explicit consideration and tends to lengthen the horizon to multi-period issues and examining the implications of agency to show how it impacts the costs of security pricing, investment banking, accounting, disclosure, and risk incentives.).

John Coffee finds that managerial underdiversification encourages management goals other than shareholder wealth maximization. \textit{See} Coffee, \textit{supra} note 376, at 110-12. On the other hand, the inclination of managers to consume excessive perquisites or to be risk adverse may well be offset by management compensation packages that are tied to firm performance.

These agency costs have been documented as differences in behavior or performance of manager-controlled and owner-controlled firms. Whether firms perform differently when management has a substantial equity stake is a subject of academic and marketplace concern. \textit{See} Gibb-Clark, \textit{Managers' Share of Firm Can Be a Valuable Asset}, Toronto Globe and Mail, Aug. 13, 1988, at B1, col. 1 ("[a] manager has all of his 'human capital' tied up in the company he works for and his talents will be worth less on the outside market if he is not seen to be doing a good job").

Manager-controlled firms are more likely to maximize sales and profits, engage in activities to smooth income and engage in conglomerate-type mergers — all of which have the potential of shifting wealth from the owners to management. See Nyman \& Sylverston, \textit{The Ownership and Control of Industry}, 31 OXFORD ECON. PAPERS 74 (1978)("owner-controlled companies have a higher rate of profit than management-controlled companies"); Smith, \textit{The Effect of the Separation of Ownership From Control on Accounting Policy Decisions}, 51 ACCT. REV. 707 (1976)("policy decisions made by manager firms smoothed income significantly more often than the policy decisions made by owner firms"); Amihud \& Lev, \textit{Risk Reduction as a Managerial Motive for Conglomerate Mergers}, 12 BELL J. ECON. 605, 615 (1981)("manager-controlled firms were found to engage in more conglomerate acquisitions than owner-controlled firms.").

Studies use the percentage of ownership of the dominant shareholder as a criterion for classifying firms as manager-controlled or owner-controlled. The greater concentration of ownership implies more control or at least potential control and fewer agency problems. Manager-controlled firms might be expected to have higher returns as a reward for bearing agency risks, however, the data does not bear this out. \textit{See} Palmer, \textit{The Profit-Performance Effects of the Separation of Ownership from Control in Large U.S. Industrial Corpora-
The power view of the income tax is at the core of the separation argument. While the power rationale was being developed during the formative years of the income tax, tax theorists did not apply it to the corporate tax, perhaps due to an inherent distaste of double taxation and the dominance of the nontax ideal of a legal personality. Kragen and McNulty identify a fundamental issue in the integration debate:

The "uneasy case for separate taxation" seems to rest on a nagging feeling that corporations, especially large publicly-held corporations, are aggregates of capital, legal entities, and groups of managers (often quite separate from owners) that have a capacity to pay, or that should be regulated, or that derive some benefits in return for which income taxes should be paid. That feeling doesn't seem to go away, even among keen analysts who follow fully the reasoning of the integrationist arguments...

The ability to control the firm's decisions has been used to identify corporations entitled to passthrough taxation. The view of the public corporation as a separate entity apart from its residual equity owners has been expressed in various ways. According to Van den Tempel, historical developments demonstrate that the corporation should be viewed as a separate entity:

These developments mean an abandonment of the idea that the share company and its shareholders can be considered as being identical. Modern industrial development has meant that notably the public share company, of which the shares are quoted on the stock exchange, when seen from an economic and social point of view has an existence of its own, independent of that of its shareholders. This impersonal entity aims at its own maintenance and growth, with a view to the object to be achieved by it. Its interests are to be found in the sphere of production and are not the same as the interest of the shareholders. The idea that

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403. The power rationale is discussed infra notes 412-46 and accompanying text.
406. See, e.g., 1985 CORPORATE PROPOSALS, supra note 300, at 17 ("corporations directly controlled by shareholders are permitted" passthrough treatment).
the share company is a form of contractual cooperation, by means of which the joint shareholders ran an enterprise, is obsolete. It is the share company which has the status of entrepreneur and which competes both with its congeners and with the enterprises of natural persons. Its income cannot exclusively be seen, as would be convenient in the absence of a real corporation tax, as partly already and partly not yet distributed dividend.\textsuperscript{407}

Kragen and McNulty's difficulty with the conduit concept is based on their recognition of the power that firm managers have over firm income:

From the equity point of view, the most troublesome feature of the partnership approach to integration is the taxation of stockholders on income over the use of which they have little or no control. Most owners of large public corporations exert no influence over the disposition of retained profits, and inclusion of these in their taxable incomes implicitly assumes that, had they received them as dividends, they would immediately have reinvested them in the corporation. Needless to say, this is an assumption of rather monumental proportions. If the proper meaning of income is gain which, if not actually \textit{realized} by the taxpayer, is at least clearly \textit{realizable} by him, profits retained by public corporations should not be included in the taxable incomes of their stockholders.\textsuperscript{408}

The liquidity of shares in publicly traded companies enables their owners to realize gains. In addition, public trading "involves a degree of lack of identity of the investor with the entity that particularly justifies separate taxation of the entity, rather than partnership conduit treatment."\textsuperscript{409} Furthermore, stockholders do not necessarily take rational account of the actions taken by the firms in which they hold shares. Their connection may be characterized under a managerialist or investment based view of the relationship between the firm and equity capital suppliers or under an agency costs view of the firm with the contract with equity viewed as merely another bargain made under constraints.\textsuperscript{410} The essence of the relationship between the firm and its residual owners, the eq-

\textsuperscript{407} A. \textsc{van den Tempel}, \textit{supra} note 3, at 8 (commenting on the adoption of the classical regime in the U.K. and Belgium).
\textsuperscript{408} 2 A. \textsc{Kragen} \& J. \textsc{McNulty}, \textit{supra} note 307, at 897.
\textsuperscript{409} 1987 \textsc{House Report}, \textit{supra} note 46, at 1067.
\textsuperscript{410} For discussion of these views of the firm, see Bratton, \textit{Theory}, \textit{supra} note 262, at 1482-17. "The fact of restructuring does not matter and restructuring takeovers do not threaten the hierarchy; they only replace one set of managers with another." \textit{Id.} at 1525.
uity suppliers as financial investors, is a market transaction in which the equity holders can liquidate their investment and embark on a savings or consumption decision regardless of the decisions of the firm managers. The extreme financial view of the powerlessness of the equity holders is that the bondholders own the firm assets and the residual equity holders have an option or a series of options on firm assets exercised by satisfying the claims or series of claims of the bondholders through interest and principal payments.

It is this view that I term the power view and rationale for the corporate tax. The power theory of the corporate income tax can be summarized as being based on "a collective taxable capacity that parallels [a company's] economic autonomy." It is a theory in the equitable taxation tradition. While the Canadian Carter Commission could find "no grounds in principle for taxing corporations," there is a ground for taxing power over income. Therefore, the power theory supports the separate taxation of corporations. This separatist power view of corporate taxation depends, in turn, on both benefits and ability-to-pay analysis.

411. See infra notes 532-52 and accompanying text.
412. These relationships were first discussed in Black & Scholes, The Pricing of Options and Corporate Liabilities, 81 J. Pol. Econ. 637, 649-52 (1973), which forms the basis for option pricing theory and contingent claims analysis for the pricing of equity and debt. Equity is conceptualized as a European call option — an option that can be exercised only on one day upon its termination — on the value of the firm's assets, with the exercise price equal to the debt's promised principal and interest payments and with an expiration date equal to the maturity date of the debt. See Mason & Merton, supra note 222, at 16-17. Debt can be viewed as made up of the riskless rate of return plus a premium for writing a put option with a specific expiration point and exercise price on the firm's assets only since the shareholders have limited liability. See Courtadon & Merrick, The Option Pricing Model and Valuation of Corporate Securities, in The Revolution in Corporate Finance 197, 202-03 (J. Stern & D. Chew eds. 1986). For a presentation of option pricing in determining the value of debt and equity, see J. Cox & M. Rubenstein, Options Markets 359-426 (1985).
413. M. Norr, supra note 10, at 32. "These arguments may not apply with full force to a closely held (generally small) corporation" where ownership and management are in the same hands. Id. at 32 n.23. Norr argues that an extension of that independent taxable capacity argument is a different power argument: the power and position of certain business enterprises, generally conducted as corporations, justify a tax on firm profits as such "to provide adequate recognition under the tax system of the economic importance of corporations as prime income recipients in a high-level economy." Id. at 33 (footnote omitted). This points to a corporate production standard and is different from the power concept based on liquidity.
414. 4 Carter Commission Report, supra note 17, at 4.
415. The benefits theory of taxation was dominant in the tax literature until the time of John Stuart Mill. See H. Groves, Tax Philosophers 29 (1974). For an overview of the benefits theory, see R. Musgrave & P. Musgrave, supra note 7, at 388-89; see also R.
The benefits theory of taxation supports a publicly traded line for


The theory has several facets. "'[B]enefit' as used by Mill . . . can be given either an objective or a subjective meaning, the former being related to some factor in the individual's welfare, objectively observed (such as greater security), the latter to a preference by him for a given course of public action at a specified price (taxes)." H. Groves, *supra*, at 30. A progressive tax may be justified by the greater value that the rich place on a benefit as evidenced by their willingness to pay more for it. *Id.*

Another variant of the theory views government as "an external agent supplying services [to business] and entitled to payment therefrom for the costs of such services." Studenski, *supra* note 298, at 630. Still another variant views government as a partner in every business. *Id.*

Closely related to benefits theory is the social-cost theory. It holds that taxation is justified to cover certain social costs that are properly assignable to business, such as removal of pollution. See R. Goode, *supra* note 10, at 30-31 (distinguishing two kinds of social costs: public services, such as education, and evils that need correcting, such as pollution); Studenski, *supra* note 298, at 631 (social costs are the "damages caused [by business] in an incidental way to the physical and human resources of society . . . ."). Benefits theory also focuses on the "privilege" of limited liability and other privileges peculiar to the corporate form. See Comm. on Federal Taxation of Corporations, *Final Report, 1939 Proc. Nat'l Tax Ass'n* 534, 580. This approach reduces the tax to an impersonal fee assessed for doing business in the corporate form that mirrors to a degree the inquiry under the *Morrissey* version of the association test.

The benefits of the corporate form include: "limited liability of stockholders, perpetual life, easy transfer of ownership, multiple sources of financing, and the possibility of intercorporate affiliations. These characteristics make it easy for corporations to grow in size and power and to tap new sources of finance and wider markets." R. Goode, *supra* note 10, at 28. According to this theory, classical corporate taxation can be viewed as a payment for the benefits that the firm receives through the tax system generally, including protection of property rights and special privileges conferred by incorporation such as limited liability. *Id.* at 27-30. "The value of the corporate-charter privilege [that is the bundle of rights that enables the corporation (and indeed a limited partnership) to act on a nationwide scale as a legal personality with divisible share capital, permanent existence, and limited liability] may be measured either by the size of the corporation's income or by the size of its assets. The relative merits of these two measures is a subject of debate." Studenski, *supra* note 298, at 643.

The benefits theory has been used to support the extension of the tax to limited partnerships on the theory that limited liability is the greatest attribute of the corporate form. See *supra* notes 248-52 and accompanying text. *But see* Harberger, *supra* note 354, at 162 (corporation income tax that has prevailed since the 1930s is too large to be justified simply as payment for limited liability).

Benefits analysis would extend business taxation, even indirect taxation, to all forms of business. See, e.g., Hunter, *Shall We Tax Corporations or Business? 26 Am. Econ. Rev. 84, 85 (1936)(net income tax on business generally); Studenski, *supra* note 298, at 630 (state-partnership variant of general benefit theory requires net income tax on business enterprises while cost-of-service variant requires taxation of business enterprises "on the basis of their capital assets, gross earnings, or 'net-value output,' . . . at proportional rates"); Colm, *supra* note 394, at 328-30 (theory of the state as partner in production justifies two types of businesses taxes: a value added tax and a special tax on business favored by particular government services).

Not surprisingly, the benefits theory has had a mixed reception as a rationale for the
the tax since it is precisely those publicly traded firms that derive benefits from the financial infrastructure; therefore those firms should pay a portion of their profits to support the cost of regulating the efficient United States markets.\footnote{417}{

classical corporate tax. \textit{See} Warren, \textit{Interest, supra} note 1, at 1600 n.72 (noting difficulty of isolating precise benefits to corporations and questioning imposition of tax on net income instead of gross receipts). Arguments against the theory are: (1) special benefits are an incidental aspect of incorporation conferred by the state because it serves the public good; (2) it is impossible to measure these benefits and thus no reliable mechanism can discern the correct extent of taxation; and (3) since incorporation is open to all, it does not have a special value.

416. Under the separatist view, ability to pay means collective ability and not personal ability. Studenski, \textit{supra} note 298, at 633; Buehler, \textit{The Taxation of Business Enterprise — Its Theory and Practice}, 183 \textit{ANNALS} 96, 97 (1936). It is economic expansion, unaided by the legal personality of the firm, that, in the separatist view, creates a separate taxing entity. \textit{See} R. Goode, \textit{supra} note 10, at 35 (ability to pay analysis is concerned with "[t]he nature of the income rather than the general economic and social status of its recipients"); Adams, \textit{Fundamental Problems of Federal Income Taxation}, 35 \textit{Q.J. ECON.} 527, 543 (1921)("dual structure of the income tax . . . is a . . . recognition of the fact that . . . the business entity has an individuality and a capacity to pay of its own").

Based on the theory of the firm literature beginning with Coase, \textit{see supra} notes 262 \& 376-77, an alternative view of ability to pay was born. It emphasizes the economies of scale and decreased monitoring risks resulting from integration of activities within a firm. In determining which firms ought to pay a separate tax under this view, there is a correlation between the participation of owners, the lack of separation, and the decreasing marginal utility of certain forms of integration. While it is easy to see the value of integration and economies of scale in large service firms, there are differences between such firms and manufacturers. To the extent that owners do not participate, the web of contracts view of the firm presumes contractual arrangements within the firm that limit moral hazard risk and exact a rate of return that would not have been possible outside of the firm.

For some firms, proponents argue that the contractual web is an unsatisfactory model. \textit{See} Hetherington \& Dooley, \textit{supra} note 258 (difficulty of voluntarily dissolving closely held corporations makes ownership illiquid and creates risk of exploitation of minority shareholders that \emph{ex ante} contracting cannot prevent). \textit{But see} Easterbrook \& Fischel, \textit{Close Corporations and Agency Costs}, 38 \textit{STAN. L. REV.} 271 (1986)(no reason to treat closely held and publicly traded companies differently). The classic argument is made in F. O'Neal \& R. Thompson, \textit{O'Neal's Oppression of Minority Shareholders} (2d ed. 1985). This view of ability-to-pay justifies in part an exemption from a firm level tax for firms in which individuals materially participate, at least for income that can be directly traced to the value of their individual participation. \textit{See infra} text at notes 673-90.

417. The United States market operates within a regulated environment of required disclosure of information to which liability provisions attach. \textit{See} 1 \textit{L. Loss \& J. Seligman, Securities Regulation} 26-28, 171-84, 218-29 (3d ed. 1989); E. Bloch, \textit{Inside Investment Banking} 299-313 (2d ed. 1989). This is in contrast with the less extensive and often nonexistent disclosure systems in other countries. \textit{See} Staff of the U.S. Securities and Exchange Comm., \textit{Internationalization of the Securities Markets} 74-245 (July 27, 1987)[hereinafter \textit{Internationalization of the Securities Markets}] detailing the directives for disclosure in the E.E.C. generally followed by the Netherlands, systems similar to the United States in Japan, Canada, and France, the less than developed disclosure systems in the United Kingdom, Germany, and Australia, and no government required disclosure in Switzerland). It is argued that regulatory oversight is necessary to promote
The argument I make here refers not only to the cost of the benefit under the benefits theory, but also to the value of that benefit. The core of the power view is the conception, derived from Berle and Means, that firms with highly liquid ownership interests and a separation of ownership from control have a separate ability to pay and possess unique benefits. The value of the profit that is earned on equity must be viewed from the standpoint of the efficiency of the market by providing information to all participants, to prevent unfair advantage by those with private information, and to ensure the efficient operation of the market. 1 L. Loss & J. Seligman, supra, at 184-93; see also J. Seligman, THE TRANSFORMATION OF WALL STREET 561-68 (1982). While proponents of the efficient market hypothesis, portfolio theory, and agency cost economics argue that disclosure requirements are unnecessary because it is in management's interest to disclose, see L. Loss & J. Seligman, supra, at 184-91 & nn.41-42, required disclosure may be mandated by the efficient market hypothesis since it rests on the need for information. For the contrasting views of disclosure, see Gellis, MANDATORY DISCLOSURE FOR MUNICIPAL SECURITIES: A REEVALUATION, 36 BUFFALO L. REV. 15, 21 & nn.19-20, 40-44 & nn.93-113 (1988). Furthermore, portfolio theory does not rebut a need for disclosure to make rational choices in a diversified portfolio of investments, and the agency theory explanation for management's interest in disclosure has not been empirically tested and may be unrealistic. L. Loss & J. Seligman, supra, at 184-92. For examples of this reasoning, see Flannery, ASYMMETRIC INFORMATION AND RISKY DEBT MATURITY CHOICE, 41 J. FIN. 19 (1986)(maturity of risky debt is a signal to the market, if there are positive transaction costs, of the true quality of the firm to counterbalance the market's view that insiders will issue securities that the market will overvalue); Mikkelson & Partch, VALUATION EFFECTS OF SECURITY OFFERINGS AND THE ISSUANCE PROCESS, 15 J. FIN. ECON. 31 (1986). If one accepts the argument that disclosure and monitoring are necessary to promote efficient markets, this framework of public information lowers the cost of capital to firms trading within this market, see infra notes 460-531 and accompanying text, as well as the cost of the regulatory effort and allows the government to be a partner in that investment, see infra note 791 and accompanying text.

418. See Kornhauser, supra note 78, at 492-97 (the benefit theory of taxation should be understood as referring to the amount of the benefit received rather than the cost); see also R. Goode, supra note 10, at 29 ("[i]f the benefit theory is accepted, it may be assumed that benefits received are closely associated with profits earned, and hence a tax on net income is justified"). I also distinguish my analysis from the previous attempts to link the corporate tax to a benefits theory based on the benefit of limited liability. It is both the cost and the value of limited liability that makes it an unclear focus for the corporate tax as a benefits theory. The benefits conferred by the corporate form vary according to the size of the firm. For example, limited liability is of greater value to small firms than to large firms. Hence, the tax should fall on small rather than large firms. This is especially true since limited liability allows for capital formation in the first instance and then, by enhancing free transferability of shares, allows capital to be maintained. M. King, PUBLIC POLICY AND THE CORPORATION 112-13 (1977). Larger firms do not need limited liability to raise capital since they can generally act as self-insurers, whereas smaller ones do. The cost of limited liability in social terms through the fostering of negligence may not be proportional or related to the size of the firm and may be higher for riskier enterprises. See supra note 252. I also recognize that limited liability may sometimes be essential for certain large firms with high risk projects, and whenever this is the case the benefits theory applies. The value or cost of that benefit cannot be limited to the actual jurisdiction (state of incorporation) that provides the legal grant.
residual owners who are the ultimate beneficiaries. The incentive society wants to give to risky investment must also be considered. The view of liquid assets as less risky, carrying a lower return premium over the risk-free rate of return because of liquidity (as will be set forth in Part III), leads to some justification under a benefits analysis for the theory that the firm's ability to earn a profit on a liquid investment entitles the government to be a partner in that investment.

b. Berle and Means Revisited — The Economic Personality of the Firm

The separatist view of the corporate tax stems from the Berle and Means economic personality view of the firm.\textsuperscript{419} The separatist theory justifies a corporate income tax because the tax is not a tax on stockholders but a tax on a separate entity.\textsuperscript{420} For Berle and Means, separation depended largely upon the operation of capital markets and the ability of the shareholders to liquidate their investments independently of the firm's investment decisions.\textsuperscript{421} Berle and Means noted that mere incorporation does not necessarily result in this separation, since some corporations are merely the alter egos of their owners.\textsuperscript{422} Rather, Berle and Means articulated a more expansive view of the "corporate system" which includes not only separation of ownership from control\textsuperscript{423} but also the market place relationship between the firm and its equity owners:

\begin{itemize}
\item \textsuperscript{419} For a discussion of the separatist view, see R. Goode, supra note 10, at 15-20.
\item \textsuperscript{420} Id. at 9-23. But see J. Ballentine, supra note 397, at 5-6 ("The profits of a corporation are owned by the stockholders and are thus the income of shareholders . . . . As a result the tax on corporate profits is a tax on the income of shareholders.").
\item \textsuperscript{421} A. Berle & G. Means, supra note 259, at 286-87; see also R. Goode, supra note 10, at 20-21 ("The individual stockholder no longer has power of disposal over the capital used by the enterprise. As Berle and Means put it, the stockholder has 'exchanged control for liquidity'.").
\item \textsuperscript{422} Berle and Means insisted that neither the form of the enterprise nor its legal status was the essence of corporate production or the legal personality of corporatism: "If the corporate form had done nothing more than this, we should have only an interesting custom according to which business would be carried out by individuals adopting for that purpose certain legal clothing. It would involve no radical shift in property tenure or in the organization of economic activity; it would inaugurate no 'system' comparable to the institution of feudalism." A. Berle & G. Means, supra note 259, at 5.
\item \textsuperscript{423} Separation of ownership from control, as used here, refers to the ability of firm managers, whether or not they are owners or share the profits of the firm, to pursue profit maximizing or other objectives separate from the wishes of a significant portion of the residual owners.
\end{itemize}
The corporate system appears only when this type of private or "close" corporation has given way to an essentially different form, the quasi-public corporation: a corporation in which a large measure of separation of ownership and control has taken place through the multiplication of owners.

Growing out of this separation are two characteristics, almost as typical of the quasi-public corporation as the separation itself—mere size and the public market for its securities. It is precisely this separation of control from ownership which makes possible tremendous aggregations of property.

Though the American law makes no distinction between the private corporation and the quasi-public, the economics of the two are essentially different. The separation of ownership from control produces a condition where the interests of owner and of ultimate manager may, and often do, diverge, and where many of the checks which formerly operated to limit the use of power disappear. Size alone tends to give these giant corporations a social significance not attached to the smaller units of private enterprise. By the use of the open market for securities, each of these corporations assumes obligations towards the investing public which transform it from a legal method clothing the rule of a few individuals into an institution at least nominally serving investors who have embarked their funds in its enterprise. New responsibilities towards the owners, the workers, the consumers, and the State thus rest upon the shoulders of those in control. In creating these new relationships, the quasi-public corporation may fairly be said to work a revolution. It has destroyed the unity that we commonly call property—has divided ownership into nominal ownership and the power formerly joined to it. Thereby the corporation has changed the nature of profit-seeking enterprise.\textsuperscript{424}

Therefore, the Berle and Means view supports a separatist view of the corporate tax neither because the corporation is public or large nor because it is characterized by a separation of ownership from control, but rather because the corporation's separation of ownership from control is accompanied by a liquid capital market. "Taxing both the profits of the public corporation and the dividends received by its stockholders does not seem to be so much double taxation of the same income as separate taxation of the

\textsuperscript{424} A. BERLE & G. MEANS, supra note 259, at 5-7.
incomes of two related economic entities.\textsuperscript{425}

This view of the public firm can be contrasted with the many definitions proposed for the closely held firm.\textsuperscript{426} Disagreement exists as to whether the essence of the close corporation is the lack of a public market for its shares alone,\textsuperscript{427} a combination of no market and close family or friendly shareholders,\textsuperscript{428} a small num-

\begin{itemize}
  \item 425. R. Goode, \emph{supra} note 10, at 25.
  
  Several factors are normally associated with closely held firms: no shares held by the general public and shares are difficult to obtain, no ready market for shares, no reliable method of valuing shares, control in relatively few hands, identity of shareholders, and operating executives whose principal source of income is salary from the firm. Martin, \textit{Factors Used In Evaluation of Closely-Held Stock}, 20 Nat'l Pub. Acct. 12, 12-13 (1975); cf. A. Hoffman, \textit{Israel's on Corporate Practice} § 4.01, at 68-70 (4th ed. 1983)(some corporations with a large number of shareholders can nevertheless be classified as closely held because of a significant identity of shareholders and managers); C. Rohrlitch, \textit{Organizing Corporate and Other Business Enterprises} § 2A.02 (5th ed. 1975)("The term 'close corporation' has been defined in such various ways that an all-purpose definition is difficult. It is commonly described either in terms of size, simply as a corporation with relatively few shareholders, or in terms of its method of marketing securities, as a corporation whose shares are not generally traded in the securities market.").
  
  427. I F. O'Neal \& R. Thompson, \emph{supra} note 426, § 1.02, at 1-4 to 1-5 (A definition that looks to a lack of trading in the securities markets is "most nearly in accord with the linguistic usages of the legal profession" and it was adopted by the authors); accord Latty, \textit{The Close Corporation and the New Carolina Business Corporation Act}, 34 N.C.L. Rev. 432, 439 (1956); Pavenstedt, \textit{The Second Circuit Reaffirms the Efficacy of Restrictive Stock Agreements to Control Estate Tax Valuation}, 51 Mich. L. Rev. 1, 1 n.1 (1952); \textit{see also} N.C. Gen. Stat. § 55-73(b) (1982)(rules against restructuring shareholder relationships like partnerships relaxed if corporation is not publicly traded); N.Y. Bus. Corp. Law § 620(c) (McKinney's 1986)(rules against restrictions on freedom of board of directors relaxed if corporation is one in which "no shares are listed on a national securities exchange or regularly quoted on an over-the-counter market by one or more members of a national or affiliated securities association").
  
  428. C. Rohrlitch, \emph{supra} note 426, at 2A.03 ("[T]he essential peculiarity of the 'close corporation' is . . . the identity between stock ownership and active management."); R. Clark, \emph{supra} note 253 § 18.3 (1986)(close corporations primarily identified by shareholder management); Tennery, \textit{The Potential of the Close Corporation: A Question of Economic Validity}, 14 How. L.J. 241, 247 (1968)("a close corporation is a group of associates who band together to conduct a business in the corporate form"); Comment, \textit{Corporations} — \textit{Definition of the Close Corporation}, 16 Vand. L. Rev. 1267, 1271-72 (1963)("The integration of management and ownership . . . may be the most useful single all-inclusive definition."); A. Conard, \textit{Corporations in Perspective} 161 (1976); \textit{see also} A. Hoffman, \emph{supra} note 426, § 4.01, at 69. \textit{But see} R. Hamilton, \textit{Corporation
ber of shareholders, or a combination of all three. Market advocates focus on the lack of an active market for shares. Closely held firms with relatively large numbers of shareholders, strong ties to the community, and nonpublicly traded shares are not uncommon. Restructuring transactions through leveraged and management buyouts may align the interests of firm managers more closely with those of equity holders, but when a reverse leveraged buyout occurs the close corporation ceases to exist. The corporate governance debate and the statutory developments

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FINANCE 131 (2d ed. 1989) (when shares of a firm are widely held in an infrequently traded "thin" public market, the firm is public for some purposes and closely held for others).


431. Easterbrook and Fischel identify four ways in which the lack of an active market for shares injures investors in closely held firms. The absence of an active secondary market (1) "makes valuation of residual claims highly uncertain," (2) "creates conflicts over dividend policy and other distributions," (3) "precludes reliance on the stock market as a monitoring device," and (4) "deprives uninformed investors of the protection of purchasing at a market price." Easterbrook & Fischel, supra note 416, at 275-76.

432. For example, Glenshaw Glass, a long-time producer of bottles for local companies, has 135 shareholders, most of whom are descendants of the company's founders. See Barcousky, Takeover Bid Made For Glenshaw Glass, Pittsburgh Post-Gazette, Aug. 20, 1988, at 23, col. 3.


434. The Model Statutory Close Corporation Supplement allows new firms unlimited access to its form of governance. New corporations wishing to elect close corporation status have no shareholder number limitation and a public offering does not invalidate the election. MODEL STAT. CLOSE CORP. SUPP. § 3(a) & Official Comment at § 3 (1984). The Supplement limits a close corporation election by an existing corporation to firms with 50 or fewer shareholders and bars share transfer except to the extent allowed by the company's articles of incorporation. Id. at §§ 3(b), 11(a). The Official Comment to § 3 indicates that the number limitation was imposed because of "[t]he danger that a large corporation with numerous shareholders might attempt to elect close corporation status in order to operate without a board of directors", and that growth beyond the 50 shareholder limit causes no problem. Id. at § 3, Official Comment.

States take a variety of positions on close corporation status. There are a surprising number of restrictions in Delaware. See DEL. CODE ANN. tit. 8 § 342(a) (1983) (Delaware does not allow a public offering and limits the number of shareholders to 30). Other states have broadly permissive provisions. See IND. CODE ANN. § 23-1-33-1(c) (West 1989) (allows corporation with 50 or fewer shareholders to dispense with a board of directors); N.Y.
that have taken place in the last twenty years demonstrate the not surprising proposition that public and large public firms, including those not necessarily publicly traded, are different from closely held, private firms.

Publicly traded firms and private firms are also distinct. "By and large the legal-historical developments and the economic functions of these two systems are quite different, and meaningful legal or economic analysis must begin by recognizing this fact." Henry Manne finds that public corporations exist in three markets: the market for investment capital exemplified by the promoter's search for new funds, the liquidity market for the buying and selling of existing securities exemplified by the organized securities exchanges, and the market for corporate control. John

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BUS. CORP. LAW § 620(c)(McKinney 1986)(no concept of "close corporation" but direct shareholder management allowed if shares not regularly traded); CALIF. CORP. CODE § 158(a) (West Supp. 1989)(close corporation limited to 35 shareholders, no limitations on trading); TEX. BUS. CORP. ACT ANN. arts. 3.01-3.06 & 12.01-12.54 (Vernon 1988 & Supp. 1989)(no limitations on the number of shareholders or the issuance of shares by a public offering). For a comparison of recent state approaches, see Siedel, Close Corporation Law: Michigan, Delaware and the Model Act, 11 DEL. J. CORP. L. 383 (1986).

435. See AM. LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS, §§ 1.03, 1.16, 1.23, 3.01, 3.02, 3.03 (Tent. Draft No. 2, 1984)(Three tiers of corporations are defined: "large publicly held corporation[s]" with 2,000 equity holders and $100 million of total assets; "publicly held corporation[s]" with 500 shareholders and $3 million of total assets; and other corporations treated as "business organizations." The first and second tier of corporations face stricter requirements than does the third tier.)

436. Federal securities laws require disclosure for large firms regardless of whether they are publicly traded. Securities Exchange Act § 12(g)(1), 15 U.S.C. § 78(g)(1) (1986). The statutory requirement has been liberalized by regulatory rule and it now requires disclosure only if there are 500 or more shareholders and total assets of more than $5 million. Rule 12g-1, 17 C.F.R. § 240.12g-1 (as amended by Adoption of Amendments to Reporting by Small Issuers, Exchange Act Release No. 34-23,406, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,012 (Aug. 15, 1986)). Large firms, which are defined as "public" and "large public" under the corporate governance provisions, see supra note 435, are generally publicly traded. Large non-traded firms do exist. See Minard, In Privacy They Thrive, FORBES, Nov. 1, 1976, at 38 (listing the largest nonpublic firms). The growing number of leveraged and management buyouts add to their ranks. On a corporate governance level, they may function like publicly traded firms but avoid the discipline of the market for corporate control.

437. For governance purposes, closely held firms are viewed as "incorporated partnerships." That view has given rise to expansive close corporation statutes in most states. The Model Statutory Close Corporation Supplement permits great latitude in the governance structure of closely held firms. See supra note 434.


439. Id. at 265. Nonpublic corporations and their markets are, of course, markedly different.
Coffee finds the duties of the majority to the minority in private firms different from the duties of corporate managers to the public in public firms.\textsuperscript{440} This difference is explained in part by the fact that participants in closely held firms do not have the securities market as an "escape mechanism" and thus are more exposed to "potential exploitation."\textsuperscript{441} While the perspectives of managers and equity holders within the closely held firm are changed through management and leveraged buyouts, the fact remains that the escape mechanism of the public market is not present.

c. The Power Rationale in a Flat Tax World

In a flat tax world, double taxation of equity is appropriate where the equity ownership interest is publicly traded and highly liquid, because of the fundamental risk differences that exist between residual owners of public firms and owners of private firms. Liquidity enables investors to be risk neutral and to exercise their consumption and savings preferences through a sale of the residual ownership interest. Liquidity also enables investors to insulate themselves from the risk preferences of managers of public firms who are generally risk averse and underdiversified.\textsuperscript{442}

Finally, liquidity allows owners to indicate to managers their

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\textsuperscript{441} Coffee, No Exit, supra note 440, at 940-41 (the closely held corporation may require closer judicial monitoring to place limits on the ability of the closely held firm to opt out of the rules of standard corporate governance).

\textsuperscript{442} This view derives from the concept of manager-shareholder relations so eloquently expressed by Professor Coffee. Coffee, supra note 376, at 80. The Coffee view synthesizes three perspectives of the firm: The first is the neoclassical view. See, e.g., Jensen & Meckling, supra note 103; Fama, Agency Problems and the Theory of the Firm, 88 J. Pol. Econ. 288 (1980). The second is the managerialist view. See, e.g., H. Simon, Models of Man: Social and Rational (1957). The third is the transaction cost view. See, e.g., O. Williamson, The Economic Institutions of Capitalism 273-325 (1985). All of these perspectives view managers as individuals who pursue goals other than the maximization of shareholder wealth. Regardless of the view adopted, a market for liquid residual equity creates opportunities which differ from those that exist where residual equity sharing is fixed.
displeasure with management strategies. The paradigm of separate risk analysis for the firm and the owners holds, even though evidence suggests that the most sophisticated investors are not diversified, that individuals with a high savings rate can satisfy consumption wants by borrowing, and that ownership of equities is through pension and other forced savings plans. The power rationale supports the separate taxation of the firm and its owners under an equitable taxation tradition. Whether it supports the double tax on efficiency grounds depends upon how the power view of the double tax is defined. It is the latter consideration that is modeled in Part III below. That model is then tested against both horizontal and vertical equity criteria and the efficiency and neutrality paradigms in Part VII.

III. PROPOSAL FOR A PROFITS TAX ON PUBLICLY TRADED FIRMS WITH LIQUID EQUITY

Taxing the firm level profits of firms with liquid equity under a double tax system is justified on ability-to-pay and horizontal equitable taxation grounds. The difference between liquid and illiquid equity ownership, generally framed as the difference between publicly traded and nonpublicly traded firms, has instinctive appeal. Therefore, it may be appropriate to tax each separately.

443. See Manne, supra note 438, at 264-65 (shareholders control managers by exercising their "freedom to dissociate").


445. There are, however, limits placed on shareholder borrowing. See supra note 319 for a discussion of margin requirements.

446. The savings choices of many individuals are altered by the favorable retirement benefits available. These incentives persuade individuals to defer consumption. In the "age of the savings planner," the decisions of individual savers are being made by group representatives. Clark, The Four Stages of Capitalism: Reflections on Investment Management Treatises, 94 HARV. L. REV. 561, 565-66 (1981)("the decision to save is only indirectly controlled by many of the workers who are to benefit from these plans (which can no longer accurately be described as 'fringe' benefits), just as the decision to invest in particular financial claims is only rarely controlled by public suppliers of capital to financial intermediaries").

447. It is the liquidity of the owners, representing their separate and independent power over income, that allows firm managers to operate without regard to the individual savings and consumption preferences of the equity owners (the Fisher Separation Theorem). See Romano, supra note 390, at 952-55. Of course, the firm owner cannot purchase assets to adjust for all consumption preferences if the market is less than complete. When faced with this circumstance, the holder will want the firm to conform to her own consumption preferences. The result is that profit maximization for public firms may not be (or indeed should not be) the most desired goal. See Grossman & Stiglitz, On Value Max-
The unique characteristics of public companies such as the existence of a market for ownership, the shareholder's typical lack of control, and the often indirect correlation between the risks and benefits accruing to the underlying productive assets and those accruing to the stock representing ownership of those assets support, at least indirectly, the classical corporate tax regime.448

Early tax reform proposals generated only limited discussion of the characteristics of the market in which a public firm exists and how that market should be defined.449 The stock market is a more-or-less closed system of property holding that is essentially independent of actual productive processes and gives rise to a separate form of valuation of those underlying processes.450 Early in-


448. Davies, however, "does not question the basic assumption that a separate corporate income tax is a useful tax which ought to be retained, regardless of who ultimately bears the burden of that tax." Davies, Public Stock, Private Stock: A Model for the Corporate Income Tax, 124 U. Pa. L. Rev. 299, 303 (1975)(footnotes omitted)(since the income is earned at the corporate level it ought to be taxed there).

449. This struggle to define the market came up in two different contexts. The first arose when commentators questioned whether Subchapter C ought to treat public and private firms differently for basic realization and recognition events. The second context involves the implementation of an accrual tax system.

When analyzing whether Subchapter C ought to treat public and private firms differently, Davies concluded that the stock exchanges were public markets. Davies, supra note 448, at 311. He was less sure about the over-the-counter market. Id. This issue is discussed fully at infra note 451.

The accrual issue was addressed by Slawson and others. Slawson proposed to tax, on an accrual basis, the annual appreciation in publicly held stock. Slawson, Taxing as Ordinary Income The Appreciation of Publicly-Held Stock, 76 YALE L.J. 623, 648 (1967). His proposal was limited to publicly held stock because published market quotations make its value readily determinable without actual disposition and a five hundred shareholder minimum and gross assets of $1 million to match Congress' proxy and reporting requirements as specified in the Securities Act Amendments of 1964. Id. at 651. Other accrual proposals for the collection of the shareholder level tax also focus on the marketability of and valuation in the public market. See Thuronyi, The Taxation of Corporate Income — A Proposal for Reform, 2 J. Am. Tax Pol'y 109, 121 & n.45 (1983)(in a proposal to replace the corporate tax computation entirely with shareholder level accrual, the proposal confined to publicly held corporations for which there is a ready market); Shakow, Taxation Without Realization: A Proposal for Accrual Taxation, 134 U. Pa. L. Rev. 1111, 1133-36, 1167 (1986)(incentives for public trading in an accrual system if the corporate tax were eliminated for publicly traded but not nonpublicly traded corporations are analyzed and an accrual system that would exclude hard-to-value securities such as those trading in a thin market is proposed); see also id. (discussion of the Twentieth Century Fund and David and Miller proposals for valuation of untraded securities). But see Note, Realizing Appreciation Without Sale: Accrual Taxation of Capital Gains on Marketable Securities, 34 STAN. L. Rev. 857, 872-73 (1982)(Publicly held status always attaches if the then S.E.C. 500 shareholders and $1 million in gross assets requirements are met regardless of market).

450. This proposition was advanced by Professor Harbrecht. See Berle, The Impact of the Corporation on Classical Economic Theory, 79 Q.J. Econ. 25, 38-39 (1965).
tuitions of the differences between firms in the public and private market fueled proposals to treat public firms differently from private firms. These differences have been heightened by the current financial attributes of the market including evidence that the efficient market hypothesis may not hold when confronted with the alleged irrationality of the October 1987 market break, gains by noise traders and discounts for shares, market participant

451. These included five proposals. One proposal was to tax the unrealized appreciation in publicly traded shares currently as ordinary income while maintaining the entity level tax. See Slawson, supra note 449, at 644-47 (corporate tax also retained); Note, supra note 410, at 872-73; Cohen, Taxing Stock Dividends and Economic Theory, 1974 Wis. L. Rev. 142, 147 n.19 (1974) (the increase in value in publicly traded shares ought to be taxed in the year of accrual similar to the treatment of interest on a savings account). The second proposal was to treat redemptions as a taxable event for the continuing shareholders or to apply the redemption provisions only to closely held businesses and not publicly held corporations. See Chirelstein, Optional Redemptions and Optional Dividends: Tax and the Re-Purchase of Common Shares, 78 Yale L.J. 739, 750-54 (1969) (noting increase in value of continuing shareholder stock on capital gain redemptions and the voluntary nature of the choice to tender and arguing that an occasional major shift of ownership interests among shareholders should not apply to publicly held corporations in essentially liquidation transactions). But see Bacon, Share Redemptions by Publicly Held Companies: A New Look at Dividend Equivalents, 26 Tax L. Rev. 283, 304 (1971) (There is no real evidence that Congress intended to limit § 302(b)(1) to prearranged exchanges in closely held companies.). The third proposal was to treat distributions from private firms differently from distributions made from public firms. See Cohen, Surrey, Tarleau & Warren, A Technical Revision of the Federal Income Tax Treatment of Corporate Distributions to Shareholders, 52 Colum. L. Rev. 1, 53 n.100 (1952) (different treatment justified because transactions in closely held corporations are usually driven by the tax consequences alone). The fourth proposal was to treat reorganizations as taxable events. See Hellerstein, Mergers, Taxes, and Realism, 71 Harv. L. Rev. 254, 281-85 (1957) (proposal limited to publicly traded stock primarily for practical reasons); H.R. Rep. No. 1337, 83d Cong., 2d Sess., reprinted in 1954 U.S. CODE CONG. & ADMIN. NEWS 4025, 4064-66 (suggesting a public/private statutory distinction for reorganizations is justified because the actions of privately held firms are more likely to be motivated by the tax avoidance plans of their shareholders). The fifth proposal involved a model whose rules distinguished recognition, distribution, and liquidation events based on the thesis that public stock is separate property and private stock is not. See Davies, supra note 351, at 301.

Davies' is the most ambitious proposal to date: to divide Subchapter C into provisions that deal differently with public and private stock on a transactional basis. Furthermore, it follows that exchanges of private stock for other private stock would not be a recognition event. This would allow unlimited deferral so long as the taxpayer remains in a private market. Not surprisingly, contributions of property to a public corporation in exchange for its stock would always be taxed under the Davies rationale and the control test of I.R.C. § 351 would be irrelevant. Contributions to private corporations, on the other hand, would receive treatment similar to I.R.C. § 721 partnership treatment.

behavior, market behavior relative to fundamental firm values, market purchases of baskets of securities, arbitrage between asset and stock markets, and the lack of valuation efficiency in the market. In particular, proposals for taxing continuing shareholders on the value created by the redemption of the shares of other shareholders was limited to public firms which used redemptions as a financial strategy; the proposals did not seek to include private firms. These proposals were supported by the fact that liquidity provides an equity holder with an exit

453. Two types of participants are present in today's market. One is the investor who brings a long term outlook to the market and the other operates with a short term perspective.

No more than 5% of the money invested in stocks is managed by long-term investors measuring the value of the business under the fundamental valuation principle. L. Lowenstein, supra note 164, at 35 (designating these investors as "Graham-and-Dodders"). Louis Lowenstein has focused attention on the remaining investors who comprise over 90% of the market and concentrate on short-term stock price behavior or use diversified portfolio techniques. Citing studies showing that many large institutional investors exhibit this speculative behavior, see L. Lowenstein, supra note 164, at 76, he notes that mutual fund managers, for instance, rarely "compare the price of the stock to either current or future earnings . . .," id, and, care little about "the amount of debt on the balance sheet," id.

454. For example, in testing the arbitrage pricing theory, it has been argued that the shares of stock traded in the market place are actually portfolios of the individual units of production in the economy. These portfolios were created through the adoption of multiple capital budgeting projects by the individual firms. Thus, the returns on specific individual units of production within a firm are not reflected when portfolios of stock are traded in the market place. Instead, what is observed in the market place is merely the portfolio of the capital budgeting decisions represented by the stock and not really the underlying productive units. See R. Haugen, Modern Investment Theory 217-23 (1986).

455. For example, the increased use of stock index futures provides institutions and individuals a strategy for hedging their transactions. If they choose, these market baskets can be leveraged by margin purchases requiring in cash only a small portion of the value of the contracts. See Japanese Begin Trading in Stock Index Futures, The N.Y. Times, Sept. 5, 1988, at 28, col. 4.

456. The existence of a different market for the stock and the underlying assets is argued by some to allow for arbitrage between the two markets. For some it is highlighted by the premiums paid in hostile takeovers and management buyouts and it raises issues concerning the social responsibility of this conduct. L. Lowenstein, supra note 164, at 154 (citing comments of Martin Shubik noting that the ability to arbitrage across markets means that there is efficiency for one form of market in day-to-day trading that is not matched in another).


458. See supra note 449.
choice if the firm does not pursue the holder's goals. Liquidity also provides the firm with a lower cost of capital and thereby increases profits. Regardless of whether the test requires solely market liquidity or includes a hybrid form of liquidity by private contract, the ultimate concern is the extent of the value of liquidity to the firm and its owners. It is the latter result of liquidity that a liquidity based test must satisfy. However, a liquid ownership test faces many of the same definitional problems as did the publicly traded test under the 1987 legislation.

A. The Value of Liquidity

1. Liquidity and the Cost of Firm Capital

Equity ownership entails three components: interest in assets, interest in cash flows, and control. For non-controlling owners, it is generally preferable to have liquidity of ownership and the ability to realize the value of the underlying assets by selling the interest in an established market. The liquidity preferences of even the largest non-institutional investors lead them to publicly traded stock. At the end of 1986, institutional investors owned from forty-two to forty-five percent of the three trillion dollars of corporate equity. For 1988, trading in the New York

459. See infra notes 640-71 and accompanying text.

460. F. Weston, The Corporate Finance Function 149 (4th ed. 1977). For example, a minority interest in a closely held company is less liquid, absent agreements, than a minority interest in a public company. Compare Easterbrook & Fischel, supra note 416, at 274-77 (the absence of a liquid market for shares in closely held corporations does not pose a risk of exploitation of minority shareholders, who cannot easily sell their shares, by majority shareholders, but does make valuation of residual claims uncertain, creates conflicts over dividend and distribution policy, precludes reliance on market monitoring, and deprives uninformed investors of the option to purchase at a market price), with Hetherington & Dooley, supra note 258, at 63 (the greatest opportunity for exploitation exists when the power to control rests with one faction mandating legislative solution). Finance theory provides an approach to the valuation of minority shares by demonstrating that the risk of diversion of value from minority owners to controlling owners can be reduced or eliminated. See J. Osteryoung, D. Nast & W. Wells, Pricing Minority Discounts in Closely Held Corporations (Florida State University Working Paper, Apr. 1989)(abstract).


462. See C. Brancato & P. Gaughan, The Growth of Institutional Investors in U.S. Capital Markets 12-14 (Columbia University School of Law Institutional Investor Project Working Paper, Nov. 1988)(42.7 percent); L. Lowenstein, supra note 164, at 58 (45 percent). The overall average institutional stockholding for all industries reported as of June 30, 1986 was 40.2%; it was 39.1% as of December 31, 1985, and 35.9% one year earlier. Office of the Chief Economist of the Securities and Exchange Commission, The Effects of Poison Pills on the Wealth of Target Shareholders 37 (Oct.
Stock Exchange was probably eighty percent institutional, with a somewhat smaller percentage of institutional trading in the American Stock Exchange and the OTC Market. These institutional holdings are in the largest public companies. The data through the third quarter of 1989 indicates that institutional investment continues to play an important role in the public markets.

Since institutional investors use many market-based trading strategies, the value of liquidity in maintaining diversification and trading value is significant to them. Institutional portfolios exhibit a high turnover rate. Since these investors make up a large per-

23, 1986) (hereinafter Poison Pills)]. Institutional investors include insurance companies, pension funds, and bank managed trust accounts. These investors "concentrate their investments in the larger capitalization companies that offer better liquidity." L. Lowenstein, supra note 164, at 58. Use of the poison pill affects such large institutional shareholders. The College Retirement Equities Fund (CREF) objected to International Paper Company's poison pill strategy because so many firms have poison pills that CREF could not register disapproval by selling its stock and investing elsewhere. L. Lowenstein, supra note 164, at 197. Institutional investors with over $100 million of equity under their management have increased their holdings of over-the-counter stocks from 5.5% in 1979 to 8.4% in 1985, with no change in Amex holdings and a decline in NYSE holdings from 93.2% to 90.3%. See M. Blume & I. Friend, Recent and Prospective Trends in Institutional Ownership and Trading of Exchange and OTC Stocks 1-2 (Rodney L. White Center for Financial Research of the Wharton School of the University of Pennsylvania Working Paper, 1986)(using data from Form 13F filings and Telstat quarterly daily pricing files, with Telstat database limited to a total of 4,881 companies which were all the NYSE and Amex firms and only larger over-the-counter companies excluding those with very limited trading or small market values).

463. In 1988, eighty percent of the trading on the New York Stock Exchange was done by institutions and members of the NYSE, while only eighteen percent was done by individuals. Securities Industry Association, Investor Activity Report 6-7 (Feb. 17, 1989) (extrapolating from data). Most acknowledge that exchange trading is becoming "increasingly institutional." L. Lowenstein, supra note 164, at 57-63.


465. Liquidity concerns were the most common reason for not investing in firms with a capitalization of less than $50 million (cited by 85% of the largest institutions and 100% of the smaller institutions surveyed). M. Blume & I. Friend, supra note 462, at 7. Valuation and ERISA concerns were also cited. Id. A high proportion of respondents cited risk-reward payoffs for all exchange and NASDAQ markets, with a higher percentage finding changes in growth significant. Id. at 9-10. Liquidity concerns were the dominant reason for market preferences, id. at 10-11, and the smaller institutions with under $100 million in common stock cited pricing and valuation second.


467. The turnover rate of institutional portfolios, the annual rate at which the portfolios are changed, was estimated at 76% in 1981, 103% in 1983, and 150% in 1985. See House Protection Hearing, supra note 16, prepared statement of A. Somer, Jr., at 5. The
centage of investment capital, there is a liquidity premium in pricing transactions that are placed in a public market. Institutional investors also may have legal and clientele imposed liquidity requirements. Some of the liquid holdings percentages can be explained by the funding obligations of pension funds, the operative prudent person rule, or by the financial contracts in mutual fund and investment advisory accounts that specify limitations on the amount of illiquid assets.

Under a variety of trading strategies, investors seek to participate in both speculation and earnings, to identify undervalued firms using fundamental analysis, to satisfy preferences for liquidity relative to yield, and to engage in financial arbitrage strategies. To the extent that liquidity plays a role in determin-

ownership turnover rate for exchange-traded companies was 80% in 1988, and turnover of exchange-traded and NASDAQ companies was 100% in 1988. See id., prepared statement of Louis Lowenstein, at 5.

468. See Pension Fund Hearing, supra note 16, prepared statement of David P. Feldman. For a discussion of the proper mix between equity and debt, compare Ambachtsheer, Pension Fund Asset Allocation: In Defense of a 60/40 Equity/Debt Asset Mix, FIN. ANALYST J., Sept.-Oct. 1987, at 14 (minimizing risk over the long-term calls for 40% to 70% investment in equities) with Leibowitz, The Dedicated Bond Portfolio in Pension Funds — Part I: Motivations and Basics, FIN. ANALYSTS J., Jan.-Feb. 1986, at 68 (dedicated bond portfolios allow corporate pension fund to take advantage of favorable fixed income markets) and Leibowitz, The Dedicated Bond Portfolio in Pension Funds — Part II: Immunization, Horizon Matching and Contingent Procedures, FIN. ANALYSTS J., Mar.-Apr. 1986, at 47. Consistent with the going concern mix is the fact that in pension funds had total assets of $1,004.5 billion, with equity holdings of $432.5 billion and bond holdings of $210.7 billion. See Koppelman, supra note 337, at 1183 n.154.

469. The ERISA standards, for instance, are expressed not as a strict percentage but rather as a fiduciary responsibility and prudent investment requirement. See 29 U.S.C.A. § 1104(a)(1985). For discussion of the ERISA prudent person rule, see Pension Fund Hearing, supra note 16, prepared statement of David P. Feldman, at 5-6 (stating “[t]his is a higher standard than other corporate/security laws, which only require that there be no negligence or gross negligence”). For a view that the prudent person rules should be rewritten with a “portfolio standard” to allow longer-term investment horizons for pension funds, see Pension Fund Hearing, supra note 16, at 17-19 (prepared statement of Ira M. Milstein).

470. The liquidity premium will change if investment funds are able to change their contractual covenants. Private investment advisory accounts contain their own restrictions on illiquid investments. Presumably, changes in these contractual terms are motivated by the liquidity concerns of the capital providers. Public funds, however, are restricted by statute. See Investment Company Act of 1940, 15 U.S.C.A. § 80a-12 (West 1981 & Supp. 1989)(illiquid investments may not exceed 10%).


472. Numerous trading strategies are available. They include: (1) using price expectations based on historical patterns; (2) using the efficient market hypothesis so that ran-
ing yield, the liquid versus illiquid investment (generally public versus private)\(^{473}\) increases the value to the firm since firms are presumed to use the least costly financing option. The cost of capital is determined, in part, by the risk factors that attach to capital. Moreover, it is likely that only a portion of the tax benefit in equities is capitalized, since equities are held by taxpayers in all brackets and since "no fully taxable or fully tax exempt alternative to stock . . . provides similar investment opportunities."\(^{474}\)

The stock market "act of magic" — transforming short term savings into long term social investment — creates value through liquidity.\(^ {476}\)
Since liquidity has value, investors are willing to accept a lower return for more liquid shares. As a result, the firm's cost of capital is lowered but at the price of the going public decision.\textsuperscript{476} The combination of liquidity and an open market for corporate ownership allows shareholders to have an investment timetable independent of the investment decisions of firm managers. However, this shareholder autonomy has other negative consequences.

Modern corporations depend on the commitment of capital to such long-lived investments as plant, equipment, and oil exploration . . . . [The stock market] enables investors to rely on the trading market for the liquidity they need, even while the managers invest and reinvest capital and earnings according to the quite different timetable of the business. The terrible dilemma of takeovers, at least at the abundant rate we have been witnessing, is that they give to shareholders — the equity investors whose dollars were thought to have been the most firmly committed at the business level — a license to disinvest collectively as well as individually.\textsuperscript{477}

The extreme benefit of liquidity, Lawrence Summers and Victoria Summers argue, produces short term private gain arguably at the cost of long term efficiency.\textsuperscript{478}

\begin{quote}
Louis Lowenstein:

A share of stock is nothing more than a share in a business, the equity capital that has been committed to the venture more or less permanently. The shareholders have liquidity so that any of them, but not all of them collectively, might sell off their shares in the stock market. Collectively their capital has been turned into bricks and mortar.

L. LOWENSTEIN, supra note 164, at 155.

Whether she is a Lowenstein "strong box" investor holding stocks for the long term, the manager of a fully diversified portfolio or market index fund, or a Coffee underdiversified firm manager, liquidity has value to her in part because she is probably not diversified efficiently. See \textit{id.} at 65 (manager should own Ford or GM but not both); M. KING & J. LEAPE, WEALTH AND PORTFOLIO COMPOSITION: THEORY AND EVIDENCE (National Bureau of Economic Research Working Paper No. 1468, 1985); Cox, \textit{Reflections on Ex Ante Compensation and Diversification of Risk and Fairness Justifications for Limiting Fiduciary Obligations of Corporate Officers, Directors, and Controlling Shareholders}, 60 TEMPLE L.Q. 47, 64 & n.65 (1987).

\textsuperscript{476} Note, however, that the firm bears some costs when it offers liquidity. See \textit{infra} note 503; see also Groth & Dubofsky, \textit{The Liquidity Factor}, in \textit{THE NASDAQ HANDBOOK} 361 (1987)(the price of liquidity translates into a higher cost of capital for security-issuing firms).

\textsuperscript{477} L. LOWENSTEIN, supra note 164, at 220 (emphasis in original).

\textsuperscript{478} Lawrence Summers and Victoria Summers have transformed the fact of extreme liquidity into an argument that the existing market is an inefficient allocator of financial resources. See L. Summers & V. Summers, \textit{supra} note 75. Liquidity may not make better markets if it causes buyers to think in terms of short-term appreciation and trading
Market microstructure finance research has come of age and has branched from models of market-making to those of understanding liquidity and its measurement by focusing on the sale of liquidity in pricing returns. The market segmentation concept of liquidity is different from the liquidity preference theory for term bond structure. Liquidity preferences other than instead of continued and substantial earnings. This would make the market into a barometer of investment opportunities instead of a barometer of underlying worth. Id. See also H. Hill, ACCOUNTING PRINCIPLES FOR THE AUTONOMOUS CORPORATE ENTITY 35 (1988) (the liquidity created by the formal stock exchanges has been a significant factor in turning share ownership from participation to speculation).


480. There are three general models of market-making. They examine: (1) the pricing and inventory behavior of risk-adverse dealers, see, e.g., Stoll, The Supply of Dealer Services in Securities Markets, 33 J. FIN. 1133, 1133 (1978); (2) risk-neutral dealers charging traders for losses whenever traders possess superior information and their activities are camouflaged by "noise traders," see, e.g., Bagehot, The Only Game in Town, FIN. ANALYSTS J. Mar.-Apr. 1971, at 12, 13; and (3) the price of liquidity services as a natural property of markets, see, e.g., Cohen, Maier, Schwartz & Whitcomb, Transaction Costs, Order Placement Strategy, and Existence of the Bid-Ask Spread, 89 J. POL. ECON. 287 (1981). Other studies are cited in Discussion, supra note 375, at 634, 636-37.

481. See generally Miller & Grossman, Liquidity and Market Structure, 43 J. FIN. 617 (1988) (presenting a simple model of market structure that conveys the essence of market liquidity); Discussion, supra note 479, at 636 (statement of David K. Whitcomb) ("It is time the big guns of finance were brought to bear on the question of liquidity and on the implications of the demand for liquidity on the relevance of the way we conventionally measure returns.").

482. Liquidity preference theory (liquidity premium theory) explains the existence of liquidity premiums for bonds that are in fact riskless. See R. HAUGEN, supra note 454, at 295-98; E. ELTON & M. GRUBER, MODERN PORTFOLIO THEORY AND INVESTMENT ANALYSIS 462-64 (3d ed. 1987). Liquidity preference theory proceeds on the assumption that the market does not regard a long-term bond as a perfect substitute for a short-term bond. For simplicity, consider bonds with no risk of default, such as Treasury bonds. The rate of return on a short-term bond is relatively certain, but a risk premium attaches to a longer term bond, since interest rates will generally fluctuate more over the life of the longer term bond. There is a greater risk of a capital loss if the long-term bond is sold before maturity than if the short-term bond is. Liquidity preference theory postulates that investors will demand an additional return, a liquidity premium to bear that risk. The yield curve on interest rates, either upward sloping over time or downward sloping, are influenced by other factors such as market expectations, but the final yield curve will result from an interaction between expectations and liquidity preference. See E. ELTON & M. GRUBER, supra note 482, at 463-64. Thus, other factors may invert the yield curve, with shorter maturities having a higher interest rate as recently occurred. Term structure of interest could also be used in the measurement of economic income. See Bankman & Klein, Accurate Taxation of Long-Term Debt: Taking into Account the Term Structure of Interest, 44 TAX L. REV. 335 (1989).

Nonetheless, there appears to be little empirical evidence of additional liquidity premiums after eight to ten months where the expected rates of return reach a peak. See gener-
the preference for term bond structure may influence the yield of high yield debt securities in the current market as initial high yield prices reflect both the equity characteristics of these securities and the illiquidity of the market and prices are highly responsive to a lack of market liquidity. The absolute value of liquidity, in the view of the economists, is not just a preference for money but a preference for liquid assets. There is presently no liquid asset that has the same return characteristics as common stock. Financial economists Amihud and Mendelson reviewed the

ally Fama, Term Premiums and Bond Returns, 13 J. Fin. Econ. 529 (1984)(examining expected returns on U.S. Treasury bills and U.S. government bond portfolios). This is explained by the fact that, while liquidity premiums that increase in size with the term to maturity are generally presumed, the presence in the market place of different investors and different instruments offering different time periods allows liquidity premiums to be effectively negated. Therefore, all investors need not have short-term horizons. See R. HAUGEN, supra note 454, at 298. Investment vehicles, such as asset-backed securities, allow these preferences to be satisfied. See Asset Finance Group First Boston Corp., Overview of Assets and Structures, in The Asset Securitization Handbook 21, 21-59 (P. Zweig ed. 1989). Whether long-term bonds have a higher variance, and whether investors regard this as desirable or undesirable, is also open to question.

In contrast to liquidity preference theory, market segmentation theory presumes that all players within the market seek to divide the market into submarkets on the basis of maturity, that investors in each market are unwilling to venture into other markets, and that liquidity preference has nothing to do with term structure. See R. HAUGEN, supra note 454, at 299-301; see also E. ELTON & M. GRUBER, supra, at 459-60 (market segmentation theory is popular with practitioners).

High yield bonds present a mixture of debt and equity financial characteristics. See infra notes 1007-08. The continued positive return spreads in excess of the default losses, whether measured as default or mortality losses, have several explanations including one pointing at market inefficiency in pricing high yield debt. See Altman, Mortality, supra note 170, at 920-21. Another explanation is that if liquidity risk is important in price determination and if it increases with lower bond rating, id., illiquidity for high yield bonds may more closely mirror illiquidity effects for equity. Even the investment grade bond market has an illiquidity premium which reflects their lack of marketability compared to Treasury bonds of similar duration, and the increased interest rate has been explained on the basis of liquidity. See Fisher, Determinants of Risk Premiums on Corporate Bonds, 67 J. Pol. Econ. 212 (1959). The illiquidity of the high yield market was always there, but with the demise of Drexel Burnham Lambert Inc. the promised liquidity of high yield debt relative to investment grade debt has declined substantially from parity on January 1, 1989 until just 90 percent of high grade bonds as of February 14, 1990. See The End of Drexel, Wall St. J., Feb. 14, 1990, at A6, col. 3. Lower grade high yield debt experienced even greater declines. See Wallace, supra note 171 (C-rated high yield debt in January 1990 was at 82 percent of the January 1989 value). This may also reflect the highly publicized defaults of Integrated Resources Inc. and Campeau Corporation. The high yield market was based on a promise of liquidity, which some observers now characterize as "illusory." See Lowenstein, supra note 190, at A6, col. 3.

benefits and costs of increased liquidity noting that increased trading costs decrease the value of securities. Using this insight, they predicted that "the greater the liquidity of an asset, the greater its value."\textsuperscript{485} Firm size is also a factor, since the benefits of increased liquidity are proportional to the initial value of the firm.\textsuperscript{486}

Illiquidity in the public market is generally measured by the bid-ask spread.\textsuperscript{487} Amihud and Mendelson have provided the only study to date that tests the relationship of risk and illiquidity to actual returns using a methodology that controls for systematic

\textsuperscript{485} Amihud & Mendelson, \textit{Asset Pricing and the Bid-Ask Spread}, 17 J. Fin. Econ. 223, 224 (1986) [hereinafter Amihud & Mendelson, \textit{Bid-Ask}]. Because "[i]nvestors require a higher expected return from an asset with lower liquidity to compensate for its higher trading costs[,] firms have an incentive to carry out policies which increase the liquidity of the financial claims they issue, since this may lower the required return on these claims and increase their value." Amihud & Mendelson, \textit{Liquidity and Asset Prices: Financial Management Implications}, Fin. Mgmt., Spring 1988, at 5, 6 [hereinafter Amihud & Mendelson, \textit{Liquidity}]. They also argue that a change in liquidity has a greater effect on the cost of capital when liquidity is high rather than when it is low, because the initial expectation of investors in less liquid assets is for long-term appreciation, which places little value on liquidity. The Amihud and Mendelson approach is secondary market based rather than fundamental valuation based. Liquidity is of value, although not directly perceived as valuable by fundamental value investors. Firms that trade in a market will have an increased cost of capital because of liquidity risk. This view of the relative value of liquidity has implications for a liquidity based test if the residual claimants in leveraged buyouts view liquidity as an unnecessary component for portfolio diversification. See supra note 173 and infra note 520.

\textsuperscript{486} Amihud & Mendelson, \textit{Liquidity}, supra note 484, at 7.

\textsuperscript{487} The bid-ask spread is simply the difference between the price bid and the price asked. Y. AMIHUD, T. Ho & R. SCHWARTZ, MARKET MAKING AND THE CHANGING STRUCTURE OF THE SECURITIES INDUSTRY 53 (1985). Amihud & Mendelson, \textit{Bid-Ask}, supra note 484, at 223-24 (illiquidity is measured by the cost of immediate execution, the spread between the selling concession, the lower bid price, and the buying premium, the higher ask price). The bid-ask spread has been approached in terms of a transaction cost to the trader for immediacy, see Demsetz, \textit{The Cost of Transacting}, 82 Q.J. Econ. 33, 35-37 (1968), including dealer inventory costs, see, e.g., Ho & Stoll, \textit{On Dealer Markets Under Competition}, 35 J. Fin. 259 (1980), and as a tradeoff between expected losses to informed traders and expected gains to uninformed traders. See, e.g., Bagehot, supra note 480, at 13-14, 22. Another measure of liquidity is the change in the bid price over time. S. Grossman & M. Miller, \textit{Liquidity and Market Structure} 21-22 (National Bureau of Economic Research Working Paper No. 2641, 1988).

Keynes once observed that while most of us could surely agree that Queen Victoria was a happier woman, but a less successful monarch than Queen Elizabeth I, we would be hard put to restate that notion in precise mathematical terms. Keynes' observation could apply with equal force to the notion of market liquidity. The T-bond Futures pit at the Chicago Board of Trade is surely more liquid than the local market for residential housing. But how much more? What is the decisive difference between them? Is the colorful open-outcry format of the T-bond Futures market the source of its great liquidity? Or does the causation run the other way?

\textit{Id.} at 2.
risk in order to isolate the role of liquidity. They tested a model against empirical data and demonstrated that the greater the risk and the illiquidity, the greater the return; with the risk-return ratio varying over time. The Amihud and Mendelson model demonstrates that firms with a low liquidity risk have a lower cost of capital than firms with a higher liquidity risk. Other models find a relationship between a perceived fundamental risk and the existence of a liquidity premium for assets, with decreases in fundamental risk decreasing the demand for liquidity. Financial economists are also concerned with the reasons for illiquidity and its financial costs.

Other evidence exists as to the value of liquid as compared to illiquid assets. Venture capital returns from seed, start-up, first-stage, second-stage, and mezzanine financings prior to a successful initial public offering reveal an ever increasing return to the earlier capital providers. A body of literature has used a variety of

488. Amihud & Mendelson, Bid-Ask, supra note 484. The model suggests and the data confirms that the average portfolio risk-adjusted returns increase with the bid-ask spread and there is a clientele effect where investors with longer holding periods select assets with higher spreads, but with a concave relationship whereby the returns on the higher spread stocks are less spread sensitive. Id. at 224-25.

489. See Corcoran, The Anatomy of Buyout Fever, INVESTMENT MGMT. REV., Jan. 1989, at 7. Corcoran postulates that the increase in perceptions of fundamental risk will increase the demand for indirect ownership of assets through which the assets are securitized and thus have liquidity. Id. at 7-8. He tests that proposition against the demand for securitized asset ownership in the form of REITs and then correlates the empirical testing of his model with the securitized assets to the general trend in mergers and acquisitions. He concludes that mergers and venture capital allocations are also correlated to fundamental risk perceptions and will increase when risk (and the transaction costs of such investments) declines. Id. at 12-14. Cf. Copeland & Galai, Information Effects on the Bid-Ask Spread, 38 J. Fin. 1457, 1468 (1983)(bid-ask spread has a positive correlation with the security's price level, price volatility, and residual risk).

490. See, e.g., Gloston & Harris, Estimating the Components of the Bid/Ask Spread, 21 J. Fin. Econ. 123 (1988)(model of the bid/ask spread based on the following components: information assymetry, inventory cost, monopoly power of specialists, and clearing costs).

491. See E. Bloch, supra note 417, at 208-10. Investor-oriented approaches to investment in private companies also show an increasing concern for the illiquidity premium. See A. Lipper, VENTURE'S FINANCING AND INVESTING IN PRIVATE COMPANIES 144-49 (rev. ed. 1988)("The only point to be certain of is that the returns anticipated from the illiquid investment must far exceed those available from marketable securities.").

There is anecdotal evidence that an investor would require a projected investment return of the private company of three to five times higher before considering the private company a suitable substitute investment for the lack of liquidity of the investment. See A. Lipper, supra, at 3, 7 (survey of professionals who caution that "sacrifice of liquidity is a serious consideration"). This anecdotal evidence may be incorrect since the returns to venture capital investors now do not approach this target return, see infra note 499, and the
methods to examine the effect of lack of marketability on stock valuation, including comparing the prices of restricted stock ("letter stock") to a public company's freely tradable stock, comparing the returns to investors in private transactions prior to public offerings, and by reviewing court decisions attempting to value closely held interests for wealth transfer and income tax purposes. The study of discounts of letter stock began with the 1971 Securities and Exchange Commission Institutional Investor Study Report which led to the requirement that institutional investors report their restricted securities and created a body of data for further study. While the earlier studies found a higher discount, especially for letter stock of over-the-counter companies, the average and median discount reported in most studies was approximately thirty-five percent. Generally, lower average discounts were found for the letter stock of NYSE and Amex compa-


494. S. Pratt, supra note 492, at 241-43.

495. Id. at 246-47 (Standard Research Consultants' studies reveal a median discount of 45 percent and the study of the author's company, Willamette Management Associates, Inc., found a 31.2 percent median discount for 33 letter stock transactions compared to freely traded stock). See also Institutional Investor Study Report, supra note 493, at 2444-56 (in the over-the-counter market, the average discount depending upon purchaser group (banks, investment advisors, life insurance companies, venture capital companies, and other institutions) ranged from 16.1 percent to 39.4 percent for reporting companies and 22.4 percent to 45.7 percent for non-reporting companies); Gelman, An Economist-Financial Analyst's Approach to Valuing Stock of a Closely-Held Company, 36 J. Tax'n 353, 354 (1972)(found average and median discounts of 33 percent); Trout, Estimation of the Discount Associated with the Transfer of Restricted Securities, 55 Taxes 381, 383 (1977)(found average discount of 33.45 percent); Moroney, Most Courts Overvalue Closely Held Stock, 51 Taxes 144, 154 (1973)(found median discount of 35 percent); Maher, Discounts for Lack of Marketability for Closely Held Business Interests, 54 Taxes 562, 564 (1976)(results indicate that discount should be around 35 percent). For a summary of the above studies, see S. Pratt, supra note 492, at 241-48.
nies depending upon the purchaser. Between 1985 and 1986, data on private transactions taken within five months prior to public offerings shows an average and a median discount of forty-three percent with a range of discounts from three to eighty-five percent. One study of data from initial public offering prospectuses found a median discount of sixty percent adjusted for change in industry stock price indexes and a median discount of 41.7 percent based on industry price-earnings ratios. Arguably these studies do not control for risk in determining the source of the discount in order to distinguish risk from liquidity, although the comparison generally was to the value of the company's comparable liquid stock and the discounts may reflect incentives to undervalue stock in certain transactions. As the venture capital industry has expanded, the amount of discounts for private companies relative to public market prices has been decreasing. Nonetheless, there is both theoretical and empirical support for the relationship of liquidity to returns, the firm's cost of capital,

496. Institutional Investor Study Report, supra note 493, at 2455-56 (Table XIV-52). For example, for the NYSE, the report finds a discount of 18.7 percent for bank purchases, 21.6 percent for investment advisor purchases, 19.9 percent for life insurance company purchases, 32.5 percent for venture capital purchases, and 9.2 percent for other institutions. Id. at 2456 (Table XIV). Discounts on the Amex were 22.5 percent for bank purchases, 25.4 percent for investment advisor purchases, 23.7 percent for life insurance company purchases, 36.3 percent for venture capital purchases, and 13 percent for other purchases. Id.

497. S. PRATT, supra note 492, at 250-57 (citing Willamette Management Study).

498. See supra note 496.

499. Observations from the venture capital industry support an annual rate of return to bridge capital providers in the last tranche of venture capital financing for high technology companies from 15 percent to 30 percent. Telephone interview with Timothy Spicer, Chief Financial Officer, Hambrecht & Quist Co. (May 26, 1989). This correlates with statistics showing lower returns to venture capital generally. See Chiang & Kallet, Risk/Return Profile of Venture Capital, 4 J. Bus. VENTURING 1, 2 (1989). Statistics not isolated to technology firms and other start-up industries might be lower since they may include savings and loan conversions. Telephone interview with Timothy Spicer, supra. There may be an "illiquidity premium" in the current market for several reasons. First, the public companies on a price-earnings ratio are undervalued relative to their business due in part to the large amount of venture capital funding of technology firms in 1982 and 1983. Id. Second, increased participation by investment banking firms in the venture capital industry, particularly mezzanine financing, has raised the values for private firms based on increased information on the industry and increased competition to provide capital to successful and potentially successful firms. Id. For the relationship of these developments to the issue of the inelasticity of demand for liquidity, see infra notes 754-76 and accompanying text. Other factors presumably could lead to an illiquidity premium. There are less established accounting standards for the valuation of venture capital portfolios, which may lead to agency costs if management compensation is based on the value of the portfolio. Portfolios may demonstrate a pricing effect that reflects a reluctance to lower values.
and the benefit of the public market.

The fact that investors can reduce their risk in any particular asset by holding a diversified portfolio at a given individual level of risk preference does not mean investors can avoid the costs of illiquidity, since those costs are borne on the purchase or sale of the security. The only remedy is to alleviate the costs of illiquidity through the financial policies of the firm. Liquidity-enhancing policies that increase the value of the firm by reducing its costs of capital include many costs of their own — the initial costs of the public offering and recurring costs such as agency costs and shareholder servicing costs — all of which will be undertaken only if the costs of increasing liquidity are less than the gains.

Portfolio theory suggests that diversification with highly illiquid assets is possible, although necessarily more costly. Nonetheless, as James Tobin demonstrates, continuously maintaining a

500. See supra note 484 and accompanying text (Amihud and Mendelson methodology). Risk preferences determine the mix of the risk level of assets that will be held by an investor under her particular utility function. See E. ELTON & M. GRUBER, supra note 482, at 179-21.

501. Amihud & Mendelson, Liquidity, supra note 484, at 7. Liquidity enhancing factors include: public offerings, organizational form, limited liability, corporate borrowing, disclosure of inside information, and certification of a new issue. Securitization of assets allows relatively illiquid portfolios of assets to gain liquidity, lowers interest costs for borrowers, and diversifies credit risks and neutralizes interest rate risks for lenders, while allowing investors to increase the volume and variety of investment options. Bryan, Introduction, in THE ASSET SECURITIZATION HANDBOOK 3-20 (P. Zweig ed. 1989); Asset Finance Group First Boston Corporation, Overview of Assets and Structures, in THE ASSET SECURITIZATION HANDBOOK 21, 25-26, 32-33 (P. Zweig ed. 1989).


503. Id. at 371-74; see also Ritter, The Cost of Going Public, 19 J. FIN. ECON. 269 (1987)(presenting evidence of direct and underwriting expenses as cost of going public). The value of public trading is comprised of: (1) access to capital without interest payments and without complying with bank liquidity rules; (2) name recognition; (3) exit perogatives for a controlling shareholder who wants to cash out and retire; (4) availability of stock options and incentives which can be used to attract highly qualified personnel; and (5) dilution of the ownership of the founders while giving them majority interest and control. See Nelson, Are You Ready to Take Your Company Public?, ENTREPRENEUR, Feb. 1988, at 63, 63-64. Realities, however, do not measure up to expectations in all cases. The disadvantages include: (1) increased reporting and filing requirements; (2) liability of management for conduct, decisions, and failure to disclose certain information; and (3) lessening of flexibility to manage the business, especially in actions that require shareholder approval. Id.

diversified portfolio generally requires not only liquidity but also monitoring.\textsuperscript{505} Evidence of the demand for liquid financial assets with high returns\textsuperscript{506} and the value of those assets,\textsuperscript{507} suggests that there is a demand for such assets that is price inelastic to the actual return of those assets.\textsuperscript{508} If so, taxing liquid equity under a double tax system is good tax policy.\textsuperscript{509}

In October of 1988, the Securities Exchange Commission proposed adding Rule 144A to the Securities Act of 1933.\textsuperscript{510} The rationale for the proposed rule is based upon both the internationalization of the world's securities markets and the growth in the private placement market.\textsuperscript{511} If adopted, this rule would allow im-

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\[\text{[hereinafter Tobin, \textit{Liquidity}].}\]
\textsuperscript{505} Tobin, \textit{Liquidity}, supra note 504.
\textsuperscript{506} See infra note 762.
\textsuperscript{507} See infra note 770.
\textsuperscript{508} See infra notes 765-70.
\textsuperscript{509} See infra notes 752-75.
\textsuperscript{511} According to S.E.C. Chairman David S. Ruder, these dual events necessitate Rule 144A:
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Development of Rule 144A has been compelled not only by internationalization of the securities markets, but also by the tremendous growth of the private placement market. In 1981, $18 billion worth of securities were privately placed in the United States. In 1987, such placements totalled approximately $139 billion. In 1988, approximately $202 billion were raised in this private placement market, representing approximately 43 percent of total corporate financing in the United States that year.

Rule 144A is intended to provided a framework in which qualifying institutional resales can be freely undertaken. This rule, as well as the resale safe harbor provisions of proposed Regulation S, should provide increased liquidity in the secondary market for privately placed securities. The potential increase in liquidity could significantly lower the discount commonly associated with private placements, which could in turn attract an increasing number of issuers, including foreign issuers, into the private placement market.

Foreign issuers that previously may have been concerned about compliance costs and liability exposure associated with registered public offerings in the United States or that may have been concerned about the financing costs inherent in placing restricted securities may find U.S. private placements more financially attractive under Rule 144A. Direct participation by foreign issuers in the U.S. capital markets would reduce the costs born by U.S. institutional investors by enabling them to invest in a diversified worldwide portfolio without leaving the U.S. securities markets.

\textit{Hearing before the Senate Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs, 101st Cong., 1st Sess. (June 15, 1989)} (prepared statement of David S. Ruder, at 24-26 (footnotes omitted)). At the same time, Chairman Ruder explained that the Commission is continuing to examine questions as to the application of
mediate resale\textsuperscript{512} of securities issued in private placements to institutional investors, creating instant trading liquidity in the private placement market.\textsuperscript{513} Testimony on proposed Rule 144A suggests that institutional investors would not invest in private placements of equity securities even if Rule 144A were adopted, unless there was a price discount reflecting the absence of the liquidity found in a public market.\textsuperscript{514} In addition, the Commission asked for comments on the value of liquidity in lowering the cost of both debt and equity. It received only the most general statements that Rule

United States registration requirements to overseas securities offerings in connection with Proposed Regulation S, Securities Act Release No. 6779, 53 Fed. Reg. 22661 (1988)(offers and sales in the U.S. should be subject to United States securities laws registration requirement even if purchasers are foreign, but sales and offers outside of the United States do not affect the United States securities markets and therefore should not be subject to registration). \textit{Id.} at 23-24.

\textsuperscript{512} For limitations on resale, see Hicks, \textit{supra} note 473, at 432-33; Analysis of Regulation D, New SEC Rulings, [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) \S 83,631, at 86,886-91 (May 1984)(reporting that Regulation D, which exempts certain private and limited offerings from registration requirements, has not replaced private placements to large institutional investors).

\textsuperscript{513} Securities Act Release No. 6806, \textit{supra} note 510, at 89, 539-40. The private placement market has largely consisted of debt securities. This changed in 1987. In that year, equity securities, mostly preferred stock, totalled $17 billion or 12\% of total new private placements in the U.S. \textit{Id.} at 89,528. Not surprisingly, the current private placement market is dominated by insurance companies. Other institutional investors only account for 10\% to 20\% of the total private placements. This disparity is related to the contractual and legal requirements of these other institutions. \textit{Id.} at 89,530. The secondary market involves almost exclusively debt securities. \textit{Id.} at 89,532. The proposed adoption of a rule permitting resales among institutional investors prompted the Commission to request comment on whether an active, liquid private market would develop alongside the public market for the same class of securities. Comment also was requested on the consequences to the liquidity and efficiency of the public market if this dual market should develop, including arbitrage opportunities between the two markets. \textit{Id.} at 89,533-34.


\textsuperscript{514} \textit{Compare} S.E.C., Roundtable on Proposed Rule 144A (Mar. 14, 1989)(hereinafter "Rule 144A Roundtable")\textsuperscript{5}(statement of Curtis Welling, Managing Director of Capital Markets, First Boston Corp.)(citing lack of liquidity and unattractiveness of private placements "if publicly-traded stock is available") \textit{with} (statement of Joseph Grundfest, Commissioner, S.E.C.)(discounts also lead to cost advantages for side-by-side public and Rule 144A markets for equity for lesser known companies), \textit{reported in} 21 Fed. Sec. L. Rep. (CCH) 413, 414 (Mar. 17, 1989).
144A would increase liquidity and lower the cost of capital.\footnote{515}

In July of 1989, the Commission re-proposed Rule 144A, restricting its scope to a single class of institutional investors. The class is based on a revision of tier one, the "qualified institutional buyer" tier, of the original proposal.\footnote{516} The Commission modified the definition of a qualified institutional buyer, rejecting a "total assets" test in favor of an amount "invested in securities" test as a method of establishing an institution's \emph{per se} sophistication in the resale market for privately placed securities.\footnote{517}

Additionally, re-proposed Rule 144A excludes the equity and debt securities\footnote{518} of a class that is publicly traded in the United States on an exchange or an automated inter-dealer quotation sys-

\footnote{515. Interview with Elisse Walter, Deputy Director, Securities and Exchange Commission, Division of Market Regulation (Mar. 15, 1989). The author's perception of the roundtable discussion of Rule 144A at the S.E.C. on March 15, 1989 which she attended is that it did not provide any empirical data on the value of liquidity and focused more on the proposed rule as it would affect debt placements rather than equity. The Comment letters also did not include a discussion of the empirical value of liquidity. \textit{See} S.E.C., \textit{Summary of Commentators' Remarks, Proposed Rule 144A, Proposed Amendments to Rules 144 and 145} (May 3, 1989).


517. \textit{Id.} at 80,224-25. The revised proposal defines "qualified institutional buyer" as an institution that has at least $100 million invested in securities at the close of its most recent fiscal year. \textit{Id.} at 80,224. The change in focus from total assets to amount invested in securities was driven by the commissions' desire to limit the number of troubled banks and thrifts eligible to participate. \textit{See} Levin \& Maher, \textit{SEC's Modified Private Placement Rule Aimed at Thrifts, Banks}, \textit{Investment Dealers' Digest}, July 17, 1989, at 5. The Commission is still debating whether to lower that threshold in adopting Rule 144A, or whether to adopt the rule as re-proposed and lower the threshold with an early amendment. Establishing the threshold for Rule 144A eligibility has been the Commissions's main obstacle in adopting the rule. \textit{Id.}

518. Prop. Rule 144A(d)(3)(i), (5) (July 11, 1989). A debt limitation on Rule 144A would heighten the issue of debt-equity classification for securities offerings. Rule 144A Roundtable, \textit{supra} note 513, at 414 (statement of Edward Benjamin, Chair, American Bar Ass'n Federal Regulation of Securities Subcommittee on the 1933 Act — General). For foreign securities not currently publicly traded in the United States, to prevent leakage of unregistered securities into the public markets, the proposed rule provides that if the securities are securities traded on a foreign exchange or designated organized foreign securities market and have been quoted within the U.S. inter-dealer quotation system within a twelve month period, reasonable steps must be taken to prevent the purchaser from reselling the securities without registration. Reasonable steps are the execution of a written agreement evidencing a commitment to prevent transfer in conjunction with a procedure administered by the issuer or a third party that is reasonably designed to prevent the transference of securities without registration to other than a qualified institutional buyer. \textit{See} Prop. Rule 144A(d)(5) (July 1, 1989).}
This exclusion would apply to NASDAQ, but would not encompass the present pink sheet market. The Commission limited the Rule's applicability despite believing that side-by-side markets for equity securities would not develop for securities that were already publicly traded, since those equity securities "presumably would still trade at a discount to the same securities in the public market," were generally offered in "transactions involving debt securities with an equity component, a leveraged buyout, a joint venture, or a restructuring . . . , [and] would be likely to flow into the public market when the holding period requirement of Rule 144 was satisfied." The Commission's exclusion of fungible securities was likely in response to the sharp pocketbook reaction of the exchanges and other commentators who stand to lose business when Rule 144A is adopted. In addition,


521. Id. at 80,233.

522. Id. at 80,223 n.12 (quoting Securities Act Release No. 6806). While the changes in management structure from leveraged buyouts may result in residual claimants becoming long term investors without liquidity, confirmed in part by a low rate of reverse leveraged buyouts, Rule 144A will provide liquidity in the third market for the institutional investors who fund the transactions. This argument was made generally in Jensen, Eclipse, supra note 173. Jensen argued that institutional investors will seek diversified portfolios of illiquid "private positions" in firms and will abandon the trading strategy that has long dominated institutional money management. Id. at 62-63. Jensen's position must assume that there is no legal restriction on holding illiquid securities, because he was apparently unaware of proposed Rule 144A. The preference for the privatization of equity is supported in part by the low number of reverse leveraged buyouts reported in C. Muscarella & M. Vetsuypens, Efficiency and Organizational Structure: A Study of Reverse LBOs (Southern Methodist University Working Paper, Apr. 1989)(reporting that only five percent of 1,300 LBOs between 1981 and 1986 have gone public again).

523. See, e.g., Levin, NYSE Still Has Misgivings About SEC Plan for Private Placements, INVESTMENT DEALERS' DIGEST, Oct. 2, 1989, at 8, 43. Whether a dual equity market for identical equity securities, rather than for debt securities, which are by their nature and by expressed covenants generally not fungible, will decrease the liquidity of the public equity market and efficiency through going private transactions to avoid the 1934 Act reporting requirements were expressed concerns. See Letter of the New York Stock Exchange to the S.E.C., dated Feb. 3, 1989, and Letter of Edward O'Brien, President of the Securities Industry Ass'n to the S.E.C., dated Feb. 16, 1989, reported in 21 Fed. Sec. L. Rep. (CCH) 381, 382 (Mar. 10, 1989). Others expressed concern that the side-by-side Rule 144A market would result in the further institutionalization of the securities markets and perceptions of removing small investors from the markets. Rule 144A Roundtable, supra note 513, at 414 (statements of Edward I. O'Brien, President, Securities Industry
the Commission indicated that it would consider whether the securities acquired within the Rule 144A exemption should be considered illiquid for purposes of the investment advisory account limitations on holdings of illiquid securities. In effect, the move toward privatization of equity will create a significant category of corporations subject to the corporate tax under theory proposed in this Article — institutional investors will replace the general public entirely and will enjoy liquidity through the Rule 144A market.

If Rule 144A is adopted for equity as well as debt issues, there will be a golden opportunity to empirically test liquidity preferences by comparing the returns for private placements before and after the adoption of the rule. The value of any resulting liquidity premium for equities (as contrasted with the risk premium for equity over debt and the ambiguous liquidity premium for high yield debt) which has been exacerbated by current market conditions can then be quantified. For example,
one current measure of the \textit{ex post} risk and liquidity premia is the return to the venture capital industry as compared to small stocks and the Standard and Poor’s 500, which can be conceptualized in part as the percentage decrease in cost of equity capital in the private rather than the public market for equity.\footnote{528}

yield holdings of all quality ranges and received discounts of four to nine points for every $1,000 of bonds if there was a market maker willing to deal. \textit{See} Wallace, \textit{End for “Junk Bond” Takeovers?}, N.Y. Times, Oct. 14, 1989, at 17, col. 3. The high yield market has changed into a tiered market with lower rated issues shunned by investors, \textit{see} Investment Insight, Wall St. J., Oct. 24, 1989, at C1, col. 1, and with a higher rate of defaults and illiquidity, \textit{see} Winkler, \textit{Junk Bond Turmoil May Be Here to Stay}, Wall St. J., Oct 24, 1989, at C1, col. 3. The use of equity sweeteners is established in the high yield market, especially when the market is soft. \textit{See} Wallace, $475 Million “Junk” Issue Sold at Sweetened Price, N.Y. Times, Oct. 21, 1989, at 43, col. 5 (noting the issue of 14.75 percent Chicago and Northwestern Acquisition Corp. bonds sweetened with ten percent of the equity of the company in a transaction to refinance prior bridge loans). \textit{See generally} Mitchell, \textit{Investors Junk Stock of Firms with Heavy Debt . . . But Bond Buyers Lured by Equity Stakes}, Wall St. J., Nov. 6, 1989, at C1, col. 5. This trend will also lead to pressures to utilize convertible preferred stock and convertible debt financing of leveraged buyouts. \textit{See} Wallace, \textit{Leveraged Buyout Leader Shifts Attention}, N.Y. Times, Nov. 3, 1989, at 29, col. 3 (reporting the formation of a Forstmann, Little & Company buyout fund that will invest in publicly traded companies without borrowing, with management’s consent, and with seats on the companies’ boards to secure positions not unlike those of Warren Buffett with the Coca-Cola Company and Salomon Brothers Inc.). The illiquidity in the junk bond market has continued as the market maker Drexel Burnham Lambert Inc. has become increasingly weakened. Eichenwald, \textit{A Financial Crisis May Force Drexel to Seek a Merger}, N.Y. Times, Feb. 13, 1990, at A1, col. 6; Henriquez, \textit{Controlling the Damage}, N.Y. Times, Feb. 13, 1990, at A1, col. 5.

Privately placed bonds yielded, on average, 50 basis points more during 1961-1977 than publicly issued bonds of similar quality, duration and tax treatment. \textit{See} Zwick, \textit{Yields on Privately Placed Corporate Bonds}, 35 J. Fin. 23 (1980). For large publicly traded companies issuing investment grade debt, “the spread between interest costs in the public and private markets is collapsing because of the pent-up demand for private deals. Instead of a typical financing premium of 0.125 to 0.25 of a percentage point, some recent private-market deals almost matched what the public market would charge.” White, \textit{Private Placement Market Attracts More Business Than It Can Handle}, Wall St. J., Feb. 10, 1989, at C1, col. 4. (referring to debt placements).

For \textit{equity} returns, market segmentation is more difficult and a presumed liquidity preference supplies a guideline to investor expectations. Bond market segmentation allows purchasers to choose between slow pay and fast pay features in investment conduits such as REMICs. Amihud and Mendelson argue that, unlike privately held bonds held by the initial purchaser until maturity, “residual claims — which usually do not have finite maturity — are more likely to be traded, hence their trading cost is of greater importance and so is the impact of illiquidity on their required returns.” Amihud & Mendelson, \textit{Liquidity}, \textit{supra} note 484, at 9. This insight is supported by valuation discounts for private firms based on lack of marketability. \textit{See supra} notes 492-98 and accompanying text.

528. Mature venture capital firms with investments over six years encountered annual average returns of 24.4 percent. \textit{See} Chiampou & Kallett, \textit{supra} note 499, at 6-7. For 1978-1987 for the comparison between the premiums for venture capital, the 1.9 percent \textit{ex ante} return over the small stock return for venture capital over the same period was in actuality a 4 percent premium. \textit{Id.} The venture capital return over the S & P 500 was
Access to public capital markets for small business also depends on the relative costs of obtaining liquidity and the maintenance of the integrity of the financial disclosure market. Studies by the Small Business Administration on the feasibility of expanding the capital markets for small business securities require an evaluation of the value of the liquidity obtained therein. Like Rule 144A, capital market developments are highly relevant to the liquidity standard.

2. Monitoring

Liquidity has value as a monitoring device for both equity holders and firms because it provides a mechanism for evaluating firm performance through market valuation of the firm's securities. Increased awareness of agency costs suggests that firms may not be profit maximizers. The agency problems that may result in expected at 5.6 percent and was actually 8.5 percent. *Id.* The returns to the venture capital industry are decreasing as additional funds are placed in the industry. *Id.* at 2.

The *ex ante* cost of capital over the Treasury bill rate for venture capital was 13.9 percent and was 12 percent for small stocks. Assuming that the venture funds in the Chiaampilou and Kallett sample were fully diversified so that the risk of the individual investments was fully hedged, their required or expected *ex ante* return over the market for small stocks was 1.9 percent. Since the liquidity-risk premium for corporate bonds over the treasury bill rate was 1.8 percent, the equity cost of capital (the equity premium above the long term bond rate) for these small stocks was roughly 10.2 percent. The equity cost of capital for venture capital above the long term corporate bond rate was roughly 12.1 percent. The equity cost of capital for small stocks was therefore approximately 85 percent of the equity cost of capital for venture capital. Venture capital required an equity return approximately 18.5 percent higher than the *ex ante* equity return for small stocks in order to invest. Based on *ex post* returns, venture capital returns were 15.2 percent above the Treasury bill rate and small stock returns were 11.2 percent. The actual *ex post* return to venture capital over the *ex post* return to long term bonds of 1.6 percent above the Treasury bill rate was 13.6 percent; the small stock return was 9.6 percent. The actual premia was 4 percent. The small stock cost of capital was 70.1 percent of the venture capital return and the actual premium for venture capital over small stocks was 40.1 percent. Viewed as an actual premium over the expected return from small stock over the expected long term bond rate, the venture capital premium was approximately 30 percent.

These very rough estimates of a liquidity premium should include a risk premium since the systematic risk of the venture capital portfolios and small stocks were not controlled. They suggest, however, that if an interest return is allowed on capital a tax policy that taxes a portion or all of the liquidity based return of liquid equity will equalize the cost of capital.

529. *See supra* notes 417 & 520.

530. The SBA has a grant proposal currently studying the feasibility of establishing a capital market for small business securities and reviewing the transaction costs and other features of the London Unlisted Securities Market and the Vancouver Market. *See Proposal* of Ulice Payne announced in Commerce Business Journal (Sept. 15 1988).

lower profits can be controlled to a great degree by the existence of a public market for ownership interests in the firm. The shareholders' collective ability to affect the market price of the firm's stock by selling their shares in the open market has been viewed by commentators as the shareholders' major influence over the firm. To the extent industry information readily exists, shareholder behavior may give owners a yardstick for measuring manager performance. However, firms with nontransferable shares have reduced access to external information. This lack of external information reduces the ability to monitor the performance of the managers and reduces the incentives to monitor.

Nontransferable ownership interests create problems in portfolio diversification as well as problems in monitoring. Since claims cannot be bought or sold, the decision to diversify is restricted and owners are required to bear risks that diversification would reduce. Furthermore, because claims cannot be concentrated, costly actions designed to increase the net cash flow of the firm are less likely to be undertaken. The existence of a publicly

532. Fama and Jensen provide a strong statement on this point:

The unrestricted transferability of common stock residual claims allows for a market that will control the agency problems that result in below-market returns on the shares. The stock market offers clear signals on the implications of internal agent decisions on net cash flows. Holders of the rights to residual claims are free to dispose of their shares and, in the process, signal the decision agents about their perceived performance. Additionally, specialists can extend a tender offer or engage in a proxy fight to alter the behavior of the decision agents and capitalize the gains from improving the efficiency of the corporation. Fama & Jensen, Separation of Ownership and Control, 26 J.L. & Econ. 301, 312-13 (1983). Others note the severe agent-principal problems in cooperatives due to the lack of transferability of ownership interests. See Porter & Scully, Economic Efficiency in Cooperatives, 30 J.L. & Econ. 489, 493 (1987). "Since the members' shares cannot exchange in the market, and since the net cash flow cannot be capitalized and sold, there is no external information available to the principals through which the performance of the agent (manager) can be evaluated."


535. In contrast to a proprietary firm where the owner can capture the entire income stream of the entrepreneurial function, in "jointly controlled firms with nontransferable claims, only a portion of additional income can be captured by the innovator if he is already a participant and none if he is an outsider, [and] [t]hus, fewer resources are dedicated to the entrepreneurial functions of innovation and organization, and fewer resources
traded market helps management determine the projects in which to invest, while it simultaneously provides the owners with a means to evaluate those projects in which management does invest.

3. Diversification and Portfolio Changes

Modern portfolio theory is based explicitly on the capital asset pricing model (CAPM) and implicitly on the efficient market hypothesis. The CAPM prices assets by the way in which they deviate from a beta of 1.0 — the risk of the market. The efficient market hypothesis posits that prices immediately reflect available public, and perhaps private, information, and that secur-

are expended in monitoring and enforcing contracts.” Porter & Scully, supra note 532, at 497.

Efficiency and the level of transferability of ownership interests has also been linked to the transferability of private ownership and government-owned (political) firms as an explanation of the lack of efficiency in the latter. See DeAlessi, Property Rights, Transactions Costs, and X-Efficiency: An Essay in Economic Theory, 73 AM. ECON. REV. 64, 68 (1983). But see Leibenstein, Property Rights and X-Efficiency: Comment, 73 AM. ECON. REV. 831 (1983).

536. The market evaluates the firm’s activities. The firm could receive feedback before embarking on a project by monitoring changes in market-based capitalized values. Indeed, a signal given by the capital-asset pricing model could be used in order to evaluate a project, see DeAlessi, supra note 535, at 68 and is explicitly used in “q” evaluations of projects, see supra note 68. This approach is risky if the stock is traded in a market with high transaction and information costs because the possibility of insolvency and/or bankruptcy is significant. This counsels greater reliance on the total variability to the market when the firm decides whether to invest in a risky asset. Id. The believed superiority of market measures of investment decisions lie behind recommendations that they be used for private firms in assessing investment decisions. See Collins & Barry, Beta-Adjusted Hurdle Rates for Proprietary Firms, 40 J. ECON. BUS. 139 (1988)(constructing a beta for private firms).

537. For a discussion of “q”, see supra note 68.

538. S. Ross & R. Westerfield, supra note 105, at 192-95; R. Brealey & S. Myers, supra note 62, at 173-203. The capital asset pricing model values the equity interest of a firm. The model assumes: (1) “capital markets are highly efficient where investors are well informed,” (2) “transaction costs are zero,” (3) “there are negligible restrictions on investment and no taxes,” (4) “no investor is large enough to affect the market price of the stock,” and (5) “investors are in general agreement about the likely performance and risk of individual securities and that their expectations are based on a common holding period.” J. VAN HORNE, FINANCIAL MANAGEMENT AND POLICY 62 (8th ed. 1989).

539. The efficient market hypothesis has been defined as having three levels of market efficiency: (1) the weak form, in which prices reflect all the information contained in the record of past prices, (2) the semi-strong form, in which prices reflect not only past prices but all other published information, and (3) the strong form, in which prices reflect not just public information but all the information that can be applied by painstaking fundamental analysis of the company and the economy. See V. BRUDNEY & M. CHIRELSTEIN, supra note 60, at 121, 123-30.
ity prices follow a random walk so that one cannot "beat" the market.\textsuperscript{540} In order to determine what risk premium — the return over and above that obtained from a riskless asset — the portfolio will command, it is no longer necessary to determine the risk inherent in a particular security. For those who accept and invest under this theory, it is only necessary to determine the systematic risk inherent in a total portfolio of securities.\textsuperscript{541}

Arbitrage pricing theory is an alternative view of asset pricing, likewise used to determine the appropriate risk-adjusted discount rate to use in valuing equity securities. It determines a risk premium relative to the market based on a weighted analysis of systematic factors affecting a stock. However, under arbitrage pricing theory the market measure of systematic risk is not beta but is measured through the sensitivity of the stock to selected economic factors.\textsuperscript{542} Alternatively, option pricing theory values the equity in the firm as a European call option on the residual value

\begin{itemize}
  \item MacQueen, \textit{Beta Is Dead! Long Live Betal}, in \textsc{The Revolution in Corporate Finance} 52, 55 (J. Stern & D. Chew eds. 1986). The most accurate beta is derived from the fundamental valuation components of the firm and the projects in which it is engaged. Rosenberg & Rudd, \textit{The Corporate Uses of Beta}, in \textsc{The Revolution in Corporate Finance} 58, 64-65 (J. Stern & D. Chew eds. 1986); Malkiel, \textit{Risk and Return: A New Look}, in \textsc{The Changing Roles of Debt and Equity in Financing U.S. Capital Formation} 27 (B. Friedman ed. 1982)(another discussion of beta). Other measures than beta such as the risk of the economy, inflation risk, interest rate risk, and dispersion of analysts forecasts could be used as a measure of a stock's systematic risk. See Malkiel, \textit{supra} at 27, 43 (suggesting that the dispersion of analysts forecasts is a better measure of systematic risk).
  \item While CAPM has provoked controversy, a useful insight from CAPM is that only the risk that investors cannot diversify away (systematic risk) should be compensated by a risk premium. S. Ross & R. Westerfield, \textit{supra} note 105, at 161-73.
  \item R. Haugen, \textit{supra} note 454, at 207-25. Arbitrage pricing theory (as distinguished from an arbitrage opportunity) is the result of several assumptions.

  We assume that the covariances that exist between security returns can be attributed to the fact that the securities respond, to one degree or another, to the pull of one or more factors. We don't specify exactly what these factors are, but we do assume that the relationship between the security returns and the factors is linear.

  \textit{Id.} at 207-208. The arbitrage pricing theory is argued to have two advantages over the capital asset pricing model: less restrictive assumptions regarding investor's preferences towards risk and return and greater testability. See R. Haugen, \textit{supra} note 454, at 155-61, 203-04, 214-15. The point of difference is that arbitrage pricing theory acknowledges that investors choose between alternative investments by examining both the expected return and other factors. Whether one accepts the capital asset pricing model, the arbitrage pricing theory, the market model, fundamental analysis, or the efficient market hypothesis as the correct view of the \textit{pricing} of securities in a market, investor assumptions with respect to risk and return, and investor desires to maximize their utility functions are always the same. See R. Haugen, \textit{supra} note 454, at 207-25.
\end{itemize}
of the assets granted the shareholders by the bondholders.543 Regardless of the theory one applies, in present value terms the price of an asset relative to the total market reaches an equilibrium based on the relative risk assessment that the market (absent any tax considerations) places on that asset.544 The value of a stock will be based on the systematic risk associated with its expected cash flow. The greater the systematic risk, the greater the risk premium relative to the market portfolio and the return required; and from the firm's point of view, the greater the cost of equity capital. Thus, an investor will invest on the basis of desired return and systematic risk, and will diversify away all unsystematic risk. The choice of a consumption or an investment decision can change the overall systematic risk of the portfolio and foist an undiversified unsystematic risk on it. Thus, liquidity (i.e. the speed with which a diversified portfolio can be readjusted) has great value.545

The individual portfolio choices of investors (utilizing either a portfolio theory investment strategy546 or fundamental valuation) are enhanced in a public market where the investor preference for liquidity relative to risk and return can be exercised.547 They are also enhanced where, as "[f]irms announce their policies (or production plans), [shareholders can] exchange shares . . . to maximize their expected utility of consumption."548 A public trading market allows the investor to maintain a diversified portfolio at all times, to choose rapidly between levels of risk, or to choose individual securities based on perceived unique properties. Liquidity confers upon equity holders the ability to capture an excess return in the market and maintain a portfolio that diversifies away unsystematic risk, while simultaneously maintaining or increasing the same risk-return ratio that was initially desired. It is the liquidity

543. See supra note 412; see also A. Barnea, R. Haugen & L. Senbet, supra note 402, at 63-64; J. Van Horne, supra note 538, at 93-113.
544. "Because stocks do not have intrinsic values, finding the market clearing price is a task which must be performed by the market's trading system." Y. Amihud, T. Ho & R. Schwartz, supra note 486, at 22.
546. Portfolio theory suggests that the rational investor should maximize the amount of return per unit of risk on the risky portfolio by diversification. See Malkiel, supra note 540, at 28-30. Furthermore, "international diversification can reduce risk." Id. at 31.
547. See Tobin, Liquidity, supra note 504 (setting forth a theory of liquidity preference derived from the Keynesian economic model).
548. M. King, supra note 418, at 131.
of the chosen investments that determines whether an investor's ideal portfolio can be maintained as circumstances change.\textsuperscript{549}

The portfolio perspective departs from the conventional Harberger analysis. Under the conventional view, capital is allocated among alternative uses in a way that equalizes the after tax rate of return on all uses of all capital. Portfolio theory recognizes that net rates of return on different uses of capital are not generally equal, but instead reflect the risk-return preferences of investors. In data collected by Martin Feldstein, the portfolio approach explains why different types of taxpayers (from high tax rate individuals to untaxed pension funds) hold mixed portfolios despite the differences in relative net rates of return on different types of assets.\textsuperscript{560} The Feldstein data also indicates that investors are sensitive to after tax returns based on the level of personal income taxation.\textsuperscript{561} Nonetheless, liquidity diminishes specific risk and permits

\begin{itemize}
\item \textsuperscript{549} The exit right for fundamental value investors is much the same except it runs over a longer horizon.
\item \textsuperscript{550} See Feldstein, \textit{Personal Taxation and Portfolio Composition: An Econometric Analysis}, 44 \textit{Econometrica} 631 (1976), reprinted in M. Feldstein, \textit{Capital Taxation} 194 (1983) (study using household survey data to explain the effect of taxes on the composition of assets held by different income classes). If risk considerations were irrelevant to these investors, each type of investor would specialize in a particular type of investment that had the highest net yield for that investors particular tax situation. The lack of specialization is significant because it implies that different groups of portfolio investors respond differently to tax-induced changes in the net rates of return, whereas the conventional analysis assumes that there are no differences in investor response, but that all capital owners respond within "infinite" asset adjustment to any divergences of net rates of return. See Litzenberger & Ramaswamy, \textit{The Effect of Personal Taxes and Dividends on Capital Asset Prices: Theory and Empirical Evidence}, 7 \textit{J. Fin. Econ.} 163 (1979) (an after-tax version of the capital asset pricing model); Malkiel & Cragg, \textit{Expectations and the Structure of Share Prices}, 60 \textit{Am. Econ. Rev.} 601 (1970) (presenting empirical study designed to measure the risk or quality of return stream to arrive at price/earning ratios). Theoretical models also predict that the existence of tradeable assets will positively impact the value of nontraded assets. See L. Svensson, \textit{Portfolio Choice and Asset Pricing with Nontraded Assets} 5 & 26 (National Bureau of Economic Research Working Paper No. 2774, 1988).
\item \textsuperscript{551} For example, part of the portfolio can consist of venture fund investments which, while having an arguably determinable beta, cannot be liquidated easily. Financial portfolio composition modeled by Feldstein shows a yield sensitivity with higher bracket individuals showing a very positive correlation for holding common stock in their portfolios relative to other financial assets which Feldstein attributes to the favorable taxation of capital gains as increasing the after-tax yield relative to risk. See Feldstein, \textit{supra} note 550, at 637-39, 648. This data does not contradict the value of liquidity since portfolios of financial assets that are measured all have marked liquidity (made up of bonds, money, preferred and common stocks). Relative to capital gains taxation increasing the after tax return, the preference for common stock with a known liquidity factor suggests that it is yield sensitive to risk (relative to return) which supports the view of the value of liquidity in common stock even to the wealthiest investors. Feldstein and Slemrod further show that,
a wider range of portfolio positions.

In summary, liquidity produces benefits for both firms and owners because it provides the ability to monitor firm performance and the ability to maintain a diversified or changing portfolio. For highly sophisticated and institutional investors pursuing active portfolio management strategies, these aspects of liquidity, along with liquidity enhancing products such as options and index futures, are key to portfolio management. For others, liquidity provides a timely exit. These liquidity benefits are what is taxed when profits are taxed at the firm level and again when distributed to the owners. For firms that decide to provide liquidity in raising or maintaining equity capital, there is no credit for taxation at the firm level and again at the owner level because the value of liquidity to the equity capital providers lowers the firm's cost of capital. Once this proposition is accepted, the question becomes, how is a liquid equity ownership standard constructed and to what extent should private contracts creating markets for ownership interests be judged equivalent to a public market?

B. Definition of Liquidity

Double taxation of entities whose ownership interests are publicly traded is appropriate because those interests are highly liquid. Liquidity is the underlying basis for finding the firm distinct from the owner and determining that the income of the firm assuming that there is a lower corporate rate than the individual personal tax rate, there will be an effect on portfolio allocations between corporate and noncorporate investment which favors corporate production even if corporate taxes exist due to the less favorable individual income tax on noncorporate income. See Feldstein & Slemrod, Personal Taxation, Portfolio Choice, and the Effect of the Corporation Income Tax, 88 J. Pol. Econ. 854 (1980).

552. This is true regardless of whether fundamental valuation or market based strategies are used. Where information is poor or where liquidity is limited, the ability to use a speculative investment strategy is limited. Gabaldon, supra note 471, at 1236 (speculation may also lead to market liquidity). While speculation increases the choices for an individual investor, not all commentators view speculation as desirable. See L. Lowenstein, supra note 164, at 202-17 (Speculation serves a useful social purpose because it allows investors to specialize in different degrees of risk. It is not costless, however, and a 100% tax on all profits from stocks sold within a year of purchase should be applied to direct real investment to more socially productive uses.). But see Bandow, Blaming the Investor, Wall St. J., June 9, 1988, at 28, col. 5 (Lowenstein's negative view of speculation is erroneous for three reasons: (1) it ignores the economic benefits of takeovers; (2) it disregards the fact that the purposes of the financial markets are to create incentives for management and distribute investment risk; and (3) it assumes that preventing people from trading their stocks would make others better off.).
is not the product of the owner. The role of the market in defining liquidity depends on the pricing mechanism of that market and its efficiency. Any definition of public trading must focus on the concept and definition of liquidity.\textsuperscript{553} A recent definition of liquidity states that it is "a quality of assets which . . . is not a very clear or easily measurable concept" and indicates the general view that there is a lack of precision in defining and measuring liquidity.\textsuperscript{554} For example, a market can be viewed as highly liquid when the volume of trading is high and the corresponding variance of price is low, regardless of the speed at which a particular transaction is consummated.\textsuperscript{555} Another definition of liquidity, important to the seller, requires that ownership interests be tradable "quickly and at a predictable price."\textsuperscript{556}

1. Realization and Speed

Liquidity is a relative condition measuring both the time it takes to have an asset exchanged for money and the loss of capital value in the exchange.\textsuperscript{557} Liquidity may in fact be a "bundle of

\begin{itemize}
\item \textsuperscript{553} Professor Marschak defined "liquidity" in the context of pricing assets as "the ratio of two contemporary prices." Marschak, \textit{Role of Liquidity Under Complete and Incomplete Information}, 39 Am. Econ. Rev. 182 (1949). This makes liquidity "independent of any price changes in the time between the buying and the selling of an asset." \textit{Id}. Marschak also found that the demand of a rational person for a commitment (an asset or a contract) depends on its liquidity under various degrees of available information. He concluded "that differences in the liquidity of various assets affect the relative demand for them even under conditions of certainty." \textit{Id}. at 187.
\item \textsuperscript{554} K. BOULDING, \textit{ECONOMIC ANALYSIS} 310 (3d ed. 1955).
\item \textsuperscript{555} For a definition of liquidity that follows this format, see Economides & Siow, \textit{The Division of Markets is Limited by the Extent of Liquidity (Spatial Competition with Externalities)}, 78 Am. Econ. Rev. 108 (1988)(The futures markets in financial assets have very few maturity dates. The presence of maturity dates would cause the market to be thinner and would cause greater price fluctuations. Traders prefer fewer maturity dates so that liquidity is enhanced in the remaining markets. The resulting choice is one of liquidity versus the number of markets.).
\item \textsuperscript{556} Lippman & McCall, \textit{An Operational Measure of Liquidity}, 76 Am. Econ. Rev. 43, 48 (1986). The definitions in \textit{infra} notes 557-67 and accompanying text owe much to the Lippman and McCall research.
\item \textsuperscript{557} The relativist view of liquidity has an impressive origin. As stated by John Maynard Keynes, "The conception of what contributes to 'liquidity' is a partly vague one, changing from time to time and depending on social practices and institutions." J. KEYNES, \textit{THE GENERAL THEORY OF EMPLOYMENT, INTEREST AND MONEY} 240 (1936)(Keynes also stated that "there is, clearly, no absolute standard of 'liquidity' but merely a scale of liquidity — a varying premium of which account has to be taken . . . in estimating the comparative attractions of holding different forms of wealth."). \textit{See also} Makower & Marschak, \textit{Assets, Prices and Monetary Theory}, 5 Economica 261, 284 (1938)("'Liquidity' has so often been used to cover all properties of money indiscriminately that it seems better
measurable properties."558 Liquidity relativism includes the Keynesian concept of distinctions among assets. According to Keynes, one asset is more liquid than another if it is "more certainly realizable at short notice without loss."559 Another view of liquidity is "an asset's capability over time of being realized in the form of funds available for immediate consumption or reinvestment — proximately in the form of money."560

Thus, liquidity has two facets: "realization" — whether the asset can be bought or sold at or near the prevailing market price — and "speed" — whether a trade can be effectuated quickly. There is generally a trade-off between price realization and transaction time that will be reflected in the ultimate price of the asset.561 A shorthand definition of liquidity is the relative ease with which an asset can be converted into cash without a loss of value.562 Any deviation from the ideal is a form of illiquidity.

2. Time, Valuation, and Market

The fact that liquidity is a relative concept is easily illustrated by the time references for transaction sales and settlements that are set forth in the various world stock exchanges.563 Liquidity and marketability generally have been viewed as synonymous concepts, but there are some distinctions. Marketability generally denotes the speed at which an asset can be turned into cash. Liquidity refers not only to the time involved to complete the transaction but also to the certainty of the price obtained. Therefore, marketability is a necessary but not a sufficient condition to ensure liquidity.564 Price continuity — prices that do not vary greatly from one transaction to another — is a second component

558. Makower & Marschak, supra note 557, at 284.
559. II J. Keynes, A Treatise on Money 67 (1930).
560. Lippman & McCall, supra note 556, at 43 (quoting J. Hirshleifer).
561. Id. at 43-44.
563. Settlement times vary from five days on the New York Exchange, two days on the Belgium Exchange, and a fixed monthly settlement date in France, to 44 days if the exchange is settled at all in the Italian stock market (because of the 40% fail rate, deliveries often take months) and 120 days in the case of sales on the Spanish stock market. See Internationalization of the Securities Markets, supra note 417, at V-72 n.146.
necessary to a liquid market. A third component of a liquid market is depth, which ensures that prices will not be volatile despite major market moves.565

The ensuing analysis will focus on three liquidity factors: (1) the time it takes to convert an ownership interest to cash — “time risk liquidity,” (2) the pricing mechanism by which the interest is so converted — “valuation liquidity,” and (3) the economic status of the participants in the market — “market risk liquidity.” Marketability will be presumed to exist, since an asset cannot be liquid without it. Opportunities to sell firm equities will be evaluated under these three criteria of liquidity to formulate standards for a liquid ownership test.

Time risk liquidity includes delays in both the opportunity to offer an ownership interest for sale and the time at which payment for the ownership interest is made. An asset is said to be liquid in this sense “if it can be sold quickly at a predictable price.”566 Various forms of trading delays increase time risk and thereby decrease liquidity. Time risk illiquidity is also present when an investor seeks to profit from the arrival of a golden opportunity to sell an ownership interest.567

Valuation liquidity requires the mechanism by which the ownership interest is priced to include an assessment of all relevant information by knowledgeable purchasers and sellers. The strongest version of valuation liquidity is a strong form of the efficient market hypothesis568 in which all available information, public or private, is reflected in the price of the ownership interest.569 While there is little evidence that this strong form of efficiency exists,570 most financial economists hold that it is highly likely

565.  Id. See also Lippman & McCall, supra note 556, at 48 (discussing Marschak’s view that liquidity denotes two properties, one of which is low variance in price).
566.  Lippman & McCall, supra note 556, at 48. The time risk prong of liquidity can also be viewed as an attribute consisting of two properties. One of these is “plasticity,” that is the ease of “maneuvering into and out of various yields after the asset has been acquired,” and the second is the “low-variability of its price.” Marschak, Money and the Theory of Assets, 6 ECONOMETRICA 311, 323 (1938).
567.  D. HICKS, THE CRISIS IN KEYNESIAN ECONOMICS 43-44 (1974) (By choosing a less liquid asset, the investor has “narrowed the band of opportunities which may be open to him” or “locked himself in.”).
568.  Efficiency of markets consists of both internal efficiency (i.e., minimized transaction costs) and external efficiency (i.e. sensitivity to new supply and demand information). Reilly, supra note 564, at 141-49, 151. External efficiency requires that market participants operate with general levels of information so that prices can adjust to information.
569.  See S. ROSS & R. WESTERFIELD, supra note 105, at 305-06.
570.  Id. at 307.
that a weak form of efficiency exists and probable that the semi-
strong form of valuation efficiency exists.\textsuperscript{671} Other evidence, how-
ever, points to the market's efficiency in processing information
but does not indicate valuation efficiency.\textsuperscript{672} If the most that can
be said about the existing public market is that a weak or semi-
strong form of valuation efficiency exists, then the presence of
weak or semi-strong valuation efficiency outside of the public mar-
ket, perhaps created by private contract, should be sufficient to
satisfy the valuation liquidity test for nonpublic markets.\textsuperscript{673}

Market risk illiquidity arises when the economic status of po-
tential purchasers or market makers produces a greater than ex-
pected risk that a sale at a reasonable price in a reasonable time
frame will not take place.\textsuperscript{674} A classic example is the case of mar-
ket makers with insufficient resources to effect a sale. At a mini-
mum, regulation of the market makers requires that they be ade-
quately capitalized. Therefore, if liquidity is provided by private
contract, the assets of the contractually obligated purchaser must
be analyzed.

Time risk liquidity, valuation liquidity, and market risk li-

\textsuperscript{571} \textit{Id.}

\textsuperscript{572} \textit{See supra} notes 452-57 and accompanying text. \textit{See also} Gordon & Korn-
hauser, \textit{supra} note 457, at 825-30, 831 n.192 (markets may be speculatively efficient in
that prevailing securities prices are the best guide to financial returns or allocatively effi-
cient in that prices are the best guide to real economic returns (a result not claimed by the
efficient market hypothesis), but at the same time market trades may be inefficient even
though the market is perfectly price revealing in that there is a lack of perfect information
for all traders).

\textsuperscript{573} There are differences between markets and in each of them private contract
handles both time risk liquidity and market risk liquidity differently.

\textsuperscript{574} Amihud, Ho and Schwartz refer to this concept as price reasonableness. The
liquidity of the asset is important, since traders avoid markets where inefficiency in the
price discovery process and inadequate information systems cause poor executions. The
result is a lack of interest in options on exchanges other than the New York Exchange and
a lack of trading on the pre-NASDAQ over-the-counter market. \textit{See} Y. AMIHUD, T. HO &
R. SCHWARTZ, \textit{supra} note 486, at 25.

Price reasonableness is related to liquidity since: (1) the individual investor views an
asset as illiquid if price volatility creates uncertainty concerning the convertibility of that
asset into cash; (2) the investor who holds a substantial portion of the stock's outstanding
shares views his position as illiquid if a change in position will adversely affect the stock's
share price; and (3) a macro point of view concludes that a market is illiquid if actual
prices do not conform to the market clearing values that would prevail if the market were
frictionless (this depends, in turn, on the size of bid-ask spreads and the location of the
spread with respect to a frictionless market price). \textit{Id.} at 25-26. Price discovery efficiency
thus depends upon both the bid-ask spread and a liquidity measure called the liquidity
ratio, which is the value of the shares traded per a one percent change in the stock's price.
The larger the ratio the more liquid the market. \textit{Id.} at 26-27.
quidity often overlap. The forms of liquidity within markets and created by private contract must be evaluated in light of these three concepts, beginning with the existing market structure.

3. Liquidity in Existing Markets

Prior to Black Monday, October 19, 1987, empirical evidence suggested that the decision to have a stock listed on either the American Stock Exchange (AMEX) or the New York Stock Exchange (NYSE), or traded on the National Association of Securities Dealers National Market System (NASDAQ/NMS), did not depend on asset size, industry group, or trading volume. While

575. S. PHILLIPS & J. ZECHER, EXCHANGE LISTING AND THE COST OF EQUITY CAPITAL 20 (March 1982)(U.S. Securities and Exchange Commission Capital Market Working Paper). The lack of efficiency in the entire National Association of Securities Dealers Automated Quotations System ("NASDAQ") over-the-counter market on Black Monday, if not reformed, may lead to an effect on the risk associated with holding securities traded through NASDAQ and affect prices. PRESIDENTIAL TASK FORCE, REPORT OF THE PRESIDENTIAL TASK FORCE ON MARKET MECHANISMS VI-62 to VI-63 (1988)(Task Force chaired by Nicholas Brady)[hereinafter BRADY COMMISSION REPORT]; accord DIVISION OF MARKET REGULATION, SECURITIES AND EXCHANGE COMM'N, THE OCTOBER 1987 MARKET BREAK 9-24 to 9-28 (Feb. 1988); see also Sanger & McConnell, Stock Exchange Listings, Firm Value, and Security Market Efficiency: The Impact of NASDAQ, 21 J. FIN & QUANT. ANALYSIS 1, 22 (1986)(The liquidity efficiency of the exchanges was superior to the over-the-counter market prior to NASDAQ. NASDAQ, however, removed that edge. This improvement notwithstanding it is still possible that signalling and other features of listing on an exchange could enhance a firm's stock price "due to factors other than improvements in liquidity.").


The New York Stock Exchange secondary market is a benchmark against which the liquidity offered by other secondary markets should be viewed. The New York Stock Exchange market is made by a combination of specialists assigned to particular stocks and functions as an auction market and a dealer market. See BRADY COMMISSION REPORT, supra at VI-4. As in an auction market, members of the New York Stock Exchange trade directly with each other for their own account or as agents for others. As in a dealer market, members also trade with the specialist in order to maintain price continuity and reasonable depth. Id. NASDAQ is an interdealer quotation network with no limit on the number of market makers or the number of stocks a market maker may trade. The "interaction of the multiple market makers in a stock, each with different order flows and a different perception of the risks and rewards of effecting a transaction at a particular price
there is disagreement as to whether any or all securities markets are efficient, exchange listed securities are the benchmark against which the liquidity risks of less optimal markets are measured. However, as the October 19, 1987 crash demonstrated, small holders of securities are generally at a disadvantage compared to institutional holders, and a negotiated market is generally

...is supposed to determine the appropriate price for a security at a given moment of time." \textit{Id.} at VI-12. The capital requirements of market makers are governed solely by Rule 15c-3-1 of the Securities and Exchange Act of 1934, which generally can be interpreted as a minimum capital requirement of $100,000. \textit{Id.}  

576. Louis Lowenstein questions the efficiency and meaning of efficiency in all markets. See L. LOWENSTEIN, \textit{supra} note 164, at 53-54. Many note that the over-the-counter market is not as efficient as the market for exchange-listed securities. See Banoff, \textit{Regulatory Subsidies, Efficient Markets, and Shelf Registration: An Analysis of Rule 415, 70 VA. L. REV. 135, 179 n.209} (1984)(citing Barry, \textit{The Economics of Outside Information and Rule 10b-5}, 129 U. Pa. L. Rev. 1307, 1349 (1981))(arguing that the market is less efficient for over-the-counter stocks, stocks traded on regional exchanges, and foreign exchanges); see also H. KRIPE, \textit{THE S.E.C. AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE 85-87} (1979)(the hypothesis that efficient markets offer little opportunity for supernormal returns drove many analysis into the "inefficient" segment of the market with the result that those segments are now efficient). The over-the-counter market may be nevertheless reasonably efficient. See generally Grant, \textit{Market Implications of Differential Amounts of Interim Information}, 18 J. AccT. RES. 155 (1980)(although data is limited, available results indicate OTC markets are relatively efficient).  

577. Presumptions that exchange traded stocks are liquid and that stocks not so listed may be illiquid underly the margin loan rules. These rules automatically qualify exchange and NASDAQ/NMS traded securities, while other over-the-counter stock must individually be qualified. See \textit{supra} note 319; see also Grube & Joy, \textit{Some Evidence on the Efficacy of Security Credit Regulation in the OTC Equity Market}, 11 J. Fin. RES. 137 (1988)(analyzing efficacy of Federal Reserve security credit regulation of OTC stocks and demonstrating that the stocks selected for margin loans are selected after they experience a relative decline in price variance which is consistent with curbing speculation, protecting investors, and improving the quality of the credit market).  

The clearing, settlement and payment process is the process by which sales are made and cash transferred. It is standardized and automated in the case of exchange and NASDAQ trading. "Clearing is the comparison or reconciliation of the trading process — the post trade agreement between involved parties that the trade was, in fact, executed in accordance with the stipulations of buyer and seller." \textit{BRADY COMMISSION REPORT, supra} note 575, at VI-15. Settlement is the actual exchange of the securities for payment, usually in a depository book entry environment in which the seller has a sufficient book entry position in the security for the delivery to occur. Once a book entry is made and payment is completed, a legal transfer of ownership is effected. Payment is the manual exchange of checks between the clearing house and its participants and is netted daily. \textit{Id.}  

The National Securities Clearing Corporation (NSCC) clears and settles trades in the New York, American, and certain regional exchanges. It guarantees each transaction as it clears, but the guarantee runs only to the broker-dealer and not to the broker-dealer's customer. Customer accounts held by broker-dealers in stocks and bonds, but not commodities including futures contracts, are insured by the Securities Investor Protection Corporation (SIPC). It is a non-profit, quasi-governmental agency that provides coverage up to $500,000 per customer. \textit{Id.} at VI-17.
less efficient than an automated or specialist market. In negotiated markets, clearing and settlement are not automated and the markets are generally not as well run.

The Pink Sheet over-the-counter (OTC) market, which was the entire OTC market before the NASDAQ system went online in 1971, is a good example of a market that is clearly less liquid. Unlike stock trading on the NASDAQ, where there is usually a firm retail price, stock trading on the Pink Sheet market can be treacherous. When a stock is on the Pink Sheets, the mar-

578. For a recent view on the markets, see Symposium on the Regulation of Secondary Trading Markets: Program Trading, Volatility, Portfolio Insurance, and the Role of Specialists and Market Makers, 74 Cornell L. Rev. 799 (1989). While there were problems on the NYSE on Black Monday in terms of price continuity, market depth and quotation spread, see Brady Commission Report, supra note 575, at VI-38 to VI-47, on NASDAQ, the problem was much worse. “For many investors, both large and small, the over-the-counter market broke down when it failed to perform its function of providing liquidity for buyers and sellers and many customer and dealer orders did not get promptly executed if they were executed at all.” Id. at VI-49. Problems included withdrawal of market makers, reduction in the depth of the market, failure to answer telephones, widening of bid-offer spreads, failure of automatic execution systems (which are required to be used only on a voluntary basis), market maker withdrawals, locked and crossed markets delaying the execution of smaller transactions, lack of price continuity, and late reporting. Id. at VI-49 to VI-63. The high degree of automation in the OTC market created unique weaknesses in trading procedures. Id. at VI-52. The basic problem in the NASDAQ system is that “the NASD found it necessary to build in trading procedures and rules which were not necessarily aimed at achieving the most efficient trading system but were believed necessary by the membership to protect their economic interests.” Id. After Black Monday N.A.S.D. made several proposals to avoid similar problems with the OTC market in the future: (1) mandatory participation in SOES for all market makers in each of the NMS securities; (2) a limitation on the acceptable reasons to withdraw from a market; (3) limitations on the ability to return to a market after withdrawal has been made; (4) elimination of preferencing market makers in locked and crossed markets; (5) maximum order limitations; and (6) the continuing of SOES executions when quotes are locked or crossed. The Task Force concluded that “had the proposed rules been in effect during the market break it is possible, if not probable, that most of the problems encountered in the execution of small orders in the over-the-counter market would not have occurred.” Id. at VI-63.

579. See, e.g., Garbade & Silber, Structural Organization of Secondary Markets: Clearing Frequency, Dealer Activity and Liquidity Risk, 34 J. Fin. 577 (1979)(liquidity risk is based on the number of market participants and equilibrium price volatility plus the frequency of market clearing and the level and effect of dealer participation). The Pink Sheet market, even for firms on the electronic bulletin board, will not have automated clearing and settlement. Telephone interview with Gary W. Guinn, Associate Director, N.A.S.D. (May 12, 1989).


Market maker is dealing with a very thin market and "frequently can adjust the price without notice."\(^{582}\) The volatility of the Pink Sheet market reflects the effort of the market maker to decrease risk by not acquiring a large inventory in a thin market. The result is that a seller cannot sell for the profit anticipated. Empirical data confirms the randomness of prices on the Pink Sheet market, thereby enforcing a perception of volatility.\(^{583}\) NASDAQ announced that it will add certain Pink Sheet securities to its automated quotation system,\(^{584}\) possibly as early as the beginning of 1990.\(^{585}\) However, even if the Pink Sheet market is an electronic bulletin board system of "on-line, real-time price information," it is still doubtful that an efficient market will exist for the 3,000 to 4,000 stocks for which pricing information is now usually provided only daily. "Many of these issues will remain illiquid because of the scant number of shares outstanding and will continue to 'trade by appointment,' whereby a market maker must search for availa-

582. R. IRWIN, supra note 581, at 120 (although a pink might have one bid/ask quotation, a big order to sell stock could cause the bid price to drop 25%); see also Market Place, supra note 581 ("The sheets are distributed daily and the prices listed in them by broker-dealers are highly negotiable.").

583. See Hamilton, Market Information and Price Dispersion: Unlisted Stocks and NASDAQ, 39 J. ECON. & BUS. 67, 77 (1987)(studies of the over-the-counter market prior to and after the implementation of NASDAQ show that NASDAQ reduced dispersion among price quotations by one-quarter to one-third); Sanger & McConnell, supra note 575, at 11-19 (liquidity on the non-NASDAQ over-the-counter market is less than that of the exchanges and NASDAQ market). While NASD regulations prescribe a maximum 5% bid/ask spread, many over-the-counter companies trade with a higher spread, and the lack of a sufficient float (less than 5 million shares) also raises liquidity risks. NEW YORK INSTITUTE OF FINANCE, TRADING STOCKS ON THE OVER THE COUNTER MARKET 37-41 (1989).

584. 'Pink Sheet' Listing Plan, N.Y. Times, May 10, 1988, at D22, col. 4. A N.A.S.D. officer notes that:

[the] up-to-date price and volume data will provide investors with the ability to track stocks as they would on all other publicly-traded issues, identify new buying opportunities, offer a better capability to monitor stock price performance, and make it easier to ascertain that the current levels of trading activity ... will give real-time information for market makers instead of data that are printed the day before they are distributed, as under the present system.

Market Place, supra note 581 (statement of Douglas F. Parrillo, Senior Vice President, N.A.S.D.).

585. Telephone interview with Gary W. Guinn, Associate Director, N.A.S.D. (Nov. 3, 1989); see also telephone interview with Gary W. Guinn, supra note 579 (the bulletin board will display price changes during trading day). An earlier version of this same bulletin board was considered for limited partnership interests. ABA Committee on Partnerships and Unincorporated Business Organizations, Publicly Traded Limited Partnerships: An Emerging Financial Alternative, 39 BUS. LAW. 709, 717-21 (1984)[hereinafter Emerging Financial Alternatives].
ble buyers or sellers to complete a transaction.\(^{586}\) Although such Pink Sheet firms may exhibit separation of ownership from control, their equity holders cannot rely on the market to produce efficient pricing.\(^{587}\)

Similarly unsatisfactory is the liquidity of the ownership interests of firms traded in other unlisted markets such as the Euroequities market,\(^{588}\) the London Unlisted Securities Market,\(^{589}\) and the United States secondary market for partnership interests.\(^{590}\) "While the limited-partnership secondary market gives investors at least some liquidity, it more closely resembles a swap-meet for baseball-card collectors than a securities market."\(^{591}\)

\(^{586}\) See Market Place, supra note 581. On the other hand, a number of these stocks were lightly traded, and have many of the characteristics most sought after by value-oriented investors.

\(^{587}\) Cox, supra note 412, at 63-64 & n.64 (noting literature on the lack of efficiency in the Pink Sheet over-the-counter market). This is arguably a different consideration from finding fair market value in a less than efficient market. See Andrews v. Commissioner, 135 F.2d 314 (2d Cir.), cert. denied, 320 U.S. 748 (1943)(even if the market is "rigged," if the investor could have disposed of the shares at the market price and the market could have accommodated the trade, the market price will be used for valuation).

\(^{588}\) The Euromarket, where the debt and equity securities of countries and corporations are bought and sold outside of their home markets, is crucial to the world's major investment banks and securities houses. "It is the forerunner of the international capital markets of the future, and any investment bank that aspires to a place in the emerging new order of global finance must be successful in it." Lohr, Hard Times for the Euromarkets, N.Y. Times, Sept. 20, 1987, § 3, at 1, col. 2. The Euroequities market, a sector of the Euromarket which barely existed in 1983, has expanded rapidly and employs a distribution channel set up for Eurobonds. For the first seven months of 1987 the Eurobond and new international equity issues almost matched the 1986 level of slightly under $200 billion. Id.

\(^{589}\) For a discussion of the rapid changes occurring in the London markets and elsewhere in Europe, see Hot Startups from Hong Kong to Hamburg, BUSINESS WEEK, May 23, 1988, at 134. Not all equity on stock markets is the same. See Kristof, Stock Markets' Role Grows in Chinese Economy, N.Y. Times, Apr. 10, 1989, at D10, col. 3 (in China stock is similar to a chance to win a prize and prices, which are set by the government sometimes as infrequently as once a month, show only an upward trend).

\(^{590}\) There is a small but well-defined "secondary market" in limited partnerships (which may not have the essential characteristics of a secondary market since it is largely unregulated and the market makers do not acquire an inventory). It consists of organized electronic exchanges (such as the National Partnership Exchange (NAPEX)), investment firms which have formed their own partnerships to purchase limited partnership interests, and informal sources of sales and purchases, such as major brokerage houses. Partnership Secondary Markets, THE STANGER REGISTER, Sept. 1987, at 36, 37-38. The total volume of such activity is at least $300 million annually (or one-half to two percent of all outstanding units). Id. at 36. In general, the purchasers of such units are interested in three year or older units, id., and in income-oriented products or those with income-producing assets, id. at 38.

\(^{591}\) A Look at Trading on the Secondary Market, Wall St. J., June 10, 1988, § 2, at 25, col. 5 (noting the lack of published quotes and independent analyst valuations in limited-partnership secondary markets). However, it is argued that even one who is rela-
When the market becomes further attenuated, it is important to ask whether the form of liquidity that is based on efficient information and valuation is actually present. On the other hand, the fact that an efficient market does not require a trading floor is illustrated by the trading desks in investment banking houses for institutional investors.\footnote{592}

C. Proposal

If double taxation of an equity return is to be based on the existence of liquidity, a test must be constructed that identifies the value of liquidity to the firm and its owners. Liquidity is present for exchange and NASDAQ securities because of structural features that eliminate time risk, market risk, and to some extent, valuation risk illiquidity. In cases of securities traded over-the-counter, but not on NASDAQ, the value of liquidity decreases since there is a diminution of the valuation mechanism. A thinly traded market is less correctly predictive than an actively traded market in reflecting equity value.\footnote{593} A thinly traded market contains fewer of the liquidity benefits generally associated with public trading,\footnote{594} and the cost of acquiring information in such a mar-

\footnote{592}{For a discussion of the efficiency of trading desks used by large institutional investors, see L. Lowenstein, \textit{supra} note 164, at 81.}

\footnote{593}{See Karpoff, \textit{The Relation Between Price Changes and Trading Volume: A Survey}, 22 J. Fin. & Quant. Analysis 109, 112 (1987) (finding that trading volume is positively related to changes in price, thus proving the old Wall Street adage that “It takes volume to make prices move.”); see also Smirlock & Starks, \textit{An Empirical Analysis of the Stock Price-Volume Relationship}, 12 J. Banking & Fin. 31, 40 (1988)(“[K]nowledge of the behavior of volume can marginally improve conditional price change forecasts based on past price change forecasts alone.”).}

\footnote{594}{See Ho & Michaely, \textit{Information Quality and Market Efficiency}, 23 J. Fin. & Quant. Analysis 53, 54 (1988) (if information costs are the same for all stocks at equilibrium at the margin and depend upon the investor’s risk preferences and since investors in small stocks do not rationally purchase high quality and more costing information on the firms, it suggests that the prices of small stock do not incorporate all publicly available information and that the market alone cannot develop an informational efficient market for thinly traded stocks); see also Amihud & Mendelson, \textit{Trading Mechanisms and Stock Returns: An Empirical Investigation}, 42 J. Fin. 533 (1987)(comparing the price of the same stock in opening and closing transactions); Garbade & Silber, \textit{supra} note 579 (establishing relationship between certain aspects of liquidity and key structural characteristics of secondary markets); Ho, Schwartz & Whitcomb, \textit{The Trading Decision and Market
ket may mean that the market is less efficient. Even the courts share this view when called upon to value ownership interests for tax purposes.596

Regardless of whether one accepts any version of the efficient market hypothesis, an efficient capital market depends on the processing of information to determine price and value.596 Information and its cost is a factor in judging market efficiency.597

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595. Long-standing judicial precedent has already adopted this principle. It holds that the sales prices for thinly traded issues will be entitled to "very little weight" in determining fair market value. See Wood v. United States, 29 F. Supp. 853, 860 (Ct. Cl. 1939).

596. See Fama, Fisher, Jensen & Roll, The Adjustment of Stock Prices to New Information, 10 INT'L ECON. REV. 1 (1969)(indirectly testing the efficient market hypothesis by measuring the speed of price adjustments when specific types of new information enter the market).

597. Information processing is the mechanism by which a market is efficient and the cost of that information is a crucial determinant in efficiency. See Gilson & Kraakman, The Mechanisms of Market Efficiency, 70 VA. L. REV. 549, 556-57, 612 (1984)(concluding "that the cost of information critically determines market efficiency because it dictates not only the amount of information attending a particular security but also the distribution of that information among traders, which in turn determines the operative capital market mechanism. . ." and that the "shorthand" descriptions of the forms of market efficiency "impl[y] that different market dynamics are involved in the reflection of different kinds of information into price, and that varying degrees of market efficiency might well be the consequence"). For example, the number of sophisticated traders in the market may also reflect whether prices fully reflect the information of the most sophisticated traders. See Grossman & Stiglitz, On the Impossibility of Information Efficient Markets, 70 AM. ECON. REV. 393, 394-95 (1980)(model positing that prices fully reflect such information only if all traders are sophisticated). Many studies view the role of information and the setting of prices. See, e.g., Pincus, Information Characteristics of Earnings Announcements and Stock Market Behavior, 21 J. ACCT. RES. 155 (1983)(information announcements are associated with differences in the speed of stock market adjustments and variability of expected returns); Ho & Michaely, supra note 594. The cost of information relative to the return may make the market less efficient as has been argued for the initial public offering market. See infra note 882. New financial instruments, such as unbundled stock — a 30-year bond paying interest at the rate of the current dividend, a share of preferred stock yielding dividends equal to the increase of the dividend on the common, and an "equity appreciation certificate" which is a warrant to purchase common in the future that replaced the common stock — which were proposed to be marketed to tax exempt investors with a dilution of their voting rights, require information for valuation. Notwithstanding their tax and alleged financial accounting attractiveness, see Sheppard, Unidentified Financial Object, 42 TAX NOTES 656 (1989), unbundled issues allegedly failed to generate market support, id. This may be precisely in part the failure of information due to its relative cost that can result in a less than efficient valuation of the securities. See Gilson & Kraakman, supra at 597-98, 615-16. Finally, the proposed issues failed to win the support
less active market is less efficient in processing this necessary information. \textsuperscript{598} Securities traded in a relatively inactive market should not qualify as highly liquid for purposes of this author’s proposal. This conclusion is supported by valuation assumptions about market efficiency applied by the courts. \textsuperscript{599}

The infrequent trading of ownership interests that can occur in an over-the-counter market has been well documented. \textsuperscript{600} Frequent trading of ownership interests that can occur in an over-the-counter market has been well documented. \textsuperscript{600} Frequent trading of ownership interests that can occur in an over-the-counter market has been well documented. \textsuperscript{600} Frequent trading of ownership interests that can occur in an over-the-counter market has been well documented. \textsuperscript{600} Frequent trading of ownership interests that can occur in an over-the-counter market has been well documented. \textsuperscript{600} Frequent trading of ownership interests that can occur in an over-the-counter market has been well documented. \textsuperscript{600} Frequent trading of ownership interests that can occur in an over-the-counter market has been well documented. \textsuperscript{600} Frequent trading of ownership interests that can occur in an over-the-counter market has been well documented. \textsuperscript{600} Frequent trading of ownership interests that can occur in an over-the-counter market has been well documented.
quent offers and acceptances ensure liquidity while maintaining low price volatility. The price assigned by the market to thinly traded shares is demonstrably lower than the actual value of those shares. The value of volume trading has been well documented. These observations lead to the conclusion that any market other than an exchange or NASDAQ market must be tested for adequacy of liquidity. An appropriate test of liquidity might be based on NASDAQ listing requirements for number of owners and firm size. Similarly, the Federal Reserve's margin requirements restricting marginable stock to exchange and NASDAQ/NMS traded (and selected other) stocks, based on factors that target firms with a low price variance, could be helpful in determining a presumption of liquidity. The decision to view size as relative to the value of liquidity is not the same as the unfocused application of the graduated corporate tax rates to aid capital formation for small business. The liquidity that institutional investors will enjoy upon adoption of proposed Rule 144A will satisfy the liquidity based test and will result in a growing category of corporations subject to the corporate tax that do not have public ownership in the traditional sense.

However, liquidity tests alone may be insufficient to establish which firms should be subject to double taxation. Numerous empirical studies demonstrate the "small-firm effect" which postulates that small firms have higher risk-adjusted returns than larger firms and a higher cost of capital. Thus, the lack of liquidity in more than a certain percentage of the ownership interests are traded during the year. See, e.g., Letter from Blake D. Rubin on Behalf of the National Partnership Exchange, Inc. to Dept of Treasury (Mar. 16, 1988)(found in full in the Tax Notes Microfiche Database Doc. No. 88-3027)(proposing safe harbor if 10% or fewer of the interests in a partnership are traded annually)(88 TNT 69-49).

Cf. Lippman & McCall, supra note 556, at 47-48 (liquidity increases with the thickness of the market, defined by the frequency of transactions in highly organized markets characterized by brisk trading, but not stating a relationship for thin markets).

For example, see the going private transactions of Piece Goods Shops, Inc. and Perfect Fit, Inc. Each had a thinly traded market which discouraged institutional investor interest. As a result, the companies traded at a discount relative to comparable companies whose stocks were actively traded. E. CRAWFORD, A MANAGEMENT GUIDE TO LEVERAGED BUYSOUTS 13, 114-21, 147-53 (1987).

See infra notes 934.

See supra notes 593-94.

See supra notes 65-67 and infra notes 1065-69 and accompanying text.

See supra notes 510-25 and accompanying text.

See supra notes 510-25 and accompanying text.

The NASDAQ listing requirements are discussed infra note 934.

See supra notes 65-67 and infra notes 1065-69 and accompanying text.

The relationship between return and market value of common stocks, 9 J. Fin. Econ. 3 (1981)(smaller firms have, on average, higher risk-adjusted yields); Reinganum, Misspecification of Capital Asset Pricing: Empirical Anomalies
the over-the-counter market could be coupled with an economic size test for the imposition of the corporate tax on the equity component. Small firms do not survive long in the market. Where

Based on Earnings' Yields and Market Values, 9 J. Fin. Econ. 19 (1981)(arguing that firm-size effect subsumes earnings-price effect and that the one-period capital asset pricing model is either misspecified or capital markets are inefficient).

It has been argued that understating the risk of small firm portfolios does not explain the small firm effect. See James & Edmister, The Relation Between Common Stock Returns Trading Activity and Market Value, 38 J. Fin. 1075 (1983)(although firm size and trading activity are related, differences in trading activity are not the underlying reason for the firm size anomaly); Reinganum, A Direct Test of Roll's Conjecture on the Firm Size Effect, 37 J. Fin. 27 (1982)(while direction of bias in estimated beta may contribute to small firm effect, magnitude of bias is too small to entirely explain firm size effect). Other explanations of the small firm effect have been offered. One is that firms listed for short periods of time have larger excess returns. See Brown & Berry, Anomalies in Security Returns and the Specification of the Market Model, 39 J. Fin. 807 (1984)(excess returns explained by misspecifications relating to listing periods of securities in the model used to measure systematic risk). Another explanation is found in the anomalies associated with biases in measuring data. See Roll, On Computing Mean Returns and the Small Firm Premium, 12 J. Fin. Econ. 371 (1983)(concluding that models estimating systemic risk are biased whenever securities are classified by any variable related to trading volume). A third explanation is that the actual risk effect is not caught by beta or variance measures based on actual Standard and Poor quality ratings. See Friend & Lang, The Size Effect on Stock Returns, 12 J. Banking & Fin. 13 (1988)(explaining size effect as the result of inadequate measures of risk and proposing that quality rankings for common stock are superior to beta and variance measures). A fourth explanation is that information relative to the firm may explain the small firm effect. See Collins, Kothari & Rayburn, Firm Size and the Information Content of Prices with Respect to Earnings, 9 J. Acct. & Econ. 111, 136 (1987)(firm size is a proxy for the amount of available information about a firm and the number of traders and professional analysts processing that information; empirical results support the hypothesis that price-based earnings will outperform univariate time series forecasts by a greater margin for larger firms than for smaller firms based on the predictive accuracy of price-based earnings forecasts); Freeman, The Association Between Accounting Earnings and Security Returns for Large and Small Firms, 9 J. Acct. & Econ. 195 (1988)(securities prices for large firms anticipate accounting profits earlier than those for small firms and, for a given level of unexpected returns, the cumulative abnormal returns for small firms are larger); see also Ho & Michaely, supra note 594 (prices of small stocks may not incorporate all public information, and general publication of information, as in a newspaper, can affect stock prices). Finally, the small firm effect has been explained as the result of the market signaling effect created by "good" firms that find it necessary to underprice initial public offerings to separate themselves from the perception that only the "bad" firms come to the market for equity. See F. Allen & G. Faulhaber, Signaling By Underpricing in the IPO Market (Wharton School Working Paper, University of Pennsylvania, Sept. 1988). For a review and synthesis of firm size effect research, see Schwert, Size and Stock Returns and Other Empirical Regularities, 12 J. Fin. Econ. 3 (1983).

For example, Ward's Business Directory of Public Firms lists only 315 firms in the non-NASDAQ over-the-counter market that have sales in excess of $500,000. Data compiled by research assistant from WARD'S I, infra note 930

609. Queen & Roll, Firm Mortality: Using Market Indicators to Predict Survival, Fin. Analysts J., May - June 1987, at 9 (size is the most reliable variable for predicting survivability of firm, with small firms having only even odds of surviving).
issuing costs are higher for smaller public firms offering new equity issues, the lack of trading opportunities plus higher equity capital costs could negate the presumed presence of liquidity as a basis for the tax. Thus, the proposal could also eliminate firms on the basis of economic size measured by both an assets and a sales test, with the amounts to be determined by the relevant evidence on the financial capability of such firms. To the extent that the risks of small firms in initial public offerings have been countered by liquidity enhancing features, such as “puttable stock” with downside valuation protection, the value of that liquidity should be considered.

Finally, the value of liquidity created by private contract must be analyzed to see if it provides the lower cost of capital that is provided by liquidity in the public market. The well-known theory of bounded rationality suggests that a private contract may

610. Data from 1974 to 1975 on the costs of underwriting new equity issues offerings shows an increasingly small cost of floatation for larger issues than for smaller issues. See Smith, Alternative Methods for Raising Capital: Rights Versus Underwritten Offerings, 5 J. FIN. ECON. 273, 276-77 (1977)(Table 1). Moreover, leverage ratios may be related to firm size and the higher cost of borrowing for small firms. See Ang, Chua & McConnell, The Administrative Costs of Corporate Bankruptcy: A Note, 37 J. FIN. 219 (1982)(discussing bankruptcy costs as a determinant of corporate capital structure); Warner, Bankruptcy Costs: Some Evidence, 32 J. FIN. 337 (1977)(concluding from models of capital structure that direct bankruptcy costs fall as the firm's market value increases). This suggests that large firms should be more highly leveraged than small firms since direct bankruptcy costs appear to constitute a larger portion of the firm's value as the value decreases and that relatively large firms tend to be more diversified and less prone to bankruptcy. See Titman & Wessels, supra note 212, at 5-6 (suggesting that small firms may be more leveraged than large firms and prefer to borrow short term through bank loans rather than issue long-term debt because of the lower fixed costs associated with the former). Issuing costs may also include the fact that investment bankers are conservative and provide insurance by underpricing new issues for both IPOs and seasoned new issues of small firms. See Tinic, Anatomy of Initial Public Offerings of Common Stock, 43 J. FIN. 718, 819 (1988).

611. The proposal is correlated with the data from Ward's on the number of small over-the-counter firms with sales over $500,000. See supra note 608.

612. Puttable stock consists of a share of common stock with a right guaranteed by the issuer (together a “unit”) that allows the unit holder to claim more stock if its market price falls below a stated level. Puttable stock is similar to convertible bonds in that it provides downside protection while allowing full participation in the upside potential. See Chen & Kensinger, Puttable Stock: A New Innovation in Equity Financing, Fin. MGMT., Spring 1988, at 27.

be less likely than the market to produce an efficient result. Redemption, put, and other arrangements within firms must be tested for whether they provide the time, market risk, and valuation certainty of a liquid public market. While negotiated contracts may fail because of the lack of information necessary for an informed agreement, safeguards in contractual arrangements which seek to produce fully informed results through audit, appraisal, sophistication of the participants, and the like must be tested.\textsuperscript{614} The infrequency of sales and redemptions strains valuation risk liquidity, time limitations strain time risk liquidity, and the lack of a guaranteed market and capitalization to fund redemptions strains market risk liquidity. Many of these issues were faced within the framework of the safe harbor notice of the 1987 publicly traded partnership legislation.\textsuperscript{615} These issues must be addressed again in a specific inquiry into the value of liquidity, rather than through a test that is based on "resemblance" to a secondary market and that does not look into the function that that secondary market is asked to perform.

\textsuperscript{614} Private contractual arrangements also raise questions as to whether valuation liquidity will exist. Agency theory suggests that larger information asymmetries exist in the private rather than public market due to absence of public information and lesser competition for the firm. In preliminary data, an empirical case is made for the private information leading to higher returns for bidders for acquisitions of small, private firms and over-the-counter firms compared to exchange listed targets. See N. Giannaris & W. Megginson, The Returns to Bidders in Small Versus Large Firm Acquisitions, (University of Georgia Working Paper, Apr. 1989). Nonetheless, the ability of an efficient market to exist between pairs of traders who are agents with incomplete information has been demonstrated. See Deere, Bilateral Trading as an Efficient Auction over Time, 96 J. Pol. Econ. 100 (1988); Vickrey, Counterspeculation, Auctions, and Competitive Sealed Tenders, 16 J. Fin. 8 (1961)(first-price, reserve auctions generate efficient outcomes). This occurs even though the actual trades between the agents are inefficient. See Myerson & Satterthwa, Efficient Mechanisms for Bilateral Trading, 29 J. Econ. Theory 265 (1983). The negotiation in a firm for a buyout where others may possess more complete information is not the same process. Accurate pricing can occur where there are significant information asymmetries among participants as long as there are enough sophisticated investors to understand the contract terms. See Gilson & Kraakman, supra note 597, at 569-70; Schwartz & Wilde, Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis, 127 U. Pa. L. Rev. 630, 640-51 (1979); cf. Brudney, Corporate Governance, Agency Costs, and the Rhetoric of Contract, 85 Colum. L. Rev. 1403, 1420-27 (1985)(arguing that market pricing cannot substitute for actual bargaining). Liquidity by a single firm or individual places the residual owner in the position of having to rely on the credit-worthiness of that party which may be a greater risk than that afforded by a market where there are literally thousands of investors willing to buy at a price and who have access to the purchase. The illiquidity factory for repurchases in some industries is classic. See Jarchow, The Real Estate Liquidity Crisis, 15 Real Estate Rev. 48 (1986).

\textsuperscript{615} See infra notes 661-71 and accompanying text.
IV. PRESENT AND PROPOSED PROVISIONS THAT DRAW THE LINE FOR DOUBLE TAXATION ON THE BASIS OF PUBLIC TRADING

The United States has not distinguished between public and private firms under the classical corporate tax system. No tax on undistributed profits has been adopted that makes any distinction between public and private firms, nor have split rate systems, other than a graduated rate on corporate income, been adopted. While a publicly traded or readily tradable standard has never been used to identify those entities subject to double taxation, a similar standard has been used for other tax law purposes. For example, public trading is a definitional mechanism for valuation, control, and targeted economic incentives. Since 1987, the publicly traded concept has been used to identify entities subject to the double tax.

A. Proposals by Congressional Committees and the Treasury

In 1983, the Staff of the Senate Finance Committee, in its

616. See I.R.C. § 453 (West 1988 & Supp. 1989). See also Temp. Treas. Reg. § 15A.453-1(b)(3)(i), -l(e)(4)(i)-(iv) (1981). An interest is readily tradeable if the interest is "regularly quoted" by brokers or dealers who make a market in the interest or if the interest is part of a security issue, a portion of which is in fact traded in an established securities market. Id. at § 15A.453-1(c)(4)(iii). The established securities market is defined as a market where quotations are distributed among brokers and dealers in a publication of general circulation. Id. at § 15A.453-1(e)(4)(iv). The installment sale regulations do not address whether a thin market constitutes a regularly quoted interest. The original issue discount rules also operate based on distinctions between whether the instrument issued is publicly offered or traded. See I.R.C. § 1273(b)(1)-(3) (West 1988 & Supp. 1989)(defining issue price).

617. I.R.C. § 170(e)(5) (West 1988). See T.D. 8199, 53 Fed. Reg. 16,076 (1988). Publicly-traded securities under I.R.C. § 170(e) are limited to securities which are: regularly traded on the over-the-counter market for which published quotations are available, listed on an exchange in which quotations are published on a daily basis, or represent a share in an open-end investment company for which quotations are published on a daily basis. Treas. Reg. § 1.170A-13(c)(7)(xi) (1988). Under the definition of an over-the-counter market, trades are public if average trading and total volume during weekly and monthly periods are circulated in a newspaper of general circulation within a month following the computational period. Treas. Reg. § 1.170A-13(c)(7)(xi)(B) (1988). In addition, restrictions that "[m]aterially affect the value of the securities to the donor or [which] prevent the securities from being freely traded" keep the securities from being treated as publicly traded. Treas. Reg. § 1.170A-13(c)(7)(xi)(C) (1988). Fair market value is not necessarily equal to market price, average trading price, or face value. Treas. Reg. § 1.170A-13(c)(7)(xi)(D) (1988).

618. See I.R.C. § 1042(c)(1)(West 1988)(ESOP rollover treatment for sale of securities only if firm has no outstanding stock "readily tradable on an established securities market").
Preliminary Report on the Reform and Simplification of the Income Taxation of Corporations, proposed public trading as a separate criterion for imposition of the corporate tax on unincorporated entities.619 This proposal would have affirmed neutrality by taxing similar organizations to the same degree. In hearings on the proposal, the Treasury and others opposed the Staff's recommendation on the ground that it was beyond the intended scope of the report, which was originally directed at the structure of corporate taxation.620 After a review of the taxation of all similar business organizations, including REITs, the Treasury stated that "one would conclude that the degree of marketability of an organization's equity interests should [not] determine the manner in which the organization is taxed."621 The Treasury noted that "a concern of the Staff may be that adoption of the other significant proposals in the report would increase the disparity between the taxation of partnership[s] and corporate profits and thereby provide incentives for conducting in partnership form many activities presently conducted by corporations."622 In October of 1983, however, the Treasury felt that the concern of "migration" to partnership form was "overstated" due to the "increased reporting and record-keeping requirements, and the uncertainties and state-to-state inconsistencies relating to the substantive law of partnerships."623 However, evidence shows that the Treasury overestimated these tax and nontax restraints.624

619. Staff of Senate Comm. on Finance, 98th Cong., 1st Sess., Staff Preliminary Report on the Reform and Simplification of the Income Taxation of Corporations 80 (Comm. Print 1983). Based on neutrality principles, the Report recommended that limited partnerships be treated as associations and taxed as corporations if their ownership interests are publicly traded as measured by "an established securities market" (as might be defined under the installment sales regulations). The Report also noted the problems of administering such partnerships under Subchapter K. Id. at 106.

620. Reform of Corporate Taxation: Hearing Before the Senate Comm. on Finance, 98th Cong., 1st Sess. 63 (1983)[hereinafter 1983 Corporate Taxation Hearing](statement of Ronald Pearlman, Deputy Assistant Secretary, Dep't of the Treasury). Other grounds included: (1) that the conclusion should be reached only after review of the taxation of all similar business organizations, and (2) that at that time the Treasury was not prepared to support proposals "which significantly broaden[ed] the two-tier tax system of taxing corporate profits." Id.

621. Id.

622. Id.

623. Id. at 64.

624. Less than two months earlier, at the annual meeting of the American Bar Association, knowledgeable practitioners exhibited great familiarity, skill, and patience in coping with the extremely difficult tax and securities law problems that publicly traded limited partnerships engender. Emerging Financial Alternatives, supra note 585. Notwithstanding
The final Staff Report on corporate taxation, issued in 1985, eliminated the recommendation for classification based on public trading, apparently because the report was issued after the Treasury had published its broader proposal requiring limited partnerships with more than thirty-five partners to be treated as corporations. In 1986, the Treasury, influenced by concerns about the administration of publicly traded entities under Subchapter K, revived the public trading test and reversed its attitude toward some of the problems it had earlier perceived. Its revival of the test was based on administrative concerns, the migration of public corporations to publicly traded limited partnerships, and the specter of start up firms as publicly traded limited partnerships.

B. Public Trading as a Worldwide Standard in Taxation

The concept of a publicly traded entity has been recognized in different tax contexts throughout the world. United States tax treaties typically bar firms from "treaty shopping," but refuse to look behind the ownership of corporations that are publicly traded on an exchange in either of the contracting states. Other coun-

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625. See Staff of Senate Comm. on Finance, 99th Cong., 1st Sess., The Subchapter C Revision Act of 1985, at 8, 9 (Comm. Print 1985); 1985 Corporate Proposals, supra note 300, at 56-57 n.109. That provision was not incorporated in the Treasury report to the President. President's Study, supra note 8, at 147.

626. 1986 House Passthrough Hearings, supra note 30, at 28-30, 30 n.13, 31-32 (statement of J. Roger Mentz) (noting that although the 1977 Blueprint study recommended corporate integration in a pure partnership passthrough model, the more recent 1984 study proposed a system of dividend relief based on the unfeasability of the full integration system).

627. 1987 Senate MLP Hearing, supra note 30, at 53 (statement of J. Roger Mentz) (anticipated problems included: the inability of an MLP to determine profit or loss shares for a partner who only participated for a portion of the year, the classification of MLP income as passive income, and whether it could be offset by passive losses). See also 1983 Corporate Taxation Hearing, supra note 620, at 64 (statement of Ronald Pearlman). TEFRA in 1982 eliminated or reduced many problems, but allocation problems are to a certain degree present in every partnership. However, these problems are diminished in publicly traded partnerships because "the reporting requirements imposed on publicly traded and registered partnerships and the public scrutiny these organizations receive make them less likely to engage in abusive activities than partnerships with fewer partners." Id.

628. See infra note 659.

629. Under the June 16, 1981 proposed draft of the United States Treasury Model Treaty, relief from double taxation is only available for corporations trading on an approved exchange, which is defined as any exchange registered with the S.E.C. and NAS-
tries impose different rates on public and private companies by either taxing publicly held firms at a higher rate, as in Canada, or at a lower rate, as in Australia, Cyprus, India, Pakistan, Thailand, and South Korea. While Canada proposed


631. Australian tax law continued to distinguish between public and private companies even after the July 1, 1987 effective date for the Imputation System for the Taxation of Dividends, although since the effective date for the imputation system, private or public status does not affect the tax liability. See Berg & Orrock, BUSINESS OPERATIONS IN AUSTRALIA, Tax Management: Foreign Investment Portfolios (BNA) No. 127-4th, at C&A-8 to -9, B-1801 (1987). Public companies are defined as: (1) those with shares (other than fixed dividend shares) listed on any stock exchange on the last day of the year, and (2) companies that are subsidiaries of other public companies throughout the whole year. A listed company is deemed to be a private company if twenty or fewer persons either control 75% or more of the voting power or equity in the company or possess the right to 75% or more of the dividends or return of capital. Prior to integration, the primary tax rate for all companies was the same (46% of taxable income). See I. WALLSCHUTZKY, AUSTRALIAN INCOME TAX LAW 338-39 (1986). But private companies were liable for an additional tax equal to 50% of the "undistributed amount." Id. at 339. The distinction between private and public companies is based on the idea that a private company is able to make decisions to accumulate income at lower rates and thus avoid distribution.

632. The basic Cypriote corporate tax rate is 42.5%. PRICE WATERHOUSE INFORMATION GUIDE, CORPORATE TAXES: A WORLDWIDE SUMMARY 95 (1988). "Public companies, including private companies which became public, are taxed during the first ten years from commencement of operations or from the date when they became public at the reduced rate of 25% instead of the standard company rate of 42.5%." Id. at 98.

633. Widely held Indian companies are taxed at a rate of 50% to 55%, depending on the amount of taxable income; whereas closely held Indian industrial companies are taxed at a rate of 55% to 60%. Id. at 187.

634. "The term 'public company' implies a company listed on any stock exchange in Pakistan, or one in which not less than 50% of the shares are held by the Pakistan government or a trust formed under Pakistan law." Id. at 329. The general income tax rate for companies other than banks is 30%. There is also a supertax of 25% that allows rebates for public companies depending on industry. Id.

635. Juristic companies and partnerships in Thailand pay taxes at a rate of 35%, while companies registered on the securities exchange of Thailand are taxed at a rate of 30%. Id. at 430.
full integration on both undistributed and distributed profits, it enacted a system that provides full dividend relief for Canadian-controlled private companies and partial dividend relief for others.\textsuperscript{637} This distinction remains in force even after the most recent tax reform.\textsuperscript{638} At least one country, France, recognizes that firms that can offer ownership interests on the public market in a manner analogous to corporations should be included within the corporate tax regime.\textsuperscript{639}

These foreign practices show that public trading is recognized as a test for distinguishing between firms. The variety of uses for which the public trading distinction is employed indicates a number of different policies at work. Taxing public firms at a lower rate than private firms is based on the presumed tendency of private firms to improperly accumulate income. When public firms are taxed at a higher rate, the presumption is that smaller enterprises ought to pay lower taxes. The split rate systems implement a policy that encourages both domestic capital formation and the establishment of smaller firms. Tax treaties that favor firms that are domestically incorporated and traded on local exchanges accept the principle that the firm is a separate entity from the owners.

C. The 1987 Publicly Traded Partnership Legislation

The stop-gap 1987 legislation on publicly traded partnerships\textsuperscript{640} was without a theoretical basis or a fully delineated constituency. The rationale for including publicly traded partnerships in the double tax regime was based on a statutory determination

\begin{footnotes}
\item[636] The first 50 million of income is taxed at the same 20\% rate for general Korean corporations, large non-listed corporations, and nonprofit corporations; the balance of the firm’s income is taxed at 30\% for general corporations, 33\% for large non-listed corporations, and 27\% for nonprofit corporations. \textit{Id.} at 235.
\item[637] For a description of the classification of Canadian corporations, see \textit{Andison, Categories of Corporations}, in \textit{REPORT OF PROCEEDINGS OF THE 24TH ANNUAL TAX CONFERENCE} 73 (1972).
\item[639] Limited partnerships with shares (societe en commandite par actions/SCPA) which with the possibility of offering negotiable shares enables it to make a public offering of its shares also are subject to varying degrees to the corporate income tax. \textit{See} \textsc{T}imeaux \textsc{moquet} \textsc{borne} & \textsc{associates}, \textit{doing business in france} ¶ 5.5[2], at 5-128.1 (1987).
\end{footnotes}
that a partnership is publicly traded if its interests are "traded on an established securities market" or if "interests in such partnership are readily tradable on a secondary market (or the substantial equivalent thereof)." \(^{641}\) Congress acted to prevent the proliferation of business structures that it believed violated the neutrality principle. \(^{642}\) These structures included any that resembled corporations in general \(^{643}\) and publicly traded corporations in particular, \(^{644}\) but that were taxed as partnerships. Congress did not base the double taxation of publicly traded partnerships on the unique value of a public market, but rather on the "unique administrative difficulties" \(^{645}\) inherent in taxing like entities differently. The legislation was directed only at publicly traded partnerships under an actual trading or readily tradable standard. The House version of the bill, which was not enacted, would have broadened the test to include an "expectation" of public trading. \(^{646}\) Nonetheless, the legislative history of the Conference Report left the definition of "readily tradable" very broad. According to some commentators and the language of the Report, the definition was based on a market trading benchmark. \(^{647}\)

The "readily tradable" standard of the 1987 legislation is supported by the legislative history that states, "[a] secondary market is generally indicated by the existence of a person standing ready to make a market in the interest." \(^{648}\) The relevance of ready tradability in a secondary market or a substantially equivalent

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\(^{641}\) I.R.C. § 7704(b) (West Supp. 1989).

\(^{642}\) "[T]he committee believes that these types of entities and their holders generally should be treated similarly for tax purposes." 1987 HOUSE REPORT, supra note 46, at 1066.

\(^{643}\) Id. ("in important respects, publicly traded partnerships resemble corporations").

\(^{644}\) Id. ("Publicly traded partnerships resemble publicly traded corporations in their business functions and in the way their interests are marketed, and limited partners as a practical matter resemble corporate shareholders in that they have limited liability, may freely transfer their interests, generally do not participate in management, and expect continuity of life of the entity for the duration of the conduct of its business enterprise.").

\(^{645}\) Id. at 1067.

\(^{646}\) See id. at 1070 (investors expect that a secondary market exists "where the interests are marketed with representations that there is likely to be a ready market for resale or other disposition of the interests or rights to income or other attributes thereof (or that the promoter or issuer intends to take steps so that such a market is created)").

\(^{647}\) See Committee on Partnerships, New York State Bar Ass'n Tax Section, Report on Issues Concerning the Definition of Publicly Traded Partnerships (June 15, 1988) [hereinafter N.Y. Bar Report] (found in full text in the Tax Notes Microfiche Database Doc. No. 88-5534a-d, 88 TNT 130-8 (June 27, 1988)).

\(^{648}\) 1987 CONFERENCE REPORT, supra note 224, at 948.
market is more cryptic. Ownership interests traded in secondary markets have been described as readily tradable in a number of instances, including where: (1) "the interest is regularly quoted by persons such as brokers or dealers who are making a market in the interest . . . on a market essentially equivalent to an over the counter market,\(^6\)\(^4\) (2) "there is not an identifiable market maker but the holder of an interest has a readily available, regular and ongoing opportunity to sell or exchange his interest through a public means of obtaining or providing information of offers to buy, sell or exchange interests,"\(^6\)\(^5\) (3) "prospective buyers and sellers have the opportunity to buy, sell or exchange interests in a time frame and with the regularity and continuity that the existence of a market maker would provide,"\(^6\)\(^5\)\(^1\) or (4) there is "[a] regular plan of redemptions or repurchases, or similar acquisitions of interests in the partnership such that the holders of interests have readily available, regular and ongoing opportunities to dispose of their interests."\(^6\)\(^5\)\(^2\) The House and Conference reports did not discuss the duties of market makers or the quality of information necessary to provide a sufficient public or private means of disposing of an interest. Nor did the reports address the effectiveness of those mechanisms in creating liquidity.\(^6\)\(^5\)\(^3\)

According to the Conference Report, "[a]n over the counter market is characterized by an interdealer quotation system which regularly disseminates quotations of obligations by identified brokers or dealers, by electronic means or otherwise."\(^6\)\(^5\)\(^4\) One of the

\(^{649}\) Id. See also 1987 House Report, supra note 46, at 1070.

\(^{650}\) 1987 Conference Report, supra note 224, at 948.

\(^{651}\) Id. at 948.

\(^{652}\) Id. at 949. See also 1987 House Report, supra note 46, at 1070.

\(^{653}\) In language not present in the House Report, the Conference Report described interests that would not be treated as readily tradable as follows:

If interests can be traded in a market that is publicly available, but offers to buy or sell interests are normally not accepted in a time frame comparable to that which would be available on a secondary market, then the interests are not treated as readily tradable on the substantial equivalent of a secondary market. For example, if interests are quoted and traded on an irregular basis as a result of bid and asked prices listed on a computerized system, and such interests cannot normally be disposed of within the time that they could be disposed of on an over the counter market, then the interests are not considered as readily tradable on the substantial equivalent of a secondary market.

1987 Conference Report, supra note 224, at 948. This language was directed at the information regarding sales of limited partnership interests provided by third party matching services and desks maintained by brokerage houses that had sold the interests. N.Y. Bar Report, supra note 647, at 27-31.

\(^{654}\) 1987 Conference Report, supra note 224, at 947.
main problems with the definition is that it focuses on the mere existence of a market rather than the efficiency of that market. While the legislative history finds that time delays indicate non-equivalence to a secondary market, other features indicating illiquidity are not mentioned. Finding an effective secondary market for publicly traded shares listed on the various exchanges or in the NASDAQ system is not difficult. The legislative history indicates that the statute would also apply to an over-the-counter market such as the pink sheet market. Although time, market, valuation, and liquidity risks received some attention from Congress, they were not addressed explicitly.\(^{655}\)

In any test involving public trading of a security, the goal should be to identify an efficient market or contract rather than to identify the mere existence of a market or an ability to sell. In most cases, efficiency will follow from the existence of the market or the contractual right.\(^{656}\) While a market maker may be recognized as a source for obtaining stock, in the over-the-counter market the market maker has no obligation to continue to deal in a security,\(^{657}\) and in the non-NASDAQ markets the requirements are even less stringent. While a firm or an individual may stand ready to purchase an interest at any time, they may lack the reserves to make good on the promise. Thus, in establishing a market reference, the legislation failed to discuss the quality of market makers or contractual provisions giving rise to liquidity.

The value of liquidity was never explicitly discussed in the

\(^{655}\) The legislative history included some discussion of illiquidity in secondary markets. The Conference Report stated that partnership interests that cannot "normally be disposed of within the time that they could be disposed of on an over the counter market . . . are not considered as readily tradeable on the substantial equivalent of a secondary market." Id. at 948. It also stated that partnership interests should not be treated as readily tradeable "where there are occasional accommodation trades of partnership interests . . . not pursuant to a put or call right, or where the underwriter that handled the issuance of the partnership interests occasionally arranges such accommodation trades." Id. These include buy-sell arrangements among partners. Id. at 948-49. On the other hand, the House Report stated that "[a] regular plan of redemptions or repurchases, or similar acquisitions of interests in the partnership such that holders of interests have readily available opportunities to dispose of their interests . . . indicates that the interests are readily tradeable . . . ." 1987 House Report, supra note 46, at 1070.

\(^{656}\) There are various dangers posed by inefficient markets. See, e.g., $250,000 Fine Imposed on Penny Stockbroker, N.Y. Times, May 3, 1988, at D2, col. 3 (securities firm charged excessive and fraudulent mark-ups on penny stock securities where 97% of the market in one company's stock was controlled by the firm and it charged mark-ups of 11% to 150% above the price it paid for the stock).

\(^{657}\) Brady Commission Report, supra note 575, at VI-50 to VI-54.
Committee reports or in the prior hearings on the Master Limited Partnership (MLP) issue; nor did Congress discuss a different rationale for deciding that "public" firms or firms with traded equity resemble corporations more than private ones. Even though the legislation was aimed at firms that resembled corporations and the problem of disincorporation, the underlying focus was to prevent start up businesses from forming as publicly traded partnerships. While the legislation focused on publicly traded limited partnerships, it included any "publicly traded partnership" as well. In addition, the test for trading — the "substantial[ly] equivalent" to a secondary market test — was broad in scope.

The legislation was directed at a perceived problem and no explicit normative rationale was given for the focus on liquidity. The legislative history included references to market concepts of timing but did not focus specifically on valuation. As a result, further guidance from the Service was required. This guidance came in the form of an administrative notice (pending final regulation) that created safe harbor limitations on the definitional section of the legislation and added both a market-based and transaction-based context to the legislative intent. The theoreti-

658. See supra note 274.

659. The dialogue at the MLP hearings made it clear that the main focus was the further erosion of the corporate tax base and the creation of start-up MLPs. After noting the fact that changes in the corporate tax base in 1986 were geared to raise significant tax revenue from the corporate sector, the Assistant Secretary of the Treasury for Tax Policy testified that allowing new start-up companies favorable tax treatment by organizing as MLPs would be as unfair as having a "rule that said all corporations doing business in Montana would not have to pay a corporate level tax." See Senate MLP Hearing, supra note 30, at 46-49 (statement of J. Roger Mentz).

660. No mention of valuation seems to have been made in the House, Senate, or Conference Reports.

661. See Advance Notice 88-75, 1988-27 I.R.B. 29 (issued June 15, 1988) [hereinafter Advance Notice]. The safe harbor will be incorporated into regulations that have not yet been issued. Id. For a discussion of the safe harbor, see Loffman, Presant & Lipton, The Impact of Notice 88-75 Concerning Publicly Traded Partnerships, 40 TAX NOTES 747 (1988); Adler, Master Limited Partnerships, 40 U. FLA. L. REV. 755, 775-77 (1988).

662. Publicly traded partnerships may also be protected from double taxation if their partnership income is mostly passive income. I.R.C. § 7704(c) (West Supp. 1989). Furthermore, many publicly traded partnerships enjoy a five-year exemption from association status by the 1987 legislation's grandfather clause. This clause will protect a partnership unless it adds "a substantial new line of business" after the legislation's effective date. Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, § 10211(e)(2)(B), 101 Stat. 1330, 1330-405.

Publicly traded partnerships are also singled out for special treatment under the passive loss rules, I.R.C. § 469(k) (West 1988), and under the provision that treats income from such partnerships as unrelated business taxable income for tax-exempt investors.
cal basis of the notice is unclear. Nevertheless, practitioners were satisfied with the guidance since the variety of partnership transfer mechanisms caused concern in the business community.

The notice provides a safe harbor for three separate forms of transactions. First, private placements are protected if: (1) the interests are issued in a transaction not registered under the Securities Act of 1933, and (2) “either (A) the partnership does not have more than 500 partners, or (B) the initial offering price of each unit” is at least $20,000 and the units cannot be subdivided for resale into units with initial offering prices of less than $20,000. Second, certain gift, large block, involuntary, and retirement transfers are disregarded in determining whether a partnership is publicly traded. Third, two alternative tests exist to determine if the interest is readily tradable. First, the interest is not readily tradable if the sum of the interests in the partnership that are sold or otherwise disposed of (including all redemptions, which are not limited to redemptions under closed-end plans, but excluding transfers not deemed to be trading) during the partnership's taxable year does not exceed 5% of the total partnership capital or profits. Second, the interest is not readily tradable if no more than 2% of the interests are traded during a calendar year, where qualified matching service transfers involving time and volume limitations and qualified redemption and repurchase agreements are disregarded (excluding redemptions under closed-end plans that have frequency of price setting and transaction completion limitations). The percentage safe

I.R.C. § 512(c) (West 1988).


665. Id. § II.E.2, at 32. A closed-end partnership is one in which “the partnership does not issue any interest after the initial offering, and the general partner or a person related to the general partner . . . does not provide contemporaneous opportunities to acquire interests in a similar or related partnerships [sic] which represent substantially identical investments.” Id.

666. Id. § II.B, at 30.

667. Id. § II.C, at 30-31. A multiple transfer of the same interest is counted as many times as it is transferred.

668. Id. § II.D, at 31. Transactions that are accomplished through a matching service, which is a listing system that matches partners who wish to dispose of their interests with persons who wish to buy them, will not cause the interest to be treated as readily tradable if certain time requirements and volume limits are met. Id.

669. For the two circumstances in which a redemption or repurchase plan will not
harbors, either the 5% or 2% version, are likely to be relied upon by many partnerships that currently offer some form of liquidity. These partnerships are less likely to rely on the broad language of the legislative history that may provide them similar protection.

The existence of a buy-sell agreement among the partners, without more, will not cause a partnership to be treated as publicly traded. Neither will the occasional and irregular purchase or redemption by the partnership, nor the acquisition by the general partner, of interests in the partnership cause the partnership to be considered as publicly traded under the provision.

While the 1987 legislation and the accompanying safe harbor notice provide guidance as to one view of the value of liquidity in treating a firm as a corporation, they fall far short of formulating an overall test based solely on liquidity. The main distinction between the public trading test of the 1987 legislation and the author's liquidity test is the treatment of redemption rights in the form of unrestricted put rights to the firm. A public trading test would treat the ability to resell these rights as analogous to the ability to buy and sell firm interests. Thus, the notice does not treat redemptions under a closed-end redemption plan qualifying for the 2% safe harbor as public trading, but as a form of liquidation of the firm. A liquidity of ownership test, on the other hand, might treat all redemptions under a closed-end plan as public trading of liquid investments in a firm. The basis for the closed-end limitation under the 2% safe harbor is less than clear. Certain private placements not accompanied by public trading are apparently treated analogously to closed-end repurchase plans, with-

constitute public trading or the creation of a substantially equivalent secondary market, see id. § II.E.1-.2, at 32.

670. It is estimated that most publicly registered partnerships, other than those that are specifically listed on exchanges and thereby grandfathered by the 1987 legislation for five years, have a trading volume of less than 5%. N.Y. Bar Report, supra note 647, at 30 n.54.

671. 1987 CONFERENCE REPORT, supra note 224, at 948-49; 1987 HOUSE REPORT, supra note 46, at 1070. Provisions of the notice conflict with the standards of public trading under ERISA, which require investment interests held by plans to be "freely tradable." The Department of Labor issued a notice that partnership agreements, which contain a provision allowing general partners to disallow trades that would cause the partnership to be treated as an association, should not be held to violate the "freely-tradeable" rule. It has issued no such ruling on the current allowance of the safe harbor limitations. See Notice on Publicly-Traded Partnerships Welcomed, But Key Issue Remains Unresolved, 40 Tax Notes 123, 124-25 (1988)(statement of R. Donald Turlington).
out any inquiry as to put rights to the firm. Under the general
definition of a market adopted by both the legislation and the Ser-
vice, such transactions are not defined as public trading but might
be treated as liquidity of an ownership interest under a liquidity
test.

V. OTHER PROPOSED RATIONALES FOR THE DOUBLE TAX ARE
INEFFECTIVE IN FORMULATING A UNIFIED THEORY

Other proposals have been made for drawing the double-tax/
single-tax line into a tax system which does not fully integrate the
corporate and individual tax bases. Characteristics that might be
helpful in determining when an entity ought to be subject to two
tiers of tax and when it ought to be allowed to have passthrough
taxation have been enumerated. 672 Several of these proposed tests
are considered below. Others, such as capital size and complexity,
are not considered since they should be viewed as speaking solely
to administrative concerns such as whether a tax ought to be col-
lected at the entity level rather than the owner level. All of the
alternative tests are rejected in a flat tax world in favor of a test
that concentrates on both the liquidity of the ownership interest
and economic size.

A. Misuse of Material Participation Standard

The historical approach to the appropriateness of double tax-
atation has been twofold: eliminate double taxation for entities
with income that is largely identified with the personal efforts of
their owners and retain double taxation for entities that have been
granted valuable legal privileges that are "worth money." 673 The
first approach focuses on owner participation and firm size in de-

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672. These characteristics include: (1) number of owners, (2) capital size and com-
plexity of debt and equity structure, (3) participation of owners and centralization of man-
agement, (4) publicly traded ownership interests, (5) economic size measured by sales,
income, net worth, and total assets, (6) nature of assets — financial intermediary-type
assets or service businesses, (7) nature of owners — C corporations, trusts, and the like, (8)
limited liability alone or in conjunction with any of the above, (9) continuity of life indicat-
ing entity status, and (10) liquidity of the ownership interest. ABA Passthrough Report,
supra note 51, at 609.

673. E. SELIGMAN, ESSAYS IN TAXATION 182 (10th ed. 1925). Compare R. Goode,
supra note 10, at 217 (partnership plan for "small closely held corporations"). with C. GA,
THE TAXATION OF CORPORATE INCOME 117 (1944)("[T]here is a business entity in
any enterprise, distinct from the human being associated with [it]. This . . . has been
carried far enough to include single proprietorships and partnerships, as well as
corporations.").
terminating which entities should be subject to double taxation.674
This approach has recently been reworked to mirror the material participation standard of the passive loss rules which distinguishes between an "aggregate or collection of individuals" and an "entity" and applies the corporate tax to firms that constitute "entities."675

674. A participation standard is an extension of the conduit theory of the firm. See infra note 675. This theory has not always been uniformly applied. In order to qualify for pass-through taxation under prior law, one had to be passive in a real estate investment trust (REIT) and active in a Subchapter S corporation. Under present law, both passive and active income in an S corporation is allowed to be passed through and taxed only once. An alternative would be to bifurcate the firm as is done in France for limited partnerships in which the names of the limited partners are not disclosed. 2 SIMEON MOQUET BORDE & ASSOCIÉS, DOING BUSINESS IN FRANCE § 13.01[3][c][ii][A] (1987).

If the tax is viewed as an excise tax on income that has been derived without the participation of the owner, then the same inquiry that led to the distinction between earned income, favorably taxed and passive income, which suffered an excise, is relevant. Distinctions between earned and unearned income are based on the relative costs of acquiring each form of income. See Blum & Kalven The Uneasy Case for Progressive Taxation, 19 U. CHI. L. REV. 417, 480-82 (1952), reprinted as W. BLUM & H. KALVEN, THE UNEASY CASE FOR PROGRESSIVE TAXATION 65-66 (1953). The idea of material participation also harkens back to the notion of income tax as an ability to pay involving sacrifice, or to use gladstone's phrase, the contrast between "industrious" and "lazy" incomes. See E. SELIGMAN, THE INCOME TAX 23-24 (1911)("The sacrifice involved in earning a given amount of income is a very different thing from the sacrifice involved in receiving an equivalent amount of unearned income."). Human capital is overtaxed by not allowing deductions for education or undertaxed by not taxing unrealized human potential. Rationalizations under the present tax system can be found for this position, see Stephan, Federal Income Taxation and Human Capital, 70 VA. L. REV. 1357, 1375 (1984). The more troubling issues are yet to be resolved. See Boskin, Notes on the Tax Treatment of Human Capital, in OFFICE OF TAX ANALYSIS, DEPT. OF TREASURY, CONFERENCE ON TAX RESEARCH, 1975, at 185, 186, 193-95 (1975)(focus should be on empirical data and theoretical models to determine whether human capital accumulation is discouraged under the current tax regime).

675. This theory was fully elaborated in Lee, supra note 267, at 83-93, 139 (analyzing resemblance test and suggesting that only privileged "deep structure" approach is to classify separate taxable units based on a "passive/active participation-by-owners dichotomy" with the "hallmark of an entrepreneurial situation requiring aggregate pass through taxation . . . the interest-holders active, or 'material,' participation in the business and perhaps, in a small enough venture, his acting as the financier."); 1987 House MLP Hearings, supra note 30, at 344 (statement of John W. Lee). See also Hobbet, Limited Partnerships: Associations or Partnerships?, 22 SAN DIEGO L. REV. 105, 113 (1985). I characterize this view as a reformulation of the aggregate-entity conflict in operative provisions of the tax law.

Limited sanctity for essentially passive investors in a firm is not without precedent. See Peterson, Corporate Control and Capitalism, 79 Q.J. ECON. 1, 23 (1965). Under the Berle view that "the shareholder's business is 'primarily to receive' . . . owners seem extravagantly over-rewarded . . . Beardsley Ruml once argued that most corporate earnings should go to the one or two top officers mostly responsible for the firm's success." Id. The suggestion has been made that passive owners should get only a capital wage in the form and rate of interest, and that management should occupy the residual equity position. See
Use of a material participation standard is supported by the centralized management prong of the corporate resemblance test, which focuses on whether the owners participate as the firm’s managers. Application of the standard to management buyouts or leveraged buyouts has not been adequately explored. The material participation standard might be useful if the goal were to

Mason, *The Apologetics of “Managerialism,”* 31 J. Bus. 1, 4 (1958) (arguing that such a system should be the result if ownership is completely divorced from control). See also E. Nourse, *Price Making in a Democracy* 94-96 (1944). While supporting the argument for entity level taxation from the argument for the corporate double tax, he concludes that both the fact of entity level taxation and, in a nonintegrated tax system, the imposition of the double tax and corporate tax burden unmitigated by graduated corporate tax rates follow the entity level taxation result. See Lee, supra note 267, at 88, 102-09.

676. Treas. Reg. § 301.7701-2(c)(3) (as amended in 1983). The value of the owner-manager’s interest relative to the firm’s total capitalization is generally the crucial determinant. See Glensder Textile Co. v. Commissioner, 46 B.T.A. 176, 185 (1942), acq., 1942-1 C.B. 8 (the general partners “were acting in their own interest . . . , which constituted five-twelfths of the partnership, and not merely in a representative capacity for a body of persons having a limited investment and a limited liability”). See also Zuckman v. United States, 524 F.2d 729, 738 (Ct. Cl. 1975). Zuckman emphasized the importance of representative capacity rather than centralized management in determining whether a limited partnership should be classified as an association:

In the corporate context, there could be no centralized management unless the management power is held and exercised in a representative capacity . . . . In the limited partnership context, however, centralized management meant that the general partner has the exclusive management power . . . and acts primarily in his own behalf . . . . The focus of inquiry must therefore be on the “representative” rather than the “centralized,” character of management, inasmuch as centralization *per se* is generally common to both corporations and limited partnerships and, hence, immaterial in distinguishing between the two. Zuchman, 524 F.2d at 738.

A general partnership formed under the UPA cannot have centralized management because of the mutual agency relationship among its members. Treas. Reg. § 301.7701-2(c)(4)(as amended in 1983). Limited partnerships formed under the ULPA also lack the characteristic of centralized management unless the general partners hold less than a substantial portion of all partnership interests. Id. See W. McKee, W. Nelson & R. Whitmire, *supra* note 245, § 3.06[4], at 3-50. This is true because if the general partners own only a small interest in the partnership, then they are acting predominantly as representatives for the limited partners and not for themselves. The present law line is defined by case law. Id. at ¶ 3.06[4], at 3-50 (20% is a brightline from the case law). Accord Rev. Proc. 89-12, *supra* note 297. But compare Prop. Treas. Reg. § 301.7701-2(h), example 1 (as amended in 1984)(20% is not a “substantial interest” and therefore the general partner will be considered to be acting in a representative capacity) with id. at example 4 (40% is a “substantial interest”).

677. A management buyout is argued on efficiency grounds to make management more entrepreneurial by aligning the interest of management with the interest of owners. *See supra* notes 44, 173 & 520. A management buyout where management owns substantially all the equity in the firm, whether directly or through an ESOP, is precisely the kind of structure that a material participation standard appears to require: risk and lack of diversification.
tax only diversified participants under a belief that the incidence of the tax on capital falls on investing shareholders rather than on the original entrepreneur or capital providers in general. The argument would be that owners that invest significant human capital in the firm are less likely to be diversified and should be singly taxed. However, advocates of the material participation standard have not proposed a single tax line based on risk diversification or other theories of firm structure choice.

A focus on participation begs the question of whether there is justification for viewing a firm as a separate taxable unit that produces economic rents or pure profits. Participation may identify the character of income in a schedular world but it does not identify the appropriate taxable units for that income. There is some evidence that owner controlled firms outperform manager


679. See Coffee, supra note 376, at 78-79.

680. While Lee speaks of entrepreneurial risk in a populist vein, see Lee, supra note 267, at 86 & n.118, 87 n.120, 88, 92 & n.134, he does not make a risk diversification argument.

681. See supra note 278.

682. The income tax is certainly more schedular after the 1986 Act and the addition of the passive activity loss and interest allocation rules of I.R.C. §§ 163 & 469.

683. Control has been used to determine whether certain forms of management produce greater firm performance. See also infra note 684. Control has been measured by a variety of methods. See, e.g., J. Munkirs, The Transformation of American Capitalism: From Competitive Market Structures to Centralized Private Sector Planning 68-72 (1985)(listing the Williams Act control test, Berle and Means test, and other tests for distinguishing between owner-controlled and manager-controlled firms).

The dual class recapitalization and leverage buyout case studies are also useful in evaluating control. Both of these transactions represent control solidification by management, although in the first the public shareholders receive stock with increased dividend participation and in the second the public shareholders have traded their shares for cash. Gilson, Evaluating Dual Class Common Stock: The Relevance of Substitutes, 73 VA. L. REV. 807, 812-14 (1987). Gilson argues that in perfect capital markets both the public shareholder and the management group would consider these two transactions to be substantively identical. Id. at 814-15. The management characteristics of companies choosing dual class transactions are evidence of the point at which management, in effect, operates
as an owner rather than as a representative of the public shareholders. Dual class recapitalizations of existing companies are argued to occur when there are dominant pre-transaction shareholder groups who put management in a position to coerce the public shareholders. *Id.* at 832-35. This demonstrates a need for a restriction on dual class transactions but not dual class capital structures that are freely chosen by new investors. *Id.* at 844. In the studies to date, the average company proposing a dual class transaction is already 30% to 48% controlled by a dominant shareholder group. *Id.* at 821-22. See also Gordon, *Ties that Bond: Dual Class Common Stock and the Problem of Shareholder Choice*, 76 Calif. L. Rev. 3, 52 & n.71 (1987); Jarrell & Poulsen, *Dual-Class Recapitalizations As Antitakeover Mechanisms*, 20 J. Fin. Econ. 129, 141 (1988); Partch, *The Creation of a Class of Limited Voting Common Stock and Shareholder Wealth*, 18 J. Fin. Econ. 1, 9 (1987)(table 3).

The S.E.C. adopted the Gilson view and issued a ruling on listing firms with dual class stock that narrowly construed the limitation on “one share, one vote” to instances of “disenfranchisement.” In effect, companies that reduce or limit shareholder’s existing rights can no longer trade those shares on the nation’s stock exchanges or in the major over-the-counter market. The S.E.C. “grandfathered” existing exchange listed companies with disparate voting rights such as “super voting” stock, which is generally issued as a defense against hostile takeovers. An exemption was also made for state anti-takeover laws, such as Indiana’s, that place conditions on the voting rights of big holders seeking control of a company. At the time of issuance, there were sixty firms traded on the NYSE that have or plan to issue such plans, 11.7 on the AMEX, and 182 on NASDAQ. See *S.E.C. Adopts Narrow Rule to Eliminate Extremely Unequal Stock Voting Rights*, Wall St. J., July 8, 1988, at 3, col. 1. See Rule 19c-4, Exchange Act Release No. 25891, 53 Fed. Reg. 26376 (1988), reprinted in [1988-89 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 84, 247 (July 7, 1988). The allowance of dual class structures in initial public offerings and the promise of the Gilson view has been criticized.

See Lowenstein, *Shareholder Voting Rights: A Response to SEC Rule 19c-4 and to Professor Gilson*, 89 Colum. L. Rev. 979, 1009 (1989) [hereinafter Lowenstein, *Response*] (criticizing S.E.C. Rule 19c-4 which allows new issues to adopt dual class voting under the belief that shareholders can freely waive and assess the waiver of voting rights, Lowenstein finds that the “IPO investor’s ‘agreement’ is unfocused and essentially nonexistent . . .” and given the short investment horizon, “the voting rights are not even their own . . .[m]ore realistically, they belong to future shareholders, as yet unknown.”).

The sparse data on leveraged buyouts indicates a much lower management ownership percentage. One study found about 23.2%. See DeAngelo, DeAngelo & Rice, supra note 502, at 383 (table 2). In their study, the mean management pre-offer ownership fraction of common stock in all going-private proposals was 45.2% and in successful proposals it was 46.3%. The median was 50.9% and 48%, respectively. *Id.* As for merger proposals, the mean management ownership was 52.9% for all merger proposals and 54.6% for the successful ones, with medians of 53% and 60%, respectively. *Id.* Tender or exchange offers involved a mean percentage of 54.4% for all such offers and 56.6% for the successful ones, with median percentages of 54% and 56.5%, respectively. *Id.* For 28 companies with an average size of $498 million, one study found management ownership averaged 6.5%. Lowenstein, supra note 44, at 736-39.

Firms going private also exhibit control characteristics. Maupin, Bidwell & Ortegren, *An Empirical Investigation of the Characteristics of Publicly-Quoted Corporations Which Change to Closely-Held Ownership Through Management Buyouts*, 11 J. Bus. Fin. & Acct. 435 (1985)(noting the distinguishing characteristics of firms most likely to achieve a management buyout as (1) a majority of company stock held by management and the board, (2) a significantly higher industry average cash flow to net worth ratio, (3) cash flows comparatively high in relation to total assets, (4) shares of stocks selling at a rela-
controlled firms. Employee ownership has also been found to produce greater results in some studies. The value of entrepreneurial control has been noted even in public companies. However, this evidence of the value of entrepreneurial control does not alleviate neutrality concerns raised by a material participation test for passthrough taxation. The ability of large non-managerial shareholders to constrain management from acting in its own self-interest and to ensure that the firm is operated more from an investor perspective illustrates the non-neutrality of such a test. Evidence of the value of the firm

See also Lawrence, A Comparative Analysis of Public Firms Going Private, 21 REV. BUS. & ECON. RES. 1 (1986). Lawrence found financial conditions and performances of companies going private statistically distinguishable from those of similar firms remaining public. Stockholder voting control was found to be much more concentrated in firms about to change ownership status, suggesting that the ability to control the voting and terms of the exchange offer weighed heavily in the private investor groups' decisions to make the firm private. Id. at 14. While public statements released to the financial press often stress other factors, including the relatively low stock price, little empirical support could be found for this emphasis. Id. at 12-14.

See, e.g., Krause, Ownership Control and Stock Market Performance, 15 J. BEHAV. ECON. 113 (1987)(finding that annual stock market returns of owner-controlled firms exceeded the returns of other firms by an average of 12% during the three year period of 1981-1983 in 390 fortune 500 firms). In Krause's study, manager-controlled firms were defined as those in which no single holding of stock was greater than 5% of the outstanding common stock, while owner-controlled firms were defined as those firms whose largest shareholder owned 20% or more of the voting common stock. Firms that did not fall into either category were treated as neutral. Id. at 114. Other studies produced conflicting results. See id. at 113. These studies have been criticized on the basis of both their statistical methodologies and their results. See, e.g., Zeitlin, Corporate Ownership and Control: The Large Corporation and the Capitalist Class, 79 AM. J. SOC. 1073, 1085-115 (1974).

See Cohen & Quarrey, Performance of Employee-Owned Small Companies: A Preliminary Study, 11 SMALL BUS. MGMT. 1, Apr. 1986, at 58, 59 (employee-owned companies "out-performed their competitors by 30 percent in sales growth and by three-to-one in employment growth"). Other studies on ESOPs show mixed results. See supra note 200 (discussion of ESOPs). See also Cook, The Ownership Culture, FORBES, Oct. 6, 1986, at 72 (examining Avondale Industries, Inc., which implemented an ESOP); Labor-Managed and Participatory Firms, 18 J. ECON. ISSUES 1189 (1984)(debate on whether labor-managed firms are more or less efficient).

See Scardino, How Murdoch Makes It Work, N.Y. Times, Aug. 14, 1988, § 3, at 1, col. 2 (since Murdoch's family owns the controlling interest in the Murdoch News Corporation, he can reach an agreement far faster than most competitors and has established a major acquisition record over the past three years).

See supra notes 44 & 173.

See Friend & Lang, An Empirical Test of the Impact of Managerial Self-Interest on Corporate Capital Structure, 43 J. FIN. 271, 280 (1988). When corporations have large non-managerial investors, the average debt ratio is significantly higher than that
founder’s ability to act as a manager demonstrates that management ownership by founding families, where the founder is a top officer or has stock control, ceases to be an entrepreneurial asset during the final growth stage of the firm. Classifying firms based on participation destroys tax neutrality for capital deployment and has a tenuous connection with the targeting of tax based on ability to pay or efficiency grounds to certain business activities.

By introducing a preference for certain forms of capital, a material participation standard would increase transaction costs as firms reorganize themselves to protect items from double taxation.

of corporations with no principal stockholders. This suggests that the existence of large non-managerial stockholders might make the interest of managers and public diversified stockholders coincide. A debt ratio is negatively related to management shareholding, meaning that there is a lower debt-to-equity ratio in firms with managers who own little equity, reflecting the greater non-diversifiable risk of debt to management than to public investors. \textit{Id. See also} Easterbrook, \textit{Two Agency-Cost Explanations of Dividends}, 74 AM. ECON. REV. 650, 653-54 (1984); Shleifer & Vishny, \textit{Large Shareholders and Corporate Control}, 94 J. POL. ECON. 461, 462, 464-65 (1986).

689. R. Morck, A. Shleifer & R. Vishny, \textit{Management Ownership and Corporate Performance: An Empirical Analysis} 18 (National Bureau of Economic Research Working Paper No. 2055, 1986). The authors argue that performance declines when managers are protected against the discipline of the market due to very large management holdings and are thus free to pursue their own objectives instead of value-maximization objectives of the firm. \textit{Id. at} 3, 18. Additionally, founding families were shown to have a negative impact on the performance of older firms. Evidence of this negative impact in very large and therefore usually older corporations, may be irrelevant to newer, faster growing firms where managerial holdings may play a more important signalling role than they are likely to play for larger firms. Analysis of the impact of officers’ stakes in performance would incorporate other compensation data. \textit{Id. at} 19; Murphy, \textit{Corporate Performance and Managerial Remuneration: An Empirical Analysis}, 7 J. ACCT. & ECON. 11, 12 (1985). Evaluation of directors should also focus on how the distribution of ownership on boards affects performance.

The logic of material participation in a schedular income tax world does not transfer to the structuring of a double tax regime.

B. Ineffectiveness of Small Number of Owners Standard

A desire to simplify administration and an aggregate view of income produced in small firms as directly stemming from the individual effort and capital of the owners formed the basis of much of the reasoning behind prior proposals that extended passthrough taxation to corporations with a small number of owners and a simple capital structure. In 1958, Subchapter S passthrough taxation was adopted for corporations with ten or fewer shareholders producing active business income in a simple equity capital structure precisely under that reasoning. Other evidence suggests that the closely held firm is not defined by its small number of owners or by its domination by participating owners, but rather is defined by the absence of a regularly operating liquid public market. Other discussions of the small number of owners criterion,

691. In both 1926 and 1928, proposals to allow small corporations the option of filing their returns as corporations or partnerships were made to the tax-writing committees. On both occasions the proposals were rejected. See R. Blakey & G. Blakey, supra note 98, at 258 & 284 (latter suggestion rejected because view of smallness should not be limited to number of owners but should also include size of profits). A partnership option for small corporations of ten or fewer shareholders was again proposed in 1929. See Weiner, Legislative Recognition of the Close Corporation, 27 Mich. L. Rev. 273 (1929). In 1946, the Treasury studied a proposed passthrough election for corporations with a limited number of individual shareholders and only one class of shares. Treasury Dep't, Division of Tax Research, The Postwar Corporation Tax Structure (Dec. 6, 1946), reprinted in Revenue Revisions, 1947-48: Hearings on Corporation Tax Problems and General Revisions Before the House Comm. on Ways and Means, 80th Cong., 1st Sess. part 2, at 1136 (1947) [hereinafter Treasury Dep't, Postwar], reprinted in part in J. Eustice & J. Kuntz, supra note 6, ¶ B.1, at A-24 to A-30. In 1954, the Senate proposed that firms with ten or fewer active shareholders be allowed to elect to be taxed as partnerships. H.R. 8300, 83rd Cong., 2d Sess. § 1351 (1954). The Senate proposal was supported by the existing views of tax commentators who believed there were strong grounds for providing small and closely held corporations with partnership treatment. See Nat'l Tax Ass'n, Comm. on the Fed. Corporate Net Income Tax, Final Report, reprinted in 1951 National Tax Association Proc. Nat'l Tax Ass'n 54, 61-62. This aggregate versus entity view of a corporation with a small number of owners and of the administrative and assignment of income rationales for the limitation on capital structure choice is continued in the present S corporation regime. See J. Eustice & J. Kuntz, supra note 6, at ¶ 1.02[1]-[3] & [5]-[6], 1.03[2][b].

692. See id. at ¶ 1.02, at 1-3 to 1-39.

693. See supra notes 426-41 and accompanying text.

694. See supra notes 426-41 and accompanying text; see also Soderquist, supra note 426, at 1394-95; cf. Ill. Ann. Stat. ch. 32, para. 1203(a) (Smith-Hurd Supp. 1988)(closed corporation defined as one having share transfer restrictions). This supposition has been recently put to the test. See Tex. Bus. Corp. Act Ann. art. 12.01-.54
while raising investment protection issues,^{695} say little about the essential elements of the firm that arguably distinguish forms of production^{696} from forms of raising capital.^{697} Evidence on dual class common stock recapitalizations suggests that less than a substantial majority of the shareholders is needed to affect the form of governance of the firm.^{698} In determining the desirability of firm-level versus owner-level collection of the tax, the small number of owners criterion has little value other than administrative convenience for tax collection and audit adjustments. Similarly, the approaches that follow the simplified structure approach of S corporations are based on a rationale of income allocation and are not a rationale for single-level taxation.^{699} Without economic size limitations,^{700} both simplicity and small number of owners criteria

(Vernon Supp. 1989)(unlimited number of shareholders, no share transfer restrictions, and no restriction for public status for new close corporations).

695. A number of owners criterion is used by the S.E.C. in two ways. Section 4(2) of the 1933 Act sets no limits on the number of offerees or purchasers. In practice, however, the higher those numbers become, the more apt the S.E.C. is to view the offering as "public" and hence subject it to the section 5 registration requirements of the Act, especially if those offerees are deemed in need of the protection disclosure provides. See, e.g., SEC v. Ralston Purina Corp., 346 U.S. 119 (1953)(finding an offering to "key" employees in violation of section 4(2) and subject to disclosure requirements). A number of owners criterion is also used more formally by the S.E.C. in several of the rules of Regulation D. For instance, rules 505 and 506 both limit the number of purchasers in a private placement to 35. See 17 C.F.R. §§ 230.505(b) & .506(b) (1988). However, under the definition section of Regulation D, accredited investors are not deemed purchasers because of their presumed ability to fend for themselves in the marketplace, and thus do not count in the 35 limit. 17 C.F.R. § 230.501(e)(1)(iv) (1988). See generally J. Hicks, 1989 LIMITED OFFERING EXCEPTIONS: REGULATION D (1989).

Federal securities laws also provide that firms with over 500 beneficial owners must file periodic reports with the Commission. See 15 U.S.C. § 78l(g)(1)(B) (1986)(section 12(g)(1)(B) of the Securities and Exchange Act of 1934). Using a number of owners test developed in securities regulation to determine which entities should receive passthrough taxation can be criticized because such a test is not based on tax policy or on a rationale that can be directly related to tax policy goals. See ABA Passthrough Report, supra note 51, at 610 ("great concern was expressed with that kind of a standard because there is no adequate determination in the rationale behind the S.E.C. requirements").

696. See supra note 278.

697. See Keyser, supra note 271, at § 10.01, 10.05 (criticizing the Treasury proposal under which "an enterprise that raised $100 million apiece from thirty-four investors would be treated as a conduit for tax purposes, while the candy store that had thirty-six limited partners, each of whom had invested $500 would be treated as an association taxable as a corporation, subject to double taxation on enterprise distributed income").

698. See supra note 683.

699. See infra notes 1049-52 & 1062-63.

700. In 1984, only 0.346% of net income from S corporations was attributed to S corporations with assets greater than $250 million. In 1985, the same figure was 0.415%. Data calculated from Internal Revenue Service, Source Book: Corporation In-