Who Should Pay the Corporate Tax in a Flat Tax World

Rebecca S. Rudnick

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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-

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I was a member and secretary of the American Bar Association Tax Section Task Force on Passthrough Entities which submitted its final report in July 1988. The views expressed in this article are my own and not those of the Task Force.

Much of the work on this article was done while I was visiting at the University of Texas School of Law. I thank my research assistants, Tami Walker and Monika Rutland, for their help and David Gunn of the Tarlton Law Library for his unfailing cooperation. For the subsequent work at Indiana I thank Melissa Brown and particularly appreciate the steadfast help of Kellye Testy. I gratefully acknowledge secretarial assistance from Shirley Walker at Indiana and Pat Floyd at Texas. A research grant from Indiana was also gratefully received for the project. Valuable comments were received at faculty workshops at Texas and Indiana, and from Calvin Johnson, Joseph Bankman, Joseph Pechman, Carl Shoup, Merritt Fox, Stephen Utz, Glenn Coven, Robert Hamilton, John Chown, Richard Bird, John Wilson, John Dzienkowski, and especially Robert Anthoine. Anjan Thakor and Michael Simkowitz at the Indiana University School of Business and Edward Altman and Ernest Bloch at the New York University Graduate School of Business were particularly helpful on financial markets and related matters.

The apparent and hidden mistakes are all my own as is the thesis.

This article is dedicated to the memory of Henry Simon Bloch who would have added immensely to its intellectual content.
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 passthrough 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.2

Under the classical corporate tax system,3 the profits of a

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).

2. Views of nonlegal problems in public finance from a lawyer's perspective have in the past given useful insights. See Klein, The Incidence of the Corporation Income Tax: A Lawyer's View of a Problem in Economics, 1965 WIS. L. REV. 576, 580-87 [hereinafter Klein, Incidence](identifying limitations in econometric models of corporate tax incidence derived from a lawyer's point of view); Anthoine, Tax Reduction and Reform: A Lawyer's View, 63 COLUM. L. REV. 808, 822-24 (1963)(review of then current legislation and offering an agenda for the future, including harmonizing the taxation of corporations and individuals).

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.\textsuperscript{4} Thus, a classical corporate tax may operate as a tax on corporate capital as well as on profits.\textsuperscript{6} By contrast, under integrated taxation regimes, only one level of tax is paid on the income generated by the firm's activity.\textsuperscript{8} 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)("[I]t is a tax on a factor of production: corporate equity capital."); Harberger, *The Incidence of the Corporation Income Tax*, 70 J. Pol. Econ. 215, 215 (1962)("[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

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The ability of firms to create deductible payments to owners for leasing, rents, salary, and debt may mean that there is no need to use the full extent of the firm's borrowing power to eliminate a firm-level tax.

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 DEP'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 1983 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


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.\(^1\) 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\(^1\) and the continued concerns over high leveraging of United States corporations\(^1\) are symptoms of the failure to implement a nondistortionary normative policy of taxation of corporate profits.

The influential Canadian Carter Commission Report,\(^1\) issued in 1966, stated that a similar rate structure for corporate income and individual income is a prerequisite to an integrated tax system

\(^{14}\) Graetz, *Can the Income Tax Continue to Be the Main Revenue Source?*, in *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, *Facing the Tax Problem* 414 (1937) (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, *The Choice Between Income and Consumption Taxes*, in *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”).

\(^{15}\) 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. 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-

\textsuperscript{25} Previous proposals lacked business community support and managers preferred retained earning financing. See Sheppard, 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. See SubCHAPTER C Conference, supra note 13, at 161 (statement of Michael Graetz).

\textsuperscript{26} See Leonard, A Pragmatic View of Corporate Integration, 35 Tax Notes 889, 891-93 (1987).


\textsuperscript{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, Master Limited Partnerships, 45 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* resemblance test for classification of unincorporated entities as "associations" taxable as corporations. Upon completion of this study, the Service issued a ruling that nominally applied *Morrissey* as interpreted in the *Kintner* regulations, but that unofficially resolves the characterization question based on the public-trading standard of I.R.C. section 7704.

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 passthrough taxation. The bias toward retained earnings

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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.
35. I.R.C. § 7704 (West Supp. 1989). See infra notes 640-71 and accompanying text. The relationship of the new Service position, see Rev. Rul. 88-76, supra note 33 (allowing a de facto public trading test for unincorporated firms) to the forthcoming Treasury studies has not been stated. See also infra notes 281-85.
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-


\textsuperscript{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. Id.

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 1-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
quisitions, 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 Harv. 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 benefit of 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 restructing 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 Omnibus

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.

46. 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).

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 beginning of an exploration of options related to debt and equity finance under the current system and of the desirability of integrating the corporate and shareholder taxes. It has also become 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 Budget Reconciliation Act of 1989), Pub. L. No. 101-239, ___ Stat. ___, 101st Cong., 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 characterize 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 “applicable 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 subject 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 corporations 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 provision 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 remainder. Corporate Financial Structures, supra note 4, at 13. See also Jacobs & Rudnick, 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 treatment of foreigners and tax-exempt entities, see infra note 147-48. Partnerships do not provide 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. 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 it should 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. Sensitive to both a

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52. All of the major speakers at the Senate LBO Hearings testified to the distortion that disfavors equity finance. See Hershey, 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, 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, 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, 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 Senate LBO Hearings, pt. 2, supra note 16, at 29-30 (prepared statement of Alan Auerbach); id. at 20 (prepared statement of Lawrence Summers). The same concern was shared in the House. See 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”); 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”); id. at 359-60 (prepared statement of Michael Blumenthal)( neutrality between debt and equity is a necessary “first step”); id. at 204 (prepared statement of Felix Rohatyn).

53. The current version of the ALI focus on acquisitions and distributions is 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 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. 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. 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.\textsuperscript{59}

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.\textsuperscript{60} 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\textsuperscript{61} and shareholder leverage can offset limits in firm level lever-

\textsuperscript{59} See infra notes 219 & 482.

\textsuperscript{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.

\textsuperscript{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 "[s]ince 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. 267, 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 to 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.

64. On the assumption that marginal investment is made solely with borrowed funds, Stiglitz and King demonstrate that a properly designed corporate tax, including perfect depreciation offsets, falls on pure profits and rents and is allocatively neutral. See Stiglitz, Taxation, Corporate Financial Policy, and the Cost of Capital, 2 J. PUB. ECON. 1 (1973)[hereinafter Stiglitz, Taxation]; Stiglitz, The Corporation Tax, 5 J. PUB. ECON. 303 (1976)[hereinafter Stiglitz, The Corporation Tax]; King, Taxation, Corporate Financial Policy, and the Cost of Capital: A Comment, 4 J. PUB. ECON. 271 (1975). Even if depreci-
To the extent that these assumptions do not hold (and to assume unlimited debt is unrealistic), the corporate tax is a tax on...

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.\(^6\) 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.\(^6\) 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,\(^6\) the appropriate


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. 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 goods)." Hayashi, Corporate Finance Side of the Q Theory of Investment, 27 J. Pub. Econ. 261, 261 (1985). Tobin's q and the value of q is used to make an evaluation of the financing decision of the firm whether to use retained earnings or new equity. The value of the firm is the reproduction cost of the capital it holds, multiplied by q, the ratio of share value to replacement cost. Firms will finance investment with the sale of new shares only if share price exceeds reproduction cost; retained earnings will be used so long as share value is less than reproduction cost. See Auerbach, Share Valuation and Corporate Equity Policy, 11 J. Pub. Econ. 291, 292-94, 303 (1979).

69. Auerbach, drawing upon the earlier work of King, elaborated this tax capitalization view of the corporate tax. See Auerbach, Wealth Maximization and the Cost of Capital, 93 Q.J. Econ. 433 (1979). For a discussion of the tax capitalization view of dividend taxes, see Poterba & Summers, supra note 66, at 230, 237-40. They demonstrate using dividend payout and investment data from the dividend tax reforms in Britain that dividend taxes are not capitalized. Id. at 264-74. Another way of viewing the difference in the shareholder level capitalization and firm level capitalization is through the use of the long run value of q. The first model predicts a value of q less than one due to the tax savings of investment through retention and the fact that future dividend taxes are capitalized and not borne by new investment. The second model predicts a q of one. Auerbach, Empirical Analysis, supra note 65, at 30.

This economic modeling does not take into account the tax benefit of repurchases and has been labeled a "trapped equity" hypothesis. See M. King & D. Fullerton, The Taxation of Income from Capital (1984). It assumes that the only way for stockholders to receive cash from their companies is through the payment of a dividend and implies that a dollar of retained earnings will be capitalized on the market as one minus the tax rate on dividends over one minus the effective tax rate on accrued capital gains. This formula establishes the rate of return required by the equity holders relative to debt but the trapped equity hypothesis has not been proved. See Warren, Integration, supra note 1, at 727-28; Kraakman, supra note 44, at 897 n.19 (suggestion that other discount hypotheses are better than trapped equity theory). The trapped equity hypothesis continues to be contested. See Poterba, supra note 41, at 470.
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 Break, The Incidence and Economic Effects of Taxation, in The Economics of Public Finance 119, 147-48 (The Brookings Institution 1974)(recounting the Smith-Stockfisch debate of the early 1950s). See also 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.\(^71\)

behavior that is not profit-maximizing. See \textit{infra} notes 348-50 & 361-67 and accompanying text. Furthermore, any firm level tax (whether in the form of a two-tiered tax or integrated with the taxation of the owners) may be shifted to labor or consumers by a firm changing its output and pricing decisions in the face of the tax. See \textit{infra} note 350. Any firm level tax may or may not have an incidence different from a direct tax on the individual firm owners. See \textit{infra} note 350. See Graetz, \textit{Assessing the Distributional Effects of Income Tax Revision: Some Lessons From Incidence Analysis}, 4 J. LEGAL STUD. 351 (1975). It may not be more difficult for direct owners who are taxed on the profits of the firm to direct the firm to shift the incidence of the tax to others. The potential for shifting is troublesome for formulating a tax policy with respect to any income tax on profits. See Klein, \textit{Incidence, supra} note 2. The potential for shifting weighs against profits taxation and supports a tax on owners when they receive distributions from the firm. See \textit{infra} notes 350 & 361-62 and accompanying text. On the other hand, the potential for shifting does not mean that income taxation of business profits should be wholly eliminated.

If the firm level tax is capitalized, the incidence assumption for the issuance of new equity is determined under the Stiglitz model. See \textit{supra} note 64. If the tax capitalization view of shareholder taxes is followed, however, the incidence assumption may also be determined under that view. See Mundstock, \textit{Taxation of Intercorporate Dividends Under an Unintegrated Regime}, 44 TAX L. REV. 1, 28 (1988)(arguing that under the tax capitalization view the dividends received deduction for common stock produces a windfall gain for corporate investors).

71. Auerbach has proposed what is in effect a bifurcated view of the shareholder level tax discount hypothesis and its effect on firm behavior. Under Auerbach's proposal, firms at the margin obtain equity funds consistent with the tax capitalization view by utilizing retentions and in other periods by using new equity which is consistent with the traditional double taxation view that dividend taxes are not capitalized. See Auerbach, \textit{Empirical Analysis, supra} note 65, at 29-30, 47-49 (noting that firms view new shares are more costly, which is verified by empirical results, and that the cost of capital varies significantly across firms with different estimated tax clienteles). For a discussion of the alternative views of tax capitalization for an exclusive proposition, see Warren, \textit{Integration, supra} note 1, at 726-28 (arguing as of 1981 that both are not proven). This parallels to a certain extent the "new view" of the corporate tax: it falls on entrepreneurs or shareholders in firms that cannot resort to retained earnings finance or debt, the latter where the interest payment is deductible to the firm, but that since there are other tax clienteles for whom holding of equity may be attractive, debt finance is not always to be preferred to equity finance. See Auerbach, \textit{Tax Integration and the "New View" of the Corporate Tax: A 1980's Perspective}, 1981 PROC. NAT'L TAX ASS'N 21, 22-23, 25 [hereinafter Auerbach, \textit{"New View"}]. Acceptance of the view that only shareholder level taxes are capitalized, not firm level taxes, would eliminate the need to single out new equity for a profits tax approach because of "windfall gain" concerns with respect to the value of firm capital other than retained earnings. The shareholder level capitalization view would determine the "windfall" based on the capitalization of shareholder level taxes. See A. Auerbach, Tax Policy and Corporate Borrowing 19 (University of Pennsylvania unpublished working paper, Sept. 1989)(forthcoming in the \textit{TAX LAW}.)("[If] taxes on distributions from \textit{existing} equity are capitalized into the value of shares and do not influence the marginal cost of capital for reinvested funds . . ., [t]his would mean a current effective rate of tax of 34 percent on reinvested equity funds, plus the effective rate of capital gains on accumulated earnings, compared to the 28 percent or 33 percent tax rate that most investors would face
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, 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. 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. 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.

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. 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

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, 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,\footnote{81. Tariff Act of 1909, ch. 6, 36 Stat. 11, \textit{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." \textit{Id.} at § 38. Modern PTPs have "shares" in the form of depository receipts.} denominated an excise tax to avoid perceived constitutional limitations,\footnote{82. The civil war income tax, which expired in 1872, taxed mercantile and industrial corporations on a pure pass-through basis. Act of July 14, 1870, ch. 255, § 15, 16 Stat. 256. The 1894 act, held unconstitutional in \textit{Pollack v. Farmer's Loan and Trust Co.}, 157 U.S. 429 (1895), taxed both individuals and corporations. \textit{Tarriff Act of 1894, ch. 349, § 27, 28 Stat. 553.}} was constitutionally upheld under the \textit{Flint v. Stone Tracy Co.}\footnote{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. \textit{See id.} at 148-58.} benefits analysis. After ratification of the sixteenth amendment\footnote{84. U.S. CONST. amend. XVI (granting Congress power to collect taxes on income "from whatever source derived" without apportionment).} in 1913, a general income tax was adopted.\footnote{85. \textit{Tarriff Act of 1913, ch. 16, 38 Stat. 114.}} The statute created a normal tax and a surtax on individuals\footnote{86. \textit{Id.} at § II(A)(1), (2).} and left in place the normal tax on corporations. It imposed a tax on dividends received by individuals and corporations,\footnote{87. \textit{Id.} at § II B.} although dividends received by individuals were exempt from the normal tax.\footnote{88. \textit{Id.} at § II D.} Until the 1986 Act, the cor-

\begin{itemize}
\item[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. \textit{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. \textit{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. \textit{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. \textit{Revenue Act of 1918, ch. 18, § 222(a), 40 Stat. 1073 (1919); see also Brooks, supra note 76, at 403.}
The 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 pass-through 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[2][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. Lent, 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. Blakey & G. Blakey, 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 passthrough 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. Pechman 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-
fects 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. Id. at 143-48 (tables 4.6 and 4.7).

Due to assumptions about the efficiency of corporate producers relative to noncorporate producers and the distortion between current consumption, which is favored by the existence of the corporate tax, and future consumption, the increased taxation of the corporate sector is argued to lead to reduced national income. See Feldstein & Frisch, 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 Res. 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. Penalty taxes were the statutory answer to deferral. While deferral was advantageous and capital gains has since caused investors to discount the value of taxable cash dividends) with Kalay, *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, *On Interpreting Security Returns During the Ex-Dividend Period*, 13 J. Fin. Econ. 3 (1984) and Grinblatt, Massulis & Titman, *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 stockholder tax rates, but are instead related to transaction costs or to a larger ex-dividend day anomaly.) See also R. Michael, *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. See Mundstock, *supra* note 70, at 29 (capitalization view); Miller, *supra* note 63, at 270 (traditional view with high bracket shareholders holding low payout shares for extra value).

100. See Klein, *Incidence, supra* note 2, at 585-86.

101. The lower corporate rates prior to the 1986 Act tempted taxpayers to use a corporation to shelter income and sheltering led, in turn, to the accumulated-earnings and personal-holding-company tax penalties. See H. SIMONS, *PERSONAL INCOME TAXATION* 185-89 (1938).

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. See Kwall, *Subchapter G of the Internal Revenue Code: Crusade Without a Cause?, 5 Vt. Tax Rev. 223 (1985); J. EUSTICE, J. KUNTZ, C. LEWIS & T. DEERING, supra note 89, at 2-11. The provision has been expanded statutorily to public corporations, thus reversing Golconda Mining Corp. v. Commissioner, 58 T.C. 139, 58 T.C. 736 (1972), *rev'd on other grounds*, 507 F.2d 594 (9th Cir. 1974). 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. 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. 1985).
taken to explain why public firms continued to pay dividends in the face of the double tax. 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, which provides support for a "tax capitalization" view of

105. For an overview of the basic theories, see J. 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. Ross & R. 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. 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. 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 Shefrin & 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 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).


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 under both the traditional view of the effect of shareholder level taxes and the view that only shareholder taxes are capitalized. Dividend taxes do not affect firm value under either view if debt and retained earnings financing, rather than new equity, dominate capital financing choices. However, for many investors, deferral of distributions coupled with share repurchase strategies created value which may not have been capitalized by returning cash to stockholders subject to lower tax rates than were dividends. Indeed, it is surprising that such strategies were not more heavily used prior to 1984, when debt

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Dividends, 14 J. Pub. Econ. 109, 110 (1980) (demonstrating that "asset market equilibrium will generate a 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. Id. at 134. It also reflects the fact that there are tax clienteles for both dividends and capital gains. See Gordon & Malkiel, supra note 62, at 152-53. This fact coupled with the repeal of the capital gains preference should change the capitalization mix.

107. See supra notes 67-69 and accompanying text.

108. 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. See D. Fullerton & J. Mackie, 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. See id. at 11.

109. See supra notes 96-102 and accompanying text.

110. See supra note 43.

111. See Gordon, 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. See Warren, Timing, supra note 102, at 501; Bryan, supra note 44, at 1054-55, 1057-58. A future distribution at a lower rate is not and creates value for the shareholder.

112. See Auerbach, 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."). 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, 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.117

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 1985.118 The explanation for this decline is twofold. First, legislative changes reduced the corporate tax base;119 and second, economic conditions reduced corporate profitability.120 The 1986 Tax Act reversed the decline by looking toward the business sector as a whole, and particularly corporations, for increased taxes.121

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.122
ing the maximum effective individual rate to 28%\(^{123}\) and setting the corporate rate at 34%.\(^{124}\) The 1986 Act inverted the longstanding relationship between the individual and corporate rates which had existed under the classical corporate tax system.\(^{128}\) 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-

\(^{123}\) See I.R.C. § 1 (West 1988 & Supp. 1989). The top marginal rate is 33% for a significant range of taxpaying individuals.

\(^{124}\) I.R.C. § 11 (West 1988 & Supp. 1989)(phase-out of graduated rates); I.R.C. § 11(b) (West 1988 & Supp. 1989)(phase-out of graduated rates at $335,000 by additional 5% tax on income greater than $100,000 for a marginal rate of 39%).

\(^{125}\) Clark, Morphogenesis, supra note 95, at 96-135. The rate relationships resulted in a historical relationship in which the highest corporate marginal rate was lower than the highest individual marginal rate. Data by Feldstein and Jun suggests that viewed an effective tax rates that relationship did not hold until 1958 for data from 1953 to 1984. See supra note 100.

In tracing the relationship between the corporate tax rate and the individual normal tax, Professor Shoup identified four stages. The first stage occurred between 1913 and 1918. During this timeframe the normal individual tax rate was the same as the corporate tax rate except in 1917, when the corporate rate was 6% and the individual rate was 4% "and dividends were exempt from the individual normal tax." Shoup, The Dividend Exclusion and Credit in the Revenue Code of 1954, 8 Nat'l Tax J. 136, 136 (1955). Another attribute of this period was that "the corporate tax was regarded as a sort of advance payment of the individual normal tax on distributed profits." Id. The second stage ran from 1919 to 1935. There, "the corporation tax rate was somewhat above the individual normal tax rate." Id. (footnote omitted). "[T]he spread between the rates developed . . . because . . . Congress was repealing . . . other taxes on corporations, notably the excess profits tax and the capital stock tax, and for this reason felt justified in slowing down the rate reduction of the corporate income tax." Id. (footnote omitted). The third period covers 1936-53 and is marked by "the repeal of all exemptions of dividends from the individual income tax." Id. at 136-37. The "corporation income was purposely subjected to double taxation, or more accurately, to extra taxation at least insofar as it was distributed to shareholders. Congress . . . [was] more concerned with the escape of undistributed profits from full taxation than it was over extra taxation of distributed profits [and] the extra taxation was almost a by-product of the confusion that arose over the issue of taxing undistributed profits." Id. at 137 (footnote omitted). The fourth era began in 1954 when the "attention [was] placed on distributed profits . . . with a view to reducing the extra taxation [and] keeping the problem of undertaxation or extra taxation of undistributed profits well out of sight, if not out of mind." Id.

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.\textsuperscript{127} 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\textsuperscript{128} 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, \textit{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 passthrough 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 passthrough 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 passthrough 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\textsuperscript{129} and the preference for debt financing.\textsuperscript{130} Tax planning since the 1986 Tax Act has tried to ensure the "disincorporation of America"\textsuperscript{131} in three ways. The first, or "nonincorporation" prong of disincorporation,\textsuperscript{132} encourages firms to earn business income in the first in-

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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.

\textit{Am. Law Inst. Federal Income Tax Project, Taxation of Partners: Subchapter K 378 (1984)[hereinafter ALI Subchapter K Study](footnote omitted and emphasis added).} 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).

\textsuperscript{129.} See infra notes 139-57 and accompanying text.
\textsuperscript{130.} See infra notes 158-74 and accompanying text.
\textsuperscript{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 Dis-incorporated?, Forbes, June 16, 1986, at 74; Saunders, Tax Reform's Tax Dodge, Forbes, Oct. 20, 1986, at 103.
\textsuperscript{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 pass-through 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,\textsuperscript{133} encourages firms to restructure themselves as partnerships\textsuperscript{134} or as S corporations entitled to passthrough taxation,\textsuperscript{135} 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,\textsuperscript{136} encourages firms to increase leverage and substitute debt for equity in leveraged buyouts or leveraged recapitalizations.\textsuperscript{137} These strategies have

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\item See Freeman, \textit{Some Early Strategies for the Methodical Disincorporation of America After the Tax Reform Act of 1986: Grafting Partnerships onto C Corporations, Running Amok with the Master Limited Partnership Concept, and Generally Endeavoring to Defeat the Intention of the Draftsmen of the Repeal of General Utilities}, \textit{64 Taxes} 962, 967-74, 982-89 (1986)(discussing a variety of “freezing” strategies). Freezing is much more difficult to accomplish under the estate and gift tax than under the income tax. See I.R.C. § 2036(c) (West 1989)(placing severe curtailment on freezing). The Service has announced that it will now rule on partnership freezes involving family partnerships that on formation have a ‘special allocation for the purpose of fixing or freezing the value of a partner’s partnership interest. See Rev. Proc. 88-3, 1988-1 I.R.B. 29, as modified by Rev. Proc. 88-51, 1988-43 I.R.B. 14. The current rules are in Rev. Proc. 89-3, 1989-1 I.R.B. 29.\textsuperscript{134}

\item Liebtag, \textit{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).\textsuperscript{135}

\item 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, \textit{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). \textit{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 \textit{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 \textit{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 \textit{Corporate Financial Structures, supra} note 4, at 78-79. All prongs, however, increase the transaction costs.\textsuperscript{137}

\item Corporate spin-offs followed by S elections were a favored technique. See Simon & Simmons, \textit{The Future of Section 355}, 40 \textit{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 \textit{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.  

Private ordering in partnerships, limited partnerships, and trusts can accomplish many of the same results as incorporation, 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, is debatable. To achieve limited partnership status and
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. 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}, \textit{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 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,\(^\text{146}\) (2) the tendency of management to retain rather than distribute earnings,\(^\text{146}\) (3) disadvantageous tax consequences for tax-exempt equity holders\(^\text{147}\) and foreigners,\(^\text{148}\) and (4) the relative nontax advantages of the corporate form.\(^\text{149}\)

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:

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\text{[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.


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(h) (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. While these four arguments leveled against MLPs as general business vehicles failed to persuade Congress, they may be borne out by subsequent developments.5

Pressures to disincorporate existed before 1986.6 The increase in S elections from 1981 to 19857 provided evidence of the increased desirability of pass-through 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].” Gabinet & Coffey, The Implication of the Economic Concept of Income for Corporation-Shareholder Income Tax Systems, 27 CASE W. RES. L. REV. 895, 907, 909 (1977).

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 have considered reincorporation. See Shearson Lehman Hutton, The “Recorporatizing” of MLPs: Devon Resources and Apache Petroleum Lead the Way, 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). INTERNAL REVENUE SERVICE, Corporation Income Tax Returns: Selected Balance Sheet, Income Statement, and Tax Items for Selected Years, 1970-1983, 5 STATISTICS OF INCOME BULL., no. 4, at 108 (Spring 1986)(Table 8); INTERNAL REVENUE SERVICE, Corporation Income Tax Returns: Balance Sheet, Income Statement, and Tax Items for Selected Income Years, 1970-1985, 7 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. 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 INTERNAL REVENUE SERVICE, SOURCE BOOK: CORPORATION INCOME TAX RETURNS (1981, 1982, 1983, 1984, 1985)[hereinafter 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 C 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

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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.

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).


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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

January - September 1988 was $13.653 billion, as compared to $14.241 billion in 1987. In 1981, partnerships in the aggregate reported a net loss for the first time in the 25 years that the statistics on partnership returns have been available. The annual statistics of the partnership then continued to show losses. Nelson, Taxes Paid by High-Income Taxpayers and the Growth of Partnerships, 5 STATISTICS OF INCOME BULL, no. 2, at 55-60 (Fall 1985); id. at 86 (table 5). The greatest net loss for the three years 1981 through 1983 occurred in 1982. The statistics of income for 1985 reversed this trend with net income in the partnership sector of $8.88 billion. 7 STATISTICS OF INCOME BULL, no. 3, at 90 (Winter 1987/1988).

155. In 1981, partnerships in the aggregate reported a net loss for the first time in the 25 years that the statistics on partnership returns have been available. The annual statistics of the partnership then continued to show losses. Nelson, Taxes Paid by High-Income Taxpayers and the Growth of Partnerships, 5 STATISTICS OF INCOME BULL, no. 2, at 55-60 (Fall 1985); id. at 86 (table 5). The greatest net loss for the three years 1981 through 1983 occurred in 1982. The statistics of income for 1985 reversed this trend with net income in the partnership sector of $8.88 billion. 7 STATISTICS OF INCOME BULL, no. 3, at 90 (Winter 1987/1988).

156. See supra notes 29-30 & 46 and accompanying text.

157. See supra notes 29-30 & 46 and accompanying text.

158. 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.

CORPORATE FINANCIAL STRUCTURES, supra note 4, at 57. The importance of the 1981 individual rate changes is also supported by evidence of the increase in S corporations and partnerships, although the effect of the 1981 Act on depreciation and the investment tax credit weakens the correlation between the 1981 Act and the increase in debt finance. Other nontax factors such as the lower risk aversion of managers and the value of leverage in the marketplace which was syndicated through the growth in the high yield debt market, which had a record year in 1986 arguably in anticipation of the 1986 Act's changes, are evidence that debt finance was not purely a 1986 phenomenon.

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 and the view of the firm as a cash flow (possibly allocating capital to industries that can be highly leveraged and away from start-up firms and more risky investment). It also arguably leads in restructuring transactions to a weakening of the debt coverage ratios. The reduction in other tax preferences in the 1986 Act may also be resulting in increased debt finance. The characteristics of that debt have changed over time.

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).


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.”

Id.

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.

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.\footnote{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.\footnote{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 monitored\footnote{170} and are argued to present posi-

\begin{itemize}
\item \footnote{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).}
\item \footnote{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.}
\item \footnote{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 MARKET 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.}
\end{itemize}
tive returns for investors, especially those who can invest on a portfolio basis, but the changing market creates additional risks. There is also a growing presence of tax-exempt investors in these leveraging transactions.

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

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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 restructuring 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.”\(^{176}\) 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.”\(^{177}\) 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.

\(^{176}\) 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

Financial Products (1988)(discussing portfolio income notes, auction rates, and remarshaled 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{188}

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{188} 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, 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.187 Debt is tax preferable for raising firm capital, although for a variety of reasons some firms do not resort to debt financing.188 Assuming taxes on dividends and interest are an important consideration, tax clienteles 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.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).

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).

189. Preferred stock has always been used to exploit the clientele effect based on the
the high yield debt market through well publicized defaults and the bankruptcy of its main market maker may mean that predictions of "deleveraging" will dominate financing in the 1990s.\footnote{Firms will "deleverage" by replacing debt with equity at a lower cost of capital since investors will demand a share of the upside in the firm and make debt too expensive, but the speculative nature of some firms will make capital difficult to obtain for middle tier and weaker companies.} 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."\footnote{A continued preference for equity and its after tax return may be the result of the systemic factors which lower the effective rate on equity below the effective rate on debt. See \textit{Corporate Financial Structures}, supra note 4, at 55-57. A tax clientele for capital gains persists after 1986 when such gains are taxed as ordinary income because of the deferral of tax on unrealized gains and the ability to time realization for maximum advantage. See Ferris & Reichenstein, \textit{A Note on the Tax-Induced Clientele Effect and Tax Reform}, 41 Nat'L Tax J. 131 (1987); see also Constantinides, \textit{Capital Market Equilibrium with Personal Tax}, 51 Econometrica 611 (1983). The effect of this continuing tax clientele is to lead to the demand that "high yield securities should offer higher before-tax returns for a given level of risk than low yield securities." Ferris & Reichenstein, \textit{ supra}, at 136. Recent studies also find that the tax changes have influenced the trading of securities. \textit{See P. Bolster, L. Lindsey & A. Mitrusi, Tax Induced Trading: The Effect of the 1986 Tax Reform Act on Stock Market Activity} 25 (National Bureau of Economic Research Working Paper No. 2659, 1988).} 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.\(^{193}\)

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\(^{193}\) Popkin, Tax Ideals in the Real World: A Comment on Professor Strnad's Approach to Tax Fairness, 62 IND. L.J. 63, 64 (1986).

\[A\text{ consumption tax}\] analysis assumes that a tax obligation is fairly discharged if it is accrued as a charge against wealth. An income tax, by contrast, requires that the tax be paid currently, out of wealth. The dispute between the income tax and the consumption tax can therefore be recast as an argument about whether a tax obligation is fairly discharged by accrual or payment. Id. See also Strnad, Taxation of Income From Capital: A Theoretical Reappraisal, 37 STAN. L. REV. 1023 (1985); Kaplow & Warren, An Income Tax by Any Other Name — A Reply to Professor Strnad, 38 STAN. L. REV. 399 (1986); Warren, Fairness of a Consumption-Type or Cash Flow Personal Income Tax, 88 HARV. L. REV. 931 (1975); Gunn, The Case for an Income Tax, 46 U. CHI. L. REV. 370 (1979). Deviation from the idea of current payment occurs only because of the realization requirement. Congress increasingly recognizes that deferral of a current payment obligation ought to give rise to interest payable to the government on deferred taxes. See, e.g., I.R.C. § 453 (West 1988 & Supp. 1989); Blum, New Role For the Treasury: Charging Interest on Tax Deferral Loans, 25 HARV. J. ON LEGIS. 1, 95 (1988)(deferred tax-payment interest should be expanded beyond
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


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{197} See generally Klein, Income Taxation and Legal Entities, 20 U.C.L.A. L. Rev. 13 (1972) [hereinafter Klein, Legal Entities]; Nacev, supra note 196, at 1023:

[B]ecause the legal concepts that give substance to these disparate tax entities predate our modern tax laws, our tax laws have not been able to develop a normative response, partly due to a lack of coherent theory, as in corporate tax integration . . . and partly because of a lack of empirical support, as in the corporate tax incidence dilemma . . . [providing] by default . . . [a] reification [of] such legal entities in the federal tax jurisprudence and confine responses to tinkering at the margins . . . .

\textit{Id.}

\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.
protect the single-taxed character of these returns when they are

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 Broadway, 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. 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. The changing nature of financial structures including high yield subordinated debt paid on a cash or an accrual basis in leveraged buyouts, adjustable rate convertible “debt,” and various forms of participating and variable rate debt 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.

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
rate... appropriate to its class [of risk]. Similar, 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. 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. 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. 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.

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 Re-capitalizations 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, Fabbozzi & 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{217}

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{218} 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{219} As a residual claim, the “equity” risk has a

\footnote{217. 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.

218. 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.

219. 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.

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. Subrahmanyam 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

225. The income tax statute has extended the view of conduit taxation for firms that represent aggregations of capital for the production of income which is the direct product of capital beyond interest and dividends received through financial intermediaries such as mutual funds (RICs) and real estate mortgage investment conduits (REMICs) but to passive forms of real estate investment. The tax treatment of real estate investment trusts (REITs) is an example of this distinction. The legislative history indicates that an amalgamation of capital deriving “passive income from real estate investments” through rental receipts and sales of real property qualifies for conduit treatment whereas real estate development would not. See Kahn, Taxation of Real Estate Investment Trusts, 48 VA. L. REV. 1011, 1012-14 (1962) (The legislation recognized that pooling of small investor funds was useful because it would stimulate the flow of investment capital. Special tax treatment for REITs was further justified due to its similarity to the treatment afforded group ownership of stocks and securities through regulated investment companies.). Real estate activities, for this reason and others, thus blur the distinctions between business and investment activities. See Rev. Rul. 75-374, 1975-2 C.B. 261 (provision of customary tenant services not a business activity and therefore the owners will be taxed as co-owners and not as partners). The income from real estate similarly blurs the distinction between business and investment income. See Suburban Realty Co. v. United States, 615 F.2d 171 (5th Cir. 1980) (The sale of property arose from the realty company’s ordinary operation of its business. The proceeds were therefore ordinary income rather than investment capital gains.).

The recent legislation on publicly traded partnerships went well beyond a view of income as product and made a rough distinction between business and investment, although it did not use those terms, by creating a category of “qualifying income” considered to be of a “passive-type.” The “passive-type” term is included in the legislative history to characterize the activities named in the statute. 1987 House Report, supra note 46, at 1067-69; HOUSE CONFERENCE COMM. RPT., H.R. CONF. REP. NO. 495, 100th Cong., 1st Sess. 946-47 (1987) [hereinafter 1987 CONFERENCE REPORT]. I.R.C. § 7704(c), (d) (West Supp. 1989). Qualifying income includes interest, dividends, real property rents, gains from the sale of real property including inventory, income and gains from exploration, development, mining or production, processing, refining, transportation or the marketing of any mineral or natural resource, any gain from the disposition of a capital asset held for the production of the above income, and certain gains from commodities and futures contracts. I.R.C. § 7704(d)(1) (West Supp. 1989). While it includes income from rental real estate, real estate with varied services, like hotels, is not treated as producing income as product. See I.R.C. § 7704(c) (West Supp. 1989). As a political compromise and explicitly couched in neutrality principles, it included a broad category of natural resources extraction and production.

[C]ertain types of natural resources and rental real estate activities have commonly or typically been conducted in partnership form, and the committee considers that disruption of present practices in such activities is currently inadvisable due to the general economic conditions in these industries. [It] does not intend to treat tax benefits from such activities more favorably than under present law, but at the same time considers it inappropriate to subject net income from such activities to the two-level corporate tax regime to the extent the activities are conducted in forms that permit a single level of tax under present law. HOUSE REPORT, supra note 46, at 1066-67. The House, however, viewed income as product as being limited only to interest, a return that the investors could earn directly, and dividends, a return already subject to the two-tier tax. Id.

The Congressional treatment of PTPs was also an example of a congressional application of what I term “transactional formalism” under the statute since it soundly rejected the view that these entities were “debt substitutes” since they often replaced corporate
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{229} 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

\footnotesize

\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.

\textsuperscript{229} \textit{See supra} notes 60-67 and accompanying text.

\textsuperscript{230} Leverage is the mechanism by which the yield on an investment including an equity investment in a corporation is increased. \textit{See R. Brealey & S. Myers, 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. \textit{See id.} at 393-401. If interest on firm debt is deductible, a leveraged financial structure increases the return on the equity. \textit{See R. Hamilton, 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:

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 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 corporate income tax (or outstanding equity) is eliminated." Id. Modigliani and Miller point out that the increase in the debt-equity ratio will result in a lower capitalization of earnings but that the overall value of the firm in a world with taxes will remain the same. In a world with taxes, the value of the firm increases by the discounted present value of the tax savings from the interest deductions and the value of the equity is correspondingly increased. A dramatic example of these two propositions is the recent trend toward corporate restructurings noted in Reporter's Study Draft, supra note 53, at 18-31. The cost of financial distress increases the cost of debt to the firm and therefore a perfectly leveraged structure is not possible. Corporate Financial Structures, supra note 4, at 54-55 (other costs of financial distress associated with high debt equity ratios include credit constraints, constraints on expenditures and operating decisions relative to the terms of the debt, and the direct costs of bankruptcy). For a dynamic view of the value of leverage to the residual equity holders, see Arditti & Pinkerton, The Valuation and Cost of Capital with a Leveraged Firm with Growth, 33 J. Fin. 54 (1978).

231. 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 argument 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 component 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, inapposite 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 enterprise 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 extent 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.232 The obvious benchmark for this riskless rate is the applicable federal rate for issues of comparable term.233 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,234 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.

Corporate Financial Structures, supra note 4, at 104-05 (noting that nontax factors such as the ability of start up firms to use interest deductions with variation on permitted rates raising neutrality concerns). The limitation of certain debt replacing equity transactions is also defined as an attempt to define risk. Id. at 108-09.

Other assessments of risk demonstrate that while the market does not reward unsystematic risk which can be diversified away with a risk premium, other factors, including inflation and earnings estimates are effective in setting the returns to firms and that the levels of risks associated with a firm is also related to the returns. Brainard, Shoven & Weiss, The Financial Valuation of the Return to Capital, 2 Brookings Papers on Economic Activity 453, 501-02 (1980).


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, 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-

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 & , 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]nlike 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. & , supra note 235, at 100.

238. & , supra note 235, at 108-09.

239. Id. at 106-07.

240. For a review of the resemblance test from the revenue acts of 1894 to 1975, see & , supra note 235. For additional history, see , 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 prosecution of some common enterprise.' 243 For fifty years the tax system has gone back and forth with less than coherent formalistic rules based on the resemblance test. 244 The present regulatory resemblance test is based on four elements: limited liability for corporate debts, centralized management, continuity of life, and free transferability of ownership interests. The Kintner regulations 245

243. Id. at 358 (citing Hecht v. Malley, 265 U.S. 144, 157 (1924)). After Morrissey, 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 constitutionality of distinguishing between unincorporated and incorporated firms was based on a benefits 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.


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 association 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{246}

\begin{enumerate}
\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. \textit{Id. at} 3-42.

\textsuperscript{246} Larson v. Commissioner, 66 T.C. 159 (1976), \textit{acq.} 1979-1 C.B. 1 (reaffirms adherence to the four factor balancing test). \textit{But see} Outlaw v. United States, 494 F.2d 1376, 1385 (Ct. Cl.), \textit{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 Larson was withdrawn to the extent that it was inconsistent with the minimum capitalization requirement. \textit{Id. The 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} \textit{See} Cleary, \textit{The Corporate Entity in Tax Cases}, 1 \textit{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} \textit{1 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS} \S 21, at
Historical research has yielded conflicting views as to both the uniqueness\(^\text{249}\) and importance\(^\text{250}\) of limited liability as a corporate attribute. While noting that limited liability economizes on transaction costs and the cost of internalizing externalities,\(^\text{251}\) commentators debate its importance to the firm as a whole.\(^\text{252}\) Nontax law

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\(^{249}\) 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, 1985).
has generally reduced legal personality and the resemblance test to rhetoric; however, tax law continues to follow the personality cult.

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 as well as by state changes in the management of limited liability.
rights of limited partners.\textsuperscript{256} New trends in state laws, like the Georgia Limited Partnership Act\textsuperscript{257} which depends on application of the Kintner test for tax classification, highlight the uncertainty arising from reliance on state law.\textsuperscript{258}

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.\textsuperscript{259} In 1932, Berle and Means advanced their revolutionary view of the firm as an economic agent rather than as a legal personality.\textsuperscript{260} 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).

\textsuperscript{256} See infra note 676.

\textsuperscript{257} GA. CODE ANN. §§ 14-9A-1 to 130 (Supp. 1988).

\textsuperscript{258} Federal Tax consequences under the resemblance test may be altered by changes in state law. See Ribstein, \textit{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, \textit{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).

\textsuperscript{259} See generally A. BERLE & G. MEANS, \textit{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).

\textsuperscript{260} A. BERLE & G. MEANS, supra note 259. \textit{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. \textit{Id.} at 127.
characteristics of the entity such as continuity of existence and centralized management, but 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., Glensder 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 ESTATE 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)(“\textit{T}he close corporation \ldots 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)(“\textit{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)(“\textit{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 \textit{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 \textit{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 Acc. 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. As will be argued shortly, 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. & ORGAN. 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. 89-16013 (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,287 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.288 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

287. See Bratton, Restructuring, supra note 175, at 92, 109-10.
288. See Easterbrook & Fischel, supra note 251.
from capital. 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.

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. 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. BROMBERG, 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 (1985)(citing Siluola 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,292 notwithstanding the fact that limited partners receive their limited liability for nontax purposes precisely because they are viewed as creditors rather than investors.293 Furthermore, if they dominate the capital structure but cannot manage the firm, then the organization assumes another corporate characteristic — representative management.294

Revenue Ruling 88-76 radically reduces the importance of the resemblance factors of limited liability and centralized management,295 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.296 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-

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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. Peckman, 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."). The 1940's witnessed theoretical debates of this type. There were calls to de-emphasize irrational forms. See, e.g., H. Groves, supra note 76, at 20-27. The major tax plans following World War II reflected this same view by proposing plans for corporate integration and taxation of new enterprises. These proposals are discussed in Blakey, Evaluation of Post-War Tax Proposals Made by Various Groups and Individuals, in How Should
Corporate tax may function solely as a collection mechanism for the fisc\textsuperscript{299} or as a back-stop to an inadequate tax payable by the taxpayer in the future.\textsuperscript{300} Alternatively, it may be used to control or restrict the absolute size of firms\textsuperscript{301} (not necessarily monopolies),\textsuperscript{302} to tax monopoly profits,\textsuperscript{303} or to pay for perceived benefits of the corporate form of business in general\textsuperscript{304} or benefits received by corporations as business entities.\textsuperscript{305} It may be imposed as a painless source\textsuperscript{306} of pure revenue\textsuperscript{307} or a revenue and economic

\textsuperscript{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).

\textsuperscript{300} Staff of JT Comm. on Taxation, 99th Cong., 1st Sess., Tax Reform Proposals: Corporate Taxation 17-18 (Comm. Print 1985)[hereinafter 1985 Corporate Proposals](tax on undistributed profits to compensate for deferral).

\textsuperscript{301} R. Musgrave & P. Musgrave, supra note 7, at 389.

\textsuperscript{302} Id.

\textsuperscript{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).

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

\textsuperscript{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).

\textsuperscript{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.' ").

\textsuperscript{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. The existence of a corporate tax allows for tax incentives and disincentives to be directed at firms. For example, if corporate savings are desired, the tax system can be used to make retentions more desirable than distributions.

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. 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. 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. The decision to incorporate and the subsequent financing choices of the firm dictate the presumed initial incidence of the tax. 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 or if shareholders are able to finance their investment totally with debt.

The Modigliani-Miller model shows that the choice between debt and equity does not matter absent taxes. Both firm level and shareholder level limitations on debt financing negate these

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308. A. KRAGEN & J. McNulty, supra note 195, at 899 ("The corporate income tax acts as an automatic stabilizer that combats inflation (or deflation).").
310. Id. A more recent justification for the corporate tax, that drew strength from the historical relationship between the corporate tax rate and individual passthrough rate, was that it provided an incentive to economic growth by putting a premium on the retention of earnings. These earnings were thus withdrawn from consumption, and investment was encouraged. See 1985 Corporate Proposals, supra note 300, at 17-18 (noting that a low corporate tax rate causes the accumulation of retained earnings). But see supra notes 114-16 and accompanying text for the view of the inefficiency of retained earnings finance.
311. The benefits and burdens of such a tax have been capitalized by the market. See 1985 Corporate Proposals, supra note 300, at 17-18.
312. See supra notes 66 & 106 and accompanying text.
313. See supra note 67.
314. See supra notes 60-69 and accompanying text.
315. See supra note 64.
316. See supra notes 63-64 and accompanying text.
317. See supra note 60.
318. See supra note 65.
319. See supra note 62 and accompanying text. For margin requirements and margin-
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.


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 & Thirsk, A Simplified Exposition of Harberger Model I: Tax Incidence, 28 NAT’L TAX J. 1, 12-13 (1975); McLure & Thirsk, 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. Whalney 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\textsuperscript{329} and S corporations.\textsuperscript{330} On the other hand, as I argue, equity and efficiency goals could also be met through a double tax.\textsuperscript{331}

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,\textsuperscript{332} 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,\textsuperscript{333} 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 Treasury 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.

\textsuperscript{329} I.R.C. § 701 (West 1988).
\textsuperscript{331} See infra notes 385-446 & 829-928 and accompanying text.
\textsuperscript{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.
\textsuperscript{333} J. Peckman, 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. The 1986 Tax Act reversed this trend by raising taxes on the corporate sector and by broadening the corporate and business tax base, but the magnitude of the effective corporate tax rate is still debated. The ability of firms to avoid taxes is not only suggested by the unusually small difference between taxable and tax-exempt bond yields, but also by the creativity of large accounting firms. Recent evidence suggests that the changes in the 1986 Tax Act have been successful in increasing the effective corporate rate, 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. If firms are able to use tax preferences to lower their marginal tax rate to a


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, Short of Euphoria, J. Econ. Persp., Summer 1987, at 59, 69.

336. See infra notes 337-39 and accompanying text.


338. 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, 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.


340. 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.
tax.

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 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. 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.\textsuperscript{349} 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.\textsuperscript{360}

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.\textsuperscript{361}

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-


\textsuperscript{360} 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 migrants 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 Dept 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.\footnote{Gravelle & Kotlikoff, The Incidence and Efficiency Costs of Corporation Taxation When Corporate and Noncorporate Firms Produce the Same Good, 97 J. POL. ECON. 749, 777-78 (1989)(Harberger two-sector approach fails to account for cross-sector substitution (non-corporate producers in the corporate market) that causes additional inefficiencies). The 1986 Tax Act lowered taxes for industries in the noncorporate sector and produced efficiency gains for corporations competing in that sector. See J. Gravelle & L. Kotlikoff, Corporate Taxation and the Efficiency Gains of the 1986 Tax Reform Act 31-34 (National Bureau of Economic Research Working Paper No. 3142, 1989).}

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.\footnote{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. Harberger, supra note 354, at 166. Although Harberger thought that the incentive to save would not be impaired, id., the effect of the tax burden shifting to labor remains unclear. Compare Lintner, 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, Tax Effects, Relative Prices, and Economic Growth, in 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). But cf. Harberger, supra note 354, at 167 (suggesting that all the major trading nations of the world taken together could be characterized as a closed economy).}
The globalization of the world economy, however, calls into question the traditional assumptions about the closed economy.\footnote{For the practical implications of shifting, see Bernheim & Shoven, Taxation and the Cost of Capital: An International Comparison, in 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-
metrically 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 consid-
eration 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. 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. 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. Success polisitic markets in which only they are subject to the tax (with no significant competition from producers not subject to the tax), ought to be included within the tax base. This approach responds to the concern that their economic presence allows them to price and invest on an after-tax basis and to shift the tax. Commentators presume that shifting does not occur in either markets of perfect competition or monopoly, see R. Musgrave & P. Musgrave, supra note 7, at 411-16, nor in oligopolies in which one of the oligopolists is less efficient and therefore made to bear the entire tax. If this presumption is accurate, then it follows that some shifting does occur among noncorporate producers. Firm managers may choose not to profit maximize in order to shift the incidence of shareholder level taxes to labor or consumers through lower wages and higher prices, thereby generating more dividends and retained earnings. See supra note 350; see also Mundstock, supra note 70, at 38.

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.

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.").

364. Others have suggested that "there 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

\begin{footnotes}
\item[365.] See infra notes 729-32 & 877-94 and accompanying text.
\item[366.] See infra notes 729-32 and accompanying text.
\item[367.] This is different from the benefits theory of the corporate tax. See infra notes 415 & 417-18 and accompanying text. That theory views the tax as a payment for the benefits of the corporate form of doing business. See J. Pechman, supra note 103, at 135-36. It is, however, related to expressions of the benefits theory. According to Goode: It is not necessary to establish a genuine difference between the corporation and its stockholders in order to justify a tax on the basis of the benefit theory. A tax imposed on the net income of the corporation may be warranted even though the real intention is to tax stockholders in relation to the benefits they enjoy indirectly through corporations. R. Goode, supra note 10, at 29-30.

Organizational analysis would limit the management efficiencies to the choice of the most efficient organizational structure which in some firms would be a partnership or limited partnership. See supra notes 278 & 364. Thus, a corporate production standard would ultimately need to pierce the view of the legal personality of the corporation and would include other forms of organization. It would also need to be sensitive to concepts of income as product.

368. Since many in the economic community have long been opposed to the corporate tax, there are few expressions in favor of this corporate production standard. Among others, Joseph Pechman has maintained this view. Cf. J. Pechman, supra note 103, at 31-32. Richard Musgrave in a very early piece expressed its content. See Musgrave, Should an Absolute Corporation Tax Be Retained?, 1946 Proc. Nat'l Tax Ass'n 111, 114-17, 119. This theory attempts to isolate particular financing characteristics that produce excess returns.
\end{footnotes}
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

\begin{quote}
369. \textit{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.

370. \textit{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. In other words, even in large service firms production may be less efficient due to the problems of information and control. 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.

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. Two economists, Ebrill and

Gravelle & Kotlikoff, supra note 353, at 757.


372. 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. See Jensen, *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. See Letters to the Editor, HARV. BUS. REV., Nov.-Dec. 1989, at 182; see also Kitching, *Early Returns on LBOs*, HARV. BUS. REV., Nov.-Dec. 1989, at 74.

374. See Ebrill & Hartman, *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); see also Gravelle, *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.\textsuperscript{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 \textit{ex ante} contracting costs are too great,\textsuperscript{376} and that firms strive to achieve overall efficiency by gravitating to the form of organization that best serves their financial and governance needs.\textsuperscript{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.

\textsuperscript{375} Ebrill & Hartman, \textit{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." \textit{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. \textit{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.\(^{378}\) 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.\(^{378}\) 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.\(^{380}\) 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, supra note 326. For a discussion of the general lack of coordination in international taxation, see Palmer, Toward Unilateral Coherence in Determining Jurisdiction to Tax Income, 30 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. See M. Norr, 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. See White Paper, 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. Id. at 196-99. These considerations in adopting imputation systems apply also in capital exporting countries. See, e.g., Lovisolo, Italy: The New Imputation System, Intertax, 1979/1, at 10; Reitsma, 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, Imputation Systems: An Overview, 4 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. See 2 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); see also Ault, 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, 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. See Bird, Imputation and the Foreign Tax Credit: Some Critical Notes from an International Perspective, 4 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, supra note 7, at 16-66, 153-82. For discussions of the taxation of direct investors, see S. Frommel, 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. The open economy model suggests that the classical corporate tax increases the rate of interest worldwide, whereas a profits tax may not. Successful interjurisdictional allocation also depends on the creditability of the tax in the home country.

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. Therefore, the allocation of income rationale has merit, but is not costless. It also does not address by

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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, *Effect of Taxation with International Capital Mobility*, in *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. *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. *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. 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. *Id.* at 144 (discussing Roger Gordon model). The Slemrod model, like others, is not without its critics. *Id.* at 148-55 (comments by Lawrence Summers)(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. See *Roin, The Grand Illusion: A Neutral System for the Taxation of International Transactions*, 75 Va. L. Rev. 919, 941-42, 959-60 (1989).

382. *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." *Id.* at 686. There is no increase even if the economy is open, provided that certain assumptions apply.

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. *See Slemrod, supra* note 381, at 130-31; *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.").

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. The power to dispose of income is the equivalent of ownership of it. 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 necktie 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{380} 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 \textit{Horst}, which stands for the proposition that present power over future income makes the income taxable to the donor. See also \textit{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); \textit{Harrison} v. \textit{Schaffner}, 312 U.S. 579, 580 (1940)(trust payments assigned by beneficiary to her children taxable to beneficiary)(citing, \textit{Lucas} v. \textit{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 \textit{Poe} v. \textit{Seaborn}, 282 U.S. 101 (1930). It was also the rationale for viewing dual working spouses as two consumption units. See \textit{Felton} v. \textit{Commissioner}, 43 T.C.M. (CCH) 278 (1982), aff'd, 723 F.2d 66 (7th Cir. 1983); \textit{Hantzis} v. \textit{Commissioner}, 38 T.C.M. (CCH) 1169 (1979), rev'd, 638 F.2d 248 (1st Cir.), \textit{cert. denied}, 452 U.S. 962 (1981). But see \textit{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} \textit{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. \textit{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. \textit{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.

\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, \textit{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, \textit{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. \textit{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. \textit{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. \textit{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.\textsuperscript{394} Under a theory of ability to pay requiring sacrifice\textsuperscript{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).\textsuperscript{396} Thus, an income tax simply cannot be justified on an ability-to-pay rationale.\textsuperscript{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\textsuperscript{398} principle, simply because it is perceived as separate from its underlying owners.\textsuperscript{399} This observation

\textsuperscript{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).

\textsuperscript{395} W. Vickrey, supra note 39, at 372-73 (discussing "traditional sacrifice criteria").

\textsuperscript{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.

\textsuperscript{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.

\textsuperscript{398} For a review of the historical literature on ability-to-pay, see Musgrave & Peacock, Introduction, in Classics in the Theory of Public Finance ix-xviii (1967).

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

[i]he earnings of General Motors are plainly not the earnings of its shareholders
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."\textsuperscript{400} 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."\textsuperscript{401} 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). \textit{But see} 2 \textsc{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.

\textit{Id.}

\textsuperscript{400} Auerbach, "New View", supra note 71, at 21. See C. \textsc{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, \textit{Legislative Recognition of the Close Corporation}, 27 \textsc{Mich. L. Rev.} 273, 283 (1929)(noting early Treasury proposal to class small corporations with partnerships for income tax purposes).

\textsuperscript{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, \textit{Cancellation of Indebtedness by Issuing Stock in Exchange: Challenging the Congressional Solution to Debt-Equity Swaps}, 63 \textsc{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. \textsc{Musgrave} & P. \textsc{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 \textsc{Gabinet} & \textsc{Coffey}, supra note 149 (realization requirement is a constitutional
theory is also at the heart of this view of the firm.\textsuperscript{402}

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\textit{But see} Cohen, supra note 98, at 147-49 n.19 (realization requirement no bar).

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, 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. \textit{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.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 realized by the taxpayer, is at least clearly realizable by him, profits retained by public corporations should not be included in the taxable incomes of their stockholders.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.”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 manageralist 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.410 The essence of the relationship between the firm and its residual owners, the eq-

407. A. VAN DEN TEMPEL, supra note 3, at 8 (commenting on the adoption of the classical regime in the U.K. and Belgium).
408. 2 A. KRAGEN & J. McNULTY, supra note 307, at 897.
409. 1987 HOUSE REPORT, supra note 46, at 1067.
410. For discussion of these views of the firm, see Bratton, Theory, 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.” Id. at 1525.
uony 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.411 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.412

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."413 It is a theory in the equitable taxation tradition. While the Canadian Carter Commission could find "no grounds in principle for taxing corporations,"414 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 benefits415 and ability-to-pay analysis.416

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.417

classical corporate tax. See Warren, 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, supra note 298, at 633; Buehler, The Taxation of Business Enterprise — Its Theory and Practice, 183 ANNALS 96, 97 (1936). It is economic expansion, unaided by the legal personality of the firm, that, in the separatist view, creates a separate taxpaying entity. See R. Goode, 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, Fundamental Problems of Federal Income Taxation, 35 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, 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. See Hetherington & Dooley, supra note 258 (difficulty of voluntarily dissolving closely held corporations makes ownership illiquid and creates risk of exploitation of minority shareholders that ex ante contracting cannot prevent). But see Easterbrook & Fischel, Close Corporations and Agency Costs, 38 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, 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. 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. See 1 L. Loss & J. Seligman, Securities Regulation 26-28, 171-84, 218-29 (3d ed. 1989); E. Bloch, Inside Investment Banking 299-313 (2d ed. 1989). This in in contrast with the less extensive and often nonexistent disclosure systems in other countries. See Staff of the U.S. Securities and Exchange Comm., Internationalization of the Securities Markets 74-245 (July 27, 1987)[hereinafter 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

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); Mikkelsen & 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. The separatist theory justifies a corporate income tax because the tax is not a tax on stockholders but a tax on a separate entity. 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. 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. Rather, Berle and Means articulated a more expansive view of the “corporate system” which includes not only separation of ownership from control but also the market place relationship between the firm and its equity owners:

419. For a discussion of the separatist view, see R. Goode, supra note 10, at 15-20.  
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.”).  
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.’”).  
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.  
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.
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. 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

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-

\textsuperscript{425} R. Goode, 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, Factors Used In Evaluation of Closely-Held Stock, 20 Nat'l Pub. Acct. 12, 12-13 (1975); cf. A. Hoffman, Israels 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. Rohrlch, 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.").

\textsuperscript{427} 1 F. O'Neal & R. Thompson, 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, The Close Corporation and the New Carolina Business Corporation Act, 34 N.C.L. Rev. 432, 439 (1956); Pavenstedt, The Second Circuit Reaffirms the Efficacy of Restrictive Stock Agreements to Control Estate Tax Valuation, 51 Mich. L. Rev. 1, 1 n.1 (1952); see also N.C. Gen. Stat. § 55-73(b) (1982)(rules against structuring 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").

\textsuperscript{428} C. Rohrlch, 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, supra note 253 § 18.3 (1986)(close corporations primarily identified by shareholder management); Tennery, 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, Corporations — 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, Corporations in Perspective 161 (1976); see also A. Hoffman, supra note 426, § 4.01, at 69. But see R. Hamilton, 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

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 public435 firms, including those not necessarily publicly traded,436 are different from closely held, private437 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."438 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.439

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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. 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." 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. 442

Finally, liquidity allows owners to indicate to managers their


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).

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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{460}

\begin{enumerate}
\item\textsuperscript{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, \textit{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).

\item\textsuperscript{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, \textit{supra} note 448, at 311. He was less sure about the over-the-counter market. \textit{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, \textit{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. \textit{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, \textit{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, \textit{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, \textit{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.).

\item\textsuperscript{450} This proposition was advanced by Professor Harbrecht. See Berle, \textit{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.\footnote{451} 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,\footnote{462} market participant

\footnote{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, \textit{supra} note 449, at 644-47 (corporate tax also retained); Note, \textit{supra} note 410, at 872-73; Cohen, \textit{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 \textit{continuing} shareholders or to apply the redemption provisions only to closely held businesses and not publicly held corporations. See Chirelstein, \textit{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). \textit{But see} Bacon, \textit{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 \S\ 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, \textit{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, \textit{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., \textit{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, \textit{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. \S\ 351 would be irrelevant. Contributions to private corporations, on the other hand, would receive treatment similar to I.R.C. \S\ 721 partnership treatment.

behavior,\textsuperscript{453} market behavior relative to fundamental firm values,\textsuperscript{464} market purchases of baskets of securities,\textsuperscript{465} arbitrage between asset and stock markets,\textsuperscript{466} and the lack of valuation efficiency in the market.\textsuperscript{467} 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.\textsuperscript{468} These proposals were supported by the fact that liquidity provides an equity holder with an exit

\textsuperscript{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 ... ", \textit{id}, and, care little about "the amount of debt on the balance sheet," \textit{id}.

\textsuperscript{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. \textit{See} R. Haugen, Modern Investment Theory 217-23 (1986).

\textsuperscript{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. \textit{See} Japanese Begin Trading in Stock Index Futures, The N.Y. Times, Sept. 5, 1988, at 28, col. 4.

\textsuperscript{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).


\textsuperscript{458} \textit{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.\footnote{See infra notes 640-71 and accompanying text.}

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.\footnote{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).}

At the end of 1986, institutional investors owned from forty-two to forty-five percent of the three trillion dollars of corporate equity.\footnote{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. 1987).}

For 1988, trading in the New York
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-
corporation and 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) 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." The stock market "act of magic" — transforming short term savings into long term social investment — creates value through liquidity.

The stock market "act of magic" — transforming short term savings into long term social investment — creates value through liquidity.

...
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. 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.

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

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

477. L. LOWENSTEIN, supra note 164, at 220 (emphasis in original).

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, 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).

483. 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." Firm size is also a factor, since the benefits of increased liquidity are proportional to the initial value of the firm.

Illiquidity in the public market is generally measured by the bid-ask spread. 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

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485. Amihud & Mendelson, Asset Pricing and the Bid-Ask Spread, 17 J. FIN. ECON. 223, 224 (1986) [hereinafter Amihud & Mendelson, 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, Liquidity and Asset Prices: Financial Management Implications, Fin. MGMT., Spring 1988, at 5, 6 [hereinafter Amihud & Mendelson, 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.

486. Amihud & Mendelson, Liquidity, supra note 484, at 7.

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, 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, The Cost of Transacting, 82 Q.J. Econ. 33, 35-37 (1968), including dealer inventory costs, see, e.g., Ho & Stoll, 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, 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?

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

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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.\textsuperscript{492} The study of discounts of letter stock began with the 1971 Securities and Exchange Commission Institutional Investor Study Report\textsuperscript{493} which led to the requirement that institutional investors report their restricted securities and created a body of data for further study.\textsuperscript{494} 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.\textsuperscript{495} Generally, lower average discounts were found for the letter stock of NYSE and Amex compa-

\textsuperscript{492} These studies are collected and summarized in S. Pratt, Valuing a Business: The Analysis and Appraisal of Closely Held Companies 238-62 (2d ed. 1989). While the value of traded stock is taken into consideration for estate tax valuation, Rev. Rul. 59-60, 1959-1 C.B. 237, discounts for lack of marketability are common. See Koffler v. Commissioner, 37 T.C.M. (CCH) 159 (1978)(value of stock transferred by gift discounted, partly because stock not publicly traded); Miller v. Commissioner, 36 T.C.M. (CCH) 39 (1977)(future market value of stock in closely held corporation discounted due to lack of marketability and dividends of minority interests); Gallum v. Commissioner, 33 T.C.M. (CCH) 284 (1974)(proper discount applied to net asset value determined, in part, on lack of marketability).


\textsuperscript{494} S. Pratt, supra note 492, at 241-43.

\textsuperscript{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,
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-

\begin{quote}
[hierinafter Tobin, \textit{Liquidity}].
\begin{itemize}
\item 505. Tobin, \textit{Liquidity}, supra note 504.
\item 506. See infra note 762.
\item 507. See infra note 770.
\item 508. See infra notes 765-70.
\item 509. See infra notes 752-75.
\item 511. According to S.E.C. Chairman David S. Ruder, these dual events necessitate Rule 144A:
\end{itemize}

\begin{quote}
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 provide 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) \textsuperscript{\$} 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.


144A would increase liquidity and lower the cost of capital.\textsuperscript{516}

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.\textsuperscript{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 \textit{per se} sophistication in the resale market for privately placed securities.\textsuperscript{517}

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

\textsuperscript{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).


\textsuperscript{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.}

\textsuperscript{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 12 months in the United States, 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,
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. 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, see Investment Insight, Wall St. J., Oct. 24, 1989, at C1, col. 1, and with a higher rate of defaults and illiquidity, 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. 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). 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. 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 weaken. Eichenwald, \textit{A Financial Crisis May Force Drexel to Seek a Merger}, N.Y. Times, Feb. 13, 1990, at A1, col. 6; Henriques, \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. 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, supra note 484}, at 9. This insight is supported by valuation discounts for private firms based on lack of marketability. See \textit{supra} notes 492-98 and accompanying text.

\footnote{528} Mature venture capital firms with investments over six years encountered annual average returns of 24.4 percent. See Chiampou & Kallett, \textit{supra} note 499, at 6-7. For 1978-1987 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.\textsuperscript{529} Studies by the Small Business Administration\textsuperscript{630} 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.\textsuperscript{631}

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. \textit{Id.} The returns to the venture capital industry are decreasing as additional funds are placed in the industry. \textit{Id.} at 2.

The \textit{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 Chiampou and Kallett sample were fully diversified so that the risk of the individual investments was fully hedged, their required or expected \textit{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 \textit{ex ante} equity return for small stocks in order to invest. Based on \textit{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 \textit{ex post} return to venture capital over the \textit{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.

\textsuperscript{529} See supra notes 417 & 520.

\textsuperscript{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).

\textsuperscript{531} See supra notes 510-28.
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. 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.

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. Alternatively, option pricing theory values the equity in the firm as a European call option on the residual value

540. MacQueen, Beta Is Dead! Long Live Beta!, in 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, The Corporate Uses of Beta, in The Revolution in Corporate Finance 58, 64-65 (J. Stern & D. Chew eds. 1986); Malkiel, Risk and Return: A New Look, in 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, supra at 27, 43 (suggesting that the dispersion of analysts forecasts is a better measure of systematic risk).

541. 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, supra note 105, at 161-73.

542. R. Haugen, 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.

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, 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 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, supra note 454, at 207-25.
of the assets granted the shareholders by the bondholders.\textsuperscript{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.\textsuperscript{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.\textsuperscript{545}

The individual portfolio choices of investors (utilizing either a portfolio theory investment strategy\textsuperscript{546} or fundamental valuation) are enhanced in a public market where the investor preference for liquidity relative to risk and return can be exercised.\textsuperscript{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."\textsuperscript{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

\footnotesize

\begin{itemize}
  \item \textsuperscript{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.
  \item \textsuperscript{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.
  \item \textsuperscript{545} But see Fouse, Risk and Liquidity: The Keys to Stock Price Behavior, FIN. ANALYSTS J., May-June 1976, at 35, 42-43 (investment in relatively illiquid securities provides an opportunity for portfolio gains).
  \item \textsuperscript{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.
  \item \textsuperscript{547} See Tobin, Liquidity, supra note 504 (setting forth a theory of liquidity preference derived from the Keynesian economic model).
  \item \textsuperscript{548} M. King, supra note 418, at 131.
\end{itemize}
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{550} The Feldstein data also indicates that investors are sensitive to after tax returns based on the level of personal income taxation.\textsuperscript{551} Nonetheless, liquidity diminishes specific risk and permits

\textsuperscript{549} The exit right for fundamental value investors is much the same except it runs over a longer horizon.

\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 investor's 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).

\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.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.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.555 Another definition of liquidity, important to the seller, requires that ownership interests be tradable "quickly and at a predictable price."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.557 Liquidity may in fact be a "bundle of

553. Professor Marschak defined "liquidity" in the context of pricing assets as "the ratio of two contemporary prices." Marschak, 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." 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." Id. at 187.


555. For a definition of liquidity that follows this format, see Economides & Siow, 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.).


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, 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."). See also Makower & Marschak, 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 not to use it for any of the separate properties of money. We thus resign ourselves to giving up 'liquidity' as a measurable concept: it is, like the price level, a bundle of measurable properties.

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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.  

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." 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.

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 hypothesis in which all available information, public or private, is reflected in the price of the ownership interest. While there is little evidence that this strong form of efficiency exists, 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, however, 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 market, 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 potential purchasers or market makers produces a greater than expected 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 market makers with insufficient resources to effect a sale. At a minimum, regulation of the market makers requires that they be adequately 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} Id.

\textsuperscript{572} See supra notes 452-57 and accompanying text. See also Gordon & Kornhauser, 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 efficient 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. See Y. AMIHUD, T. HO & R. SCHWARTZ, 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). 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. 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." *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. *Id.*

576. Louis Lowenstein questions the efficiency and meaning of efficiency in all markets. See L. LOWENSTEIN, *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, Regulatory Subsidies, Efficient Markets, and Shelf Registration: An Analysis of Rule 415, 70 VA. L. REV. 135, 179 n.209 (1984)(citing Barry, *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, 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, 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 *supra* note 319; see also Grube & Joy, 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." 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. *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. *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).

580. BRADY COMMISSION REPORT, supra note 575, at VI-13.

market maker is dealing with a very thin market and "frequently can adjust the price without notice." 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. NASDAQ announced that it will add certain Pink Sheet securities to its automated quotation system, possibly as early as the beginning of 1990. 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."\textsuperscript{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.\textsuperscript{587}

Similarly unsatisfactory is the liquidity of the ownership interests of firms traded in other unlisted markets such as the Euroequities market,\textsuperscript{588} the London Unlisted Securities Market,\textsuperscript{589} and the United States secondary market for partnership interests.\textsuperscript{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."\textsuperscript{591}

\textsuperscript{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.

\textsuperscript{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).

\textsuperscript{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, \textit{Hard Times for the Euromarkets}, N.Y. Times, Sept. 20, 1987, \S 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. \textit{Id.}

\textsuperscript{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, \textit{Business Week}, May 23, 1988, at 134. Not all equity on stock markets is the same. See Kristof, \textit{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).

\textsuperscript{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, \textit{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). \textit{Id.} at 36. In general, the purchasers of such units are interested in three year or older units, \textit{id.}, and in income-oriented products or those with income-producing assets, \textit{id.} at 38.

\textsuperscript{591} A Look at Trading on the Secondary Market, Wall St. J., June 10, 1988, \S 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.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.593 A thinly traded market contains fewer of the liquidity benefits generally associated with public trading,594 and the cost of acquiring information in such a mar-

592. For a discussion of the efficiency of trading desks used by large institutional investors, see L. LOWENSTEIN, supra note 164, at 81.


594. See Ho & Michaely, 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, 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, supra note 579 (establishing relationship between certain aspects of liquidity and key structural characteristics of secondary markets); Ho, Schwartz & Whitcomb, 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.\(^{597}\) A

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Clearing Under Transaction Price Uncertainty, 40 J. FIN. 21 (1985)(comparing the effects of trading friction due to batch trading to the Pareto efficient ideal); Smidt, Continuous versus Intermittent Trading on Auction Markets, 14 J. FIN. & QUANT. ANALYSIS 837 (1979)(questioning assumptions normally made about market efficiency by introducing evidence that systematic trading patterns depend on the processes which produce transactions).

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'Rel. 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 in-
formation.\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} Fre-

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of the S.E.C. See Norris, \textit{S.E.C. Objection Dooms "Unbundled Stock Units"}, N.Y. Times,
Mar. 29, 1989, at D6, col. 3. Based on the cost and availability of information, the effi-
ciency of the market for limited partnerships interests is of limited efficiency. See supra
notes 590-91 and accompanying text. The Hamilton results supply strong support for the
hypothesis that the extent of price dispersion in the market is an economic decision based
on the costs and benefits of price information. See Hamilton, supra note 583. In the mar-
kets for unlisted common stock, the implementation of the NASDAQ system was a dis-
crete event that raised the marginal value and reduced the marginal cost of price informa-
tion. See id. at 69 (offering five hypotheses that relate the costs and benefits of information
to the extent of equilibrium quotation dispersion: (1) quotation dispersion relates inversely
to the volume of trading; (2) dispersion is greater as prices have greater temporal volatility,
since as supply and demand conditions are less stable, the value of market information
depreciates more rapidly; (3) if an investor has large or frequent transactions, the expected
benefit of search is greater than for smaller or infrequent transactions, and since financial
institutions are the large traders of unlisted stock, the third hypothesis is that stock held by
a larger number of institutions has less dispersion; (4) a large number of market-makers in
a stock increases quotation dispersion, for if each market-maker simply draws randomly
from the information set, then more market-makers increase dispersion and since more
searches are required to gather the same information, the cost of information is greater;
and (5) dispersion is greater for higher-priced stocks).

598. For example, the regional securities sub-market (NASDAQ-reported, geo-
graphically-based firms) which exhibits low trading volume, is not widely held, and has
only a limited national exposure has been shown to have a higher systematic risk compo-
nent. Senchak & Beedles, \textit{Price Behavior in a Regional Over-the-Counter Securities Mar-
ket}, 2 J. Fin. Res. 119, 119 (1979)(five-year study of price behavior and investment char-
acteristics of the common stock of 47 southwestern firms). "This investment medium may
provide relatively frequent opportunities for extremely large yields for the individual inves-
tor. In return, the investor must cope with the high risk, which may be caused by the
infrequency with which important information arrives, inadequate monitoring of the infor-
mation by others, and the illiquidity associated with positioning in a thinly traded stock." Id.
at 129.

599. Generally the market price for traded shares is accepted as the correct valua-
tion under the view that the market has dealt with all the available information correctly.
See, e.g., Johnson v. Commissioner, 673 F.2d 262 (9th Cir. 1982)(information if known on
valuation date would have depressed the price of stock not considered). \textit{But see}, e.g., Estate
regarding merger negotiations and the value of certain intangibles one of rationales for
disregarding market quotations). If the market is made up of relatively sophisticated inves-
tors, see Downer v. Commissioner, 48 T.C. 86, 94 (1967)(presence of unsophisticated in-
vestors in market considered in discounting value of stock in question).

600. \textit{See}, e.g., Dimson, \textit{Risk Measurement When Shares Are Subject to Infrequent
Trading}, 7 J. Fin. Econ. 197 (1979). The disadvantages of thin trading, see supra notes
593-94 and accompanying text, support proposals to limit to public trading status, if not
quent offers and acceptances ensure liquidity while maintaining low price volatility.\textsuperscript{601} The price assigned by the market to thinly traded shares is demonstrably lower than the actual value of those shares.\textsuperscript{602} The value of volume trading has been well documented.\textsuperscript{603} 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.\textsuperscript{604} 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.\textsuperscript{605} 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.\textsuperscript{606}

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.\textsuperscript{607} Thus, the lack of liquidity in

\textsuperscript{601} 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).

\textsuperscript{602} 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 BUYSOUTHS 13, 114-21, 147-53 (1987).

\textsuperscript{603} See supra notes 593-94.

\textsuperscript{604} The NASDAQ listing requirements are discussed infra note 934.

\textsuperscript{605} See supra notes 65-67 and infra notes 1065-69 and accompanying text.

\textsuperscript{606} See supra notes 510-25 and accompanying text.

\textsuperscript{607} Banz, 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).

608. 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 1, 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

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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.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.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.

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 creditworthiness 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).

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
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.\textsuperscript{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.\textsuperscript{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."\textsuperscript{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."\textsuperscript{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."\textsuperscript{623} However, evidence shows that the Treasury overestimated these tax and nontax restraints.\textsuperscript{624}
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-

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

\textsuperscript{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.

\textsuperscript{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).

\textsuperscript{638} \textit{See Bucovetsky \& Bird, Tax Reform in Canada: A Progress Report, 25 NAT'L TAX J. 15 (1972)(discussing the process by which the Canadian Income Tax Code was comprehensively revised in 1972). In 1988 Canada adopted significant new tax legislation that does not alter the treatment of corporations.}

\textsuperscript{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 1 SIMEON MOQUET BORDE \& ASSOCIATES, DOING BUSINESS IN FRANCE} ¶ 5.5[2], at 5-128.1 (1987).

\textsuperscript{640} I.R.C. § 7704 (West Supp. 1989).
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)." Congress acted to prevent the proliferation of business structures that it believed violated the neutrality principle. These structures included any that resembled corporations in general and publicly traded corporations in particular, 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" 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. 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.

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." The relevance of ready tradability in a secondary market or a substantially equivalent

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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,"649 (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,"660 (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,"653 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."652 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.653

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."654 One of the

649. Id. See also 1987 House Report, supra note 46, at 1070.
660. 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.
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.\(^5\)

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.\(^6\) 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,\(^7\) 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

\(^5\) 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." \textit{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." \textit{Id.} These include buy-sell arrangements among partners. \textit{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 \textit{House REPORT}, supra note 46, at 1070.

\(^6\) There are various dangers posed by inefficient markets. \textit{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).

\(^7\) \textit{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(c)(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 $20,000.666 Second, certain gift, large block, involuntary, and retirement transfers are disregarded in determining whether a partnership is publicly traded.667 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)668 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,669 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).669 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.\textsuperscript{670} 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.\textsuperscript{671}

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-

\textsuperscript{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.

\textsuperscript{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-tradable" 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 Service, 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 collected 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 taxation 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-

672. These characteristics include: (1) number of owners, (2) capital size and complexity of debt and equity structure, (3) participation of owners and centralization of management, (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 indicating 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. GAA, 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 "en-
tity" 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
passthrough 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 &

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. Distinc-
tions 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
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. SELIG-
MAN, 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 Taxa-
tion 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 (analyz-
ing resemblance test and suggesting that only policies "deep structure" approach is to
classify separate taxable units based on a "passive/active participation-by-owners dichot-
omy" 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 Hear-
ings, supra note 30, at 344 (statement of John W. Lee). See also Hobbet, Limited Partner-
ships: Associations or Partnerships?, 22 SAN DIEGO L. REV. 105, 113 (1985). I character-
ize 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 ex-
travagantly 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

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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

684. 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).

685. See Cohen & Quarrey, Performance of Employee-Owned Small Companies: A Preliminary Study, 1 SMALL BUS. MGMT., 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).

686. 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).

687. See supra notes 44 & 173.

688. 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.\textsuperscript{689} 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.\textsuperscript{690}

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}, \textit{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).

\textsuperscript{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.\(^{691}\) 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.\(^{692}\) Other evidence suggests\(^{693}\) 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.\(^{694}\) 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. \textit{See} R. Blakey \& G. Blakey, \textit{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. \textit{See} Weiner, \textit{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. \textit{TREASURY DEP’T, DIVISION OF TAX RESEARCH, THE POSTWAR CORPORATION TAX STRUCTURE} (Dec. 6, 1946), \textit{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 \textit{TREASURY DEP’T, POSTWAR}], \textit{reprinted in part in} J. Eustice \& J. Kuntz, \textit{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. \textit{See} Nat’l Tax Ass’n, Comm. on the Fed. Corporate Net Income Tax, \textit{Final Report}, \textit{reprinted in} 1951 \textit{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. \textit{See} J. Eustice \& J. Kuntz, \textit{supra} note 6, at ¶ 1.02[1]-[3] \& [5]-[6], 1.03[2][b].

\(^{692}\) \textit{See id.} at ¶ 1.02, at 1-3 to 1-39.

\(^{693}\) \textit{See supra} notes 426-41 and accompanying text.

\(^{694}\) \textit{See supra} notes 426-41 and accompanying text; \textit{see also} Soderquist, \textit{supra} note 426, at 1394-95; \textit{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. \textit{See} Tex. Bus. Corp. Act Ann. art. 12.01-54.
while raising investment protection issues, say little about the essential elements of the firm that arguably distinguish forms of production from forms of raising capital. 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. 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. Without economic size limitations, 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 EXEMPTIONS: 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 pass-through 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 27, 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-
are of little use.

C. Economic Size Standard

In 1961, the first proposal to impose a progressive entity level tax, in other words a doing business tax, on all forms of business met a lukewarm reception. The proposed tax excepted "a special classification of small businesses, limited in number of investors and in net worth." The simple system contained little analysis of the desirability of a progressive doing business tax. A doing business tax would prescribe the appropriate tax with reference to the size of the entity, and thus double taxation of large businesses would be the norm rather than the exception. The proposal was apparently an attempt to tax the economic rents of such firms, but it would result in a tax on "bigness" without reason.

COME TAX RETURNS (1984 & 1985)(compiled from relevant S corporation data from table entitled "all industries returns with and without net income"). Nonetheless, $250 million S corporation is a surprising phenomenon.

701. See Caplin, supra note 254, at 260-63. The cornerstone of the proposal was to adopt a doing business tax that would be at sharply progressive rates starting from 10% and rising according to revenue needs. Distributions from these entities would be taxed to the owners under an earnings and profits analysis.

702. William Klein provided the most in depth discussion. He dismissed the proposal in a footnote as not responsive to the manner in which taxation of individually owned businesses have been taxed in the past. See Klein, Legal Entities, supra note 196, at 57 n.186.

703. See Caplin, supra note 254, at 261. These firms would be allowed to pass through losses and receive ordinary deductions for loans, guarantees, and capital investments. To ease any administrative burdens, the passthrough entities could be limited to unincorporated ventures and newly formed corporations without an earnings and profits history. Id. at 262. The remaining businesses would all be "associations" eligible for the benefits of corporate status including retirement plans, with liquidations, reorganizations, and distributions in kind modeled on the Subchapter C rules. The problem of the use of multiple entities to avoid the doing business tax was considered. No consideration was made of the treatment of interest payments to owners, although a basis step-up upon death would not be allowed and would eliminate the ability to distribute post-death distributions of previous earnings free of individual taxation for those firms that were not exempted from the doing business tax. Id. at 262-63.

704. The doing business tax stems from early twentieth century British proposals, see J. Stamp, supra note 91, at 43 (size-based test for the taxation of business measured by capital). These proposals attempted to tax a perceived ability-to-pay arising from the power of aggregation and had some of the core concepts of an excess profits tax. Business taxation based on economic size as an ability-to-pay concept was advocated by Studenski. Studenski noted that under the net income and size of enterprise standards, an enterprise is measured by its capital assets. Therefore, the taxing ability would increase progressively with the size of the enterprise and these enterprises would be taxed according to this doctrine on their net income at rates graduated in accordance with the size of their capital assets. However, the difficulty with this plan would be developing a scale of graduation based on the size of assets which would be equally applicable to all industries and conditions. Studenski, supra note 298, at 636-38.
“Bigness” criteria would create a level playing field among all firms of the same size, though not necessarily the same profitability, if the determination of which entities should be subject to the tax were based solely on gross receipts rather than net income. While an economic size test based on gross receipts does

705. The only other major proposal for a doing business tax based on net income and not market share was based on the level of gross receipts. Several members of the ABA Tax Section Pass-Through Entities Task Force suggested a proposal for entity classification based on economic size. See Draft Report of the Pass-Through Task Force: Taxation of Partnerships and Corporations (July 15, 1987) (found in full text in the Tax Notes Microfiche Database Doc. No. 87-5584). The proposal was advanced as a solution to the perceived PTP crisis. The report received the attention of proponents of passthrough taxation of publicly traded partnerships. See R. Clark, The Long (or Short) Happy Life of Master Limited Partnerships 1981-1987 (1987) (found in full text in the Tax Notes Microfiche Database Doc. No. 87-6816).

An economic-size test that would tax all business capital would distinguish between income from investment (interest, passive rents, and the like) and income from “business” in a manner that would discriminate between business producers and financial intermediaries. The distinction would be based on perceived economic distinctions between the enterprises, such that the classical corporate tax was intended to be paid by the “big” business entities and that the passthrough tax was intended for “little” business entities. See K. Simon, Memorandum to Members of Task Force on Pass-Through Entities (May 6, 1987) (found in full text in the Tax Notes Microfiche Database Doc. No. 87-5584). Proponents of an economic-size test favored the simplicity of integrating all small firms into Subchapter K and all large firms into Subchapter C as a means of preventing the evasion of the classical corporate tax regime by large passthrough entities. Arguments in support of economic size as the distinguishing characteristic for imposing the corporate tax include: (1) small businesses have difficulty obtaining credit without the personal guarantee of the owners and therefore liability is not truly limited, (2) smaller businesses need a simpler tax regime, (3) an entity-level tax is a cost that reduces a small firm’s ability to compete with a large one, and (4) because the choice of classification is made for the entities fewer resources need to be devoted to choice of form decisions. Entry into the classical corporate tax regime would be based solely on economic size as measured by gross receipts regardless of whether an entity is in the form of a corporation, partnership, or sole proprietorship. The difficulty with such a system is the inevitable bouncing back and forth over the bright line amount such as occurred with the excess profits tax. However, historical profits tests based on averaging have been used under other tax and economic control regimes. See, e.g., R. Staples & R. Borneman, Excess Profits Tax Law and Practice 1 (3d ed. 1941) (“the tax is charged upon the amount by which the profits in a chargeable accounting period exceed the standard profits of the business”) (detailing the United Kingdom system). This may hinder a business’ future planning and, like a progressive tax, penalize a business for growth.

706. The deficiencies of taxable income as a method to control bigness have been noted. See A. Feld, Tax Policy and Corporate Concentration 140 (1982) (Taxable income as a base for an income tax “does not correlate . . . well with market concentration” since “[m]any firms that dominate particular markets could escape tax altogether if their incomes fall below [the specific benchmark], whereas the tax would apply to firms with relatively small market shares but many profit centers.”). Proposals based on income include a revenue neutral business surcharge, based on nationwide rather than industry-wide standards, to reduce the burden on small firms. Id. at 139-42 (Feld proposes an additional bracket for high levels of corporate income; for example, a tax of 60% could be
not have the same problems in policing deductible payments to owners, determining those industries to which the tax ought to apply would pose difficulties because different businesses have different margins of profitability on gross receipts. Other size-based standards are possible, but they also present problems. Additionally, if the classical corporate tax was a tax to prevent "bigness," the economic size of the firm as measured by net assets or market power would be relevant to the level of taxation. Eco-
nomic size limitations have been enacted at the state level to limit the ability of corporations to obtain transparent status, but the failure to enact analogous limitations for unincorporated firms suggests that a different policy is being adopted at the state level.

A doing business tax on all firms that are neither financial intermediaries producing income directly from capital nor firms producing income directly from human capital has a limited appeal. The ability to aggregate labor and capital to produce income gives rise to an ability to pay tax and represents power over income. The most problematic focus of the economic size test

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710. See, e.g., Douglas, State Tax & Budget Actions, 41 TAX NOTES 619, 619-20 (1988). Massachusetts enacted legislation recognizing S corporations at the state level for the first time and then, within several months, limited that recognition to firms with less than $6 million in gross receipts. Id. The limitation on gross receipts, while enacted as a revenue raising measure, also suggests a version of taxation that limits access to pass-through treatment solely to small corporations.

711. Under a benefits analysis, a corporate level tax is appropriate based on the value of the corporate franchise that is granted by the state. For example, under the due process clause and the commerce clause a state may not tax a firm in a manner that is not related to the benefits that in fact have been granted by the state to that firm. Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159, 164-66 (1983)(examining the appropriateness of state taxation of corporate earnings, and requiring a "minimal connection" or 'nexus' between the interstate activities and the taxing state, and a 'rational relationship between the income attributed to the state and the interstate values of the enterprise.' ")(quoting Exxon Corp. v. Wisconsin Dep't of Revenue, 447 U.S. 207, 219-20 (1980). Thus, under a benefits analysis, the relationship between an economic-size limitation and the ability to pass-through income suggests that the value of limited liability is high for large firms attempting to raise capital. Yet, determining the value of the corporate franchise in terms of gross receipts may not be an appropriate measure of either the power that comes from wealth (which a net assets based test would measure) or the actual ability to pay (a net income test). Reliance on gross receipts merely serves as a cut-off point or benchmark that is easily calculated and audited rather than one with an underlying theoretical basis.

712. Recognizing the fact that a small firm has a limited amount of power as well as a limited ability to pay would serve as a concession to firms that are essentially not operating on the economic scale to which a doing business tax ought to apply. The view that the special circumstances and limited ability to compete of small firms should lead to exemptions for such firms from the normal operating rules for the taxation of business and investment has been around for a long time. See TREASURY DEP'T, DIVISION OF TAX RESEARCH, TAXATION OF SMALL BUSINESS 42-57 (Oct. 1947) [hereinafter TREASURY DEP'T, SMALL BUSINESS] (detailed discussion of past and then current proposals for special tax treatment of small businesses); H. Groves, supra note 76, at 117-29 (discussion of pros and cons of a doing business tax if applied to small firms).
stems from the failure to consider its application in the context of a global economy and foreign investment.\textsuperscript{713} Double taxation based on economic size would cause an immediate shift in the value of business capital for the same reasons integration is argued to produce windfall gains.\textsuperscript{714} Even assuming that the classical corporate tax regime prior to 1986 was at parity with the pass-through regime, after 1986 it clearly is not.\textsuperscript{715}

D. Surcharge on Passthrough Income

Under the assumption that all "business" income should be taxed twice and that the tax system should specify when the second tax is to be collected, a proposal for a surcharge on passthrough income was made\textsuperscript{716} to eliminate the distinction between passthrough and corporate investment.\textsuperscript{717} The surcharge proposal distinguished between different forms of passthrough income by allowing firm level deductions for salaries, rents, and interest thereby paralleling the current corporate tax base.\textsuperscript{718} Thus, the surtax or excise tax on passthrough entities including sole proprie-

\begin{itemize}
\item \textsuperscript{713} See supra note 355.
\item \textsuperscript{714} See supra notes 8 & 127 and accompanying text.
\item \textsuperscript{715} See supra notes 80-190 and accompanying text.
\item \textsuperscript{716} See Brooks, supra note 76. Surtaxes have been proposed for pure revenue raising purposes rather than for influencing taxpayer behavior. See 1987 Revenue Options, supra note 46, at 84-87. The ALI Reporter's 1982 proposal for an excise tax on nondividend distributions came from this tradition as does the current tentative proposal for a firm-level tax on nondividend distributions in lieu of limitations on interest deductibility limitations. The ALI Study noted that the difference in tax between capital gain and ordinary income led to a distortion regarding the value of distributions. Reporter's Study on Corporate Distributions, supra note 54, at 444-49, 457-60. The study also noted that a share repurchase was equivalent to a dividend distribution. These observations lead to the conclusion that dividend taxation should remain in effect. Id. at 405-17, 436-41. The ALI Reporter proposed a "compensating excise" to equalize the revenue loss to the government. The proposal also claimed to reduce the distortions that result from taxing non-dividend distributions (both current and future) at a more favorable rate than "the immediate burden of shareholder taxes on dividend distributions." Reporter's Study on Corporate Distributions, supra note 54, at 327-29. For a description of the proposal, see id. at 442-86 (Proposal R2.1). A "last in first out" (LIFO) usage surcharge has also been recently proposed as a corporation's price for the privilege of using the LIFO method. See DeFilipps, LIFO-User Surtax, 35 Tax Notes 1235 (1987).
\item \textsuperscript{717} Imposing a surcharge on passthrough income is an attempt to equalize the effective tax rate of non-corporate capital and the effective tax rate of corporate capital. It has been suggested that this be done directly through different depreciation rates for the corporate and non-corporate sectors using a general equilibrium analysis. See generally Jorgenson & Yun, Tax Policy and Capital Allocation, 88 Scandanavian J. Econ. 355 (1986)(discussing various methods for establishing an equilibrium).
\item \textsuperscript{718} See Brooks, supra note 76, at 428.
\end{itemize}
torships is, in effect, an increased rate on passthrough income.

The surcharge proposal has many defects. Like the economic size test, it does not deal adequately with global investment, the normative basis for the classical corporate tax and its structural features, and the rationale for the windfall gains and losses if the tax is capitalized. If adopted, the surcharge rate would be difficult to establish (although less difficult in a relatively flat tax world) since the recipient's tax rate is used to determine the appropriate tax rate for the firm's income. The surcharge proposal also fails to identify the economic rent that is to be taxed. The surcharge would have to be enacted in conjunction with or with reference to changes in the corporate provisions that deal with the treatment of share repurchases, the substitution of debt for equity, and the stepped-up basis at death, all of which affect the effective rate of tax on corporate investment. Additionally, the surcharge is not a satisfactory solution since it does not solve any of the problems associated with administration or collection. It also fails to identify precisely when the difference between the passthrough tax rate and the corporate tax rate is sufficient to influence the choice of business form and the rationale for the effective rate of taxation on corporations.

E. Return to the Pre-1986 System

Another view of the corporate double tax regime, one that was in place prior to 1986, is that it roughly offset competing interests by including a lower rate on corporate level income, a capital gains tax preference on sales and redemptions of corporate

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719. The appropriate rate would also require a decision about the appropriate time period for deferral and the appropriate interest discount rate to be charged. Although an account of previously taxed income would not have to be maintained, the entities to which such a surcharge would apply would have to be perfect passthrough entities. For example, S corporations would be required to pass on the character of tax exempt interest. A complex combination of factors governs the business entity decision, including tax rates, items included in the tax base, and the risk of future legislation adverse to either passthrough or classical corporate regimes. Moreover, the requirements of transition rules for shifts into another form of business taxation — passthrough to corporate or vice versa — defy rational rate setting. Without empirical data, the surcharge rate will either be set too high or too low. Cf. Break & Pechman, Relationship Between the Corporation and Individual Income Taxes, 28 Nat'l Tax J. 341, 342 (1975)(problem in estimating timing of distribution or sale of stock). While sole proprietorships, corporations, and partnerships might be exempted for personal service income under the latest formulation, the calculus for other forms of income becomes complex and greater tensions will arise as taxpayers endeavor to characterize income as “personal service” to take advantage of lower rates.
stock, and a tax preference for liquidating distributions of assets. The 1986 Act altered that balance and placed the corporate tax in a state of disequilibrium.720 One option is therefore a return to the pre-1986 system.721 While a return to the classical system722 with its compensating biases of a capital gains rate and an individual rate higher than or equal to the corporate rate may provide a rough equality in financing decisions,723 merely finding equality does not lead to a normative basis for any classical tax levy.724

720. See supra text accompanying notes 122-27.

721. Zolt, supra note 27, at 874-77 (noting this option and other options including curtailing self-help integration and actual integration of the corporate-shareholder tax). Amid the complexities of the classical system, Eric Zolt details the "compensating biases" of the individual and corporate tax regimes that he maintains held the United States classical corporate tax system in a "rough equality" with passthrough taxation prior to the Tax Reform Act of 1986 and the Omnibus Revenue Act of 1987. Id. at 845.

722. Asserting that the compensating balances have been destroyed, Professor Zolt suggested that if a classical system is to be maintained the balances must be restored and direct legislation must be enacted that would limit the shift by existing firms to passthrough status through S corporation elections, initial debt financing, the repurchase of equity followed by debt financing, the replacement of debt with equity, freezing strategies, and joint ventures. Id. at 876-77.

723. Id. at 876. Professor Zolt considers the effect of a return to these structural biases by updating Professor Warren's analysis of the deferral effect of a corporate tax (Warren, Integration, supra note 1, at 722-25) and noting that in order to earn the equivalent of a 10% return in a passthrough entity over a ten-year period of accumulation, a corporate investment must earn 13.83% after 1986 as compared to 11.06% before 1986. See Zolt, supra note 25, at 862. It has been argued that the corporate form produces efficiency gains. See supra notes 364-77 and accompanying text. If the efficiency of corporate producers results in a 10% advantage over noncorporate producers, it would be unfair to tax corporate producers in a manner which would cause them to yield an additional 20% rate of efficiency. While Professor Zolt advances Warren's analysis of the deferral effect of a corporate tax and shows the effect of the 1986 and 1987 changes on retained earnings and debt finance strategies, Zolt, supra note 27, at 859-68, he does not advance the description of the role of a classical corporate tax.

724. The evidence of the efficacy of the prior equilibrium is also open to question. The move away from the corporate form, the corporate tax, and the use of debt financing did not begin in 1986. See supra note 152 (detailing the increase in the number of S elections), note 155 (reversal of the trend of losses in partnership returns beginning in 1985), and note 159 (increase in debt financing after 1981). The graduated corporate tax rate structure for the first $100,000 of corporate income was widely used by closely held corporations in conjunction with deductions for corporate expenses to greatly reduce or eliminate their corporate level tax. It is difficult to differentiate among the three major structural changes to the taxation of corporations and their shareholders: the inverted highest marginal tax rates, the repeal of the capital gains preference, and the repeal of the General Utilities rule on liquidations. A complex series of relationships including firm-level efficiency and access to capital may explain the growth of the corporate sector. See supra notes 103-06 and accompanying text. Merely changing the rates to achieve parity between corporations and individuals is insufficient to effect a change. This would have no effect on the preference for debt financing of new investment but would restore the balance between debt and retained earnings financing. The effect of a capital gains preference must also be
Analyzing the financial and nontax inducements that support the proposal is not enough to support any congressional program to turn back the clock. This is true of all considerations of the double tax regime that lack a normative point of view.

VI. TESTING THE PROPOSAL AGAINST TAX POLICY CRITERIA

The ability to issue liquid equity interests decreases the cost of capital and facilitates the creation of excess profits. Traditional public finance theory classifies the existing corporate tax as a tax on capital since it includes a tax at the firm level on both the interest return and the equity return on investment considered. Commentators disagree as to whether the capital gains preference in the double-tax system under prior law and the relationship of rates created a distortion on sales to third parties. See Clark, supra note 446 ("capital gains preference is related to lawmakers' awareness of the rise of the modern corporation and its numerous public shareholders"). But see Waggoner, Eliminating the Capital Gains Preference Part II: The Problem of Corporate Taxation, 49 U. COLO. L. REV. 9 (1977)(capital gains treatment is a distortion in the corporate tax system and should be eliminated through either adoption of integration or current taxation of the appreciation in corporate stock). Commentators also disagree as to whether the capital gains preference created distortions on redemptions. Compare REPORTER'S STUDY ON CORPORATE DISTRIBUTIONS, supra note 54, at 442-86 (advocating an excise tax on nondividend distributions in large or public firms) and Bryan, supra note 44, at 1057, 1071 and Chirelstein, supra note 412, 751, 754-55 (1969)(Congress' intent was not to permit certain optional dividends to escape treatment as taxable distributions) with Kahn, Comments on "Tax Neutrality Between Equity Capital and Debt", 30 WAYNE L. REV. 1081, 1083-85 (1984)(an excise tax on non-dividend distributions would increase the cost of doing business in the corporate form and therefore should be discouraged) and Warren, Integration, supra note 1, at 728 (a stronger case would be based on the economic evidence as to how the market discounts the value of public stock). See also Gravelle & Lindsey, Capital Gains, 40 TAX NOTES 397, 399 (1988)(a capital gains preference is appropriate in a double-tax system since returns on investment have previously been discounted to reflect firm level tax). Although Professor Zolt is troubled by the fact that public firms are increasingly bearing the burden of the corporate tax after the self-help integration limitations of the 1987 Tax Act, he sets forth no normative criteria to evaluate its effect. See Zolt, supra note 27, at 874-75.

725. See Zolt, supra note 27, at 868-74.

726. Excess profits are economic returns in excess of what is required to attract capital. Such returns are generally attributable to economic power. Excess profit is also known as pure economic profit. See H. ROSEN, PUBLIC FINANCE 278-79 (2d. ed 1988). Reference in this article to excess profit is to the concept of profit attributable to a factor indicating economic power or advantage.

727. This tax as a tax on capital is the basis of the Harberger analysis. See Harberger, supra note 5. For an argument that it is a tax on the return from capital, see Ebrill & Hartman, supra note 374, at 421. See also Fazzari, supra note 122, at 30 (noting that "corporations will have an incentive to pay out a greater proportion of their income as dividends and finance more new investment with debt [reducing] the efficiency distortion caused by the nondeductibility of foregone interest from internal finance at low inflation rates").
Even the new view of the corporate tax recognizes that it falls in part on capital to the extent that it is not avoided by debt finance. A profits tax in public finance terminology refers to a tax that falls on the profits of a firm and treats the cost of capital as just another cost of producing the firm profit. Under this view, allowing a deduction for an interest return on equity capital at the firm level treats that return as a cost to the firm and converts the corporate tax into a profits tax.  

This article argues that extra taxation of investment is a burden that potentially causes deadweight loss through the loss of national output. It therefore seeks to isolate a form of investment that can be taxed without creating such a loss. It accepts the fact that there will be a tax incidence and then seeks to identify situations in which imposing this burden does not interfere with either the equity or efficiency goals of society. This section will demonstrate that taxation of the profit attributable to liquidity is justified under profits taxation theory, under optimal taxation theory, and under efficiency arguments in conjunction with the equitable taxation tradition.

A. Profits Taxation Theory

Classical public finance theory holds that the taxation of pure economic profits is progressive and minimally disruptive, and therefore should be pursued before any other type of income taxation is imposed. A refinement on this form of profits taxation is

728. This view is to be contrasted with a pure profits tax that would tax the economic rents that accrue to a firm. In perfect capital markets and under perfect competition there would be no economic rents since economic rents are produced generally by exercise of economic power.

729. The incidence of a profits tax is completely absorbed by the firm and does not affect the supply of goods or the prices paid by consumers. See H. Rosen, supra note 726, at 278-79. The view is that a general tax on profits cannot be shifted. See E. Seligman, The Shifting and Incidence of Taxation 362 (4th ed. 1921) ("If profits represent the surplus above cost of production, a general tax on this surplus cannot influence the cost of production. Price cannot be altered, and the interests of the consumer cannot be affected. It is the producer who bears the tax, both immediately and ultimately."). In my view, the cost to the firm of equity is one such input and if the demand for such capital is price inelastic, then financing decisions will not change for new capital — it will just mean that the owners give up additional profits, or a higher level of profits that they would otherwise have been able to keep given the value of the liquidity — it is just as if the interest cost had risen. The early proponents of profits taxation included Adam Smith and David Ricardo. See C. Shoup, Ricardo on Taxation 115-25 (1960). However, Ricardo did not consider profits taxation in the context of an income tax. Id. at 219-24. For some this view stems from the belief that the incidence of the tax falls on the owners of the firm. For Ricardo the view
the taxation of the excess profits of a firm, determined with reference to a benchmark of returns on its capital. Under classical stems from his theory of rent, see id. at 116, whereas Smith thought the tax was shifted to input providers. Id. at 115. Many economists believe that a separate firm-level tax is justified only if it is designed as a tax on economic rents or pure profits. See Boadway, Bruce & Mintz, The Corporate Tax: Should It Be Reformed or Abolished?, in REPORT OF PROCEEDINGS OF THE 34TH ANNUAL TAX CONFERENCE 25, 28-29 (1982). The taxation of economic profits is argued to have its incidence on the owners of the firm:

Economists have usually held that a tax on net profits does not directly affect prices or wages, although some have challenged this view. The opinion that a profits tax does not stimulate a price rise is based fundamentally on the conviction that the tax is not in the economic sense a cost of production. Under competitive conditions, prices are supposed to be set by market forces beyond the control of individual firms. In cases of monopoly, prices are presumed in any case to be set at the most profitable level in the light of demand and costs. Economists have usually argued that the objective of all producers can be assumed to be maximum profits. They contend that any firm — whether in a competitive, monopolistic, or mixed market — which has set its price and output most advantageously before a tax is imposed on true profits, will find the tax no reason for changing either price or output. It is argued that the tax will reduce the amount of profits which can be retained, but that it will still be advantageous to have the maximum obtainable profits before tax. Maximum profits before tax, it is held, will yield maximum net income after subtraction of tax.

TREASURY DEP'T, POSTWAR, supra note 691, at 1140. Accord H. ROSEN, supra note 726, at 278-79. Moreover, under the view that corporate profits are in fact "economic surplus, unnecessary to vigorous functioning of the economy . . . , [t]axation of such surplus is regarded as a desirable source of revenue." TREASURY DEP'T, POSTWAR, supra note 691, at 1139. Other models view the taxation of the pure profits element of the corporate tax as nondistortionary since a tax on the risk premium leaves incentives unaffected because the government provides offsetting benefits to investors by absorbing a fraction of the risk of the investment. The taxes on capital are viewed as distorting only to the extent that the total taxes from a risk free investment are greater than zero. See Gordon, supra note 352, at 16-17.

In addition to the ALI Reporter's recognition of the corporate tax as a profits tax, other legal commentators have proposed the same: "It might fairly be recognized, however, that the return on equity capital includes not only the element of entrepreneurial profit, on which double tax is properly imposed under our present system, but also a pure interest element of compensation for the use of shareholders' capital, which might fairly be excluded from the corporate tax base like interest and other costs." Plumb, The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal, 26 Tax L. REV. 369, 627-28 & n.1534 (1971)(advocating a limited step of allowing deductions for nonparticipating preferred dividends due to revenue loss from full interest deduction on common stock and perceived problems in measuring and segregating interest and noting earlier views of interest as an appropriate cost for determining the double taxation of the equity return).

730. Taxation based on the value of increased production is the basis for the excess profits tax. See J. STAMP, supra note 91, at 66-67.

Each business may be looked upon as a collective entity of "hard assets" with a capital cost value, to which there is attached, with this ordinary human association, the normal accretion of products, viz. average interest; then any concern, which by fortunate Konjunktur has a much larger accretion than others (i.e. a real goodwill) has a greater capacity to bear tax thereon without impairment of
economic theory, any profit produced by an enterprise is attributable to monopoly power, and in an economy displaying a competitive equilibrium no economic profit is generated. Furthermore, neoclassical theory postulates that enterprises can avoid showing all but profits by financing their marginal capital expenditures with borrowed funds. Both classical theory on the existence of excess profits and neoclassical theory on the sources of funds assume the existence of a perfect credit market in which such borrowing is both feasible and costless. These observations have been summarized by Professor Phelps:

Viewed through the lens of classical theory, then, taxable corporate profits are telltale evidence of corporate income beyond the return needed by the enterprises to obtain their capital from savers. In theory, the surplus or, more accurately, an arbitrarily large fraction of it, can be taxed away without causing a decline in the rate of interest that enterprises can afford — and be willing to bid — for investible savings and thus without a diminution of investment and saving.

Under the principles set forth earlier, the current United
States classical corporate tax system taxes more than profit in excess of interest, unless one assumes that firms are fully leveraged and that equity owners are fully leveraged. While corporate debt-equity levels in the United States have risen in recent years for a variety of tax and nontax reasons, they are nonetheless lower than those of many foreign firms operating in a financial atmosphere different from that currently facing United States firms. For the most highly-leveraged firms, both United States firms and foreign firms with income effectively connected to the United States, the current tax is closer to, but is not, a profits tax. Entrepreneurs facing incorporation have the value of their firm reduced by the firm level tax to the extent that initial leveraging does not offset it. Investment with retained earnings bears a portion of this double tax due to the inverted rate structure.

Profit entices entrepreneurs who, under one of the theories of entrepreneurship, are inspired to undertake courses of action

733. See supra notes 61-64.
734. Many theorize that debt-equity levels are rising due to taxes, wealth transfers, and efficiency gains. See Corporate Financial Structures, supra note 4, at 689-90. Explanations include the sociological inclination of current corporate managers to be less risk averse than in the past. Senate LBO Hearings, supra note 16, at 51-52 (prepared statement of Alan Greenspan).

It has been argued that increased corporate debt will lead to systemic changes that will cause relationships between the government and firms to be "social" not "economic." House LBO Hearings I, supra note 16, at 280-83 (prepared statement of Henry Kaufman). 735. See infra notes 909 & 916.
736. See A. Atkinson & J. Stiglitz, supra note 5, at 129 (When there are constant returns to scale and when interest is not deductible, then the corporate tax is properly viewed as a tax on the return to capital and not a pure profits tax. However, when interest is deductible, the tax may fall on pure profits, rather than on the return to capital.). 737. This should be true if the shareholder level tax is what is capitalized for mature firms. See supra note 71.
738. The entrepreneurial discovery process has its roots in other philosophy. See J. Gray, Hayek on Liberty 37 (2d ed. 1986)(arguing that economists have never been able to predict the impact that entrepreneurs will have in the market because economic theories misjudge the type of information on which entrepreneurs rely). Theories are drawn from disciplines of economics, psychology, sociology and anthropology. B. Mokry, Entrepreneurship and Public Policy: Can Government Stimulate Business Start Ups? 16 (1988)("By removing the entrepreneur from his social setting, economic theories are not useful for identifying who we should try to help by government policy."). See also R. Hébert & A. Link, The Entrepreneur (2d ed. 1988)(defining the characteristics of the entrepreneur and her role in the economic order); Entrepreneurship and the Outlook for America (J. Backman ed. 1983)(lectures addressing the role of entrepreneurship in the United States). The available theories have been classified as trait-based, economic, and contingency (a combination of personal, economic, and sociological variables). B. Mokry, supra, at 15-23. Economic studies have focused on numerous entrepreneurial attributes. See, e.g., id. at 15 (listing various studies on the nature of the entrepreneur).
unexpected by the market at large. This has led to the view that profits are justified on a "finders-keepers" rationale.\footnote{1} The social value of encouraging start-up firms and entrepreneurial investment outside of major industrial corporations has recently been challenged.\footnote{2} Nevertheless, studies show that innovations produce both high private cash flow returns through additional production and social returns through the resource savings attributable to innovation.\footnote{3} Assuming that profit plays an incentive role in inspiring entrepreneurial discovery, it is unclear whether partial taxation of these profits affects these incentives.\footnote{4} However, it appears that the greater the taxation of profits, the lower the incentive effect.\footnote{5}

A profits tax can be a component of an optimal tax structure that causes producers to maximize profits while maintaining production efficiency.\footnote{6} Moreover, taxation of any profit shifts a por-

\footnote{1} See I. KIRZNER, PERCEPTION, OPPORTUNITY AND PROFIT: STUDIES IN THE THEORY OF ENTREPRENEURSHIP 212-24 (1979).

\footnote{2} There is a longstanding and increasing academic debate over whether entrepreneurs are helpful for long-term economic growth or cause energies to be diverted from larger organizations with greater resources. See Johnston, Growth Stirs Debate Over Role of Small Firms, ROCHESTER BUS. J., Oct. 24, 1988, at 1. "Small entrepreneurial manufacturers, Fortune 500 companies and research institutions each argue that America's future economic strength lies in their hands." Id. An academic position has developed that the emergence of many entrepreneurs saps energy for foreign competition. Id. at 12-13 (detailing local examples of successful innovations and many studies pro and con on the value of small business entrepreneurial innovation, research and development, and capital sufficiency to compete effectively with foreign giants). Phelps makes a similar observation that if new ideas are duplicative and produce wasteful competition, it is unclear if even prior to the adoption of a profits tax that there is underinvestment in ideas and that the tax produces any harm. See Phelps, supra note 94, at 693.


\footnote{4} For a criticism of the neoclassical view that excess profits taxation is not distortionary, see KIRZNER, TAXES AND DISCOVERY: AN ENTREPRENEURIAL PERSPECTIVE, in DISCOVERY AND THE CAPITALIST PROCESS 93-118 (1985). Kirzner argues that the entrepreneur is one who discovers an hitherto unnoticed course of action and that the incentive for this discovery is excess profit. However, as long as the reward in a single tax world is at least comparable to the reward for being an employee (given the risk factors), then entrepreneurial discovery will take place. See L. THUROW, THE IMPACT OF TAXES ON THE AMERICAN ECONOMY 65-66 (1971)(extending this argument to capitalists generally).

\footnote{5} See I. KIRZNER, supra note 739.

\footnote{6} The goal of optimal taxation policy in both income and producer taxes is to maximize social welfare and which may involve direction through taxes wealth transfers to particular groups. Mirrlees asserts that while the theory of optimal profits taxation suggests a 100 percent of profits tax on all producers to produce production efficiency, it might be desirable to lower the profits tax rate on the less efficient producer to arrange lump sum transfers to those to whom the benefits of the profits inure. This observation has relevance to the liquidity standard, since while taxing away only a portion of pure profits of the firm
tion of the risk of loss to the government, and under some but not all models this effect causes increased investment.\textsuperscript{746} If the corporate tax is thought of as a tax on the risks borne by the shareholders, a distinction between liquid and illiquid ownership interests would be maintained by taxing investments with a lesser liquidity risk and not taxing more risky illiquid investments.\textsuperscript{746}

To reiterate what was set forth earlier, unless one assumes that both firms and equity owners are fully leveraged, the current United States classical corporate tax system taxes more than excess profits. In other words, a firm that does not borrow as much as it can must really be viewed as borrowing from the sharehold-

\textsuperscript{attributable to liquidity, it increases the economic rents to other sectors, which while lowering the after tax returns to them may, if less efficient cause a loss of output, but nonetheless directs income to them. See Mirrlees, On Producer Taxation, 49 Rev. Econ. Stud. 105, 108 (1972). See also Stiglitz & Dasgupta, Differential Taxation, Public Goods, and Economic Efficiency, 38 Rev. Econ. Stud. 151 (1971)(exploring differential profits and commodity taxation). Cf. Sandmo, Optimal Taxation, 6 J. Pub. Econ. 37, 47-48 (1976)(describing the Mirrlees optimal tax model and noting that a separate tax on corporate profits might well be desirable). Calvo and Phelps offer a rationale for a profits tax in a general equilibrium setting by showing that taxes will induce an increase in the amount of labor supplied, thereby increasing output. See Calvo & Phelps, A Model of Non-Walrasian General Equilibrium, in Macroeconomics, Prices and Quantities 135, 135-50 (J. Tobin ed. 1983)(output is worth more (in labor units) to households than it costs, since price exceeds marginal cost causing the value of labor's marginal product to exceed the wage). This rationale assumes that the pure profit per unit of output increases with increases in the real interest rate, and that the proceeds of a flat rate of tax on profits are used to finance an employment subsidy or a cut in wage income tax.

\textsuperscript{745.} There is no \textit{a priori} argument to suggest that the tax must reduce risk-taking by corporations and some models find the presence of the tax to increase risk-taking. See Gordon, supra note 352, at 22-25 (risk-sharing through taxation of excess profits induces riskier investment even when individuals bear ultimate risk of loss if allocated efficiently by the private market); Domar \& Musgrave, Proportional Income Taxation and Risk-Taking, 58 Q.J. Econ. 388, 389 (1944)(same with government bearing risk of loss). Bulow and Summers argue that the opposite is true. See Bulow \& Summers, The Taxation of Risky Assets, 92 J. Pol. Econ. 20 (1984). \textit{But see} R. Gordon \& J. Wilson, MEASURING THE EFFICIENCY COST OF TAXING RISKY CAPITAL INCOME (National Bureau of Economic Research Working Paper No. 1992, 1986)(rejecting Bulow and Summers model). Jack Mintz shows that for entrepreneurs with decreasing marginal risk aversion and a decreasing return to scale in production, if the tax falls on pure profits there will not necessarily be an increase in risky projects. A change to increasing risk aversion will, however, increase investment in risky projects. Where firms must be equity financed and the corporate rate is higher than the individual rate, individuals may be less willing to invest in risky projects. \textit{See} Mintz, Some Additional Results on Investment, Risk-Taking, and Full Loss Offset Corporate Taxation With Interest Deductibility, 96 Q.J. Econ. 631 (1981).

\textsuperscript{746.} The desire to encourage risk-taking is an argument for limiting the corporate tax to publicly traded firms because of the risk that is borne by owners of nonpublic firms. Cf. R. Boadway \& H. Kitchen, CANADIAN TAX POLICY 168, 179 (2d ed. 1984)(analogous argument used to defend public/private distinctions under Canadian tax law).
ers and thus creating an interest-like return on equity. While theory shows that the double tax on the interest component of the equity return can be offset by borrowing at the individual level, reality suggests that this is not possible and that a firm level tax on the equity return will burden the riskless return. Moreover, if the equity owner can borrow funds to purchase shares held by firms and deduct the cost of borrowing, and if the marginal personal tax rate is lower than the corporate rate, then the individual deducts less from income for equity investment than would a firm. With decreasing absolute risk aversion, the willingness of these investors to invest in risky projects where future debt financing will not be possible declines.

B. Optimal Taxation Theory

A test for the liquidity proposal as a profits tax under optimal taxation principles must be based on the following three arguments. First, excess profit or pure profit is defined as the value of liquidity, which increases the value of the firm's assets and decreases the cost of capital. Second, the value of liquidity, as viewed by both capital suppliers and suppliers of liquidity, is inelastic. Accordingly, the introduction of the tax will not reduce the amount of liquidity, nor will it disrupt the public market. Furthermore, an increase in the cost of capital with a deadweight loss due to less efficient risk sharing in the less liquid market will not occur, and there will be no other negative distortion from the imposition of the tax which would lead to a lower output. Third, a value to imposing a tax exists in both a closed and open economy,
even if in an open economy it causes the wage rate and the interest on savings to decrease, if there is revenue that can be used to help households.

1. Optimal Taxation and Commodities

The optimal taxation tradition\(^{760}\) and its view of both the corporation income tax and any profits tax\(^{761}\) suggests that no social

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750. Optimal tax theory under the Mirrlees model, set forth in Mirrlees, *An Exploration in the Theory of Optimum Income Taxation*, 38 Rev. Econ. Stud. 175 (1971), states that a person's welfare or set of opportunities depends positively on the after-tax wage rate obtainable for her work, the after-tax real rate of interest available on savings for bequests and retirement, and the "indirect utility function" of optimum tax theory. Mirrlees concludes that under optimal tax theory a tax against profits should be levied on that basis. An optimal pattern of taxes is one which, if imposed and offset by sufficient increases in income, will result in an equal percentage change in consumption of all goods and services. See Samuelson, *Theory of Optimal Taxation*, 30 J. Pub. Econ. 137, 139 (1986). Under optimal tax principles, taxation of inelastic qualities will not decrease social welfare, since by collecting tax revenues the output of society will not be reduced. The theory has also been used to justify the structure of the rate system. Under optimal tax principles, taxation of inelastic qualities will not decrease social welfare, since by collecting tax revenues the output of society will not be reduced. See Bankman & Griffith, *Social Welfare and the Rate Structure: A New Look at Progressive Taxation*, 75 Calif. L. Rev. 1905, 1946-67 (1987)(suggesting a modified Mirrlees optimal tax model, based on a rejection of the theory that pure efficiency gains are desirable in and of themselves as support for a progressive rate structure; and suggesting using normative goals and distribution and incentive effects of the tax structure to produce rate structures that vary according to assumptions about individual utility, the nature of the economic structure, and the distribution of abilities). For a discussion of the Mirrlees 1971 and Atkinson 1972 models, see Steln, *On the Specification of Models of Optimum Income Taxation*, 6 J. Pub. Econ. 123, 123-29 (1975).

[The optimal tax theory postulates a] utility function ... which specifies the taxpayer's choice between goods and leisure and his responses to tax and transfer rates [and] a social welfare function which permits alternative states of distribution to be ranked ... [to deduce] an optimal structure of income tax ... (assuming a given distribution of earnings capacities) which will maximize social welfare under that function.

Musgrave, *ET, OT and SBT*, 6 J. Pub. Econ. 3, 15 (1976). Thus, optimal tax theory, while criticized for ignoring horizontal equity in the derivation of its utility functions, may validate progressive taxation since a progressive system results in a social welfare gain, the loss at the high-income end being less than the gain at the low-income end. *Id.* See Bankman & Griffith, *supra*, at 1967 ("if a goal of the tax system is to maximize individual welfare, the rate structure should be progressive").

751. The optimal tax literature posits that the optimal corporation tax is "slightly, if at all, higher than the personal income tax on debt interest." See Flemming, *A Reappraisal of the Corporation Income Tax*, 6 J. Pub. Econ. 163 (1976). If the tax rate is higher than the interest rate then there is a disincentive for invention. "If one assumes that there is a maximum to the amount of capital that can be employed without incorporation, the effect of an increase in the corporation tax rate, to a level in excess of the personal tax rate, may not be the substitution of debt for equity but rather the inhibition of incorporation." *Id.* at 166. If this rate structure inhibits incorporation, the corporate tax base will be
welfare loss will accompany a tax that is applied to activities or commodities for which demand is inelastic.\textsuperscript{752} Under this view, the tax system is a series of excise taxes\textsuperscript{763} aimed at increasing social welfare. Thus, if it can be demonstrated that the demand for liquid assets with equity returns is relatively inelastic,\textsuperscript{754} then optimal tax theory will support the liquidity bright line at the appropriate rate.\textsuperscript{755} At some point the rate of tax overrides the inelasticity of the demand for liquidity, which is a point to be determined in adopting a liquidity standard.\textsuperscript{756}

A tax on a good for which the demand and supply is inelastic will not cause less of it to be produced even though it raises the price of the good. Liquidity is not a good for which there is a direct demand, but the same principle applies to its derived demand. This argument is supported by the tendency of new and established firms to wait for the market to open to obtain needed very small, and the tax will act as a disincentive to some inventors and, under the maximum debt-equity rule, will inhibit the “optimal scale of exploitation of ‘ideas.’” Id. See supra note 744.

752. “Activities or commodities for which the substitution effects are the smallest ought to be taxed more heavily, \textit{ceteris paribus}, since larger substitution effects in response to tax increases produce larger deadweight losses (the inverse elasticity rule).” Hettich & Winer, \textit{Blueprints and Pathways: The Shifting Foundations of Tax Reforms}, 38 NAT'L TAX J. 423, 428 (1985). Under the commodity taxation theory, the Ramsey rule holds that “taxes should be such as to diminish the production of all commodities in the same proportion.” See Ramsey, \textit{A Contribution to the Theory of Taxation}, 37 ECON. J. 47, 54 (1927)(emphasis in original).

753. Bankman & Griffith, supra note 750, at 1951-58, 1962-65 (applying the Mirrles model of optimal taxation to the individual income tax and demonstrating that the effects of the tax are based in part on the elasticity of substitution between consumption and leisure).

754. The starting point is, of course, an intuition. In considering optimal tax theory, Paul Samuelson wrote:

An interesting question for further careful analysis is the following: How do we form intuitive notions about the relevant elasticities, and how do we make best approximate guesses based upon such notions? I suspect that in the absence of knowledge, many economists implicitly treat all the [substitution elasticities] as approximately equal, with all cross-terms of diffused small magnitude. An assessment of the validity and relevance of such an assumption is urgently needed.

Samuelson, supra note 750, at 140.

755. For the evidence on inelasticity of liquidity demand, see supra notes 447-615 and accompanying text. See Gottschalk, \textit{Sales Climbed for Partnerships in 2nd Quarter}, Wall St. J., July 14, 1988, § 2, at 29, col. 5 (decrease by 93.9% of master limited partnerships and 23.2% of non-traded partnerships). The importance of the tax rate is demonstrated by the absence of new offerings of publicly traded limited partnerships without qualifying income since the 1987 legislation. The full classical regime is sufficient to inhibit liquidity enhancement. The question for policy makers is at what point is liquidity still sufficiently inelastic.

756. See infra note 794 and accompanying text.
injections of equity funds, the tendency of venture capitalists to cash in on investments, and the tendency of smaller firms to rely on more costly alternative private arrangements available in the event of closed markets.

Although research on venture capital is in its infancy, the 1984 study of Regulation D sheds some light on the use of Regulation D offerings to bridge the equity gap with relatively illiquid equity capital. More recent data on the private placement market finds that it is overwhelmingly a debt market with little secondary trading on the equity side. Capital providers demonstrate strong liquidity preferences. Evidence also suggests that investors are increasingly willing to rely on private rather than public forms of contract. While institutional investors provide

757. The inelasticity of demand for a public market for new firms is supported by evidence of an investment demand for initial public offerings. This “encourages earlier stage venture capital investment by promising an early opportunity to realize capital gains on the initial public offering and subsequent public sales of stockholdings.” Brophy, Venture Capital Research, in The Art and Science of Entrepreneurship 119, 129 (D. Sexton & R. Smilor eds. 1986). The initial public offering market also provides a vehicle for “price discovery” by those negotiating venture capital financings, since in many cases qualifying young companies choose to go public instead of raising funds through the private and venture capital route. Id. Going public is “[i]n the venture capital context . . . the culmination of the ‘exit’ plan, the date on which shares held by the founder, employees, and investors will become liquid and their plan to cash in their chips will approach fruition.” J. Bartlett, Venture Capital § 14.1, at 263 (1988). Over 60% of the portfolio companies invested in by venture capital firms are expected to be liquidated by going public or merging upwards with a public firm. See Jr. Econ. Comm., Venture Capital and Innovation, 98th Cong., 2d Sess., xi-xii S. Prt. 98-288 (Dec. 28, 1984). For other views of venture capital, see Hearing on the Role of the Venture Capital Industry in the American Economy Before the Subcommittee on International Trade, Finance, and Security Economics of the Joint Economic Comm., 97th Cong., 2d Sess. (Sept. 30, 1982); Hearing on Venture Capital Financing via SBIC’s and MESBIC’s Before the Subcommittee on SBA and SBIC Authority, Minority Enterprise and General Small Business Problems of the Committee on Small Business of the House of Representatives, 97th Cong., 2d Sess., (Nov. 23, 1982). Established firms can generally wait for a favorable time to issue new equity. See Lowenstein, Response, supra note 683 (reliance on retained earnings and debt).


759. See Analysis of Regulation D, supra note 510.


761. See supra note 512.

762. See supra notes 460-75 and accompanying text. These preferences include mutual fund and investment advisory account covenants, evidence on individual portfolio preferences, the cost of private placements relative to public offerings, and funding requirements of pension trusts. See supra note 469.

763. Hawthorne, The Perilous World of Private Placements, Institutional Inves-
funds to venture capital, they do so on a portfolio basis, treating venture capital as a small portion of a diversified portfolio of liquid and illiquid assets.\(^{764}\) Inelasticity of liquidity demand is also indicated by the reluctance of pension fund investors to rely heavily on the private placement market even without recourse to the prudent person rule.\(^{765}\) The argument that the demand for liquidity is inelastic may also depend on the market's current perception of the risk associated with ownership of securitized assets — liquid holdings of illiquid assets — versus the risk associated with direct ownership of assets.\(^{766}\)

\(^{764}\) TOR, Dec. 1988, at 79, 81. The private market may also be much more volatile than the public market. For example, limited partners in leveraged buyout partnerships typically provide 80 percent of the equity financing, see White, Many Institutional Investors Nervous About LBOs Turn Off Cash Spigot, Wall St. J., Nov. 9, 1988, at C1, col. 4, and recent evidence show strong institutional, pension fund, and corporate participation as limited partners in buyout funds, id., as well as in “vulture funds” that invest in the securities of the bankrupt companies which are expected by some to be the result of excessive leveraging, see Wallace, Investors Await a Rash of Defaults, N.Y. Times, Nov. 5, 1988, at 35, col. 3 (noting that the funds are almost exclusively institutional). Overpricing of leveraged buyout candidates, risk of bankruptcy for highly leveraged takeovers at high prices, and fear of adverse tax legislation on the interest deduction may contribute to lower amounts of equity capital for going private buyout transactions. See White, supra. There is other evidence that the public and private markets could mesh. See, e.g., Bensman, Shifting Boundaries: Moving the Line Between the Public and Private Markets, INVESTMENT DEALERS' DIGEST, Mar. 21, 1988, at 16, 17-18 (noting the private placement market for bridge financings and acquisition financings but not noting start-up equity activity).

\(^{765}\) It is generally agreed that the portfolio perspective is the correct view for all institutional investments. See Pension Hearing, supra note 16, prepared statement of David P. Feldman, at 10-11. Venture capital is just one investment in a diversified portfolio. See Hawthorne, supra note 763, at 79, 81 (pension funds now invest 50 percent in U.S. corporate equities, 35 percent in domestic bonds, 5 percent in real estate, 5 percent internationally, and 5 percent in LBOs, venture capital, workout funds, and mezzanine financing, with the latter percentage expected to rise in the 1990s). For reflections on the portfolio nature of venture capital and institutional investment, see Brophy & Guthner, Publicly Traded Venture Capital Funds: Implications for Institutional “Fund of Funds” Investors, 3 J. BUS. VENTURING 187 (1987); Robinson, Emerging Strategies in the Venture Capital Industry, 2 J. BUS. VENTURING 53 (1987).

\(^{766}\) Hawthorne, supra note 763 (noting that fund managers invest in private placements of venture capital for the returns but note investments in venture capital funds do not have the measuring devices such as beta to monitor performance, although they may be developing). Some of the most bullish view the investment as an investment in future equities. Id.

\(^{766}\) It has been argued that the current takeover climate “implies a negative value of the liquidity option in contrast to its long run value which must be positive.” See Corcoran, supra note 489, at 11. Corcoran posits that the risk premia for fundamental risk is declining and there is now less aversion to holding illiquid equity assets despite high fees and transaction costs. He also compares data on REIT securitized asset values with real estate equity asset values and finds empirical evidence for a shift in the fundamental risk premia, he demonstrates a near parity in 1988 as compared to a 30% premium for securi-
Portfolio theory suggests that diversification is possible with even highly illiquid assets.\textsuperscript{767} The maintenance of a continuously diversified portfolio requires liquidity and monitoring.\textsuperscript{768} The inelasticity of the demand for liquidity is based on both the portfolio perspective of institutional investors, which are limited by law and under the constraints of finance theory to the prudent investment of funds,\textsuperscript{769} and the value that individual investors who may not be diversified have for assets that allow them to exercise consumption choices.\textsuperscript{770} The growth of the institutional market and the underlying preferences of capital providers makes up the demand for liquidity.

While in 1987 the venture capital market was estimated at $4.2 billion, with one-half of that amount provided by institutional investors,\textsuperscript{771} the market for initial public offerings was substantially larger, approximately $16.38 billion.\textsuperscript{772} At some point, most firms find it necessary to look to the increased liquidity of the public market in order to value the firm or obtain increased capital for expansion. Thus, the choice of liquidity can be said to be inelastic. Publicly traded corporations with highly liquid ownership interests possess the requisite inelastic quality — there is no alternative for many enterprises to such "corporatism."

The demand for liquidity for equity may be different from the demand for liquidity for debt. The risk of equity securities is of an infinite term. Furthermore, the risk preferences of those willing to invest in illiquid equity may be different from the risk preferences of debt providers. For start-up enterprises, liquidity may be irrelevant up to a certain point. Nonetheless, for outsiders, agency costs are curbed by liquidity and thus outsiders may prefer liquidity since it minimizes moral hazard risk.\textsuperscript{773} Venture fund
participants, like leveraged buyout participants, generally proceed on the assumption of a future cash out. These intangibles may affect the evaluation of public corporate investment by capital providers. To the extent that these factors lower the return that capital providers would otherwise demand, taxation of the income from this form of investment at a rate higher than other investment opportunities will not lower the amount of capital invested. The most extreme application of this reasoning would support an absolute corporate tax without an interest deduction. Even this would lead to the leveraging of firms as they seek a capital structure that minimizes the after-tax cost of capital.

Under public finance analysis, the demand and supply of the good to be taxed as well as the income effects on those taxed must be evaluated in determining the existence and extent of excess burdens or deadweight losses from a tax. Thus, the crucial inquiries are whether the demand for liquidity is inelastic, whether the supply of liquidity is price elastic, inelastic, or infinitely elastic, and whether there are any compensating income effects from the tax. If demand for liquidity by capital providers is inelastic and the supply of liquidity is either price inelastic or infinitely elastic through the existing markets and capital facilitators, the liquidity bright line for taxing the profit component of equity is consistent with views expressed in the economics literature that an excess profits tax is nondistortionary and will produce little or no deadweight loss.

774. See infra notes 1039-40 and accompanying text. But see supra note 520 and accompanying text.

775. The argument that "corporatism" is inelastic, see supra notes 364-77, and that corporate production is less risky due to loss offsets, see supra note 745, is related to this inquiry. In the Gordon model of corporate production, see Gordon, supra note 352, at 25, production is only characterized as "corporate" if the firm is publicly held. Because public firms can efficiently allocate the risk that is presumed to exist in the marketplace, part of the return to public firms can be viewed as excess profit. See id. at 6-15.

776. See supra note 230.

777. Neoclassical economic theory holds that a tax that falls on pure profits is the least distortionary since it falls on the return that is in excess of the return needed to attract labor or capital. Thus, it falls on the owners of the firm and presumably cannot be shifted in a perfectly competitive market. See Flemming, supra note 751, at 169 (concluding that a corporation tax without an interest deduction is not an optimal method of taxing pure profits).

778. The cost of the excess burden of a tax is quantified by the loss of the "good" taxed. See J. STIGLITZ, ECONOMICS OF THE PUBLIC SECTOR 413-23 (2d ed. 1988). In this case the "good" would be that which governs in part the amount of capital that is invested in firms. The excess burden of a tax is the difference between the decrease in the amount of "goods" and the increase in the tax revenues collected. H. ROSEN, supra note 726, at 292.
The determination of whether a profits tax on firms with liquid equity will produce a deadweight loss by lowering the amount of capital invested depends upon the effect of the tax on both the supply of and demand for liquidity. The demand for liquidity will affect the amount of capital that will be invested in the firms that are taxed under the liquidity bright line. It is also the demand that the entrepreneurs face when looking for investment funds for expansion or for valuing their firms. If the demand for liquidity is an inelastic demand in the deployment of equity capital, then taxing firms which utilize this mechanism for equity capital formation will, if the supply of liquidity is inelastic, create little deadweight loss. The amount of the deadweight loss would depend upon the amount of the tax and the slope of the demand and supply curves. Admittedly, this necessitates empirical research, the rough estimates and intuitions of which have been set forth in this article.

I assume that the supply of liquidity is highly inelastic. I also assume that the tax will not alter the income of the providers of liquidity, since the loss of revenue is balanced by a revenue gain from providing access to capital through other sources. There is no income effect relative to the demand for liquidity since it is unclear if the owners of the noncorporate capital whose returns will be bid up are actually those individuals with the public corporate

There is little excess burden or deadweight loss if the supply and demand for the good is inelastic. See R. Musgrave & P. Musgrave, supra note 7, at 292-94. The relative elasticities of supply and demand must be assessed to determine excess burden. H. Rosen, supra note 726, at n.10. The excess burden is much greater if there is an elastic supply. The income effect after the imposition of the tax also must be addressed to determine excess burden. It is argued here that there is no income effect on the firm — the amount of its income does not change other than from the imposition of the tax — from a liquidity-based tax.

It is difficult to model the impact of a liquidity standard. Since economic models assume that perfect competition can be obtained cost-free, the imposition of a cost for trading or a limitation on the ability to trade would affect these models. In effect, testing the impact of a liquidity standard would require the ability to model a transaction cost. To date, economic theory has had difficulty doing this. Furthermore, perhaps only the demand for liquidity would be relevant in determining excess burden. This is analogous to the fact that a supply curve for a monopolist is irrelevant since the monopolist sets price and quantity in relationship to demand. See P. Samuelson & W. Nordhaus, Economics 575-80 (30th ed. 1989). The supply of liquidity is in a sense fixed by the demand, although the cost of obtaining liquidity may increase if firms supplying liquidity lose economies of scale.

779. The investment banking community is well-established as are the necessary market mechanisms of the exchanges, the over-the-counter market, and other secondary markets. A liquidity standard should not result in less liquidity due to an increased cost. E. Bloch, supra note 417, at 35-59.
stock. A high percentage of wealthy individuals have a high percentage of assets in stock rather than real estate. Standard economic theory heightens the importance of offsetting income effects by holding that it is the excess burden over the compensated rather than the uncompensated demand curve that is important. In other words, if there has been a greater amount of income directed at the investor whose investment has been more heavily taxed, the actual excess burden of the tax is higher since additional income is necessary to sustain the desired level of consumption. Thus, since there is no compensating income change, only the uncompensated response — the price effect on the amount of liquidity — must be measured to determine if there is a deadweight loss to society.

A tax on equity is a flat rate tax if one accepts the discount of corporate shares by either the firm level tax or the shareholder level tax hypothesis. The extent to which it is a burden on the firm or the entrepreneur depends upon whether the quantity of “X” that is desired will be reduced or the price “Y” increased. That depends upon the characteristics of the demand and supply curves for the item. Here I am concerned with equity funds. If the demand for the capital providers is inelastic, the derived demand affecting the firm is inelastic. A tax on liquidity increases the price of capital. To the extent that the supply of liquidity is inelastic, the tax on liquidity given the risk preferences of the capital suppliers will result in the incidence of the tax on the firm — the cost of capital of the firm that finances with equity or is not perfectly leveraged will be increased by the tax with an imposition of the tax on existing equity holders and entrepreneurs who go public. The firm can choose or not choose the taxable route. However, the institutional constraints as to the risk preferences of equity capital suppliers suggest strongly that the firm’s available capital needs may not be met, and that the benefits of liquidity in terms of wealth enhancement, future firm benefits, and the lower cost of capital from being in the system of public information and valuation will not be realized. With both an inelastic demand for liquidity and a highly inelastic supply, taxing away a portion of the firm’s profits due to liquidity produces little or no deadweight

780. See infra notes 885-93 and accompanying text.
781. See H. ROSEN, supra note 726, at 298-302 & 310.
782. See supra notes 460-531 and accompanying text.
2. Profits Taxation Viewed Under Optimal Tax Principles

In a recent work extending optimal tax theory to profits taxation, Edmund Phelps argues that there is a social welfare benefit to taxing a firm's pure profit. Phelps admits, however, that it is less clear whether a profits tax would produce a net social benefit in an open economy where a sizable portion of capital investment has to be equity financed. In such an economy, the percentage of equity financing relative to debt financing would be a relevant inquiry. Where innovators are able to finance all of their development costs with debt, there can be no harm from a profits tax. If innovators are equity financed there is a cost associated with a profits tax that must be weighed against the ex-

783. For firms able to take advantage of innovative financing options, the rewrite of the corporate tax as a profits tax may lead to lower transaction costs. For a view that increases in transaction costs generate substantial revenue for investment bankers due to shifts in financing to public debt in combination with leveraged buyouts, see Reich, Leveraged Buyouts: America Pays the Price, N.Y. Times Magazine, Jan. 29, 1989, § 6, at 32, col. 1.

784. Phelps, supra note 94, at 691. This is a countereffect to the Harberger model. Under the Harberger assumptions in a closed economy, the introduction or increase of the profits tax reduces wages beyond the power of the profits tax revenue to compensate. A decrease of the tax (when positive) raises wages by more than enough for workers to be able to compensate the Treasury and still gain through a net rise of the after-tax wage rate. If there is some monopoly power, the firm’s profits then represent an economic profit or pure profit rather than a competitive return to capital not offset by interest deductions. This effect is supported by the Stiglitz objection to the Harberger model: If firms finance their capital expenditures through borrowing, the profits tax (whether or not there are positive profits) will not raise the cost of capital and hence will not have the Harberger effects on capital stock and wages. Professor Phelps summarizes these arguments as follows: “The Harberger argument asks to have its cake and eat it too; that is, to suppose that credit markets are seriously imperfect, so the classical option of financing purely (or even predominantly) with debt is closed, while the product and labor markets reliably ensure that capital and labor (before tax) receive their marginal products.” Id. at 682 (also noting that the proportion of the capital stock financed through equity has been declining).

785. Id. at 691-92. Phelps concludes as follows: “In view of the uncertainty over the consequences for profits tax incidence . . . one is compelled to admit that economic theorizing does not provide a strong a priori basis for a high corporate profits tax nor for a zero profits tax rate.” Id. at 694.

786. For a review of changing debt-equity ratios, see supra notes 159-61.

787. Under the Stiglitz view, in perfect capital markets a properly designed corporate tax falls on pure profits and rents and is allocatively neutral. Stiglitz, Taxation, supra note 64, at 32-33. Where the firm-level tax rate is lower than the owner-level tax rate, the firm-level tax does not itself create distortions provided that debt interest and true depreciation are deductible. See Stiglitz, The Corporation Tax, supra note 64, at 304.
pected benefits of such a tax.\textsuperscript{788}

Regardless of the outcome of the cost/benefit analysis, if the appropriate rate of tax on the pure profit attributable to liquidity is applied, then the cost of capital among firms — those with liquid equity and those without it — will be equalized. This profits-as-surplus view of taxation for firms with liquid equity arguably holds in an open economy where the incidence of the firm level profits tax may be on labor\textsuperscript{789} rather than on capital in general.\textsuperscript{790} To the extent that there is greater risk in the private market and one wants to direct funds to this risky market, it might be viewed as appropriate to tax the risky asset at a lower rate if risk aversion is increasing relative to the safe asset.\textsuperscript{791}

Under the Phelps general equilibrium model of a profits tax in an open economy, a profits tax may cause after-tax wages to rise at a greater rate than it causes dividends to fall.\textsuperscript{792} Viewing profit to include a return to capital in the form of interest, Phelps demonstrates that, depending upon the rate, there may be an increase in social welfare if profits are taxed.

The conclusion to which this analysis points, considered in isolation from other factors, is that up to a point the imposition of a tax rate on corporate profits is welfare increasing. The principal benefit is that the siphoning off of some of the firms' pure profit, originating from the information frictions prevailing in

\textsuperscript{788} Profits taxation may be distortionary since an introduction of a profits tax generates a first-order cost — curtailing investment in ideas when there is already a gap between marginal social product and the private cost of capital — that might overwhelm the first-order benefit that can be expected from the redistribution of some of the economic profit originating in product market imperfections. Therefore, it may be entirely consistent not to apply a profits tax to firms that are predictably equity financed and in a start-up phase. On the other hand, the view that there is "over-investment in the development of new products and techniques" would suggest that there is a benefit to the introduction of profits taxation. See Phelps, supra note 94, at 693-94.

\textsuperscript{789} See Harberger, supra note 352, at 163, 166 ("If, as I believe, land is not an important input into corporate tradable products in the United States, then labor must bear more than the full burden of our corporation income tax."). Cf. Kimbrough, The Corporation Income Tax in the Open Economy, 25 INT'L ECON. REV. 391 (1984)(analyzing the impact of changes in corporate tax rates on the exchange rate and balance of payments accounts).

\textsuperscript{790} The corporate form may also produce excess returns. See Phelps, supra note 94, at 691-92 ("It is reasonable to conclude that the profits-as-surplus view of the benefit from a profits tax rate . . . survives in an open economy model . . . .").


\textsuperscript{792} Phelps, supra note 94, at 683-90.
product markets or more classical sources, makes possible a net addition to total tax revenue out of which there can be a lightening of the marginal tax rates on work, a consequent narrowing of the wedge between the after-tax real wage and the marginal productivity of labor, and a resulting increase in the amount of work done and output produced. The principal cost is that the consequent efflux of capital reduces the before-tax wage, which finally limits the optimum size of the profits tax rate to something less than 100 percent. There are side benefits if there is a real appreciation of the currency or if foreign shareowners bear some of the redistributive burden of the profits tax — and a side cost if instead there is a real exchange rate depreciation. With the introduction of partial equity-financing it is still possible, though less likely, that an increase of after-tax wages will result. It was noted that any improvement of the after-tax wage will be less than offset by the fall of dividends — some capital will move abroad to restore some of the dividends; consequently there is a greater possibility of a net income effect strong enough to induce a cutback in the amount of labor supplied; but the resulting damage cannot erase the extra net income created (when after-tax wages rise by more than households’ dividends finally fall), since it is only because their after-tax income has increased that households would work less.

It is reasonable to conclude that the profits-as-surplus view of the benefit from a profits tax rate (up to a point) survives in an open-economy model and may well survive even though a sizable portion of capital investment (including investment at the margin) has to be equity financed. It is perhaps true that the element of surplus, or pure profit, in taxable corporate profits is not typically as large as a proportion of the capital stock; but it should be noted that the effect of profits taxation on the cost of capital is proportional to the real rate of interest, which is not typically large — near zero in the decade before the enactment in 1981 of fiscal incentives to invest in the United States.793

Other models of profits taxation do not contradict this view.794

793. Id. at 691-92.

794. Flemming concludes and supports Ricardo that pure profits should be taxed away before a distorting tax is introduced, but that deterrents to incorporation and invention suggest that the optimal tax is less than 100 percent. He also defines the nondistortionary corporate tax version of a profits tax as one that exempts interest from the firm level tax. See Flemming, supra note 751, at 163, 166-69. Like Flemming, this article views a limit to the amount of capital that can be employed without liquid equity, which is my substitution for the value of incorporation, and suggests that the rate of profit tax is less than 100 percent to capture only the value of that liquidity.
The result of this argument is the following. First, the taxation of pure profits is a tax that has its incidence on the owners of the firm, since the firm will continue to price and produce goods in exactly the same manner as before the imposition of the tax. Second, to the extent that taxation of pure profits causes the rates of return in one sector to be less than in another, there may be migration of capital. However, if the demand for capital is different in the different sectors and there is an inelasticity of demand for and supply of capital in each sector, there will be no such migration. Optimal tax theory helps confirm this view, since it posits that the demand function for liquidity will not cause less of it to be produced by firms deciding to raise equity capital. Taxation of this pure profit will not cause a migration from public corporate investment and there will not be a barrier to entry to the public corporate sector.

Investor liquidity preferences result in the tax being borne by entrepreneurs who go public or by existing public shareholders in firms that are required to issue equity. In an open economy, profits taxation can be viewed as a component of an optimal tax system that will not reduce output while allowing tax subsidies to labor. To the extent that share prices do not fully capitalize the tax, the tax is borne by all shareholders and, under the Harberger assumptions in a closed economy, by all capital. On the other hand, investors invest on an after-tax basis. For entrepreneurs contemplating the going public decision, the presence of liquidity produces a pure profit to them. This suggests that the decision to allocate capital away from the taxed sector is determined by after-tax returns (the decision to remain private), but the public sector provides through liquidity an economic profit that tax policy demonstrates can be taxed away.

Even if the lowering of after-tax returns in the public sector causes capital to be reallocated to the private sector, the sector to which it is reallocated may be the start-up sector for equity investments. For existing shareholders who have the ability to exit from firms that decide to issue new equity, transaction costs may keep them from exiting. While there is evidence that the public market may provide superior risk sharing arrangements, it does not necessarily provide a higher production efficiency and thus the Harberger assumption of deadweight loss may not apply.

795. See infra note 841 and accompanying text.
Another effect may be the unwillingness of shareholders to invest in firms that may in the future resort to equity finance and a concomitant favoring of firms that can finance from retained earnings or debt, even if the latter strategy is one of greater risk. This is the same bias that exists in a heightened form under the present system. This investment choice would provide a wealth reallocation to those firms in the retained earning category and their shareholders. Another scenario would be an investment decision to invest in smaller and start-up companies. The Amihud and Mendelson data demonstrates that there is a correlation between risk and liquidity with stocks with lesser liquidity having greater returns. If investors equate illiquidity with risk, then investors would invest in start-up firms that promise greater returns in exchange for higher risk. This theory is considered further in Part VI.E.3 of this Article.

C. Implementation of Profits Taxation and the ALI Proposals

The theory of profits taxation advanced in this Article requires that only the equity return on investment be taxed. This is consistent with the renewed proposals of the ALI Reporter to allow a deduction for an interest-like return on new equity. The 1982 proposals by the ALI Reporter on the classical system are currently under discussion in a supplemental study and are the subject of a recent proposal. The original study called for a limitation on the deduction of interest for major shareholder indebtedness, the allowance of an interest-like deduction to the firm for a portion of the dividend paid on new equity, and, in order to monitor and define the newly contributed capital account, a reduction of the interest deduction of the corporation if nondividend distributions or equity acquisitions exceeded new equity contributions. In both the original and supplemental study drafts, the

796. See supra notes 484-90 and accompanying text.
797. See Reporter's Study on Corporate Distributions, supra note 53.
798. See Reporter's Study Draft, supra note 53.
799. Reporter's Study on Corporate Distributions, supra note 53, at 368-69, 381-82 (Proposal R1(3))(limitation on deduction for interest paid on debt of shareholder owning ten percent or more of corporation to the amount allowed for the new equity deduction).
800. Id. at 367-68, 370-73 (Proposal R1(1)-(3))(defining new equity, amount of the interest deduction, and treatment of the payment by the recipient).
801. Id. at 368, 373-79 (Proposal R1(4)). This proposal denied an interest deduction on acquisition indebtedness and certain other debt if nondividend distributions and equity
ALI Reporter has not taken a position on the resemblance test for determining what is an "association" taxed as a corporation. The ALI Reporter assumed that the double tax regime for corporations and associations would continue and made proposals with a view to "reduce or eliminate the disparity between debt and equity . . . and to reduce the disparity between dividend and nondividend distributions."  

The ALI Reporter proposed, in both the original and supplemental studies, a deduction for a paid interest-like return on new equity contributions. The supplemental proposal continues to define new equity, to provide the rate of the deductible return on new equity, and to create a new equity account to monitor contributions exceeded capital paid in and thus caused the newly contributed equity account to be negative. This formula reduced the corporation's deduction for interest paid by an "amount equal to interest, at the corporation's average rate of interest paid, on such negative amount" and would limit the deduction for certain interest on shareholder indebtedness. *Id.* at 368.

802. The ALI in its study of partnership taxation, took a position on the taxation of publicly traded limited partnerships and reaffirmed the resemblance test for testing other partnerships. ALI SUBCHAPTER K STUDY, supra note 128, at 366-93 (Proposal Q). The failure of the ALI Reporter to do so may be explained by the fact that the supplemental corporate study was limited to distribution and acquisition issues.


804. REPORTER'S STUDY ON CORPORATE DISTRIBUTIONS, supra note 53, at 329. Accord. REPORTER'S STUDY DRAFT, supra note 53, at 2-4. Proposals for the correct taxation of nondividend distributions are now covered in a proposal for "A Minimum Tax on Distributions," see REPORTER'S STUDY DRAFT, supra, at 54-80 (Proposal 1), and are considered in relationship to the author's proposal in Part VII of this article. For the proposal's genesis, see GROUP DRAFT NO. 18, supra note 53, at 61-62 & n.27 (citing draft paper by Professor George Yin suggesting a uniform corporate distributions tax at a flat rate on all corporate distributions regardless of the recipient's rate for other transactions).

805. REPORTER'S STUDY ON CORPORATE DISTRIBUTIONS, supra note 53, at 356-400 (Proposal R1); REPORTER'S STUDY DRAFT, supra note 53, at 88-97 (Proposal 3).

806. New equity is defined in terms of a "Qualified Contributed Capital" account that would "include all amounts paid in for stock or as shareholder contributions to capital after the effective date." REPORTER'S STUDY DRAFT, supra note 53, at 92-93 (Proposal 3(c)). Qualified Contributed Capital would allow a firm to deduct a portion of any dividend paid based on an applicable rate of interest determined by the interest return on equity times the amount of the Qualified Contributed Capital. *Id.* at 87-88 (Proposal 3(a)). The Qualified Contributed Capital would be reduced by capital distributions. *Id.* at 94-95. Excess dividend distributions would entitle the corporation to a carryover for a proposed three to five year period. *Id.* at 88, 96 (Proposal 3(e)).

807. The proposal in the supplemental study uses a rate two percentage points above the federal long-term bond rate as the applicable interest amount. *Id.* at 105 (Proposal 3(b)). The original version of the proposal used a rate that would be set from time to time and "approximate the prevailing yield on high-grade corporate bonds." REPORTER'S STUDY ON CORPORATE DISTRIBUTIONS, supra note 53, at 367 (Proposal R1(2)(A)). The supple-
the payment of returns to new equity contributions. Unlike the original study, the interest deduction on debt is at all times limited to the applicable deductible rate for new equity in order to achieve neutrality between debt and equity financing. This is an important assumption since it also in effect defines the tax base as the profits of the firm after interest reflecting the time value of

808. The original study viewed the newly contributed capital provision as independent of the Reporter's other proposals on distributions. See REPORTER'S STUDY ON CORPORATE DISTRIBUTIONS, supra note 53, at 373-74. However, the newly contributed capital provision was coordinated with those proposals, particularly with the excise tax on nontax-dividend distributions. See id. at 367. Nonetheless, a mechanism is required to prevent the conversion of existing equity capital to Qualified Contributed Capital (because of the windfall gain concerns discussed in the text at infra note 810). The current mechanism uses the concept of a "Covered Distribution" whereby a corporation that distributes money or property to a shareholder other than dividends and other dividend-like distributions and that has debt from the transaction after the distribution is deemed to have "Converted Equity." REPORTER'S STUDY DRAFT, supra note 53, at 80 (Proposal 2(a)). Interest on Converted Equity is nondeductible. Id. Under the Reporter's earlier proposal, a subsequent capital contribution after retirement of previously issued preferred stock was eligible to be treated as Qualified Contributed Capital and dividends on previously issued preferred stock were not entitled to a deduction. See REPORTER'S STUDY ON CORPORATE DISTRIBUTIONS, supra note 53, 369-70, 399-400 (Proposal R1(10)). Under the supplemental study proposals, retirement of straight preferred stock would not trigger the minimum tax on distribution and additional equity capital contributions would be Qualified Contributed Capital. See REPORTER'S STUDY DRAFT, supra note 53, at 55, 80, 87-89 (Proposals 1(a)(5), 2(a), 3). The current version uses the "Minimum Tax on Distributions" to deal with distributions other than dividends. Id. at 94. It also suggests that a tax credit might be allowed for a distribution charged against Qualified Contributed Capital as if the distribution had been subject to the minimum tax on distributions. Id. at 94-95 (Proposal 3(h)). The Reporter remains open to discussion as to whether the disallowance should come first. Id. at 94.

For a discussion of the treatment of debt and the interest deduction in connection with an interest return on new equity, see infra notes 987-1023 and accompanying text.

809. The original ALI Reporter's proposal only limited the interest deduction to the applicable deductible interest return on new equity to major shareholders. The Reporter's Study Draft does not impose a limitation on the interest deduction on debt at the applicable rate times the amount of contributed debt capital within the boundaries of the new equity proposal. Nonetheless, the Reporter's Study Draft does include a denial of the interest deduction in excess of the applicable rate in Proposal 2(b), see REPORTER'S STUDY DRAFT, supra note 53, at 83-84, which the Reporter believed was a desirable mechanism by which perfect neutrality between the debt or equity finance decision can be achieved without the apparent need to define "debt" as opposed to "equity." See id. at 7-11, 84-88. The apparent change from the approach in 1982 to reduce the deduction for major shareholder indebtedness may be in part the ALI Reporter's view that with the present inverted rate structure debt financing will always be the preferable alternative (at least for corporations producing current income). Cf. id. at 9-11 (discussion of role of personal and corporate tax rates on the decision for new equity, retained earnings, and debt finance).
money is paid. Since the ALI Reporter’s proposals are based on a belief that firm level taxes are capitalized into the price of existing equity securities,\textsuperscript{810} the proposal is limited to new equity in order to prevent a perceived windfall gain if returns to old equity were similarly treated. Under both the original and supplemental proposals, the new equity account does not include accumulated but unpaid earnings from new equity contributions.\textsuperscript{811} While it is possible to integrate the new equity proposal with a credit rather than a deduction mechanism, the former would pass on the benefits of the deductible return to the existing shareholders unless the new equity were kept separate from old equity.\textsuperscript{812}

The new equity proposal, which makes no attempt to distinguish debt from equity, is limited to a deduction for dividends that are paid.\textsuperscript{813} The corporation is the taxpayer in the first instance,

\textsuperscript{810} Windfall gain concerns were the reason the proposal was limited to new equity. Reporter’s Study Draft, supra note 53, at 91, 92-93 (“Moreover, from the standpoint of fairness, shares have traded on the general understanding that there would be a corporate income tax, with no deduction for dividends, and to change the rule on that now, for all shareholders, would produce significant shifts in wealth but with no basis for confidence they would get to the right people.”). Accord Reporter’s Study on Corporate Distributions, supra note 53, at 363-66.

\textsuperscript{811} Reporter’s Study Draft, supra note 53, at 92-93 (Proposal 3(c)).

\textsuperscript{812} See Corporate Financial Structures, supra note 4, at 102-03 (noting that the credit mechanism would cause new shares entitled to the credit to trade at a premium relative to old shares thus transferring the benefit to old shareholders and that the deduction mechanism would cause all shares to trade the same and benefit old and new equity alike). These results should not change regardless of how tax exempts and foreigners were treated under the system. See infra note 824-25. A prior proposal, that would accomplish integration through exclusion of the dividend from income, would be more difficult to accommodate in this limited double tax world. See Peel, A Proposal for Eliminating Double Taxation of Dividends, 39 Tax Law. 1 (1985)

\textsuperscript{813} Reporter’s Study on Corporate Distributions, supra note 53, at 367 (“deduction should be allowed for dividends paid”); Reporter’s Study Draft, supra note 53, at 88 (“deduction shall be allowed for dividends paid”). Rather than sticking to what Alvin Warren has termed results “strikingly consistent” with [the profits view of an instinctive understating of] the profits basis theory of the corporate tax which allows an interest return on equity finance, see Warren, Integration, supra note 1, at 760, the ALI Reporter justifies the limitation to dividends paid by reference to the formal nature of a “dividend” — “dividends do not accrue in the same way interest does,” Reporter’s Study Draft, supra note 53, at 93 — rather than on its constituent economic parts. The payment requirement is further justified by references to arbitrage between accrual deductions and cash method inclusion, and the presumed greater symmetry in “matching” under a cash method of accounting for interest and dividends. See id. To the extent that the firm does not pay a dividend and obtain a deduction for a portion of its “interest” cost, it is a surrogate taxpayer for the shareholder. See Warren, Timing, supra note 97, at 501, 503. Under this view, the firm level tax would be retained “in lieu of the individual tax that would have been paid on an actual distribution.” Reporter’s Study on Corporate Distributions, supra note 53, at 388.
making it the surrogate taxpayer for the shareholder. Where the tax rates for the shareholder and the corporation are the same, the proposal is tax neutral whether the tax is paid by the corporation or the shareholder; where corporate rates are higher, the proposal is not tax neutral.\textsuperscript{814} Firms that are equity financed and unable to pay a current interest-like return would find little comfort in the proposal even with the proposed three to five year carryover.\textsuperscript{815} An elective accrual proposal would do much to help such start-up firms.\textsuperscript{816} Likewise, to the extent that accrual basis interest deductions are allowed on debt, even if partially restricted as under the

\begin{footnotesize}
\textsuperscript{814} The rationale for the payment requirement was advanced in the original proposal subject to "the assumption that corporate rates would continue to be lower than individual shareholder rates [and the] rate differential [would] make it worthwhile to accumulate in some cases [including in the case allowing a] deduction for dividends paid." REPORTER'S STUDY ON CORPORATE DISTRIBUTIONS, supra note 53, at 387. This rate differential was considered to be present not where the graduated rates obtained but under the then existing rate relationships; the graduated rates could be limited to newly invested capital. Id. at 387-88. These conditions still obtain for those firms subject to the graduated rates, but for profitable firms subject to the highest corporate rate retention is a more costly policy. At a minimum, serious consideration should be given to the ALI Reporter's earlier suggestion that "unused dividend-paid allowances . . . [could] be added to qualified contributed capital." Id. at 388.

There should be some relief for dividends that are not currently paid, given a flat tax perspective, and the ALI Reporter's proposals do provide for allowing unpaid dividends to be deducted in the future through a three to five year carryover mechanism. An alternative approach would be to add the allowable but unpaid dividends to the qualified contributed capital account and adjust the shareholder's basis. See REPORTER'S STUDY DRAFT, supra note 53, at 88-89.

\textsuperscript{815} See REPORTER'S STUDY DRAFT, supra note 53, at 89 (proposal 3(e)). The proposal does not so state but the carryover would have to be on a first-in-first-out basis ("FIFO"). The corporation would be the initial taxpayer and presumably the market would capitalize the likelihood of expired and unused deductions. The rationale for the limited carryover rule, which is limited unlike the carryover rule for debt, is that "defaulted shareholder debt is not a model on which to build." Id. at 94. Since many start-up firms require retained earning financing, this proposal, even with the carryover, would deter start-up equity capital.

\textsuperscript{816} A better provision for start-up firms would be to allow an elective accrual of the interest return which would be reversed if not paid within a three year period on a first in first out basis. To the extent that there is a current rate arbitrage not favoring retention of earnings, this might be justified as a provision to aid new capital formation. The elective nature of the provision would allow firms to determine whether their tax equity clientele would prefer the loss of the firm level deduction. The need for electivity is supported by recent models of integration through a dividends-paid deduction or shareholder credit suggest that the relevant view is that of the individual tax. Chang, supra note 390, at 262-63. The decision would depend in part on the treatment of that payment as "interest" or a "dividend" to the investor. The limitation of the interest deduction to new equity precludes such adjusting mechanism as a refundable credit for firm level taxes paid for owners in a lower tax bracket. Cf. Warren, Integration, supra note 1, at 744-49.
\end{footnotesize}
1989 legislation, the proposal is not neutral between debt and equity financing although it does reflect the underlying risks undertaken by equity holders. The proposal limits the deduction to a relatively risk-free amount equal to the long-term risk-free rate plus a two percent risk premium reflecting, but not tied to, the risk premium on high grade corporate bonds. It is coupled with the disallowance of interest deductions in excess of that amount, thereby lessening somewhat the failure to equate accrual interest deductions to an accrual interest payment on equity. Such failure becomes more significant where the inverted rates obtain. Tax-exempt and foreign investors also would face a reduced yield under equity finance as compared to debt finance with accrual deductions.

If the rationale for this continued bias is that firms should be encouraged to distribute in order to allow equity owners the choice to reinvest and to promote efficiency gains, that should be explicitly stated in any revised proposal. If accrual basis deductions are not allowed or are not chosen under any elective system, at a minimum the accumulated but unpaid amount of interest return should be added to qualified contributed capital. Even if the

817. Zero coupon and payment-in-kind debentures are widely used for this purpose. See House LBO Hearings 1, supra note 16, at 554 (prepared statement of Martin Ginsburg); id. at 558-62 (prepared statement of Jack Levin). Deferred interest debentures (DIBs) are zero coupon bonds. They are similar to payment-in-kind debentures (PIKs) under which the issuer has the option to pay the coupon rate of interest in cash or issue a coupon for the accrued interest. See L. Goodman & A. Cohen, Valuing Deferred Coupon Debentures (Goldman, Sachs & Co., Financial Strategies Group, May, 1988); L. Goodman & A. Cohen, Pay-in-Kind Debentures: Structure and Valuation (Goldman, Sachs & Co., Financial Strategies Group, Nov. 1987). Legislation aimed at bifurcating the debt and equity features of such bonds changes the result. See supra note 49.

818. Since the deduction is limited to the federal long-term rate plus two percent, the deduction in either case represents a two percent premium over the riskless rate of return. The risk referred to in the text is the default risk.

819. See infra note 1015.

820. See supra notes 183-85 & 816 and accompanying text.

821. Professor Warren criticized the original proposal for not allowing accumulations to be added to the qualified capital account since that would mean that the income was double taxed and favored a retention strategy. Warren, Integration, supra note 1, at 756. Under current rate relationships, the retained but unpaid interest could be added to without this distortion. In the supplemental proposal, the ALI Reporter's objection to including unpaid amounts in Qualified Contributed Capital is essentially a "function of rates", measured by "the investor's tax rate, since it is the investor's tax that is postponed. If these rates are different, then there will be some difference, or bias, between internal financing (accumulation) and external financing (distribution and reconstitution) after all." Reporter's Study Draft, supra note 53, at 91. While this states the issue, and the view from the firm of the relative cost of capital from borrowing or retained earnings refines it,
firm level tax rate is at least as high or higher than the new equity provider's tax rate, which is the case in 1989, excluding the graduated rates, there is still a need to exclude accumulations on new equity from the new equity account in excess of any accumulation attributable to the accrued but unpaid interest-like return on new equity if the concern is that equity capital at the firm level must be subject to a double tax before deductible withdrawals are possible.\textsuperscript{822}

Finally, while tax-exempt and foreign equity holders are mentioned in the original proposal, they are omitted from the supplemental proposal.\textsuperscript{823} The treatment of payments to foreign\textsuperscript{824} and tax-exempt\textsuperscript{825} holders is significant under the ALI Reporter's

\textit{see id.} at 92, it does not resolve the essential problem that the unpaid interest return will bear a tax and the income from it retained in the firm including the interest return will bear a double tax.

822. To allow a firm-level deduction for interest on accumulated earnings in excess of the interest return which was not paid would be an application of the principle of the value of deferral first noted by E. Cary Brown — exemption from taxation of the return from principal is equivalent to exemption from taxation of that principal. \textit{See W. ANDREWS, BASIC FEDERAL INCOME TAXATION 116-21 (3d ed. 1985). For an illustration of the value of that deferral, see REPORTER'S STUDY DRAFT, supra note 53, at 17-38. In effect, it would allow the shareholder to reinvest the retained earnings of the firm without a double tax on the principal portion of those reinvested earnings in excess of the allowable interest return. This is a different consideration from whether the accrued but unpaid interest return ought, in a flat tax world of equivalent corporate-shareholder rates or in an inverted rate world of higher corporate rates, to be allowed as a deduction to the firm or whether the shareholder ought to receive credit in the Qualified Contributed Capital account for this amount.}

823. \textit{See REPORTER'S STUDY ON CORPORATE DISTRIBUTIONS, supra note 53, at 393 ("the proposal has been shaped by analogy to interest, which is fully deductible by a corporate payor even if the recipient is a tax-exempt institution or foreign investor").}

824. Under the new equity proposal, the interest-like return should be treated as a dividend which reflects the risks on the recipient level and would leave foreign investment the way it is. While treatment of the payment as portfolio interest would increase the attractiveness of investment in new equity, it would do so at a revenue cost and further exacerbate the differences in treatment of noncorporate versus corporate investment. The question of whether to impose a compensatory withholding tax on the interest-like portion deducted for non-treaty recipients and to retain authority for the Treasury to impose compensatory withholding for leverage in renegotiating treaties must still be considered. \textit{See CORPORATE FINANCIAL STRUCTURES, supra note 4, at 99-100.}

825. For tax exempt institutions that invest in equities, the characterization of the new equity return as interest or a dividend makes no difference, since both are tax exempt. Yet the allowance of the firm level deduction duplicates the present major distortion created by interest on debt: deduction of an amount on which no tax is collected from the recipient. These issues, especially in connection with zero coupon debt, have been noted in proposals made to impose a tax on interest recipients, \textit{see House LBO Hearings I, supra note 16, at 554 (prepared statement of Martin Ginsburg); id. at 560-61 (prepared statement of Jack Levin), and in pending legislation. See note 49. The correct answer is to treat the return as interest for the firm, as a dividend taxable for the recipient, and as unrelated
version of the new equity proposal and under my profits tax version of the new equity proposal with a public-private distinction. If the proposal is not coupled with a general interest deduction limitation, the biases that exist between debt and equity finance will continue, although ameliorated, and pressure will again be placed upon the classification of firm securities as debt or equity. Limitations on interest deductions on debt replacing equity are required if the current classical regime is to continue without erosion of the tax base, to reflect the increase in wealth of the continuing equity holders and to monitor the new equity system. However, even if the ALI Reporter’s proposal is adopted

business income for tax exempts. This equalizes the investment between the corporate and noncorporate sectors; although it does increase the relative attractiveness of debt, but the existence of the firm level interest-like deduction simultaneously increases the tax attractiveness of equity.

826. See infra text accompanying notes 987-1023.

827. The relationship between the new equity proposal, the limitation on interest deductibility, and portfolio investment must also be explained. The ability of corporations to deduct dividends received from other corporations is related to the ALI Reporter’s proposals on debt replacing equity and newly contributed equity. See I.R.C. § 243 (West 1988)(dividends-received deduction). The ALI Reporter would disallow deductions for dividends received for firms that make portfolio investments in other corporations. REPORTER’S STUDY ON CORPORATE DISTRIBUTIONS, supra note 53, at 490-92 (Proposal R3); REPORTER’S STUDY DRAFT, supra note 53, at 97-101 (Proposal 4)(a simplified version of Reporter’s Proposal R3). Portfolio investment is distinguished from direct investment which requires ownership of 10 percent or more of the other firm’s stock under the ALI Reporter’s original proposal. REPORTER’S STUDY ON CORPORATE DISTRIBUTIONS, supra note 53, at 490-91 (Proposal R3(1)(A)(ii))(elective provision for designation of direct investment if 10 percent ownership threshold is met). Accord 1987 REVENUE OPTIONS, supra note 46, at 164-67. The direct investment threshold is 20 percent under the ALI Reporter’s current proposal. REPORTER’S STUDY DRAFT, supra note 53, at 97 (Proposal 4(a)(1)). The theory is that the return on portfolio investment is a substitute for debt issued by the firm, and that the arbitrage possibilities created by issuing preferred and indeed common stock ought not to be allowed through directing issues to corporate purchasers. The proposed solution is to eliminate the exemption of intercorporate dividends with respect to limited or casual portfolio investment. Since the proposal is applicable to newly issued shares, it would be equivalent to a form of partial integration that would be adopted for the newly contributed equity. Under the ALI approach, old equity (at least in the form of preferred stock) would not be affected. The rationale for limiting the repeal of the exclusion for intercorporate dividends to new equity is that, at least for preferred stock, it appears that the stock has been priced on the basis of low taxability of dividends to corporate investors.

To the extent proposals are adopted to equalize retained earnings financing and new equity financing, and to limit the dividends received deduction on portfolio stock investment by corporations, the double tax line for new equity remains important. A recent House proposal was to reduce the deduction for dividends received by corporations owning less than 20% of the stock of another corporation to 60% in 1989 and 55% in 1990 and to set the requirement for non-portfolio investment at more than 20% ownership. See Description of Possible Comm. Amendment Proposed by Chairman Rostenkowski to H.R. 4333, The Technical Correction Act of 1988, prepared by the Staff of the Joint Comm. on Taxation,
without a general interest deduction limitation, its likely effect will be an overall increase in capital allocation efficiency. "[T]his partial deductibility should make debt-capital ratios fall and stimulate corporate investment, with implied efficiency gains." 

The issues of a general interest deduction limitation, a limitation on debt replacing equity, and the appropriate new equity interest rate are considered in Part VII.B.2 of this Article.

D. Summary of Profits and Optimal Tax Theory and the Liquidity Standard

The theory of profits taxation suggests that the nonliquid ownership distinction accurately identifies those firms that obtain capital cost benefits from liquidity and the public market. For a tax that is a series of excise taxes in the optimal tax tradition, a line can be drawn based on liquidity. Perfect neutrality between debt and equity finance cannot be obtained under the present tax rate conditions without a limitation on the deductibility of interest on debt for firms that would have the equity portion of their return double taxed. This raises the distortion between the cost of financing between corporate and noncorporate producers and for foreigners making bids for United States firms. This Article's proposal removes much of the pressure for debt finance in the closely held context by removing those firms from the double tax category. The preference for debt financing as an alternative to equity in the publicly held context is an issue that has become greatly removed from the question of debt-equity classification in the


828. Gordon & Malkiel, supra note 62, at 180. However, under some of the proposals under discussion in the past such as the proposal for a tax on nondividend distributions, equalization of retentions and repurchases might not change the equilibrium debt-equity ratios for firms or the equilibrium allocation of capital between the corporate and noncorporate sectors. Id. at 180 n.95.

Other models of the corporate tax indicate the efficiency and equity enhancement of even partial removal of the corporate tax burden. Under the assumption that there is a positive cost of bankruptcy, a higher debt-equity ratio increases the risk of the firm and the firm must offer a higher risk premium to debt and equity. Ballentine and McLure model a corporate tax that has a greater burden on noncorporate capital and a reduction of the corporate tax as providing a greater gain for noncorporate capital due to the lower risk premiums that must be offered in the corporate sector. See Ballentine & McLure, Corporate Tax Integration: Incidence and Effects on Financial Structure, in Treasury Dept., Compendium of Tax Research 243 (1978).
closely held context.

The choice to limit the interest deduction on debt to the interest deduction on new equity raises other considerations. These issues are dealt with further in Part VII of this Article. If no limitation is placed on the deductibility of the interest on debt, nonetheless a public-private distinction allowing a deduction for the interest component on new equity while taxing the profits component may comport with the belief that nonpublic firms are less able to choose long term debt finance over equity finance. Admittedly, some nonpublic firms have as great an ability to substitute public or liquid debt for equity as that of public firms. Nonetheless, such a view of the double tax system, even with a deduction for dividends on new equity equal to the federal rate of interest plus a risk premium, would leave the double tax system as a tax on the excess profits of firms that resort to equity finance or as a tax on wealth enhancement and entrepreneurship.

E. The Equitable Taxation Tradition and Efficiency

Tax provisions generally are evaluated under traditional criteria of equity, efficiency, neutrality, and simplicity. The traditional theory of equitable taxation has two tenets. The first, horizontal equity, requires the equal treatment of equals. The second, vertical equity, calls for the unequal treatment of unequals. It requires those with a greater ability to pay to pay more. In the United States, efficiency has traditionally been weighed against equity in formulating tax policy. Neutral re-


830. Sneed, supra note 829, at 579; Musgrave, supra note 750, at 4 ("It is called for by the principle of equal justice under the law and is accepted as a value judgment or ethical axiom, not as a proposition of economic efficiency.").

831. Musgrave, supra note 750, at 4 ("Vertical equity calls for a meaningful pattern of differentiation between people in unequal positions, related to society's evaluation of various states of well-being."). The flat tax focuses on an ideal of ability to pay, which is to some extent divorced from traditional vertical equity concerns. See 1 TREASURY I STUDY, supra note 8, at 14-15. Vertical equity has a role in evaluating a double-tax system. Cf. 1 TREASURY I STUDY, supra note 8, at 15. See, e.g., Mundstock, supra note 1, at 1183 n.11 (vertical equity not used to appraise taxation of intangible business capital).

832. A competing view attempts to formulate tax policy entirely on efficiency grounds, although modeling efficiency throughout society is extremely difficult and cur-
fers to a bundle of concepts, including the avoidance of incentives for a tax-induced response without reason to prefer that response, transactional neutrality — the economic side of horizontal equity, and, under a free market economic perspective, a preference for an economy operating without governmental interference. The goal of simplicity is to limit compliance and enforcement costs.

1. Horizontal Equity

A determination of whether horizontal equity — equal treatment of equals — is violated by a tax proposal is problematic. Horizontal equity only applies to precise equals, and determining the degree to which horizontal equity is violated by any particular action is difficult. In formulating a tax policy position with recently imprecise. See Ballard, Shoven & Whaley, The Total Welfare Costs of the United States Tax System: A General Equilibrium Approach, 38 Nat’l Tax J. 125, 125 (1985). The economic efficiency of taxpayer responses does not reflect true economic efficiency unless it is assumed that investment and consumption decisions are made primarily on the basis of their economic rather than tax-benefit merits. See S. Rep. No. 313, 99th Cong., 2d Sess. 7-8 (1986). For a view of the problems of determining whether efficiency is better promoted by changing a narrow provision, rather than by a more comprehensive tax revision, see Mundstock, supra note 1, at 1183 n.14 (preferring adoption of the more modest neutrality criterion to avoid the problems associated with the efficiency criterion). See also 1 Treasury I Study, supra note 8, at 13, 18 (arguing that the least disruptive changes may be the most efficient).

833. 1 Treasury I Study, supra note 8, at 13; Mundstock, supra note 1, at 1183. Transaction costs are allocatively troubling. But see Gilson, Value Creation by Business Lawyers: Legal Skills and Asset Pricing, 94 Yale L.J. 239, 255 (1984)(arguing that lawyers are “transaction cost engineers, devising efficient mechanisms which bridge the gap between capital asset pricing theory’s hypothetical world of perfect markets and the less-than-perfect reality of effecting transactions in this world”) (emphasis in original). The cost of capital trade-offs for firms under the current regime of unlimited interest deductibility will decrease the cost of capital for firms that are equity financed and increase the cost of capital for firms that are debt financed, thereby increasing the incentive to issue equity rather than debt securities. Cf. G. Hatsopoulos, P. Krugman, & J. Poterba, Overconsumption: The Challenge to U.S. Economic Policy 26-27 (American Business Conference Working Paper, 1989)(Appendix IV presents the formula for evaluating this cost of capital phenomenon).

834. 1 Treasury I Study, supra note 8, at 13 (neutrality also requires uniform treatment of all sources and uses of income under a comprehensive definition of income). 835. See Mundstock, supra note 1, at 1183 n.14 (arguing that efficiency is greatest in the absence of government intervention).

836. 1 Treasury I Study, supra note 8, at 15-16.

837. Problems in defining the notion of horizontal equity generally have been viewed as problems of measurement rather than definition. See Kaplow, Horizontal Equity: Measures in Search of a Principle, 42 Nat’l Tax J. 139, 140-41, 146-48 (1989)(explaining the concept of horizontal equity through the tradition of the social welfare framework which horizontal equity attempts, at least in part, to reject).
spect to generally public and non-public firms, one must analyze the degree to which firms with liquid ownership interests are different from firms with illiquid ownership interests. The power rationale for the double tax set forth in section II.B.5. of this Article supports this horizontal equity argument by demonstrating the differences between such firms and their financial investor owners. Firms with liquid ownership interests traded in a public market may be different from firms existing in a private market for this and other reasons. 838 This fact was noted by the ALI Reporter in discussing his original proposal for the tax treatment of nondividend distributions.

There is a frequently reiterated intuition that perhaps the problems of public and private corporations are sufficiently different to merit different treatment. One needs to pursue that notion with care, of course, since any substantial difference in burdens on the two types might create its own set of distortions, inequities, and definitional problems in distinguishing between them. But still the idea should be explored. Often a private corporation itself provides the sole practical market for its shares; shares are purchased from the corporation and sold back to it, commonly at book value or some other formula price. 839

The literature studying asset deployment decisions finds a distinction between public and private firms in the initial decision to finance an entrepreneurial idea. In an important model, two finance economists, Salman Shah and Anjan Thakor, 840 validate the theory that the capital market risk-sharing opportunities provided by public incorporation are inherently superior to the risk-sharing opportunities available in the private firm. 841 They find

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A related problem is whether the entity to be taxed has an ability to pay. Several rationales suggest that firms have an ability to pay. See supra notes 341-45, 394-97 & 416 and accompanying text. Assuming that the incidence of the tax falls in part on the owners, who are appropriate taxpayers under a view of vertical equity, vertical equity considerations also support an ability to pay the tax at the firm level.

838. The advantages of public corporations have been viewed as a justification for the corporate tax based on the "access to nationwide, sometimes worldwide, sources of financing [through] the stock markets." See R. Paul, Taxation in the United States 425 (1954). See also supra notes 415 & 417-18.

839. See Reporter's Study on Corporate Distributions, supra note 54, at 485.

840. See Shah & Thakor, supra note 678 (Modeling a theory that public sale of equity is the preferred alternative when either capital market issue costs are low or the asset's idiosyncratic risk is high, and when the owner of the asset is either sufficiently risk adverse or sufficiently optimistic about the asset's expected return. As a result, those assets deemed most valuable by their owners will tend to be publicly incorporated.).

841. Id. 56-57. They posit that "the recent surge in LBO's resulting in private own-
that "the most productive assets in the economy will tend to be publicly owned and traded."\textsuperscript{842}

The public firm uses the market as a measure of the success of its investment decisions, whereas the private firm does not. Agency risks,\textsuperscript{843} which Louis Lowenstein\textsuperscript{844} has summarized as the inclination of managers to be less careful with another person's money than with their own, are also greater in public firms. Expropriation risks,\textsuperscript{845} the risk that the majority owner will expropriate all returns for herself, are greater in private firms. The ability to choose between consumption and savings regardless of choices by firm managers and the ability to borrow against liquid financial assets\textsuperscript{846} also support horizontal equity distinctions.

Analysis of investment decisions is also different in public firms,\textsuperscript{847} where managers view investment and production decisions on the basis of the market performance of their shares.\textsuperscript{848} Liquid ownership interests allow the firm managers, who may also be owners, to pursue firm policies without worrying about diversifying the specific investments of the firm. They need not worry

\textsuperscript{842} \textit{Id.} at 43 (emphasis in original). The fact that the best companies will become publicly owned is exhibited by the $3 billion sale of Triangle Publications, Inc., a private company, to be publicly owned by Murdoch News Corporation. See Scardino, supra note 686, \S 3, at 1, col. 2.

\textsuperscript{843} \textit{See supra} note 402.

\textsuperscript{844} L. Lowenstein, \textit{supra} note 164.

\textsuperscript{845} In owner-dominated firms, minority owners face the problem that, absent sufficient \textit{ex ante} contracting, the owners will expropriate all the firm's assets in the form of salary or other payments. For initial purchases of part of a business, a firm outsider will offer less and require a higher return out of a fear that the owner-operator will take more than her rightful share of the benefits of ownership.

\textsuperscript{846} \textit{See infra} note 894.

\textsuperscript{847} \textit{See} Diamond, \textit{The Role of a Stock Market in a General Equilibrium Model With Technological Uncertainty}, 57 Am. Econ. Rev. 759 (1967); \textit{see also} W. Baumol, \textit{The Stock Market and Economic Efficiency} 4 (1965)(the stock market is "the allocator of capital resources \textit{par excellence}" and the stock market provides essentially all the risk-pooling possibilities that could be provided); Arrow, \textit{The Role of Securities in the Optimal Allocation of Risk-Bearing}, 31 Rev. Econ. Stud. 91 (1964); Leland, \textit{Production Theory and the Stock Market}, 5 Bell J. Econ. 125 (1974)(finding that the essential role of the stock market is to determine production decisions under uncertainty and equilibrium output conditions involving both production (cost) and financial (market value) variables). \textit{But see} Stiglitz, \textit{On the Optimality of the Stock Market Allocation of Investment}, 86 Q.J. Econ. 25 (1972) (questioning the allocation of resources).

\textsuperscript{848} Tobin's Q theory is used by public firm managers to evaluate a potential firm's investment based on its effect on share price. \textit{See} Hayashi, \textit{Corporate Finance Side of the Q Theory of Investment}, 27 J. Pub. Econ. 261 (1985); Poterba & Summers, \textit{supra} note 66.
about diversifying the firm's investments because the underlying ownership of the firm can be diversified by shareholders individually holding diversified portfolios. Liquid equity allows the equity investment to be a monitoring device on firm managers and provides the necessary exit right for minority shareholders who no longer have to rely upon state law and other protections of their interests in the face of majority action.

Corporate governance perspectives are different in public, especially large public, firms and in closely held firms. Management perspectives on taxes may also differ. Financial accounting principles recognize that shareholder equity in private firms is different from shareholder equity in public firms. Ultimate disclosure may depend on shareholders' agreements rather than state law.

849. Portfolio theory suggests that firm managers should not diversify within the firm through conglomerate mergers since the shareholders can diversify more efficiently outside of the firm. However, one reason for firm managers to pursue mergers and diversification within the firm is that firm managers are heavily under-diversified, since their human capital is tied up with the specific firm through pension funds and salaries. The resulting diversification within the firm may be less optimal than that of the individual shareholders holding a diversified portfolio. Managerial underdiversification thus encourages goals other than shareholder wealth maximization.


851. See supra note 435. See also Romano, supra note 390, at 934 (defining corporation).

852. Public managers look at taxes from the corporate perspective only, whereas private managers look at taxes from the public, the private, the entity, and the ownership levels. W. Klein & J. Coffee, supra note 40, at 276. Accord R. Goode, supra note 10, at 197 ("managers of large corporations evaluate investment prospects primarily on the basis of the return to the corporation and only secondarily on the basis of the return to the shareholders"). To a certain degree, owner-controlled public firms can be viewed as an exception to this rule.


854. See L. Lowenstein, supra note 164, at 111 (few states require distribution of audited financial statements).
There is a growing literature on the going public decision. Closely held businesses that decide to go public do so to raise capital, to gain liquidity for existing stockholders, to command a higher price on their future sale due to the resultant increase in information on the firm, and to benefit from the exposure and prestige of being a public company. The capital thus acquired provides funds for expansion at a lower cost than financing from traditional lending institutions. Often, the choice to go public is

855. The literature is both theoretical and practical. Taking the company public enables the firm to raise significant new equity at a lower cost, place a higher value on the company, decrease restrictions on the company's operations, facilitate future financing, enhance the company image in the eyes of the investment community, create a competitive advantage over other companies in the same field, and enable the company to use public stock for stock option and stock purchase plans. Beinecke, Luger & Mitchell, Deciding Whether To Go Public: Certain Basic Considerations, in PRACTISING LAW INST., How To PREPARE AN INITIAL PUBLIC OFFERING IN THE CURRENT MARKET 9, 11-12 (1988). Disadvantages of going public include dilution of present management and sharing of earnings with public stockholders, increased disclosure requirements, offering expenditures, demands for dividend payments when dividends are not necessarily in the best interests of the firm, conflicts of interest between management and their fiduciary duties to the public shareholders, and of course, less favorable tax treatment. Id. at 13-16. Without a public offering only limited amounts of stock can be sold and an accredited investors standard would be applied. Id. at 16-17. See also ERNST & WHINNEY, DECIDING TO GO PUBLIC 1-10 (1984).

The theoretical literature focuses on both the choice to go public and the event itself. For a discussion of the choice, see Giammarino & Lewis, A Theory of Negotiated Equity Financing, 1989 REV. FIN. STUD. 265 (analyzing how the price is set when the firm issues new equity); Ritter, supra note 463 (analyzing the cost of going public in terms of direct expenses and underpricing); C. Barry, C. Muscarella, J. Peavy & M. Vetsuypens, Venture Capital and Initial Public Offerings (Center for the Study of Financial Institutions and Markets, Southern Methodist University, working paper no. 88-12, July 1988)(comparing venture backed initial public offerings with their non-venture backed counterparts). For a discussion of the event, see Tinic, supra note 610; F. Allen & G. Faulhaber, Some Like it Hot: Underpricing New Issues (University of Pennsylvania Fishman-Davidson Center for the Study of the Service Sector, Dec. 1987)(Certain entrepreneurs deliberately underprice their initial public offering because their subsequent performance will cause stock values to rise. When this occurs, the entrepreneur sells out at the higher market value thereby recouping the prior paper loss.); J. Ritter, A Theory of Investment Banking Contract Choice (University of Michigan Working Paper, Aug. 1988)(examines the relationship between underpricing and the informed/uninformed investor); Ibbotson, Sindelar & Ritter, Initial Public Offerings, J. APPLIED CORP. FIN., Summer 1988, at 37.


857. 1 G. ROBINSON & K. EPPLE, GOING PUBLIC 4-5 (2d ed. 1978). A variant on this is the ability to strengthen operations through the use of public funds to repay outstanding loans. Accord Barden, Going Public — What It Involves, J. ACCT., Mar. 1984, at 63, 63-64.
made either to survive in the industry or to avoid bankruptcy. Notwithstanding perceived inefficiencies in the capital markets, the growth of publicly traded limited partnerships to achieve effective utilization of corporate assets is an example of this phenomenon. When a firm reaches a certain size, in order to grow and compete effectively in its market, the choice between being publicly traded or being merged into another firm is validated by anecdotal and other evidence. A market for the shares also allows the shares to be used as incentive compensation to attract talented employees. The need for the public market is demonstrated by the use by takeover specialists of shell public companies to make hostile acquisitions. For the private buyout funds and venture capitalists, the public market is an easy route to exit from their investment should they choose to take the firm public or sell to a public firm.

A public market is also of benefit to the continuing owners.

858. See, e.g., the Smuckers Co. described at infra note 862.
859. For example, Frost Bros. Inc., which operates high-fashion specialty stores was purchased in a $40 million leveraged buyout from Manhattan Industries. Subsequently it was offered for sale when it found itself short of cash and unable to raise revenue from traditional sources. While the company needed capital it could not go to the public market with a stock offering because the October of 1987 stock market crash made the offering virtually impossible. Thus, the strategy was to sell some of the assets of the firm and to keep the more profitable divisions. Schnitt, Frost Searching for Buyer, Austin American-Statesman, Mar. 25, 1988, at C1, col. 1. Frost Bros. decided in the end to solve its financial problems by reorganizing under Chapter 11. Schnitt, Frost Bros. Petition Lists 3,000-plus Creditors, Austin American-Statesman, Apr. 21, 1988, at F1, col. 3.
860. See, e.g., Margotta, Distorting Corporate Investment, N.Y. Times, Sept. 27, 1987, § 3, at 2, col. 3 (arguing that diverse corporate operating strategies are beneficial to the market but that increasingly large investors are forcing uniformity upon corporations and hostile takeover is the price of noncompliance.).
861. Going public proved useful for liquidation MLPs and roll-out MLPs. It is also a rationale for acquisition MLPs. See Turlington & Beeson, supra note 51.
862. 1 G. ROBINSON & K. EPPLER, supra note 857, § 4, at 11-12. For example, Smucker's had the choice in the 1960s of being merged into a larger firm through a sell-out of the family business to the highest corporate bidder or selling enough shares to raise the needed cash without loss of control. The company opted for the latter course of action and has been listed on the New York Stock Exchange since 1965. Of Jams and a Family, N.Y. Times (Magazine), Nov. 15, 1987, § 6, at 82, 88.
863. Id. To the extent tax preferred alternatives such as ESOPs are present, the value of the public market for shares may be discounted.
864. C. BRUCK, supra note 319, at 110, 120 (noting the need for a public company to use for acquisitions).
865. See infra note 1039.
Under current law, when equity prices become attractive, management can (with few transaction costs) choose to absorb equity by marketplace repurchases, thereby increasing the net worth of the remaining shareholders without incurring the taxation of a dividend distribution. Another difference between publicly traded and nonpublicly traded ownership interests is that publicly traded interests can be used by the firm for acquisitions by merger and other reorganizations. “By using stock in lieu of hard earned after tax profits, the aggressive company may be able to buy up competitive or supplementary companies.” Indeed, current structural provisions of the classical system may put a premium on that form of acquisition.

Public status generally allows firms to borrow on more favorable terms and with fewer restrictions than nonpublic companies. The increased equity that public participation provides creates a stronger balance sheet and motivates lenders to make larger loans. While public debt placed by private firms is not unknown, public firms have access to the market for the issuance of debt. Moreover, publicly traded debt is viewed as less risky than nonpublicly traded debt due to its presumed liquidity.

In a general sense, the efficient operation of a market for equities has “helped bind the corporation, an organization ostensibly
operating only in the world of real resources, to the quite different world of credit and finance."873 Access to world-wide capital markets is not to be understated. An international interdependency of capital markets is predicted for the future, and may be a reality at present as evidenced by the ripple effect of Wall Street's Black Monday.874

The different systems for private and public stock may also be based on a difference between the manner in which private firms and public firms are valued.875 However, this difference has


It has created an incentive for financial institutions like banks to list themselves on exchanges; for private firms of all kinds to go public, including brokerage houses and advertising agencies that had always been closely-held; for mutual savings and loan associations to change gender and become business corporations, enabling depositors (and others) to enjoy new values created by the stock market.

Id. at 406-07 (footnotes omitted). In short, the stock markets changed the nature of corporate production and the creation of investor wealth.


There are numerous country funds in the United States capital market, such as the Japan Fund in the 1960s, the Mexico Fund in the 1970s and more recently, the Korea Fund, the Australia Fund, the Italy Fund, the Indonesia Fund, and the Scandinavian Fund. Transaction costs, information costs and legal restrictions are overcome by a dual listing of a firm's securities on foreign capital markets, with attendant asset-pricing adjustments. Alexander, Eun & Janakiramaman, Asset Pricing and Dual Listing on Foreign Capital Markets: A Note, 42 J. FIN. 151 (1987).

875. See L. Lowenstein, supra note 164, at 140-41 (distinguishing valuation of private firms from public companies). This approach builds on the view of Graham and Dodd. See B. Graham & D. Dodd, Security Analysis 484-85 (3d ed. 1951).

The "going private" transactions in the 1970's were feared to have had a negative impact on minority shareholders and to have presented opportunities for managerial self dealing. Compare Brudney & Chirelstein, A Restatement of Corporate Freeze-outs, 87 YALE L.J. 1354, 1371 (1978)(All going-private transactions should be prohibited because they involve only the rearrangement of ownership of the single operating entity and provide no significant productive benefit to offset the threat of managerial self dealing. Brudney and Chirelstein would permit parent-subsidiary transactions effected at a "fair price" because such transactions involve the combination of two operating entities and thus include the possibility of productive gain) with DeAngelo, DeAngelo & Rice. supra note 502, at 368-69 (going private transactions did not result in unfair treatment for minority shareholders).

On the other hand, private ownership avoids the cost of public ownership and thus leads to savings for the firm. See supra note 503. The DeAngelo, DeAngelo and Rice study notes that some publicly held firms will find it cost effective to go private. DeAngelo, De-
narrowed since firms targeted for acquisition are now valued for their cash flow. Ultimately, the value of liquidity, detailed in Part III.A of this Article, demonstrates a difference in the profits that are generated by public and private firms so that a properly measured profits tax maintains horizontal equity. Many of the characteristics that support horizontal equity also support the creation of pure profits for firms in the public market in addition to and in part because of the value of liquidity to equity owners.

2. Vertical Equity

A tax on the profits of firms with liquid ownership interests is also validated on vertical equity grounds. Generally, corporations account for over eighty percent of total business receipts, and corporations are the principal vehicle of personal wealth-holding, both directly and through institutional investments. Entry to

Angelo & Rice, supra at 502. Recent history with investment banking proves this point. In some recent transactions investment bankers have chosen share repurchase programs to lower their capitalization while remaining public, or have planned to merge with private firms. See Wayne, First Boston's Lesson for the Street, N.Y. Times, Sept. 4, 1988, § 3, at 1, col. 2. A decision to go private does not necessarily foreclose a future decision to go public again, and cash in on increasing market and firm values. Id.

It appears that the valuation process used for private firms simply aggregates the values of the specific assets of the firm and that the valuation process used for public firms proceeds differently. See Booth, supra note 44, at 1640-43.

876. See supra notes 144 & 173.

877. See L. Lowenstein, supra note 164, at 88. These corporations are not necessarily public. Scherer, Corporate Ownership and Control, in The U.S. Business Corporation 43, 44-45 (J. Meyer & J. Gustafson eds. 1988) (asserting that most of the 50,000 largest corporations defined as those with receipts greater than $10 million based on 1982 returns are private since the Compusat records for 1985 only showed 6,500 "public firms," a statistic that does not reflect the non-NASDAQ/NMS and Pink Sheet market). See also Clark, supra note 446, at 568 (first stage capitalists who are direct owners comprise a small, elite group of wealthy persons, and stage two capitalists, the 25 million individual shareholders, are also "distinctly upper class").

The NYSE's eleventh survey of shareownership, conducted in mid-1985, revealed record growth in the number of Americans who own stock. NYSE, Fact Book 56 (32d ed. 1987) [hereinafterFact Book]. The NYSE estimated that 133 million individuals owned stock indirectly by year-end 1980. This represented an 11% increase from 120 million in 1975. Id. at 59. After an increase of 10.1 million shareholders between 1981 and 1983, 1984 and 1985 yielded another impressive gain of 11%, for an increase of 4.68 million shareholders. Id. at 56. Shareowners' median age in 1985 was 44 years — a decline from previous years even though the national median had been rising steadily. Shareowner household income rose from $33,200 in 1983 to $36,800 in 1985 while the national median rose from $20,200 to $22,400. Id. at 57. The total number of shareholders in 1985 was 47 million, up from 32.8 million in 1981. There were 25,000 more women than men owning stock in 1985, while in 1983, there were 1,159,000 more women than men in the stock market. Id. 19,854,000 shareholders had four years or more of college (the highest concent-
the public capital markets creates great value for entrepreneurs. Some find that "the most persuasive of all reasons for going public is the desire of the owners to gain an immediate increase in their personal wealth." Wealth enhancement occurs because the ownership interest is offered to the public at a price that is higher than could be obtained if a comparable part of the business had been sold privately. Evidence on the underpricing of initial public offerings, the long term lower returns of new issues, and other inefficiencies does not change this analysis. Evidence of the lack

878. Publicly traded stock plays a large role in savings as witnessed by the large institutional holdings of publicly traded firms. It is estimated that by the year 2000, over one-half of the publicly traded stock in the United States will be owned by pension funds. $60 Billion in the Balance, N.Y. Times (Magazine), Mar. 27, 1988, § 6, at 17. In the Blume and Friend data, domestic pension plans constituted 68% of the investors with over $2 billion in common stocks and 36% of the investors with between $100 million and $2 billion in common stocks. M. Blume & I. Friend, supra note 462, at 5 (data from survey of institutional investors).


880. An extreme example of wealth enhancement occurred in the investment banking industry. For example, in the period 1970-1987, there were 37 initial public offerings of investment banking firms that were self-marketed during "bull" equity markets. C. Muscarella & M. Vetsuypens, A Simple Test of Baron's Model of IPO Underpricing 5 (Southern Methodist University Working Paper No. 87-14, Oct. 1987). Restrictions on sales after an initial public offering are typical since bailouts of owners are viewed by the public and the underwriters as suspicious and thus underwriting agreements typically limit the amount of securities that the owners may offer in a secondary offering to the public for their own accounts. 1 G. ROBINSON & K. EPPLER, supra note 857, § 2, at 7 (bailout is suspect if the owners sell more than 30-35% of their own stock). For those firms in which the owners are precluded from selling their shares after the initial public offering the wealth is only on paper. Wallace, Investment Firm Seen in Offering, N.Y. Times, Mar. 5, 1988, § 1, at 35, col. 3 (the lapse of the two year restriction on Morgan Stanley inside shareholders will allow them to finally cash in on the wealth enhancement from going public). For some, the continued value of public trading is mixed. See Wayne, First Boston's Lesson for the Street, N.Y. Times, Sept. 8, 1988, § 3, at 1, col. 2 (detailing First Boston and other investment banking firms finding the public arena less attractive despite previous public offerings). Firms can also find replacements for capital by closer ties to financial institutions. See Eichenwald, Investment Firm Stake by Met Life, N.Y. Times, May 4, 1989, at D1, col. 6 (after going private merger of First Boston with Credit Suisse, Metropolitan Life Insurance Co. became a ten percent shareholder).

881. See R. ALTMAN, CREATING INVESTOR DEMAND FOR COMPANY STOCK 67-109 (1988) (detailing method for increasing firm value through public equity offering). 1 G. ROBINSON & K. EPPLER, supra note 857, at 7-8 (public values the past profitability and future growth which is returned to the founders as a "premium" for past work and demonstrated skills). Of course, private sales are also possible.

882. The IPO market allows entrepreneurs to capitalize their businesses in a market that is argued to be not efficient. In criticizing the S.E.C.'s adoption of Rule 19c-4 which allows a new issue of stock in a company to deviate from the one share one vote concept, Louis Lowenstein evaluated the new issue market as the least efficient of the securities markets as compared to the secondary trading market due to the relatively small volume of
of diversification by individuals and institutions also does not

shares, the lack of a prior market, high commission and transaction costs, a limited number of informed participants, and the lack of research in a “market of this manic-depressive quality.” See Lowenstein, Response, supra note 683, at 990-95 (“We have long believed in the United States that the new issue market, far from being one of the most perfect markets, is one of the least perfect.”). The IPO market is argued both to under-price new issues, allowing the original outside investors who have been favored with a portion of the initial distribution an almost assured gain, and to over-price new issues due to the fact that a very high percentage of these firms fail to offer superior market-adjusted returns. See id. at 996-99 (insiders are usually precluded in the underwriting agreement from selling their shares for a specified one or two year time period). The evidence of underpricing leading to excess returns on initial public offerings, see, e.g., Ritter, The ‘Hot Issue’ Market of 1980, 57 J. Bus. 215 (1984), has been explained in many ways including the superior knowledge of investment bankers leading to the optimal contract involving underpricing, see, e.g., Baron, A Model of the Demand for Investment Banking Advising and Distribution Services for New Issues, 37 J. Fin. 955 (1982), informed investors crowding out uniformed investors, see, e.g., Rock, Why New Issues Are Underpriced, 15 J. Fin. Econ. 187 (1986), underwriters building up their reputations, see, e.g., Gilson & Kraakman, supra note 597, at 619-21, or providing insurance, see, e.g., Tinic, supra note 610, and quality signalling by entrepreneurs with superior knowledge through underpricing, see, e.g., F. Allen & G. Faulhaber, supra note 803, or by selling a smaller than optimal amount of ownership, see, e.g., Leland & Pyle, Information Asymmetries, Financial Structure, and Financial Intermediation, 32 J. Fin. 371 (1977), or a combination of both in the face of risk adverse issuers known to investors, see, e.g., Grinblatt & Hwang, Signalling and the Pricing of New Issues, 44 J. Fin. 393 (1989). This evidence has been interpreted as a means to entice investors in a high transaction cost investment which translates into large underwriting fees. See Lowenstein, Response, supra note 683, at 995 (analogizing the selling of IPO new issues to “watching a pitchman playing ‘three card monte’ on the streets of New York”). To be sure, the assertion that underpricing is the result of the desire of investment banker exercising a monopoly power in the underwriting of small, start-up, and speculative firms to favor institutional and preferred clients with sure profits is disputed. See Tinic, supra note 610, at 791-92, 795-97 (demonstrating that from evidence of the excess returns both before and after the Securities Act of 1933 and the lesser excess returns for underwritings by prestigious underwriters that the underpricing of new issues operates as a form of insurance to the marketplace for IPOs). Nonetheless, the long-term, market-adjusted return failure rate is documented by a recent study showing in a sample of 1500 companies going public in 1975-1984 that after a two year period the average issue had underperformed the market average. See Lowenstein, Response, supra note 683, at 996 (citing J. Ritter, The Long Run Performance of Initial Public Offers (Univ. of Mich. Bus. School Working Paper, Nov. 1988)). The evidence on the lack of efficiency in the marketing, initial pricing, and after trading does not change the analysis here as to the value of liquidity unless the trading factor of liquidity is not represented to be present or other indices of the lack of efficiency in the anticipated secondary market trading are present. Liquidity concerns lead industry analysts to predict that for 1989 issues will not be salable unless they have a $10 to $15 million float. Markowski, New Stock Offerings Set for Rise This Year, THE REUTER Bus. REP., BC Cycle, Jan. 19, 1989. The representation as to liquidity allows a market capitalization, even if the process by which that market valuation is achieved is argued to be less efficient due to the small number of informed participants and the moral hazard risks due to the nature of those informed participants. It is the assurance of the secondary market trading which gives liquidity its value, even if the process by which secondary market access is made is less than efficient and the initial pricing is less efficient than secondary market
change the analysis.\textsuperscript{883}

The distributional evidence of the corporate tax incidence analysis shows that if at least half of the corporate tax burden falls on shareholders or capital, then the corporate tax will operate as a progressive element within the income tax structure.\textsuperscript{884} If the incidence analysis is accepted, then the assumption that corporate taxes are correlated with income levels supports the tax on vertical equity grounds.

pricing. Liquidity in the IPO directly translates into the lack of the need for restrictive agreement such as would occur in venture capital financing. The questions about the IPO market as an efficient market — even though there is evidence of the belief that it is efficient and is played by fully informed participants — does not change the analysis here as to the value of liquidity. The lack of efficiency in the market and the fact that profits in the after market are available precisely because of liquidity means that the value of liquidity should be high. For firms that are successful, the IPO allows the entrepreneur access to funds, even though the initial offering price is low relative to the immediate after-market trading, and the nature of liquidity allows investors to exit a risky stock quickly.

IPOs are a small segment of the market as a whole. See Lowenstein, \textit{Response, supra} note 683, at 993-95. Dollar volume for 1987 was $24 billion and for 1988 $23.9 billion, but there were 552 issues in 1987 as compared to 287 in 1988. Investment banking spreads are from 3 to 6 or 6\% percent on equity and 1 percent on debt. Markowski, \textit{supra}. For the importance of information announcements of the timing and pricing of new equity issues under the presumption that insiders have superior knowledge in predicting when firms will issue equity, see R. KORAJCZYK, D. LUCAS & R. MCDONALD, \textit{The Effect of Information Releases on the Pricing and Timing of Equity Issues: Theory and Evidence} 1-3, 24, 34-35 (National Bureau of Economic Research Working Paper No. 2727, 1988)(finding that since smaller firms have less information generally, they theoretically should and empirically do wait for fresh information announcements). Limited partnerships have replaced IPOs as the primary financing vehicle for new businesses (over 60 percent in real estate, oil and gas, leasing, and cable television). Investment Partnership Ass'n, Investment Partnership Ass'n Study Findings 2-3 (1989)(found in full text in the Tax Notes Microfiche Database Doc. No. 89-2308)(partnerships also surpassed equity mutual funds). This does not change the analysis as to the value of liquidity in the IPO equity market for firms that are not traditionally financed by partnerships in asset specific and other businesses.

\textsuperscript{883} See \textit{supra} note 475.

\textsuperscript{884} J. PECHMAN, \textit{Who Paid the Taxes, 1966-85?}, at 31-33, 36-37 (1985). Imputing all of the corporate tax to be distributed to income classes under this incidence analysis may be incorrect since perhaps only the double tax element, not accounting for the value of deferral, should be imputed. However, the 1986 Act eliminates, except for small firms, a deferral value, so that the entire amount should be allocated. Questions of allocating the distribution and imputing the tax to the upper income group who are the owners of liquid assets through pension plans and other institutional holdings arise. \textit{Compare} J. PECHMAN, \textit{supra}, at 15-16, 39-40 (capital income received by nonprofit institutions and pension funds explicitly ignored in imputing taxes on corporate income) with Feldstein, \textit{Imputing Corporate Tax Liabilities to Individual Taxpayers}, 41 \textit{Nat'l Tax J.} 37, 43-45 (1987)(imputing all corporate level taxes to the corporate sponsor of the plan under a defined benefit analysis since information on defined contribution plans, which are about one-third of all plans, is not available and it is a distortion under the Pechman approach not to account for taxes borne by pension plans in some way).
Drawing the double tax line at firms with liquid equity that are generally publicly held is also supported by the financial characteristics of high income families and holders of net wealth. Survey data shows that families increase their relative holdings of financial assets (other than demand deposits and businesses) as their income rises. Real estate is the largest single asset held by

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885. The research on the current wealth of high income families is limited. For one of the few recent studies, see Avery & Elliehausen, Financial Characteristics of High-Income Families, 72 Fed. Res. Bull. 163, 165-67 (1986) (tabular data showing various characteristics of high income families).


Updated estate tax data for 1982 shows that for wealthholders with assets of $1 million or more, corporate stock constitutes 38.5 percent of their assets, compared to 24.6 percent in real estate. For wealthholders with assets of more than $500,000 and less than $1 million, real estate is 41.6 percent and corporate stock is 20.1 percent. See Schwartz, Estimates of Personal Wealth, 1982: A Second Look, Stat. Income Bull., Spring 1988, at 31, 32 (figure C). The inelasticity of demand for liquidity is demonstrated by these top wealthholders. For wealthholders with assets over $500,000 and less than $1 million, cash is 10.5 percent of assets and bonds are 4.8 percent. For wealthholders with assets of $1 million or more, cash is only 6.5 percent of assets and bonds are 9 percent. That is, while the percentage of cash decreases, the percentage of liquid cash plus bonds remains approximately the same.

Other studies show that tax policy impacts vertical equity since most corporate equity is owned directly or indirectly by the wealthy. See Summers, supra note 8, at 105 (estimating that about 75% of all stock is held directly by individuals and about half of this figure belongs to families with incomes in the top 1% of the income distribution nationally). The remaining stock is mostly held by pension funds, foreigners, and insurance companies. Ownership by pension funds results in ownership by the affluent but the consequences of ownership by insurance companies and foreigners are less than clear. Id. at 105.

Melvin Eisenberg studied the concentration of shareholders in 1976 and found a very high degree of ownership among a relatively small number of top wealthholders. M. Eisenberg, The Structure of the Corporation 52-53 (1976). Eisenberg cites 1962 data to find a high degree of concentration of shareholders, presumably public, among a relatively small number of wealthholders. Id. (71% owned by individuals with assets over $250,000, 53% with assets over $500,000, and 40.5% with assets over $1 million).

887. Avery & Elliehausen, supra note 885, at 170-71. Fewer than fifty percent of families with incomes between $50,000 and $99,999 own publicly traded stock directly. Id. at 170. Publicly traded stock makes up a relatively smaller portion of their portfolio than it does for families as income rises. The top 0.05% of the income distribution hold 43% of their assets in publicly traded stock and the top income levels of $280,000 or more hold 20% of their assets in publicly traded stock. Id. at 171. The diversification of portfolios increases as income level increases. "[T]he majority of families with incomes of $100,000 or more that own stocks have shares of five or more companies in their stock portfolios." Id. at 171. In addition, stock trading activity increases with income levels. Id. at 171-72. In
all top wealthholders with assets in excess of $300,000, but for millionaires corporate stock is the largest portion of their portfolios, although this composition is changing and should continue to change to the extent that the wealthiest individuals invest in buyout funds and real estate is less favorably taxed. These characteristics of high income families suggest that double taxation of publicly traded interests will maintain vertical equity.

Perhaps not surprisingly, liquidity preferences for demand deposits and risk aversion in high income families decrease with income level. At the higher income levels, as compared to the population as a whole, families are willing to trade risk for return. The presence of higher risk investment opportunities coupled with liquidity allows high income families to maintain a diversified portfolio more easily and at a higher rate of return than they otherwise could. Stock market equity is also believed to be held by individuals with a wide variety of other assets in their portfolios. Households with liquid assets that suffer income reverses reduce their consumption spending less than households without them. This suggests that at some point liquidity provides a basis for consumption choices and the tradeoff between current and future consumption, which is presumably greater for wealthier households. Evidence on the individual portfolio responsiveness

this same 1986 survey of high income families, a surprising characteristic was noted: those with family income between $150,000-$279,999 "have an anomalously high share of their assets invested in business." Id. at 167. The characteristic is probably traceable to "the extremely large business holdings (more than $300 million)" of this group. Id.

888. Schwartz, supra note 886, at 3. However, between 1976 and 1982 "[c]orporate stock declined from 42 percent to 31 percent of the assets, and real estate rose from less that 15 percent to nearly 24 percent of the assets." Id. "While noncorporate business assets were less than 4 percent of millionaires' assets in 1976, their share increased to 10 percent in 1982." Id. This is reflected in the 222 percent increase in the value of partnership assets. Id.

889. Avery & Elliehausen, supra note 885, at 168 ("More than two-thirds of high income families but only 38 percent of the population as a whole reported being willing to tie up money for an intermediate or long period of time to earn higher returns.").

890. This behavioral insight was noted by Avery & Elliehausen, supra note 885. On the other hand, evidence suggests that there are higher returns in various sectors. Id. at 175 (families headed by entrepreneurs and by individuals in banking, insurance, and real estate are more likely to earn the highest incomes).


892. I recognize that the Friedman-Savage utility function will find that individuals will trade consumption for savings relative to their budget constraints. See R. BOADWAY & D. WILDASIN, PUBLIC SECTOR ECONOMICS 64-65, 216-19 (2d ed. 1984). The Friedman-Savage function also supports the inelasticity of demand for liquidity for individuals on lower budget constraints. Assuming, however, that the marginal utility from consumption
between long term debt and equity, both of which exhibit liquidity characteristics, does not affect an underlying preference for high yielding liquid assets.\footnote{883}

Liquid corporate equity securities also have value as collateral for margin and other debt.\footnote{884} While shares in private firms have great value, to the extent that they are illiquid or subject to restrictions on transferability, their value as collateral is limited.

3. Economic Efficiency and Neutrality

Neutrality is served by a tax proposal that is the least disruptive to the existing system and that does not significantly alter taxpayer behavior.\footnote{885} For example, the neutrality objection to the decreases with income the risk-return savings choice for individuals at the highest wealth levels may not reflect as great a liquidity premium.

\footnote{893} Individual portfolios show a sluggishness in responding to market based changes, which is consistent with a demand for a means of payment and the presence of transaction costs. See Friedman, The Substitutability of Debt and Equity Securities, in \textit{Corporate Capital Structures in the United States} 197, 206-14 (B. Friedman ed. 1985). Modeling of portfolio choices shows the substitutability of long term debt for equity in individual portfolios, \textit{Id.} at 205-30 (utilizing mean-variance portfolio theory to explain asset portfolio choices). \textit{But see Corporate Capital Structures in the United States} 233-38 (B. Friedman ed. 1985) (comments by Gary Smith indicating that long term debt was modeled as a riskier asset than it is). Other evidence also based on portfolio theory shows an increasing correlation between bond and stock returns and risk premia. See Bodie, Kane & McDonald, \textit{Risk and Required Returns on Debt and Equity}, in \textit{Financing Corporate Capital Formation} 51, 53-63 (B. Friedman ed. 1986).

\footnote{894} Margin debt is defined as leveraged speculation on credit in securities or commodities with the securities or commodities acting as collateral and is regulated by the Federal Reserve Board. See Note, \textit{SEC Rule 10b-16 and the Regulation of Margin Credit}, 87 \textsc{Yale L.J.} 372, 372 n.5 (1977). For a discussion of margin requirements and marginable stock, see \textit{supra} note 319. At the time of the market break, the amount extended by broker-dealers through margin accounts was significant. Twenty-five broker-dealers contacted by the S.E.C. reported credit extended in securities accounts in excess of $31 billion, with margin calls of $1.6 billion, $1.5 billion, and $1.1 billion on October 19, 20, and 21, respectively, with liquidations of securities in margin accounts of $293 million, $426 million, and $327 million on those respective days. Market Break, \textit{supra} note 575, at 5-12 to 5-13.

In 1987, corporate equity securities of individuals totalled $2,106.8 billion, including $409.1 billion of mutual fund shares. Board of Governors of the Federal Reserve System, Flow of Funds Accounts of Financial Assets and Liabilities Year-End, 1964-87, at 6 (1988). Equity in noncorporate businesses was $2,371.5 billion. \textit{Id.} The amount of individual household security credit which presumably was margin debt was $49.7 billion. Other debt for which corporate securities could be used as collateral totalled $183.2 billion, made up of $47.4 billion of bank loans, $87.4 billion of other loans, and $48.4 billion of other mortgages. \textit{Id.} In addition, there was $78.2 billion in tax-exempt, installment, and other consumer debt. To the extent that favorable tax treatment and leverage is still available to corporate recipients of dividends, the liquidity of the investment also indicates separate wealth.

\footnote{895} This tax policy is sometimes expressed as the theory of second best, and is akin
single taxation of publicly traded partnership income was that publicly traded partnerships were accessing capital at the same cost and providing the same benefits as were firms subject to double taxation, even though the publicly traded partnership equity returns were analogous to the returns on high yield debt (junk bonds) and even though the same projects could have been financed with retained earnings.896

Optimal tax theory efficiency analysis (discussed in section VI.B of this Article) suggests that public firms subject to double taxation on profits will suffer a loss of liquidity or capital corresponding to the extent that the demand for and supply of liquidity are inelastic. If double taxation creates a loss, the relative returns in the liquid versus illiquid sectors will be in disequilibrium; and under the Harberger assumptions, capital will flow to the illiquid sector. If capital flows to the illiquid sector, then the result of lowering the return for public equity may be the release of capital for start-up and risky firms as well as other firms in the private market. To the extent that the profits tax proposal lowers the tax barrier to both incorporation and the going public decision, efficient risk sharing in the public market and its capital raising advantages are promoted.897 The explanation of the effects of this form of taxation depends upon assumptions concerning capital risk preferences and capital deployment mobility that are common in general and partial equilibrium models, the recognition that there are alternative nonbusiness investments such as real estate, and the recognition that loss offset provisions may be the key to investment in risky firms.898
It may be argued under more traditional efficiency analysis that double-taxing only those firms whose ownership interests are traded on a liquid market will interfere with economic efficiency by discouraging the formation of new firms financed with liquid equity. To the extent that all existing firms with liquid ownership interests that do not produce passive income as publicly traded partnerships are already subject to the double tax, however, adopting a liquidity standard would cause limited disruption. Disruption will also be limited if it is true that only limited amounts of capital can be raised without offering liquidity. If income and new firms without income to offset start-up losses, and creates a preference for conglomerates over undiversified firms. See Campisano & Romano, *Recovering Losses: The Case for Full Loss Offsets*, 76 NW U.L. REV. 709, 719-30 (1981). For a nontechnical explanation of the assumptions of and some limitations on general equilibrium modelling, see H. Rosen, supra note 726, at 282-88.

Cf. Verbit, *Taxing Wealth: Recent Proposals from the United States, France and the United Kingdom*, 60 BOSTON U. L. REV. 1, 14 (1980) (French Commission rejection of wealth taxation that would apply to public but not nonpublic shares on grounds of inhibiting firms from going public at the time the government was trying to build the equity market).

899. Equity financing is the preferred mechanism for new firms. Studies show, however, that only about five percent of all possible investments are ultimately funded by venture capitalists. B. Mokry, supra note 738, at 25. The creation of a supportive entrepreneurial environment goes beyond tax policy. A supportive informational and resource network and a strong management base are also necessary. See JOINT ECON. COMM., 98TH CONG., 2D SESS., THE U.S. CLIMATE FOR ENTREPRENEURSHIP AND INNOVATION (Comm. Print 1984).

Informal venture capital sources are also available for limited amounts of funds. See REPORT OF THE PRESIDENT, THE STATE OF SMALL BUSINESS 79-80 (1987). For financing patterns of small business, see id. at 65-103. The existence of Small Business Investment Companies (SBICs) and direct public investment helps new firms that are frequently undercapitalized and heavily indebted. Venture capital "has risen dramatically [from its pre-1979 level] when the top tax rate on capital gains dropped from 49% to 28% .... By 1986 the total amount of venture financing disbursed by individuals and institutions was more than five times what it was in 1978, and the volume of new venture commitments made in 1986 was more than seven times the 1978 level." B. Friedman, *Day of Reckoning* 268 (1988). For the view that individuals are the small venture capital investors even if the capital gains differential is restored, see Brophy, supra note 757, at 121-28. In 1978 total venture capital disbursement was $600 million compared to $82 billion of net business investment. By 1986 venture capital had grown to only $3 billion out of a net investment total of $81 billion. The effect of individual tax rates is also suspect. By 1986 individuals provided just 12% of venture capital financing, other taxable investors provided 33%, with tax exempt institutions providing more than half of the financing. Business incorporations are also small, suggesting that while venture capital may provide a crucial catalyst for the introduction of advanced production technologies, the 1980's tax measures probably were not supportive of start-ups. See B. Friedman, supra, at 269. Financing decisions for entrepreneurs also rely on the availability of venture capital which has increased from $250 million in 1975 to $1 billion in 1980. See Backman, *Entrepreneurship: An Overview*, in *Entrepreneurship and the Outlook for America* 3, 21 (J. Backman ed. 1983).
portfolio allocations or total savings are responsive to rates of return, the supply of funds to the corporate sector is likely to be highly elastic.\textsuperscript{901} There is evidence that portfolio composition responds to net after tax returns to individuals.\textsuperscript{902} However, even if new taxes on equities lower the after tax returns to existing equity holders, there is still no alternative to common stock with the same return characteristics. The lack of any alternative liquid investment with the same characteristics suggests that taxation will not change the demand for assets. This argument, of course, assumes that there is not a more favorable tax substitute, such as high yield debt with the same return characteristics. If a substitute investment exists, there is a stronger argument for neutralizing the distinction between equity taxed as debt and equity taxed as equity.

Increased equity formation in private and high risk ventures

\textsuperscript{901} The public market at some point becomes a necessity as a source of capital. \textit{See id.} at 21 ("In time the initial funds raised prove to be inadequate and it is necessary either to 'pass the hat' again among the original investors or go public.") Many small companies use regional investment banks for their first public offering because these companies have little or no track record and are too small to interest the large Wall Street investment banking houses. The public market is also an attractive exit route that attracts venture funds. Brophy, \textit{supra} note 757, at 128 ("Going public . . . is an attractive exit route or source of investment liquidity for the entrepreneur, the venture capitalist, and the ultimate investor.").

Reallocation of economic resources through leveraged buyouts and stock repurchases is believed to lead to the formation and flow of capital to more risky enterprises. The argument for debt financed transactions supported by Michael Jensen is that it promotes efficient allocation of capital investment by allowing shareholders who receive buyout payments to invest them in growing companies starved for capital. This presumes that these investors will continue to save rather than consume and that they will also be willing to save in a riskier segment. \textit{See} Jensen, \textit{supra} note 116, at 25. There is no real evidence that the released capital goes to growing companies. \textit{See} Uchitelle, \textit{Pushing the Stakes to New Heights}, N.Y. Times, Oct. 30, 1988, § 3, at 1, col. 3. New equity financing has not increased. "Even if the shareholder whose stock is bought out immediately reinvests the proceeds in some other company's stock, his doing so only amounts to buying the new 'investment' from some other shareholder who is willing to sell it. In the absence of new stock issues by at least some companies, the only way the corporate sector as a whole can get the money back is to earn it in profits over time (without paying it back out as dividends) or to borrow it." \textit{See} B. Friedman, \textit{supra} note 900, at 265. A tax policy that favors new equity formation in smaller less liquid businesses should aid the flow of funds to the venture capital industry. If liquidity preferences reflect different attitudes toward risk, a liquidity-based bright line should promote equity savings in the illiquid sector.

\textsuperscript{902} \textit{See} Summers, \textit{supra} note 8, at 114. Empirical studies show that portfolio allocations are sensitive to tax considerations. \textit{See} Feldstein, \textit{supra} note 884. Savings elasticity estimates range from zero to 0.8 and are 0.4 for most calculations. \textit{See}, e.g., C. Ballard, D. Fullerton, J. Shoven & J. Whalley, \textit{A General Equilibrium Model for Tax Policy Evaluation} 28-29, 138 (1985)(using Boskin's 0.4 elasticity).
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may lead to an increase in wealth for entrepreneurs, with a possible attendant distortion of vertical equity, but it also increases efficiency. It is precisely this trade-off between equity and efficiency that occurs when vertical equity redirects wealth from savers in less risky ventures to those in more risky ventures. Vertical equity is preserved to the extent that the tax applies only when entrepreneurs or their venture capital suppliers "cash in" their investments.

The risk of bankruptcy resulting from the preference for debt financing has many facets. Finance theory in a weighted cost of capital approach posits that the optimal capital structure will be derived from the cost of capital preferences. An increase in the level of debt financing causes the level of risk to debt holders to increase and causes them to demand a higher interest rate. When the risk return preferences of equity holders are taken into account, the risk of debt financing causes the cost of capital to be higher for a firm that is entirely financed by debt than for a firm that is financed by a mixture of securities. When taxes are taken into account, the optimal mix of securities again changes as the payers and recipients adjust their after tax return expectations to reflect taxes. The tax system then is not neutral as to a firm's chosen form of financing and it favors debt financing where, as under the current system, interest is deductible and interest recipients are in a lower tax bracket than the firm. In other words, the tax system affects the risk return calculation.

A tax that is neutral regarding the choice between debt and equity financing should be preferred over the current system, since the benefits and dangers of favoring one form of financing over the other are unclear. The argument for favoring debt financing is

903. See supra notes 877-94 and accompanying text.

904. The conclusions about households and their risk preferences are mixed. See Avery & Elliehausen, supra note 885 (finding high income households to be risk preferrers). But see Gregory, Relative Wealth and Risk Taking: A Short Note on the Friedman-Savage Utility Function, 88 J. Pol. Econ. 1226, 1228-29 (1980) (higher wealth persons are risk adverse and lower wealth ones risk preferrers). There is also some evidence that investors do not invest on an after-tax basis. Portfolios of institutions show approximately the same dividend yield as the market as a whole, despite the very low (or zero) tax rate applicable to institutions. See Blume & Friend, Institutional Investors: A Rapidly Growing Presence in NASDAQ, in THE NASDAQ HANDBOOK: THE STOCK MARKET OF TOMORROW — TODAY 191-211 (1987).

905. See supra notes 188-89.

906. See supra note 66.

907. See supra notes 188-89.
based on three factors which stem from imperfections in the market: (1) the preference for noncontingent claims on firm assets due to the costliness of making claims contingent on the firm’s financial condition, (2) the incentives created by requiring firm managers and owners to bear the full consequences of firm decisions, and (3) the lower costs of obtaining capital from risk adverse lenders, which is related in part to the equity premium puzzle of financial economics, since equity is more costly than debt.908

Under current economic conditions, there may be nontax reasons for additional corporate debt.909 There also may be safeguards under the current regime which may limit both the firm level and macroeconomic risks of debt.910


909. Senate LBO Hearings, pt. 2, supra note 16, at 193 (prepared statement of Lawrence Summers)(fact that most public companies weathered well the recession of the 1980s, high real interest rates, slower inflation, and fluctuations of the dollar “would lead to some increases in acceptable levels of leverage”). For example, there is mixed evidence on the effect of high debt levels and research and development spending. Compare id. at 192 (while investment outlays decline following LBOs, LBOs occur in industries in which spending on research is low and no evidence is present to determine “the productivity of investments that are foregone”) with House LBO Hearings I, supra note 16, at 680-85 (prepared statement of Ernest Bloch of the National Science Foundation)(R & D falls significantly with LBOs to a potentially worrisome level). For other views of the effect of capital structure on research and development, see Corporate Financial Structures, supra note 4, at 61-62. Industry by industry debt-equity ratios in Japan and Germany are significantly higher than in the United States. See Bartlett, Corporate Debt: Is it Riskier in U.S.?, N.Y. Times, Nov. 10, 1988, at D1, col. 3 (while leverage is higher, debt is used to finance plant and equipment rather than financial restructuring amid a closer relationship between lending institutions and industry than exists in the United States). There is also evidence that United States corporations are underleveraged compared to those in Japan and Germany on a book value basis but currently have the same leverage based on a market value approach and without the same financial institutional safeguards. See Wall, Leverage Ratios of U.S. Nonfinancial Corporations, Econ. Rev., May-June 1988, at 12. Nonetheless, there is other evidence of the difference between debt in Japanese and United States corporations: in Japan, most of the debt is continually refinanced by the banks that provide most of the debt finance for Japanese corporations. See R. Ballon & I. Tomita, The Financial Behavior of Japanese Corporations 123 (1988)(“The remaining 60% to 80% [of capital in Japanese corporations] were borrowed from the same banks that were willing to finance this relentless expansion so long as former loans were repaid without delay. The foreign reader of Japanese financial statements had the impression that debt was never refunded but continuously expanded.”). For the description of the distrust of equity finance in Japan and a review of the composition of Japanese corporate capital structure, see id. at 83-156.

910. Institutional arrangements in leveraged buyouts are said to be already in place to privatize the risks of bankruptcy, as in the Japanese system, so that the participants in leveraged buyout arrangements will find it more efficient to preserve value outside of the usual bankruptcy process. See House Protection Hearings, supra note 16, prepared statement of Michael C. Jensen, at 5-8. The alignment of the holders of junk bonds with the
The argument for favoring equity financing views equity as a mechanism for risk sharing that allows high risk projects to develop, although at a greater cost to the firm. Henry Kaufman, who sees the trend toward debt finance as one of “decapitalization,” argues that equity should be preferred in capital structure since it foretells the macroeconomic risk of bankruptcy and the economic and social cost of financial distress. Equity financing also allows managers discretion to retain funds for develop-

interests of equity holders may reduce the incentive to force liquidations and the presumed reluctance of the system to force bankruptcy. See Senate LBO Hearings, pt. 2, supra note 16, at 203 (prepared statement of Lawrence Summers). This may not rise to the level of “relationship investing” present in Germany and Japan. See House Protection Hearings, supra note 16, prepared statement of Louis Lowenstein, at 23-25 (United States investment banking is more transactional-oriented than relationship-oriented with an attenuated relationship between lender and borrower). In addition, zero coupon debt lets the firm ride out temporary financial difficulties and the credit markets have an increased ability to sustain “fallen angels.” House Protection Hearings, supra note 16, prepared statement of Michael C. Jensen, at 7-8.

911. The equity premium puzzle explains this phenomenon and has been explained as both the limitation on diversification with equity and limitations on insurance, see Mankiw, The Equity Premium and the Concentration of Aggregate Shocks, 17 J. Fin. Econ. 211 (1986); cf. Mehra & Prescott, The Equity Premium: A Puzzle, 15 J. Monetary Econ. 145 (1985)(similar observation from monetary economics), and a higher costs of equity rather than debt capital based upon the so-called “lemon” hypothesis that insiders have superior information and only bring less valuable projects to be equity rather than debt financed. See, e.g., Narayanan, Debt versus Equity under Asymmetric Information, 23 J. Fin. & Quant. Analysis 39 (1988)(where asymmetric information exists in which only insiders know the quality of the firm, risky debt is more advantageous than equity since issuance of debt is less attractive to inferior firms and debt’s advantage is also that it keeps unprofitable firms out of the market thus improving the quality of the market). For the importance of information announcements of the timing and pricing of new equity issues under the presumption that insiders have superior knowledge in predicting when firms will issue equity, see R. Korajczyk, D. Lucas & R. McDonald, The Effect of Information Releases on the Pricing and Timing of Equity Issues: Theory and Evidence 1-3, 24, 34-35 (National Bureau of Economic Research Working Paper No. 2727, 1988) (finding that since smaller firms have less information generally, they theoretically should and empirically do wait for fresh information announcements). The higher cost of equity might also be related to the difference in liquidity preference for debt and equity.

912. See Kaufman, Halting the Leverage Binge, Institutional Investor, Apr. 1989, at 23 [hereinafter Kaufman, Halting]; Equity: The Last Resort, ECONOMIST, June 7, 1986, at 27 (noting anti-equity trend). The use of debt has also been alleged to encourage “speculation, under-maintenance of corporate properties, and reduction of wages or employment.” Warren, Interest, supra note 1, at 1607.

913. The costs of bankruptcy include its attendant dislocations at the firm level including rescheduling and workouts and the lesser return to the bondholders who shift some of the risk of bankruptcy to the shareholders in exchange for a lower return. For a review of the costs of financial distress and bankruptcy, see CORPORATE FINANCIAL STRUCTURES, supra note 4, at 63-71.
On the other hand, substitution of debt securities for equity causes interest rates to rise and may destroy investor confidence in current market valuation. The social and economic costs of financial distress and bankruptcy include not only the revenue cost and the accompanying need for alternative funds to finance government goods and services, but also include the cost of changing the financial structure to more closely resemble the German and Japanese models which forestall bankruptcy costs (although in Japan the public equity market is providing record amounts of capital and Germany is predicting expanded public offerings of family held private firms) and may result in a concentration of assets and a change in financial institutions.

914. Equity finance is required in order to free manager's decisions from the complete need to use cash flow for interest payments. Debt limits the ability of the firm to embark on long term investment projects for future expansion and competitiveness and is contrary to worldwide trends in corporations which are lowering debt on the balance sheet. See Kaufman, Halting, supra note 912, at 23. Accord House LBO Hearings I, supra note 16, at 798 (prepared statement of F.M. Scherer) ("V]ery little is known about the extent to which heavy leverage and the incentives of the 'going private - going public' cycle leads to real sacrifices of long- run economic strength").

915. See Kaufman, Halting, supra note 912.

916. 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 408-18 (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). Even Japan which in the past relied upon debt and the private market for equity securities has adopted a preference for a market based approach to raising equity capital. See R. Ballon & I. Tomita, supra note 909, at 107 (noting that since 1984 most capital increases by major banks have been public offerings at a market price). In the first eight months of 1989, Japanese corporations raised $110 billion in public equity funds as compared to $20 billion by United States corporations. See Sterngold, Japan Leading U.S. in Raising Capital for Corporations, N.Y. Times, Oct. 27, 1989, at A1, col. 6. Public offerings in Germany of family-held firms are predicted to change the mergers and acquisitions climate in Germany by making more companies available for acquisition. See Greenhouse, Europe's Buyout Bulge, N.Y. Times, Nov. 5, 1989, § 3, at 1, col. 2 & at 6, col. 6.

917. See supra notes 173 & 909-10 and accompanying text.

918. As stated by Henry Kaufman:

We must all understand that corporate debt can never be a full substitute for equity. Debt involves defined corporate obligations of interest payments and repayment schedules. It is a preemptive factor in corporate cash flow and may limit management flexibility. The abuse of the debt-creation process contributes to corporate failures and, for society as a whole, runs the risk of debauching the essence of economic democracy.

Equity, in contrast, allows freedom of decision-making and often reflects confidence in society and its political and economic institutions. If we diminish the role of equity, we invite the specter of business control shifting first to finan-
everyone accepts the risk of bankruptcy argument either in theory919 or based on the evidence to date,920 and some see the effi-

919. The risk of bankruptcy and financial distress is debated. Bradford and Stuart argue that the extent of macroeconomic losses caused by the substitution of debt for equity are still unknown. See Bradford & Stuart, Issues in the Measurement and Interpretation of Effective Tax Rates, 39 Nat'l Tax J. 307, 310 (1986) (while "controlling equity owners in a highly leveraged firm may direct the firm to take excessive risks, with a resulting excessive probability of bankruptcy . . . . it seems implausible that bankruptcies burn up billions of dollars per year worth of real resources in lawyers fees"). Fox sets forth the arguments against the view of financial distress through bankruptcy for the exercise of market driven and tax incentives for increased debt finance and in the context of his proposal for a mandatory universal dividend payout rule and his argument that debt finance is more efficient as inducing firms to riskier and more efficient investment status:

[A] significant increase in corporate debt/equity ratios may be harmful from a macroeconomic point of view. Because the performance of corporations are positively correlated, an economy of highly leveraged corporations might be susceptible to a massive wave of bankruptcies occurring during a general economic downturn much less severe than the Depression of the 1930s. Such a wave might be disastrous because of its effect on the confidence of investors, who by living previously in a less levered world are used to thinking of bankruptcy as a very occasional thing, and because of the organizational strains it would impose on financial institutions.

Balanced against these arguments are a series of claims relating to their assumptions: the administrative and other costs of bankruptcy may be exaggerated, the expected costs of bankruptcy on workers and communities may be reflected in firm contracts with these constituencies and thus considered in the determination of the debt/equity ratio, and investors may rationally interpret the bankruptcy of a highly leveraged corporations as a less significant indicator of bad economic times than the bankruptcy of a less levered one. Furthermore, there are real benefits from leverage as a way of economically satisfying different investor tastes and beliefs . . . .

M. Fox, supra note 36, at 394 n. (footnotes omitted). Gordon and Malkiel set forth convincing reasoning for the risk of bankruptcy and costs of financial distress in noting that the decision to finance an extra dollar with debt will increase the probability of bankruptcy and the moral hazard risk of risky debt which will be split among the existing bondholders, equity holders, and junior bondholders: (1) alternatives to formal bankruptcy are themselves costly and complex with uncertain outcomes, (2) coalitions within the firm avoiding bankruptcy may inflict externalities on the other coalition within the firm that would be favored under bankruptcy, (3) managers will ignore the costs borne by bondholders in favor of shareholders, and (4) formal bankruptcy may be the only means for new financing. Because taxes influence portfolio choices it is unclear if all are compensated for the additional risk for the risk of bankruptcy. Gordon & Malkiel, supra note 62, at 145-51. For a summary of the literature on the effect of bankruptcy costs on the decision to issue debt, see Haugen & Senbet, Bankruptcy and Agency Costs: Their Significance to the Theory of
ciency of debt as outweighing its risks. Nevertheless, a tax incentive to pursue debt rather than equity financing distorts the risk return profile for financing the firm, discriminates between firms that can resort to debt rather than equity financing, and contains a macroeconomic rationale for tax neutrality in the debt-equity choice.

Neutrality between firms that can be debt financed and firms that must be equity financed also suggests that the tax distortion may be significant for capital allocation. Neutrality considerations indicate that the taxation of high yield bonds should conform to the taxation of profits; a return that is in the nature of an equity

*Optimal Capital Structure, 23 J. Fin & Quant. Anal. 27, 28-34 (1988)* arguing that bankruptcy costs can be internalized by the adequate provision in corporate charters and bond indentures, but noting and disputing the empirical evidence on the indirect costs of bankruptcy as confusing the costs of bankruptcy with the costs of liquidation, see Altman, *A Further Investigation of the Bankruptcy Cost Question, 39 J. Fin. 1067 (1984)*, while noting empirical data on the decision of smaller firms with higher probabilities of bankruptcy to issue less debt, see Castanias, *Bankruptcy Risk and Optimal Capital Structure, 38 J. Fin. 1617 (1983)*. For a review of the risks in theory and practice, see Bratton, *Restructuring, supra* note 175, at 160-70.

920. See *supra* notes 159-74 and accompanying text. The corporate debt level at the end of June 1988 totaled $1.78 trillion up from $1 trillion in 1982 and the interest payments on that debt utilized 20% of corporations’ available cash — a level usually reached only during recessions. See Uchitelle, *supra* note 901, at 1, col. 2. The increased level of debt and the replacement of debt with equity increases the risk of bankruptcy. *Id.* For example, the Bernanke and Campbell study of 1500 large corporations showed that if they were to encounter a recession similar to the one in 1974, 10% of them might go bankrupt. *Id.*

921. The efficiency benefits of debt are set forth in the “free cash flow” theory under which managers accepting high payout requirements works as a binding commitment to keep the managers from misinvesting firm assets. See Jensen, *Takeovers, supra* note 116, at 29-32 (noting that “[m]any of the benefits in going-private and leveraged buyout transactions seem to be due to the control function of debt”). *Accord Miller, The Modigliani-Miller Propositions After Thirty Years, J. Econ. Persp.,* Fall 1988, at 99, 112-15. See also *supra* notes 173 & 520.

922. These neutrality considerations were summarized as follows: The truly pertinent questions, relevant to the soundness of the tax system, are whether the tax laws should discriminate against equity capital and discourage the formation of new and risky enterprises on which the growth of the economy depends; whether the tax laws should compel corporations, if they are to remain competitive, to make the maximum possible use of debt financing, even to an extent that may be unhealthy in the case of outside debt and unrealistic in the case of debt to shareholders, or whether the tax laws should be as neutral as possible in their effect upon such business judgments; and finally, whether an equitable and efficient tax system can longer tolerate a self-selected tax burden, permitting a taxpayer, by exercising his admittedly free right to choose a capital structure, to determine for himself how large a tax shall be borne for the privilege of doing business in corporate form.

Plumb, *supra* note 729, at 620-21 (footnotes omitted).
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risk should be taxed as equity. Additionally, neutrality is required to avoid a distortion of the firm's decision to control agency costs caused by a tax induced change in the firm's preferred choice of capital structure for optimal monitoring and bonding of the firm's participants. In a world with taxes, the disparate tax treatment of equity and debt changes the focus of the Modigliani-Miller capital structure irrelevance proposition to an agency costs perspective combined with bankruptcy cost avoidance, and tax neutrality is required to avoid the creation of agency costs. Additionally, neutrality between debt and equity financing minimizes transaction costs. If one believes that the market does not appropriately factor in the macroeconomic risk of bankruptcy, an allowance of accrual based deductions for interest on equity capital but not for debt could be given.

Neutrality dictates that unless corporate production provides a unique and definable benefit, the double tax regime should be confined to firms with liquid equity regardless of form. Divorcing the double tax question from resemblance allows other neutrality goals to be pursued. However, abandoning the resemblance requirement would increase the importance of previously minor neutrality concerns. These concerns include whether Subchapter S should be amended to conform more fully with the partnership model, and whether entity level collection in addition to the current entity level audit provisions is appropriate for large partnerships or S corporations. Another issue of increased importance would be the construction of the interest allocation and passive loss rules for passthrough entities. Full implementation of the system would require integration, either on a deduction or credit

923. See infra notes 1007-09 and accompanying text.
924. See A. Barnea, R. Haugen & L. Senbet, supra note 402.
925. See Levmore, The Positive Role of Tax Law in Corporate and Capital Markets, 12 J. Corp. L. 483, 487-88 (1987). See also House LBO Hearings I, supra note 16, at 436-49 (prepared statement of Larry E. Ribstein)(debt is a part of the corporate contract for governance relations, the social costs of which are affected by both tax biases and the current state of the bankruptcy rules that lead to inefficient restructuring); Bratton, Restructuring, supra note 217, at 127-29; Levmore, Monitors and Freeriders in Commercial and Corporate Law Settings, 92 Yale L.J. 49, 66-68 (1982).
926. Cf. Miller, Financial Innovation: The Last Twenty Years and the Next, 21 J. Fin. & Quant. Anal. 459 (1986) (arguing that taxes and regulation were the central reason for financial innovation).
928. See supra notes 364-77 and accompanying text.
model, of nonliquid start-up firms that desire a more complex capital structure than could be provided by Subchapter S.

4. Simplicity and Revenue

A liquidity standard would simplify the business tax system. A liquidity standard could be adopted in combination with a policy pursuing integration through a deduction for the interest return on new equity. The deduction could also be applied to old equity if transitional relief to lessen the windfall gain were provided.

It has been suggested that a new equity proposal alone would produce limited revenue loss.929 Identifying the direct revenue loss rather than the extended economic effects of the proposal requires an assumption as to who the current publicly traded taxpayers are and the amount of tax revenue collected from them. A reasonably accurate picture of the corporate population can be drawn by combining various sources, although the data I use does not reflect the going private and leveraged buyout phenomenon from 1986 to the present. According to Ward’s Business Directory for 1985, there are approximately 7,240 United States publicly traded companies with assets over one million dollars.930 In 1985, 6,459 companies, including banks and insurance companies, were trading on the NYSE, NASDAQ, and Amex.931 In 1986, these exchanges


To be included [in this directory], companies must have at least $5 million in annual sales. The directory is published annually in two volumes.

Companies are listed under the Standard Industrial Classification which most closely represents their major product line.

Volume 1 [of Ward’s] contains private companies with sales of $11 million per year and higher and 7,000 publicly traded companies.

Id. at 2.

Financial data on the public companies are compiled from fiscal 1985 results. Financial data on the private companies are compiled from fiscal 1984 and 1985 results.

Ward’s was chosen because it has a section of public companies with stock exchange symbols and a separate section of public and private companies and includes partnerships, sole proprietorships, and joint ventures. Ward’s was also easily compared to the I.R.S. data because it lists the total assets of the companies which helps determine the number of public companies within a given asset group. Ward’s organization by S.I.C. groupings permits public and private activities within a given industry to be compared.

931. NATIONAL ASSOCIATION OF SECURITIES DEALERS, THE NASDAQ HANDBOOK
listed approximately 355 foreign companies.\footnote{932} Assuming the number of foreign companies did not change significantly from 1985 to 1986, approximately 6,100 United States companies traded on the two major exchanges and NASDAQ.

Ward’s Business Directory for 1985 lists 7,283 domestic public companies, including several publicly traded limited partnerships; some of these companies (349) are traded on markets other than the NYSE, NASDAQ, and Amex.\footnote{933} The number of United States companies listed on the two major exchanges and NASDAQ, according to Ward’s, is 6,934. The discrepancy can be explained by Ward’s reporting criteria. Ward’s fails to identify companies traded either internally (owned by employees) or through their parent company, fails to obtain full data from reporting and nonreporting over-the-counter firms which would increase the number of firms covered, and fails to list public companies with sales under half a million dollars.\footnote{934}

\footnote{67 (1987)[hereinafter NASDAQ HANDBOOK].}

\footnote{932. Telephone interview conducted by Tami Walker (research assistant to author) with representatives of NYSE, Amex and NASDAQ in Feb. 1988 (NYSE had 59, Amex had 23, NASDAQ had 273).}

\footnote{933. Compiled from 1 INFORMATION ACCESS COMPANY, WARD’S BUSINESS DIRECTORY OF LARGEST U.S. COMPANIES (1986) [hereinafter WARD’S II] (section A part 1 — Public Companies Ranked Within S.I.C. Industries by Sales Size).

\footnote{934. Ward’s includes as publicly traded shares that are listed on the Pink Sheets so long as the companies have sales over $.5 million. Ward’s, however, does not monitor the Pink Sheets. Unlike Ward’s, NASDAQ includes firms that have low annual sales. “The standards for entering the NASDAQ system are deliberately modest” to allow “efficient trading mechanisms” for small companies and to “encourage capital venture investments.” NASDAQ HANDBOOK, supra note 931, at 86.

To enter the NASDAQ system, a company must have $2 million or more in total assets, $1 million or more in capital and surplus, a public float of 100,000 shares or greater, at least 300 shareholders of record, and at least 2 market makers. \textit{Id.} at 85. “The standards for entering NASDAQ/NMS are more stringent. . . .” \textit{Id.} at 86. To be continued in NASDAQ, a company must maintain assets of at least $750,000, and capital and surplus of at least $375,000. The public float and shareholders of record requirements are the same as for original listing, and the company must continue to have at least one market maker. \textit{Id.} at 85.

For original listing on the American Stock Exchange, there are minimum guidelines, but in certain circumstances, an application may be approved even though the company does not meet all the guidelines. A company must have had pre-tax income of $750,000 in the last fiscal year or two of the last three fiscal years; stockholder’s equity of $4 million; 500,000 shares publicly held with a market value of at least $3,000,000 and a minimum price per share of $3.00. There must be 800 stockholders if the public float is less than one million shares. “The exchange may also consider the listing of a company’s securities if the company has a minimum of 500,000 shares publicly held, a minimum of 400 shareholders and the daily volume of trading in the issue has been approximately 2,000 shares or more for the six months preceding the date of application.” AMERICAN STOCK EXCHANGE FACT}
The value of the public corporate equities market can be estimated by reference to the value of the public corporate equities traded on the exchanges and NASDAQ (not including the Pink Sheets) as compiled by the SEC, and the value of the total corporate equities market maintained by the Board of Governors of the Federal Reserve. For 1985, the SEC estimated that the value of total public corporate equities was $2,160 billion,\textsuperscript{935} and the Board of Governors estimated the total corporate equities held by individuals and institutions at $2,868.1 billion.\textsuperscript{936} Based on those estimates, only $708.1 billion of corporate equities, constituting

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\textsuperscript{935} INTERNATIONALIZATION OF THE SECURITIES MARKETS, supra note 417, at 11-12. In a later publication, the S.E.C. estimated the total value of public corporate equities in 1985 as $1,951.8 billion instead of $2,160 billion. U.S. SECURITIES AND EXCHANGE COMMISSION, FIFTY-THIRD ANNUAL REPORT: 1987 131 (1988). This downward revision would of course alter the computations performed in the text.

\textsuperscript{936} BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, FLOW OF FUNDS ACCOUNTS FINANCIAL ASSETS AND LIABILITIES YEAR-END, 1962-85 40 (1986). Households held $1,949.4 billion (including $283 billion in mutual funds). Some of the remaining amounts (in billions) were held by the following sectors: foreigners ($125.9), commercial banks ($1), mutual savings banks ($5.2), insurance ($662.6), and brokers and dealers ($11.1).
24.69% of the total value of corporate equities, are not publicly traded as defined by the SEC. The increasing number and size of going private transactions — leveraged and management buyouts — since 1985 should increase the nonpublic percentage. If one assumes that the profitability of public companies is at least equal to that of nonpublic companies, then the loss of revenue caused by excluding the nonpublic corporations from the corporate tax base would be 24.69% of corporate tax revenues adjusted for losses due to taxation at less than the highest marginal corporate and individual rates. To the extent that nonpublic firms have a lower rate of profitability on their assets, which is part of what is reflected in the value of corporate equities, the revenue loss from excluding them is much less. Moreover, if the amount of revenue presently lost by the S election is considered, since it is not reflected in the above data, the revenue loss is even lower.

Other methods have been used to estimate the total value of publicly traded corporate equities. In developing a specific proposal for an accrual income tax system that gives attention to problems of valuation and liquidity, David Shakow recognized the difficulty in valuing corporate stock that is not publicly traded.937 Professor Shakow estimated that only 15.9% of all stock held by individuals comes from corporations for which values are difficult to obtain.938 His best source for this conclusion is an analysis939 of the Internal Revenue Service's summary of 1965 estate tax returns.940 The estate tax return data should not be taken at face value, and the researchers who analyzed the estate tax returns recognized a number of potentially serious inadequacies in the estimates derived from that data.941 The assets and liabilities of de-
ecedents may not be typical since they may hold more liquid equity assets.\textsuperscript{942}

Based on what is known about the ratio of public companies to private companies in the 1985 data, Professor Shakow's estimate that the public sector accounts for 84.1\% of the value of all corporate stock seems low. Moreover, the data eliminated S corporation stock from the definition of corporate stock, thereby limiting unnecessarily the scope of the corporate community. A better approach would have been to estimate the value of Subchapter S corporations and then delete this value if appropriate.\textsuperscript{943} Also, the data introduced inaccuracies by converting dividends to market value on the basis of sample estimates for a particular class of stock.\textsuperscript{944}

Because of the known aversion of institutions to illiquidity, it seems probable that the largest percentage of the $708.1 billion in nonpublic equities was held by individuals. Since individuals held a total of $1,949.4 billion of corporate equities,\textsuperscript{945} attributing all of the nonpublic corporate equities to individuals would mean that the percentage of stock ownership by individuals of hard-to-value or nonpublic stock was 36.33\%. Thus, even if the nonpublic stock ownership were distributed pro rata between individuals (including foreign individuals) and other owners, the percentage of private investment would be 24.69\%. Conversely, if all nonpublic stock ownership were attributable to individuals (but not including foreigners), the percentage of private investment would be

\begin{itemize}
\item of living individuals in the top wealth groups,
\item deficiencies in the mortality rates used to characterize specific groups in the population,
\item systematic understatement in the estate tax estimates of the values of certain assets held by the top wealth groups (including closely held stock and large blocks of publicly traded issues) even after the reported values are adjusted on the basis of sample audits, and
\item the treatment of individuals rather than families or households as the basic consumer units.
\end{itemize}

\textit{Id.} (footnote omitted).

\textsuperscript{942} Estate tax returns are filed by a more elderly section of the population in the top wealth groups. These older individuals want liquid assets so they would shun stock in a closely held corporation. Closely held corporations are often family businesses and it would seem logical that many older individuals would have divested themselves of their common stock in the family business before their death, if possible, by sale or recapitalization.

\textsuperscript{943} Blume, Crockett & Friend, \textit{supra} note 886, at 34. The $61 billion estimate of the small corporations taxed as partnerships was based on (1) dividends of $1.3 billion for such stock, (2) an assumed dividend yield of 3.5\% (which is relatively high to reflect the lack of marketability of the shares), and (3) the average ratio of total dividends to dividend-paying market value for nonfinancial firms traded over-the-counter.

\textsuperscript{944} \textit{Id.} at 22.

\textsuperscript{945} \textit{See supra} note 936.
36.33%. Both of these figures are much higher than Shakow's estimate of 15.9%.

The fact that nonpublic companies pay a significant portion of the corporate tax can be confirmed by other data that suggests that a significant percentage of companies paying the corporate tax in 1985 were not publicly traded. Only about 74.4% of the companies with assets of $250 million or more are public, although this statistic does not show relative value within the asset group. Of the remaining 25.6% of the corporations, some are S corporations, some are foreign corporations with income effectively connected to the United States, and some are large closely held corporations. In 1985, the companies with assets over $50 million made up 0.70% of all corporations filing returns. A significant number of these large companies are public.

In comparing public and private companies by industry for 1985, Ward's lists 36,214 private companies with sales over $11 million and 7,301 public companies. Analysis of the Ward's...
data reveals that private companies, which include sole proprietorships, joint ventures, and general and limited partnerships, outnumber public companies by a ratio of five to one. Even though the private companies dominate the represented industries in numbers, they do not dominate the industries in sales volume. Another finding which shows that public companies dominate the industries in size is in concentration of employees. Certain types of industries were more heavily dominated in number by private companies, others were dominated by public companies, and

Matthew Jewel, Ward's researcher (Feb. 12, 1988).

951. The analysis reflected in infra notes 952-56 and accompanying text was compiled by my research assistant, Tami Walker, using data extracted from WARD'S I, supra note 930, at 90-94.

For example, health care industries were private to public in a 5:1 ratio. In the dairy products industry (S.I.C. 202) there are 473 private companies and 15 public companies. This yields a 32:1 ratio. Id. at 90.

952. Id. at 95. In 207 (57%) of these industries, private companies dominated the industry beyond the 5:1 ratio. One hundred and fifty-three of these industries had a higher proportion of sales attributable to the public companies within the S.I.C. Code. Id. at 90-94. In the dairy products industry, even with a 32:1 private to public ratio, there were $32.112 billion in sales attributed to the 15 public companies and $36.107 billion attributed to the 473 private companies (i.e., 47% of the total sales of the industry were from public companies which represented only 3% of the population within the industry). Id. at 90.

953. See id. at 95. Within the same 207 industries which are dominated in number by the private companies, 151 of the industries show a greater concentration of employees in the public companies. Id. at 90-94. Again using the dairy products industry as an example, there are more total employees in the 15 public companies (52.3%) which make up 3% of the firms within the industry, than in the 473 private companies which employ only 47.7% of the total employees within the industry. Id. at 90.

954. Examples of some of the industries dominated by private companies as of 1985 are: farming, construction, carpentry, food production, tobacco, textiles, clothing, lumber and paper products, printing and publishing, chemicals, drugs, glass, leather, pottery, stone, metals, machinery, equipment, motor vehicles, jewelry, toys, passenger transportation (except air transportation), export-import wholesale, liquor, gasoline stations, motor vehicles dealers, household furnishings and appliances (retail), security broker-dealers, ad agencies, retail grocery stores, service industries (accounting, scientific research, and engineering), and motion picture theaters. Id. at 90-94. The growth of public firms in industries such as advertising and security broker-dealers would change the mix. It does not necessarily follow that the remaining 54 industries within the 207 were industries in which privately held companies dominated in sales. However, 35 of these industries had no public companies.

Id.

955. Some examples of industries dominated by publicly traded companies include mining, electronic components, radio and television receiving equipment, communication equipment, telephone communication, telegraph communication, electric and gas utility, radio and television broadcasting, electric services, water supply, sanitary services, all banking, all insurance, investment offices, hotels, motels, computer and data processing, and motion picture production. Id.
others had interesting and perhaps unique characteristics.956

These alternate methods of estimating the value of publicly traded equities present no convincing argument that the revenue loss from implementing the liquidity proposal will be significant. Allowance of an interest return on new equity for double taxed firms would produce a revenue loss, but given the reliance on debt and retained earnings financing it would not be great for existing firms.

VII. IMPLEMENTING A LIQUIDITY BASED SYSTEM: AGENDA FOR INQUIRY

As a general matter, a liquidity test must take into account the quality of the market for sale of ownership interests, the guarantees for liquidity afforded by the firm, the ability to have a true valuation of the interests, an easy disposal mechanism with limited transaction costs, and an effective market mechanism for eliminating any minority discount. Other relevant concerns include the size of the firms able to take advantage of a lower cost of capital through offering liquid interests and the fungibility of high yield long or medium term debt and liquid equity.

There are currently two unresolved issues concerning the structural systems for the taxation of corporations that affect this proposal. The first is the treatment of debt and interest payments by the firm; the second is the treatment of nondividend distributions and debt recapitalizations. Another issue that will affect this proposal is the possibility that the capital gains preference will be reenacted. The proposal may also be affected by the treatment of foreign investment and tax exempt equity holders. These issues

956. There are numerous notable examples of industries without public companies. Beer, wine, distilled alcoholic beverages wholesale (S.I.C. 518) has 130 private companies. Motor vehicle dealers new and used retail (S.I.C. 551) has 1,052 private companies. Retail fuel and ice dealers (S.I.C. 598) has 34 private companies. Retail family clothing stores (S.I.C. 565) has 35 private companies. Gasoline service stations (S.I.C. 554) has 87 private companies. Plumbing, heating and air conditioning (S.I.C. 171) has 120 private companies. Rubber and plastic footwear (S.I.C. 304) has 20 private companies. Pipe lines except natural gas (S.I.C. 461) has 36 private companies. There are several other industries that have fewer than 20 companies within the industry. Id.

In the crude petroleum natural gas industry (S.I.C. 131) there were more public companies (184) than private companies (133), and the private companies generated more sales and employed more individuals. This is the opposite result from that noted in the dairy product industry and it supports claims of the value of the independent oil and gas producers. There were several industries with no publicly traded companies. Id. A tax on traded companies would completely overlook these industries.
and others relevant to the implementation of the liquidity proposal are discussed below. Specific issues to be addressed include: (1) the identification of the markets and private contracts to which the standard should be applied, (2) the treatment of capital structure, (3) the identification and treatment of debt and firm level deductions, (4) the treatment of capital gains, (5) the treatment of windfall gains and losses, (6) the treatment of shifts from public to private or private to public status, (7) the treatment of foreign firms, (8) the treatment of joint ventures and interfirm investment, (9) the treatment of co-ownership and financial intermediary definitions, and (10) access to Subchapters S and K and graduated business tax rates.

A. Applicability

A firm's ability to offer the requisite liquidity for a substantial portion of the ownership interests of the firm should mean that all equity ownership interests of the firm are treated as liquid. The benefits accruing to the issuer are significant. Whether a firm benefits from a public marketplace could be determined by reference to its trading volume. One possibility would be to provide for higher volume limitations than are presently included in the publicly traded partnerships safe harbor limitations. Establishing volume limitations and combining them with a number-of-owners limitation would require further study.

With respect to private contract liquidity, the ability of the firm to make actual redemptions or repurchases can be quantified. A liquidity test requires determining the quality of transferability. Liquidity does not exist where a substantial discount is applied upon transfer, or where other restrictions on a full fair market value price are imposed. In partnerships and corporations, the ability to limit transferability of stock through the use of restrictions is regulated under state law.

957. See supra notes 447-552 and accompanying text.
958. See supra notes 600-12 and accompanying text.
959. The safe harbor provisions applicable to limited partnerships quantified redemption at 10%. For a discussion of this provision, see supra note 669 and accompanying text.
960. See Hicks, supra note 473, at 417-20 (examining the theoretical basis for federal law resale limitations and proposing a rationale for reform that balances security holder freedom and public protection in a way that minimizes the cost of liquidating an investment). State law is in sharp contrast with federal securities law which attaches transfer restraints to certain securities transactions and establishes both the scope and duration of limitations and makes them enforceable irrespective of actual knowledge. Id. at 418-19.
freely transferable and highly liquid stock has been altered by state takeover laws.961 The state law restrictions increase the cost of capital significantly for public firms with a principal place of business, or significant assets and resident shareholders, in adopting states.962 These restrictions may require shares in such firms to be treated as less than highly liquid for tax purposes. State takeover laws, which are also termed control share acquisition statutes, business combination statutes, and appraisal statutes,963 allow shares of target companies to be traded without attaching a value to control, which results in a reduction in value due to the decreased possibility of acquisition.964 The transfer of shares is not otherwise restricted by state law when authorized by a shareholder vote, except under state fair price statutes.965 However, state fair price statutes only restrict transfers to a particular pur-


[T]he evidence tends to support the view that these amendments increase the bargaining power of management in the event of a control bid, to the detriment of shareholder wealth [and] reduce the frequency of takeover bids significantly while not improving the expected value of shareholder gains in those takeover contests that do occur.

Id. at 367. Other de facto restrictions on transferability have been proposed, such as 100% taxation of gain on stock not held over one year. L. Lowenstein, supra note 164, at 202-14. State law restrictions remedy problems that are left unchecked by the open market for securities. See Booth, The Promise of State Takeover Statutes, 86 Mich. L. Rev. 1635, 1668-70 (1988)(noting the need to insure a fair outcome as between shareholders and bidders in takeover contests and the concern that, under the statutes, shareholders as a group may be overcompensated).

962. The Indiana control share acquisition provisions, for example, define an "issuing public corporation" as a corporation that has 100 or more shareholders, its principal place of business, its principal office or substantial assets within Indiana, and either more than 10% of its shareholders resident in Indiana, more than 10% of its shares owned by Indiana residents, or 10,000 shareholders resident in Indiana. IND. CODE ANN. § 23-1-42-4 (West 1989).

Studies show that too many state law restrictions may drive down share value. See OFFICE OF THE CHIEF ECONOMIST OF THE SECURITIES AND EXCHANGE COMMISSION, SHAREHOLDER WEALTH EFFECTS OF OHIO LEGISLATION AFFECTING TAKEOVERS 3 (May 18, 1987)(passage of Ohio law caused share prices to drop about 2%); see also POISON PILLS, supra note 462, at 43 (poison pills are harmful to target shareholders and the statistics justify rejecting the general theory that the pills benefit target shareholders.).

963. Booth, supra note 961, at 1675-81 (discussing New York Law with respect to business combination statutes, Pennsylvania's adoption of appraisal statutes, and Illinois law with respect to control share statutes).

964. POISON PILLS, supra note 462, at 42-43.

965. Booth, supra note 961, at 1673-74 (discussing the merit and inefficiency of fair price statutes).
chaser at a determined price under a cash-out merger. Since these laws do not completely eliminate liquidity, they are not relevant to the proposed tax test.

Because a liquidity based test focuses on the lower cost of capital to firms with liquid equity, an economic size limitation based on the benefits that liquidity affords to large firms and the increased costs borne by small firms is relevant. Tax bills related to capital formation incentives for small business may be no more than wish lists, although firm size standards have frequently been used in tax legislation. Any classification by eco-

966. Economic size per se is a determinant of the structural characteristics of organizations. See Kimberly, Organizational Size and the Structuralist Perspective: A Review, Critique, and Proposal, 21 ADMIN. SCI. Q. 571 (1976) (reviewing the conceptual and empirical status of size as a variable in the study of organizations). There is confusion about whether size involves sheer economic volume (based primarily on the scale of the markets in which the firm chooses to compete) or complexity (based on the combination of various different markets in which the firm participates). See N. CAPON, J. FARLEY, & J. HULBERT, CORPORATE STRATEGIC PLANNING 170 (1988) (considering size with respect to economic volume and complexity).

Many studies have identified a positive relationship between market share and profitability. Studies that relate capital intensity to firm profitability typically indicate a negative relationship. Id. at 173 (citing relevant studies). Economists have concluded that a positive relationship exists on two grounds: first, high capital intensity provides a barrier to entry and second, capital intensity is related to firm size. Because size, under an economy of scale argument, should be related to profitability, capital intensity should also be related to profitability. The negative relationship is supported by studies that indicate that large size leads to inefficiencies, poor communications, and delayed decision-making. Id. at 172-73. Small firms could also be defined as firms that cease to exhibit the small firm effect. See Seyhun, The January Effect and Aggregate Insider Trading, 43 J. FIN. 129, 131 (1988) (examining the seasonal pattern of aggregate insider trading and viewing the small firms as having an average market value of stock less than $25 million). The small firm which includes the increase in demand for small firm stock in January is explained by a large positive return at the end of the year that arises from predictable changes in the demand for different securities. Alternatively the large returns in January for small firms represent compensation for the higher risk of trading against informed traders. Id. at 129-30.

967. See, e.g., the bills described in Hearings Before the Subcomm. on Taxation and Debt Management Generally of the Comm. on Finance, 96th Cong., 2d Sess. (1980) [hereinafter Small Business Tax Hearings]. Included in the hearings are: S. 487 (Small Business Private Investment Act of 1979 — providing a credit for investment in original issue small business stock); S. 1481 (credit for investing in small business participating debentures); S. 1967 (Capital Formation Incentive Act of 1979 — reserve for the net gain from certain market-making activities); S. 2136 (Small Business Tax Reduction Act of 1979 — corporate tax rate reductions); and S. 2168 (Subchapter S Capital Formation Act of 1979 — permitting a small business corporation to have 35 shareholder's and to issue certain additional stock).

nomic size for federal income taxation purposes must be cognizant of both firm access to financing and firm competitiveness within the industry. Small businesses often have limited financing options,\(^9\) causing small firms to pay much more than large firms

Financing alternatives studies show some support for a $6 million asset capitalization. See, e.g., Small Business Tax Hearings, supranote 967, at 279, chart 1 (prepared by the U.S. Small Business Administration in its Report of the SBA Task Force on Venture and Equity Capital for Small Business (Jan. 1977))(based on 1975-1976 financial market conditions the break-even point occurs where income is $10 million and asset capitalization is $6 million). This was also viewed as the break-even point for private placements under S.E.C. Rule 144, registration under the 1983 Act and the offering of a public financing. Commercial banks also use this as an outer limit for financing on a personal basis. For a chart of these findings, see id. Asset based size standards include $1 million for I.R.C. section 1244 stock, and an estimated tax requirement for large corporations to pay 90% of the current years' tax if the firm has taxable income of $1 million or more for any taxable year during the three years immediately preceding the taxable year involved. See I.R.C. § 6655(g)(2) (West Supp. 1989).


Small business investment companies (SBICs) were formed to help small businesses overcome various capital access disadvantages. See generally 2 R. HAFT, VENTURE CAPITAL AND SMALL BUSINESS FINANCING §§ 2.01-2.09 (1st rev. ed. 1985)(setting forth general requirements for long-term financing under the Small Business Investment Act of 1958).

The difference between businesses that were "small" and those that were not was a point of contention. Arguments had previously been made for a small business asset size standard of $50 million, and for purposes of the following report, a business was considered "small" if it had a market capitalization (i.e., the market value of securities outstanding), of $50 million or less. National Association of Securities Dealers, Report of Joint Industry-Government Committee on Small Business Financing (1979), reprinted in Small Business Tax Hearings, supra note 967, at 277-78. The figure was selected by the committee as a means of distinguishing between "large" and "small" businesses based on the fact that issues below that level are normally excluded from the investment portfolios of many institutional investors. "This factor, coupled with a myriad of other factors discussed in succeeding chapters of this report, has left this category of issuer starved for equity capital." Id. at 278.

Defining a "small" business as a $50 million dollar enterprise by either assets or revenue is viewed by some legislators with incredulity. Small Business Tax Hearings, supranote 967, at 465 (statement of Sen. Byrd). It is assumed that a firm of that size would exceed or approach 1,000 employees. Id. at 464, 484 (statement of Gilbert Levin recommending that SBA should define a small business as an enterprise generating $50 million per year in total revenues or one composed of 1,000 employees). Other bills viewed the threshold amount as $25 million. See, e.g., S. 1481, reprinted in id. at 47; S. 653, reprinted in id. at 17 (nonrecognition of gain on the sale of certain small business stock); and S. 487, reprinted in id. at 7 (credit for investment in original issue stock of small businesses). The difficulty in obtaining financing for a company until it has achieved $10 million in revenue
when issuing new equity,\textsuperscript{970} and somewhat more when issuing long term debt.\textsuperscript{971} Eliminating the double taxation of equity for small firms may therefore be appropriate. Large firms also tend to be more highly leveraged than small firms because they tend to be more diversified, and therefore, less prone to bankruptcy than small firms.\textsuperscript{972}

has been noted, although it was also noted that this difficulty did not, in years past, confront small businesses. \textit{Id.} at 8, 278.

Many of the proposals giving small business tax incentives would make both public companies and those required to file a section 12(g) registration ineligible. \textit{See, e.g.}, H.R. 4015, 97th Cong., 1st Sess. (1981)(business not “small” if it had securities outstanding that were subject to regulation by the S.E.C); S. 1481, reprinted in \textit{Small Business Tax Hearings, supra note 967}, at 54. Other bills were not so limited. \textit{See, e.g.}, S. 653 reprinted \textit{in id.} at 16 (nonrecognition of gain on the sale of small business stock in issuers with equity capital which does not exceed $25 million); S. 487, reprinted \textit{in id} at 7, 11 (credit for investment in original issue stock of small business if the aggregate sale price of the stock does not exceed $7.5 million).

The size at which small business can expect special relief is decreasing. For example, SBIC equity capital and long-term debt financing is now limited to ventures having a net worth of $6 million or less and an average annual net income (over the two most recent taxable years) of not more than $2 million. \textit{See 13 C.F.R. §§ 107.3 & 121.4} (1988). A recent bill allows capital gains treatment for the sale of shares that are held for five years or more in firms with assets of $10 million or less. \textit{See S. 1541, 101st Cong., 1st Sess.} (1989), 135 \textit{CONG. REC.} S10,280 (daily ed. Aug. 4, 1989).

The capital needs of small business are difficult to determine and the capital market bias against small business, although reviewed in numerous studies, is based on largely anecdotal and inconclusive empirical evidence. Gallagher, \textit{Small Business Taxation, Capital Formation and Innovation, reprinted in 5 STUDIES IN TAXATION, PUBLIC FINANCE & RELATED SUBJECTS: A COMPENDIUM 88, 101} (1981)(“[B]ecause no strong documentation on capital market failures exist, policy makers have little guidance regarding the ‘appropriate’ tax treatment of small business. Inadequate data sources and lack of knowledge of various capital market processes have prevented definitive conclusions.”). Venture capital financing availability is a stated reason to terminate the SBIC program. \textit{REPORT OF THE PRESIDENT, supra note 728}, at 58 (“As a reflection of the private sector’s capacity to accommodate small business borrowing needs . . . the Administration has proposed the discontinuation of credit assistance programs of the SBA, including SBIC programs.”); \textit{see also} B. FRIEDMAN, supra note 927, at 268 (availability of venture capital is increasing).


\textit{971. See} Warner, \textit{Bankruptcy Costs: Some Evidence}, 32 \textit{J. FIN.} 337, 337 (1977)(“The ratio of direct bankruptcy costs to the market values the firm appears to fall as the value of the firm increases.”); Ang, Chua & McConnell, \textit{The Administrative Costs of Corporate Bankruptcy: A Note}, 37 \textit{J. FIN.} 219 (1982)(“[S]cale effect in administrative costs of bankruptcy, wherein the dollar amount of the administrative costs is a concave function of the liquidating value of the firm.”); Titman & Wessels, \textit{supra note 212}, at 6 (1988)(suggesting that “small firms may be more leveraged than large firms and they may prefer to borrow short term (through bank loans) rather than issue of long-term debt because of the lower fixed costs associated with this alternative.”).

\textit{972. See} Titman & Wessels, \textit{supra note 212}, at 5-6.
Exchange and NASDAQ listing standards also focus on size to determine whether a firm will be able to attract market makers and maintain an efficient market. Both NASDAQ limitations and Small Business Administration standards reflect a concern with relative market power. An appropriate response to the distinctive aspects of small firms would be to set the initial capitalization, at which double taxation would begin, at a level equal to or higher than the minimum requirements for listing on the NASDAQ system. This would accurately reflect liquidity concerns, market power limitations, and differences in the cost of financing. Appropriately, such a standard would exempt many small start-up enterprises.

B. Capital Structure Assumptions and Debt-Equity Classification

1. In General

The rationales for a double tax system are also related to the assumptions underlying that system. Replacing equity with debt

973. For additional information regarding the size determination of a corporation, see 13 C.F.R. § 121, Small Business Size Standards, reprinted in 52 Fed. Reg. 32870 (1987) (the most recent proposal for size standard revisions). Modification of the size standards which are generally based on gross receipts or employee number were revised to make existing size standards compatible with the new industrial classification system. See 52 Fed. Reg. 2400 (1987), modified, 52 Fed. Reg. 6133 (1987). Examples of the current size standards are: computer manufacturing, $1 billion and 2,500 employees; scheduled air transportation, $1.5 billion and 1,500 employees; local trucking without storage, $12.5 million and 100 employees; books, current periodicals and newspapers wholesale, 100 employees and 85 employees; computer and software retail stores, $4.5 million and 50 employees.

The SBA standards can also be viewed as relative, and not based on direct market comparisons. The service industry of the legal profession is one example. In 1980, the SBA proposed a 15 employee size standard (presumably including the number of employee owners). Later, in 1987 it proposed an additional gross receipts standard of $3.5 million. These are unrealistic in the era of megafirms which offer expanded services in different departments. According to the National Law Journal's 1989 survey, the nation's largest firm is Baker & McKenzie, with 1,339 lawyers, followed by Jones, Day, Reavis & Pogue, with 1,088 lawyers, and Skadden, Arps, Slate, Meagher & Flom, with 1,053 lawyers. More than half of the firms making the list of 250 firms have 200 or more lawyers. Nat'l L.J., Sept. 18, 1989, at 51 (Annual Survey of the Nation's Largest Law Firms).

974. The NASDAQ listing requirements are discussed at supra note 934.

975. One could also permit an entity or a "business" that had not previously been conducted as a business to operate free of the corporate tax for a minimum of three years. This would alleviate start-up costs thus helping new firms survive. Indeed, the absence of full loss offsets distorts the decision to invest in risky and start-up firms since these firms have no income from which to deduct present losses. See supra note 898 and accompanying text.

976. If the assumption of the system is that all income will bear a double tax, then
without a shareholder level tax circumvents these assumptions unless, as under the ALI Reporter's original proposal, an excise tax is imposed on nondividend distributions and, as under the Reporter's present proposal, a minimum tax is imposed on corporate distributions. Another issue is the extent to which capital structure must be frozen. While it is debatable whether the allowance of a firm level interest deduction causes leveraged buyouts or acquisition premia, it cannot be denied that an interest deduction funds the premia by allowing a cash flow valuation of the firm's ability to be purchased by new owners in a bootstrap transaction. The deduction of interest may not cause acquisition premia, but there is little evidence that it does not fund it. Capital structure shifts can thus be viewed as circumventing assumptions underlying the double tax regime. The necessity of maintaining the assumptions underlying the double tax does not lessen the concern over capital structure change and the appropriate toll charge for such change. Another issue is the extent to which
existing biases, such as the debt for equity bias, must be limited even in the initial structuring of firms.983

The imposition of limitations on firm restructuring without a compensating tax and limitations on the form of firm capitalization ab initio are two separate issues. The first reflects the symmetry in a double tax regime which views payments that benefit continuing owners as constructive but does not tax them. The second is one that seeks to limit, perhaps artificially, the distortions created by the firm level tax through interest deductibility limitations based on gross receipts, net assets, interest rate, and percentage of debt to equity. The adoption of the double tax system with a liquidity standard would lessen the need for such limitations. Any new equity integration proposal requires a mechanism to prevent the conversion of old equity into new equity without the appropriate tax cost.984 This issue is really a subset of the problems surrounding the appropriate treatment of nondividend distributions within Subchapter C, but has a separate focus in an integration system that is concerned with windfall gain985 and the creation of a circular vehicle for integration of old equity.986

2. Debt-Equity Classification and Firm Level Deductions

The liquidity standard raises three specific questions regarding debt-equity classification. First, are new rules needed to better distinguish debt from equity? Second, are new rules needed to prevent or compensate the tax system for debt replacing equity transactions? Finally, should there be a limitation on the deductibility of interest in order properly to measure economic income or profit?987 If the proposal made herein were adopted, the issue of

basis of $40 and earnings and profits of the firm are $65. The ordinary income would be $65 and the shareholder would have a $5 capital loss. The correct computation of earnings and profits would reflect a decrease in earnings and profits from a redemption, which would also be taxed under this method.

983. This takes many forms, including the various proposals for interest deduction limitations discussed infra notes 987-1023 and accompanying text. Saul Levmore demonstrates the reasons for this difference between the change of expectations and the initial financing of the firm as producing different policy justifications. Levmore, supra note 925, at 491.

984. See supra note 801 and accompanying text.
985. See supra notes 8 & 127 and accompanying text.
986. See supra notes 801 & 808 and accompanying text.
987. The measurement of economic income of a firm is the starting point for a double tax on profit. A normative determination of economic income includes a deduction for the real rather than inflationary component of interest and a consideration of disallow-
debt-equity classification would largely be eliminated for firms without liquid equity.\textsuperscript{988} For firms not in the double tax system, the determination of debt and equity, except for arbitrage opportunities, is relatively unimportant.\textsuperscript{989} However, neutrality between debt and equity cannot be achieved for firms with liquid equity unless there is a meaningful definition of the difference between an equity risk and a debt risk. The nature of the risk is economically the most important feature in distinguishing a contingent right to income and a return of principal from a noncontingent one,\textsuperscript{990} for both straight debt\textsuperscript{991} and hybrid instruments.\textsuperscript{992} This

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  \item For the purpose of interest deductions where the investment financed is subject to a low or zero effective tax rate. See \textit{Corporate Financial Structures}, supra note 4, at 77-78. As discussed in relationship to the liquidity proposal, no consideration of disallowance of interest based on the effective tax rate of the income it produces is made because that is an issue beyond the scope of this article and applicable to all forms of investment.

  \textsuperscript{988} If there were a collection of the single level tax at the firm level, a classification issue might still exist where debt to shareholders would provide some advantages through rate arbitrage or because of the return allowed on equity for some reason set at a lower rate than the return on debt. Arbitrage for debt placed to tax exempts, or preferred stock to corporate shareholders would still be possible. \textit{Cf. Corporate Financial Structures}, supra note 4, at 112-13 ("Consideration should be given to limiting the tax arbitrage potential of pass-through entities, if tax arbitrage is limited in the corporate sector.")

  \textsuperscript{989} This is not to suggest that arbitrage is unimportant or should be ignored.

  \textsuperscript{990} I.R.C. § 385(b) (West 1988) lists relevant factors drawn from case law to determine the noncontingent nature of debt. Other factors, such as the participation in voting rights, while an important right of control generally associated with equity participation, the absence of which are not as controlling given the ability of firms to create dual class structures for equity. This risk analysis is different from whether the interest is expected to be paid out of the firm's cash flow, the debt-equity ratio of the firm issuing the debt, and other traditional factors in the debt-equity classification, \textit{see Plumb, supra note 729, at 503-37, but seeks to determine at what point a return is an "equity" profit and a part of economic income in a neutral system allowing a return for noncontingent capital contributions. It is also somewhat different from the view of some that "the sources of risk for equity and low grade bonds are quite different." \textit{House LBO Hearings I, supra note 16}, at 60-61 (prepared statement of Alan Auerbach) (also noting that interest deduction denial to produce neutrality "depends on the relative tax treatment of debt and equity, not on the riskiness of debt").

  \textsuperscript{991} The line between high yield subordinated debt and preferred stock is indefinite. \textit{See Warren, Integration, supra note 1, at 738.}

  \textsuperscript{992} In spite of contingent claims analysis that values the debt and equity components of convertibles, a case can be made that certain "hybird" instruments should be initially treated as equity. \textit{See Klein, The Convertible Bond: A Peculiar Package, 123 U. Pa. L. Rev. 547, 570 (1975)} (convertible debt is "deferred equity"). In examining the tax consequences of convertible and other issues, the restrictions in the instruments relative to the rate of return also must be examined. \textit{Cf. Bratton, The Economics and Jurisprudence of Convertible Bonds, 1984 Wis. L. Rev. 667. Convertibles have large and significant equity components directly related to the probability of a conversion induced common stock decline. This theory conflicts with the notion that debt increases the firm's value by increasing its financial leverage. \textit{See Janjigian, The Leverage Changing Consequences of Converti-}
classification has in the past been viewed as an all or nothing proposition, but recent legislation bifurcates the debt-equity treatment of a single instrument reflecting the concept of interest as a less risky cost of capital. This approach parallels and advances the tax policy goals of some of the proposals for elimination of the bias toward debt finance but not others. If neutrality

ble Debt Financing, FIN. MGMT., Autumn 1987, at 15, 20. In the October of 1987 crash, convertibles traded in line with junk bonds and this prompted their decline to be much worse than common stocks or straight debt. See Wrubel, Rag Tops, FIN. WORLD, Dec. 29, 1987, at 100 (convertible investors were caught off guard by how little downside protection was provided by their convertible coupons).

993. See supra note 49. This includes not only regulatory authority to bifurcate instruments — an arguable extension of the power of the Treasury — but also explicit statutory bifurcation of certain original issue discount bonds into preferred stock and debt components to the extent that actual interest is paid. See OBRA, supra note 49, at § 7208(a).

994. This also includes with respect to original issue discount bonds a view of payment as a highly relevant factor in assessing equity risk. Cf. Galai & Masulis, The Option Pricing Model and the Risk Factor of Stock, 3 J. FIN. ECON. 53 (1976).

995. Many solutions to the debt-equity problem are offered to advance various goals. Professor Graetz, who views the issue as at least providing for a single tax on income from the firm, and if 'Congress desires, a double tax on other income, proposes a nonrefundable credit for firm level taxes paid on net pre-tax income before any interest deduction, which would have the result of taxing interest at least once and a portion of dividends once and if distributed to taxable shareholders, a portion of dividends twice. See Graetz, The Tax Aspects of Leveraged Buyouts and Other Corporate Restructuring Transactions, 42 TAX NOTES 721 (1989)(resulting windfall gain and loss would be shifted among the same taxable and tax exempt shareholders and bondholders, with a probable net gain to individuals). Th. liquidity proposal is consistent with this proposal in identifying the firms for which double taxation is appropriate. The ALI Reporter’s proposal to grandfather existing investment payments and limit interest deductions on new equity and new debt, see supra notes 797-828 and accompanying text, also is consistent with the liquidity proposal in defining what portion of a firm’s economic income should be double taxed. James Poterba has suggested to lower the cost of capital that either a percentage of all capital be deductible (at rates that would not produce a revenue loss) as the conclusion of a joint study, see G. Hatsopoulos, J. Poterba & P. Krugman, supra note 833; Kleinbard, supra note 221, or that a portion of new equity capital be entitled a deduction, see House LBO Hearings II, supra note 16 (prepared statement of James M. Poterba). These proposals are consistent with a liquidity standard.

Other proposals aimed at specific transactions, such as interest in connection with hostile or friendly acquisition, increasing the scope of I.R.C. § 279, disallowing interest on new or existing debt that replaces equity without adopting an interest-like return for new or existing equity, disallowing interest deductions at a set debt-equity ratio or a percentage of taxable income, and disallowance of interest above a specific rate or interest reflecting inflation for new or existing debt without allowing an interest return on new or existing equity, or total disallowance of the interest deduction are not related to the goals of the liquidity proposal. For a description of these proposals, see CORPORATE FINANCIAL STRUCTURES, supra note 4, at 103-12; Clark & Sunley, Corporate Debt: What Are the Issues and What Are the Choices?, 42 Nat’l TAX J. 273, 279-82 (1989). Even if adopted in connection with relief for equity, interest deduction limitations based on debt-equity ratios or
between debt and equity finance is not achieved through a parallel allowance of an interest deduction on equity and a limitation on the interest deduction on debt, proposals to better define debt and equity or to provide the appropriate interest return to all firm capital take on greater meaning.

A mechanism is needed that will prevent the replacement of old equity with new equity and debt. Such replacements can be viewed as a distribution to the existing equity holders since the benefit of increased leverage inures to them. In comparing these replacements in existing firms with the leveraging of new firms, the issue is whether the tax paid by the redeemed shareholders in the existing firm fully compensates for the increase in value of the firm to the remaining shareholders based on leverage. Proposals

taxable income do less to define the risk of equity than does a rate limitation for interest deductions.

These proposals include the instruction to the Treasury to classify instruments as part debt and part equity. The Senate report accompanying the amendment to I.R.C. § 385 suggests the following approach:

Section 385 is amended to allow the Treasury Department to characterize an instrument having significant debt and equity characteristics as part debt and part equity. For example, such treatment may be appropriate in circumstances where a debt instrument provides for payments that are dependent to a significant extent (whether in whole or in part) on corporate performance, whether through equity kickers, contingent interest, significant deferral of payment, subordination, or an interest sufficiently high to suggest a significant risk of default.

SENATE REPORT TO H.R. 3299, 101st Cong., 1st Sess. 66 (1989). To the extent a high interest rate suggests an equity risk, bifurcation is not the analytically correct result based on risk-return analysis. See infra notes 1007-09 and accompanying text. Several other proposals aimed at debt equity classification are more like proposals aimed solely at debt and the interest deduction. See, e.g., House LBO Hearings I, supra note 16, at 917 (prepared statement of Alan L. Feld), reprinted in 42 TAX NOTES 735 (1989) (deny the interest deduction where the firm's debt to equity ratio exceeds 4:1 for large firms); Plumb, supra note 729, at 629-32 (patternning the limitation on debt-equity ratios under early tax law); Bierman & Bierman, A Corporate Tax Reform Proposal, 33 TAX NOTES 841, 843 (1986)(deny all interest deductions). Other proposals deal in a more detailed manner with the issue of classification. Thompson, Debt/Equity Issues: A Suggested Approach to LBOs, 42 TAX NOTES 483 (1989)(proposing brightline rules to distinguish debt from equity and limitations on conversions of equity to debt in LBOs). These proposals include (1) limiting the interest deduction for debt replacing more than 80 percent of equity, (2) requiring a minimum payment of 80 percent of the applicable federal rate for debt classification, (3) requiring convertibles to bear a rate of interest at least 90 percent of the applicable federal rate, (4) disallowing the deduction for contingent payments or interest paid in stock or debt of the issuer, (5) requiring a duration of 30 years or less with special rules for 25 percent shareholders of 20 years or longer, and (6) providing special rules for demand loans. Id. See supra notes 221 & 995.

See supra note 4, at 107-08.

For the value of leverage inuring to the benefit of the equity holders, see supra note 230. The current view of the value of such leverage is that "[t]he shareholders in a
to deny the interest deduction for debt replacing equity transactions thus may be viewed as transforming the benefit of leverage into a constructive dividend, taxed at the firm level, to the remaining shareholders.\textsuperscript{1000} Under these proposals, new firms will start fresh whereas old firms will face the freezing of their capital structures. Therefore, while these proposals remove the tax inducement for debt replacing equity transactions, they raise neutrality issues in the entire treatment of capital structure and the current operation of the capital markets.\textsuperscript{1001} Neutrality may best be accomplished by treating the payment of principal on debt that replaces equity through redemptions or liquidations as a taxable distribution to the remaining shareholders that is followed by a retribution to the firm. Whether the retribution should be viewed as debt, which would be treated under the rules applicable to new debt and would characterize the interest payment to the creditor with whom the debt was placed, or as an equity contribution, which would characterize the interest payment to the contributor under the rules applicable to new equity, is also an issue.

The scope of the ALI Reporter’s proposal for a minimum tax on distributions extends beyond debt replacing equity transactions. The Reporter’s proposal would characterize the principal payment on newly issued or existing debt as a distribution which would be taxed to the remaining shareholders through the firm level payment of the shareholder level tax. The proposal would characterize the interest payment under the rules applicable to dividends on equity rather than debt, although the Reporter’s new equity proposal allows partial deductibility of dividends and limits debt payments to the same rate.\textsuperscript{1002} However, an argument can be made levered, limited-liability corporation are thus essentially the owners of a call option whose exercise price is the promise in the senior securities.” Miller, supra note 215, at 109.

\textsuperscript{1000} This is precisely the Chirelstein-Bacon debate over the appropriate tax treatment of redemptions. See supra note 451.

\textsuperscript{1001} The determination of exactly which interest to limit is a problem, for example whether it should be limited if a purchaser makes a debt financed acquisition of assets and the firm is liquidated and whether there would be liquidation-reincorporation problems. See House LBO Hearings I, supra note 16, at 400 (prepared statement of Alvin Warren). It is for precisely these neutrality reasons that many policy makers testified in favor of not limiting the interest deduction on debt as a single approach to the taxation of debt and equity. For example, Alan Greenspan testified in favor of not limiting interest deductibility. See Senate LBO Hearings, pt. 2, supra note 16, at 56 (prepared statement of Alan Greenspan). The focus of the SEC, on the other hand, has been on the adequacy of disclosure of risks presented by LBOs. See House LBO Hearings I, supra note 16, at 113-70 (prepared statement of David S. Ruder).

\textsuperscript{1002} See Reporter’s Study Draft, supra note 53, at 80-85 (Proposal 2(a)).
that the applicable rules should be those for debt.\textsuperscript{1003} Under the Reporter's proposal, the minimum tax would capitalize the double tax for any nontaxable distributions to shareholders under an implicit contract that corporate income will bear a double tax.\textsuperscript{1004} The minimum tax on distributions would be a permanent structural feature that would capitalize the double tax\textsuperscript{1005} by treating principal payments as distributions to the remaining shareholders as a basic structural tenet of the tax system.\textsuperscript{1006} It would also prevent the conversion of old equity into new equity if an interest-like deduction for payments on new equity is allowed; and it would be neutral for both new and old firms.

Achieving tax neutrality for the choice between future financing with debt or equity in new firms is more difficult and raises other neutrality issues. There is substantial evidence that the holders of high yield debt bear risks that are at a minimum somewhere between the risks faced by equity holders and those faced by debt holders. This evidence is based on the functioning of junk bonds relative to changes in the underlying value of the firm and interest rates and the betas of high yield debt portfolios relative to the betas of treasury and investment grade debt portfolios,\textsuperscript{1007} and

\begin{itemize}
  \item corporate payment of a minimum tax on distributions would create a nonrefundable credit for the shareholders and would assure double taxation of all distributions, but not the interest payments in debt replacing equity transactions. \textit{See} Warren, Restructuring, supra note 1, at 719.
  \item The argument for treating the recontribution as debt by the existing shareholders is that the full double tax has been paid, it is presumably held by a creditor such that under existing rules it would be treated as debt such and that merely the pro rata benefit to the existing shareholders should not cause it to be recharacterized as equity. Even if held pro rata by the remaining shareholders, it would have been first tested as to whether it constitutes debt or equity. \textsuperscript{1004}
  \item \textit{See} Graetz, supra note 995, at 722 (noting that the view of the ALI project is "that the existing corporate tax regime is the equivalent of an implicit contract that once assets are placed in corporate solution, they will not be removed without incurring a tax burden that reflects the costs of future corporate taxes"). \textsuperscript{1005}
  \item \textit{See} House LBO Hearings I, supra note 16, at 62-64 (prepared statement of Alan Auerbach) (minimum tax on distributions accomplishes the same result of getting at the windfall problem through a tax deferral with interest; whether it encourages or discourages conversions of equity into debt, repurchases or dividends depends on the view of the provisions for a tax on distributions to be a permanent fixture of the income tax). \textsuperscript{1006}
  \item \textit{See} Warren, Restructuring, supra note 1, at 720 (noting that "Congress could enact a new corporate tax on distributions, creditable at the shareholder level . . . perhaps coupled with a partial deduction for dividend payments with respect to new equity contributions . . . [as a] solution . . . definitely preferable to limiting interest deductibility, if Congress accepts the view that the central tax system problem relates to elimination of future corporate taxes through nontaxable distributions, whether or not debt financed"). \textsuperscript{1007}
  \item Support for classifying junk bonds as equity comes from the fact that the mar-
ket values of high yield bonds are somewhat less sensitive to increases in interest rates and respond to a greater degree than investment grade debt to changes in the financial outlook of the underlying company. J. Hampton, Handbook for Financial Decision Makers 151 (1979). The equity factor of high-yield bonds is used to explain the relatively high level of real interest rates on these corporate securities despite the nominal interest rate plunge. Boss, Has the Growth in Corporate Debt Led to Increased Risk?, Bus. Econ., Jan. 1982, at 46, 47. Junk bonds have a risk different from investment grade bonds due to two features:

First, since junk bonds have higher coupon rates, they have shorter 'durations' than investment grade bonds. That is, the weighted average of the times at which cash is received over the life of the bond is shorter for a junk bond. This in turn implies that junk bonds values are less sensitive to interest rate fluctuations than the values of investment grade bonds. Since the 1977-1986 period was one of substantial interest rate fluctuations, this factor may have dominated the relative variability of realized bond returns.

Second, junk bonds are typically protected by smaller equity cushions than investment grade bonds, and these are more sensitive to fluctuations in the value of the issuing firm's assets. The value of the assets in turn reflects the present value of the operating cash flows they generate. As a result, the variability of junk bond returns is more heavily influenced by sector, industry, and firm-specific factors than is that of investment grade bonds. However, much of the risk stemming from these fluctuations may be diversifiable [just as the systematic risk in stocks is diversifiable]. Thus the risk of a large portfolio or index may be substantially less than the average risk of the individual bonds.

Taken as a whole, the investment characteristics of junk bonds are unlike those of either high grade bonds or common stocks. Their lower sensitivity to interest rate changes and the diversifiability of a substantial portion of their risk make them unlike high-grade bonds. Like common stocks, junk bond values move up and down with the value of the issuing firm's asset. Unlike common stocks, however, this upward movement is truncated for junk bonds beyond a certain point. This is because most junk bonds are callable; and if the issuing firm's creditworthiness improves dramatically, it will find it advantageous to call the bonds and refinance at a lower rate.

In the final analysis, investing in junk bonds may be most akin to a covered call option strategy, whereby a portfolio manager buys common stocks but also writes call options on those stocks. If the stocks fail to appreciate, the portfolio manager still receives the premium income from having written the call options. If the stocks do appreciate, however, the portfolio's upside potential is limited, because the stocks will be called away.

Perry & Taggart, The Growing Role of Junk Bonds, J. Applied Corp. Fin., Spring 1988, at 37, 40, 43-44 (noting that junk bonds can substitute for new equity issue while allowing the firm to utilize its full borrowing capacity). Perry and Taggart's update of their original study demonstrates the increased equity features of high yield debt instruments. See K. Perry & R. Taggart, The Development of the Junk Bond Market and Its Role in Portfolio Management and Corporate Finance (unpublished working paper, Feb. 1989). High yield bonds outperformed stocks and outperformed investment grade bonds prior to recessions, but they underperformed investment grade bonds during periods of recession. While interest rates are rising prior to a recession, the percentage of high yield volatility attributable to company and sector risks is higher and those effects outweigh the interest rate effect. Id. at 4-5. The beta and standard deviations of monthly returns for the high yield bond market were 0.354 and 2.336 respectively. These beta and standard deviations are closer to the deviations for large stocks (1.086 and 4.332 respectively) and small stocks (1.123 and
it is based on the risks of junk bonds in bankruptcy. To the extent that junk bond debt is priced as residual equity, capital structure neutrality and the calculation of economic income are not maintained without a limitation on the deductibility of interest. Another approach would be to disallow the interest deduction entirely for such high yield debt which demonstrates a greater similarity to equity through beta comparisons based on interest rates and to fully enforce the equity characteristics by treating the distribution as a dividend. Under the proposed liquidity test for double taxation, liquid "debt" functions in the same manner as does liquid equity, notwithstanding the difference in the liquidity premium and the preference for debt rather than equity securi-

4.232 respectively) than are the deviations of investment grade bonds (0.269 and 1.849 respectively). Id. at 6, 24. The variance in high yield bonds was regressed against investment grade bonds and common stocks. For the period 1982-1986, 50.2% of the variance in junk bond returns is attributable to movements in the investment grade bond market, 27.1% of the variance is attributable to movements in the general stock market, and the remaining variance is not explained by movements in either market which leads to diversification opportunities unique to the high yield bond market. Id. at 7. Finally, the return for unit of risk in the junk bond market is substantially higher for 1982-1986 than for stocks and investment grade bonds. Id. at 8, 25. Whether this has changed is an open question. Using mutual fund data from funds invested in low grade bonds, Cornell and Green find that (1) the variance for low grade, high yield bonds is "considerably greater" than that for high grade bonds after the variance for interest rates is removed, (2) a 14 percent change in long term Treasury bond prices has an impact on high grade bond prices that is responsive to interest rates that is almost 15 times greater than the impact on low grade bond prices, and (3) market factors other than interest rates affect low grade bonds more than high grade bonds. See B. Cornell & K. Green, The Investment Performance of Low-Grade Bond Funds 9, 12 (University of California at Los Angeles Working Paper, Oct. 1989). They also find betas of .20 for long term Treasury bonds, .22 for high grade bonds, and .43 for low grade bonds as compared to the market beta of 1.0. Id. at Table I. Other evidence suggests that high yield bonds are not perfect substitutes for the stock of firms issuing the bonds. See Blume & Keim, Lower-Grade Bonds: Their Risks and Returns, FIN. ANALYSTS J., July-Aug. 1987, at 26, 32-33.

If the capital redeployment theory is applied, then those changes in the value of junk bond debt which reflect risk in the issuer form an equity risk. The change in the yield relative to interest rates, on the other hand, is a debt or market interest rate risk. The Miller-Modigliani model demonstrates that the before tax return on equity increases as the return on debt decreases. Hedging portfolios for junk bonds also resemble hedging strategies for common stocks. See Bookstaber & Jacob, The Composite Hedge: Controlling the Credit Risk of High-Yield Bonds, 42 FIN. ANALYSTS J., Mar.-Apr. 1986, at 25. For the use of junk bonds in place of equity, see Pozdena, Takeovers and Junk Bonds, BUYOUTS & ACQUISITIONS, Jul-Aug. 1987, at 41.

For existing firms, the ability to offer junk bond financing removes the bite of the corporate tax on a portion of profits.

If the profits tax model is accepted as the appropriate model for the corporate tax, rather than an absolute classical system that fully enforces the equity characteristics of high yield debt, then the rate of the interest deduction allowed under any profits tax proposal must either match the rate in the marketplace for "debt" or the interest deduction allowed on debt must be limited to a riskless rate of return plus a risk premium reflecting the risk in the highest grade of debt for private rather than government issued debt securities. To the extent that any deduction for payments to the debt or equity suppliers of capital to the firm is allowed for an interest rate that reflects payment for an equity premium, it reduces the tax base of the profits tax and distorts the measurement of economic income. This conclusion is based on the view that any rate in excess of the return on Treasury bills reflects both a liquidity risk based on time and an issuer risk factor. The underlying return reflects the real interest rate and inflation. Any return in excess of the return to riskless federal debt securities of similar duration reflects a premium for risk; and to the extent that the instrument is not traded in a market as liquid as the Treasury securities market, any excess reflects a liquidity premium. Determining the amount of the premium for issuer risk and then determining the point at which risk is a contingent equity risk rather than a noncontingent debt risk is the issue, even though financial theory demonstrates that there is no principled distinction between debt and equity financial claims. The precise rate of the permissible interest return is extremely important.

1009. Under the CAPM, the determination of the equity cost of capital is made with reference to the risk free rate of return and the market risk premium which is multiplied by the firm's beta. See R. Brealey & S. Myers, supra note 62, at 136-40. This analysis provides a means to check, relative to the interest rate on debt, the appropriate equity risk of the firm relative to its debt risk above the risk free return. For firms without a beta, industry betas could be used as a benchmark for the riskiness of the firm as to all other firms. Significant deviation between the debt cost of capital and the equity cost of capital between industries could be utilized to determine the appropriate interest rate benchmark.

1010. This view is very close to the one discussed by Ronald Pearlman, Chief of Staff of the Joint Comm. on Taxation. See Daily Tax Report (BNA), May 16, 1989, at G-6 ("economists should be able to agree that rates exceeding Treasury instrument rates by a substantial amount no longer represent interest but instead are a payment in the nature of equity made to compensate the investor for taking a financial risk").

1011. The approach is one to measure economic income. See Corporate Financial Structures, supra note 4, at 104 ("If one accepts the premise that all interest on debt is properly deductible without regard to whether the debt supports an asset that produces
tant because it defines the profit element that should be double taxed, and under the liquidity theory for the double tax it defines the appropriate tax base for income inuring to the benefit of the equity holders even though the holders may now be holding instruments nominally denominated as debt. (The percentage of the liquidity premium relative to the percentage of the equity return would establish the appropriate tax rate). To the extent that the interest deduction limitation on debt is not at the same rate as the interest allowance on equity, the limitation can be viewed as violating neutrality as compared to noncorporate or illiquid investment.\textsuperscript{1012} Defining an equity liquidity risk is the key. If there is little or no liquidity premium for large firms in the private market for high grade debt,\textsuperscript{1013} the limitation of the interest deduction at a high grade bond rate, even if measured against the federal rate plus a risk premium, would allow a purer risk adjusted return to 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 non-risk portion to be fully deductible. A primary issue with respect to this type of approach is the selection of the permitted deductible 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 considerably less important.". The difficulty in segregating interest from equity profits and earnings from personal services is also not an absolute bar to the correct taxation and determination of pure profits. \textit{But see} W. \textsc{Vickrey}, \textit{supra} note 39, at 353-54 (income from equities and participating interests is an inadequate measure of economic control). The approach in the ALI supplemental study reflects this concern, although the selection there of the federal rate plus two percent does not reflect a uniform view of the appropriateness of that rate:

\begin{quote}
It is not important for the operation of this proposal that this rate be exactly right. Indeed it is not clear what exactly right would mean. The effort should be to pick something approximating what the market would likely demand for a nonparticipating debt investment in an enterprise that is not unduly leveraged; but what that means is more a matter of judgment than measurement. Other suggestions about what the rate should be are welcome.
\end{quote}

\textit{Reporter's Study Draft, supra} note 53, at 93. \textit{Cf. Reporter's Study on Corporate Distributions, supra} note 53, at 373 ("The precise level at which the specified rate is fixed is distinctly less important than that some rate be set and allowed"). A neutral interest disallowance could be fashioned based on a combination of the risk element, the extent to which payments are made (to the extent that dividends can be paid), the balance sheet ratio, and the share of operating earnings paid out in interest or the ratio of interest to dividend payments. \textit{Senate LBO Hearings}, pt. 2, \textit{supra} note 16, at 201-02 (prepared statement of Lawrence Summers)(limitation on this approach is that it does not deal with repurchases or with unbundled stock). This approach also fails to deal with the interest component of rental payments. \textit{See} C. \textsc{Shoup}, \textit{supra} note 298, at 314.

\textsuperscript{1012} \textit{See} \textsc{Corporate Financial Structures, supra} note 4, at 112-13.

\textsuperscript{1013} \textit{See supra} notes 483 & 527.
capital and would not tax the equity risk. The high grade bond rate may not be the appropriate measure of a reasonable debt risk, as evidenced by the ability of firms to issue debt at less than the high grade rate and the acceptance in the market of higher leveraging of firms. However, allowing a return on the time value of money component of the use of capital may be highly appropriate as a means of measuring economic income. Thus, whether the rate should be two percent over the federal rate as in the current ALI proposal or six percent as in recent legislation with respect to accrual interest deductions is an issue to be resolved based on the ultimate goal of the system. If the goal is to define a tax base of economic income, then the cost of capital allowance should be the same for debt and equity instruments in determining "profits." If the goal is neutrality with the existing market for debt denominated instruments, then the choice of the higher rate for the deductible interest return on equity is appropriate even though it does not measure economic income. Finally, if some neutrality with debt is preferred in computing economic income and profits and in the debt-equity choice, then debt can be classified separately from equity and equity can be given a cost of capital allowance based on the investment grade bond rate.

Even if an interest deduction limitation and an allowance of an interest return on equity capital are not adopted based on a specified rate, the rules for determining debt-equity classification should be revisited. In order to distinguish debt from equity, the classification rules must focus more clearly on the market based approach to high yield debt and its relationship to underlying firm equity values and cash flow. Proposals that require actual cash payment go far in this regard.

1014. Limiting the interest deduction to the federal rate without a risk premium would be incorrect unless one accepts the double taxation of business returns in excess of the riskless rate of return. That position is not advocated by this Article which finds double taxation to be appropriate only under an excess profits analysis as to the value of liquidity.

1015. The original proposal for a rate geared to investment grade bonds is for those companies that can issue them, exactly right, see REPORTER'S STUDY ON CORPORATE DISTRIBUTIONS, supra note 53, at 367, under the assumption of a fair noncontingent return to capital, but does not go far enough in determining the appropriate rate if neutrality between debt and equity is to be achieved and if that rate is the rate used to limited interest deductibility for corporations but not other taxpayers.

1016. See, e.g., House LBO Hearings I, supra note 16, at 560-61 (prepared statement of Jack Levin). In some proposals, it is this risk characteristic that would cause all zero coupon debt to be treated as equity. See Thompson, supra note 996, at 485; see also supra note 186 and accompanying text.
In determining the appropriate interest rate for equity, which may also be the rate to which debt securities are limited, the rate could be adjusted for smaller firms. Equity risk premia vary by industry and activity. Without distorting the double taxation of the equity risk premium of a given firm, an allowance of an interest deduction on equity could be set at a permissible rate of return to take into account the higher degree of market risk existing in smaller companies that leads to higher borrowing costs. A market measure such as beta provides a measure of market risk by size and by industry. For example, the permissible rate of return allowable as an interest deduction in the case of large firms could be set at the high grade bond rate whereas the permissible rate for small firms could be set at a rate several points higher — a rate that arguably would compensate equity risks in such firms which are reflected in higher borrowing costs based on size but would be neutral as to the underlying business risk of the firms. Setting the permissible interest component at a higher figure for smaller companies would provide a desirable incentive for individual investors, although increasingly the percentage of venture capital is from tax exempt and corporate funds, since equity investment would be less discounted upon entry to the double tax system when going public.

There are both horizontal and vertical equity grounds for allowing those smaller firms subjected to double taxation a higher rate of return. Perhaps market capitali-

1017. See supra notes 607-10 and accompanying text; see also Corporate Financial Structures, supra note 4, at 104-05 ("[E]ven though it is arguable that a high degree of risk suggests an equity investment, and that a high interest rate suggest a high degree of risk, the practical result of such an approach may be that certain startup firms, or firms involved in inherently risky ventures, may be more restricted in their ability to deduct all of the interest demanded by investors than other more established or stable firms. A variation in the permitted rate might be adopted for such situations; however, arguments then may be raised that whichever taxpayers are permitted the higher deductions may obtain a competitive advantage over other ventures also involving risk, which may have implications for neutrality of the tax system in this respect."). This is related in part to the role and value of liquidity for large and small firms in placing debt in the public and private markets. See, e.g., Hays, Jochnk & Melicher, Differential Determinants of Risk Premiums in the Public and Private Corporate Bond Market, 2 J. Fin. Res. 143, 149-51 (1979)(investors in the public market are more concerned with marketability and quality as indicated by the default risk measures).

1018. For evidence of the increased costs of borrowing in smaller firms, see supra notes 607-10.

zation and size would be a useful and fair distinction for the allowance of a higher interest deduction for smaller firms however they are defined.

The limitation of the interest deduction has an additional effect in a profits tax based on the liquidity standard. If the return on many high yield bonds closely resembles an equity return, a liquid form of that financing might be considered "equity" and placement of liquid high yield bonds would cause the firm to pay the double tax. This would have ramifications for firms that are private and trade equity privately, but choose to issue high yield debt publicly. If there is no limitation on the use of high yield debt by firms that trade equity privately, a capitalization standard may be necessary to determine whether these firms are more properly viewed as significantly owned by the debt providers. Debt-to-equity ratios would be appropriate indicators for making this determination. This suggests an additional need to define the equity risk in a liquidity system as based on the rate of return.

In summary, the proposal made herein would eliminate many of the concerns about debt-equity classification if a double tax system is to be maintained. It would also use market financial data to identify those firms that can be allocated interest relief on a sliding scale. A limitation based on gross assets would not be as analytically pure of an approach. Integration of the tax through a deduction of dividends equal to the disallowance of bond interest could be phased in along with the proposal made herein. Other issues remain which are beyond the scope of this article such as allowing tax exempt entities to receive interest payments without tax addressed in part by recent "earnings stripping" legislation, rate arbitrage, and intercorporate investment.

In my view, neutrality between debt and new equity financing

1020. See supra note 995.
1022. See supra notes 49 & 987-89.
1023. For example, the bias for foreign acquisitions by any limitation on the interest deduction (rather than a better definition of the equity return), could be avoided if a rule were adopted that would limit interest deductions in recapitalizations only and for the amount by which U.S. taxpayers are generally limited and limiting the deduction of any U.S. interest paid to foreigners after an acquisition if it is traced to payment of foreign indebtedness used to acquire the stock. See Thompson, supra note 996, at 486.
cannot be obtained without first better defining debt and equity risks when determining the allowance of a deduction for returns on debt and equity. The proposal herein completely eliminates many firms from the double taxation category, and for those firms it eliminates the tax induced concern over financial structure. Nonetheless, for firms within the double tax category, any reduction in the distinction between debt and equity financing advances neutrality in the corporate finance decision. A reduction in this distinction is also required for the proper calculation of economic income in the formulation of a profits tax.

C. Capital Gains Preference

The liquidity proposal requires that the rates on corporate equity be at a parity with or higher than the individual rates in order to prevent the firm from creating a deferral value for corporate investment. The essence of the liquidity standard is an admitted double tax on equity. Under the generally accepted view, a capital gains preference at the shareholder level will, under the current system, cause retentions to be favored over distributions unless it is offset by a significantly higher corporate rate. The adoption of a capital gains differential in either rate, or the allowance of a basis adjustment to prevent taxation of inflationary gains, will cause a preference for equity by high bracket taxpayers relative to debt and will lower the equity cost of capital to firms even if the corporate rate is higher than the individual rate. The distortion of a capital gains preference under these circumstances does not affect the liquidity proposal. Indeed, in the ongoing debate over the capital gains preference which is beyond the scope of this article, recent views of the value of a capital

1024. See supra notes 94-102 and accompanying text.

1025. See Constantinides, supra note 106 (timing option of equity to realize capital losses and defer gains); Miller, supra note 61 (value of equity taxation through unlimited deferral); see also supra note 106. Feldstein and Slemrod find that at least under pre-1986 tax law that the portfolio effect for shareholder for whom the corporate tax double tax regime is favorable due to the treatment of retentions if these individuals are also more responsive to after-tax yield differentials, will result will be a corporate tax that both increases the effective tax rate of corporate income and increases investment in corporations. Feldstein & Slemrod, supra note 551.

1026. See, e.g., Hearings Before the Senate Finance Comm. on Capital Gains, 101st Cong., 1st Sess. (Mar. 14, 1989). See also Gravelle & Lindsey, Capital Gains, 38 Tax Notes 397 (1988) ("capital gains represent a deferred return on an investment that may already be heavily taxed" and for corporate source income may be justified in reducing the differential between it and the taxation of noncorporate production at an efficiency
gains preference in ameliorating the so-called "lock-in" effect\textsuperscript{1027} and its role in promoting venture capital\textsuperscript{1028} are particularly relevant to the liquidity standard.

Recent views find that the capital gains preference has less to do with the funneling of cash to venture capital\textsuperscript{1028} than do loss offset provisions for venture capital losses.\textsuperscript{1029} As to the lock-in effect, the preference has a strong effect on the change in and diversification of investors' existing portfolios in similar financial assets, but little effect on new capital formation.\textsuperscript{1031} The issue is not just the elasticity of the demand for capital gains,\textsuperscript{1029} or the revenue gain or loss,\textsuperscript{1032} but the taxation of such investments. The proposal advanced in this Article operates regardless of the imposition of a capital gains preference, and promotes taxation of ven-

\textsuperscript{1027} See Auerbach, Capital Gains Taxation and Tax Reform, 42 NAT'L TAX J. 391, 395 (1989).
\textsuperscript{1029} This proposition is advanced on two bases. First, most venture capital investment is made by investors not subject to the individual capital gains rates. In 1987, individuals made up only 18.5 percent of the capital providers of new firms, while corporate and untaxed capital providers were much more significant. The venture capital industry may be effective at getting equity capital to firms when they need it so that the corporate ordinary income rate is even more important. Id. at 375-79. Second, the overwhelming majority of capital gains transactions are in investments that are not start-up firms. Id. at 375, 380-82. Nonetheless, there may be a link between the capital gains rate and the demand for venture capital funds in the occupational decisions of entrepreneurs based on their human capital investment horizons. See Poterba, Venture Capital and Capital Gains Taxation, in 3 TAX POLICY AND THE ECONOMY 47, 56-63 (L. Summers ed. 1989). This link is a variation on the finders-keepers motivation for entrepreneurial discovery. See supra note 739 and accompanying text. For the same point made with great wit, see Baker, Quoth the Maven: Venture Capital and Tax Reform, 32 TAX NOTES 1087 (1986).
\textsuperscript{1030} Targeting capital gains treatment specifically to venture capital start-ups in risky industries is a possibility. See Poterba, supra note 1028, at 382-84. More generous loss offset provisions may be more effective given the high rate of business failures. Id. at 384. For a discussion of other alternatives, see Auerbach, supra note 1027, at 397-400 (indexing basis to offset for inflation, special provisions for venture capital, realization of gains at death, accrual taxation of gains, and dividend integration). See also supra note 898.
\textsuperscript{1031} Auerbach, supra note 1027, at 395 ("[Lock-in] is a distortion to the distribution of assets across investors, not to the overall composition of assets.").
\textsuperscript{1032} Auten, Burman & Randolph, Estimation and Interpretation of Capital Gains Realization Behavior: Evidence From Panel Data, 42 NAT'L TAX J. 353, 353-60 (1989) (estimating elasticities through time-series and panel data and reviewing the elasticity studies to date).
ture capital by lowering the tax burden on start-up investments operating in the public market if sufficient liquidity is not present.

D. New and Existing Equity

A liquidity standard would simplify the windfall gain and loss problems that exist under the current system. Since the double tax line would be drawn on liquidity, other policy considerations could be met by expanding Subchapter S significantly for new firms. Implementing the liquidity standard for firms that would fall outside of the double tax regime also raises windfall gain questions. If firms were integrated under the S regime, the current toll charge on electing S corporation status should be reviewed to determine if it adequately compensates the tax system for income and assets that have been in the double tax regime. One of the main difficulties in allowing an unlimited S election for larger firms is the extent of the windfall gain. Even though the windfall gain problem may prevent the integration of existing firms unless transitional relief is provided or unless the bifurcated view of tax capitalization is accepted, a new class of equity ownership in new and existing firms could be integrated under any number of partial integration models. Integration of existing equity, coupled with transitional relief to avoid windfall gains, could also be accomplished under a liquidity standard by fully integrating all firms without liquid equity and allowing an interest-like deduction for all firms with liquid equity.

E. Public to Private and Private to Public Shifts

Any system that bases entity level taxation on public trading or liquidity must monitor transfers from public status to private status. Institutional investors financing leveraged buyouts or management buyouts and venture capital investors generally plan to liquidate their investments through the public market. A safe-

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1034. Expanding the scope of Subchapter S to include all but "public" firms would require a transitional provision for existing firms that are presently larger than the arbitrary 35 owner limitation.
1035. See infra note 1060.
1036. The incentive effect of integrating existing capital is also suspect since the benefit inures to existing investors. See Summers, supra note 8, at 118-19.
1037. Windfall gains are discussed at supra notes 60-71.
1038. See supra note 828 and accompanying text.
1039. Kohlberg, Kravis, Roberts & Company operates in this way. Its equity base of $40 billion gives it sufficient capital to purchase all ten Minneapolis based Fortune 500...
guard is required to ensure that previously undistributed earnings, subject to an entity level tax, will be taxed when they are later distributed to the owners. Based on reverse leveraged buyout data, five to seven years is a reasonable period for determining whether a change to illiquid ownership is permanent.® If proposed Rule 144A is adopted in its present form, then most companies with equity principally owned by institutional investors following privatization will remain subject to the corporate tax because of the liquidity enjoyed by the equity holders.

The flipside of public firms that go private and then reappear on the public market in a reverse leveraged buyout are firms that are initially private and then plan to go public. A question companies should it choose to do so. See Loomis, Buyout Kings, FORTUNE, July 4, 1988, at 52, 53. The company treats its operations as an investment, not a permanent holding. Thus it operates as "a conglomerate always in flux" Id. at 54. See also Brophy, supra note 757, at 130 (venture "capital investors [are] interested in 'cashing' out after reasonably short (three to five) year holding period."); L. Lowenstein, supra note 164, at 182-83 (The advantages of private ownership are largely short in duration and an investor group will not be content for long with merely paper profits. This means that the going private firm is "inherently unstable and will soon metamorphose into something quite different."). But see supra note 520 and accompanying text.

1040. "Typical buyouts are geared to a five-year time horizon." Kraakman, supra note 44, at 912 n.78. Other data from 1981-1986 reverse LBOs suggests an average of three years. See C. Muscarella & M. Vetsuypens, supra note 173, at 5. Moreover, during the rising stock market of 1987, the time period was significantly shortened. See SUBCOMM. ON OVERSIGHT INVESTIGATIONS OF THE HOUSE COMM. ON ENERGY AND COMMERCE, 100TH CONG., 1ST SESS., LEVERAGED BUYOUTS AND THE POT OF GOLD: TRENDS, PUBLIC POLICY AND CASE STUDIES 26 (Comm. Print 1987)[hereinafter POT OF GOLD]. Other evidence also suggests that the period is much shorter than five years. See Don't Leap at These Reverse LBOs, MONEY, July, 1987, at 13; POT OF GOLD, supra, at 1040 ("While there were 30 reverse LBO's during [all of] 1986 . . . 13 LBO's were estimated to have gone [sic] public during the first quarter of 1987, raising . . . approximately $623 million in new capital.").

Profit for these reverse LBO's can be dramatic. Gibson Greeting Card was taken private in 1982 for a price of $80 million. It went public again a year-and-a-half later for $290 million. POT OF GOLD, supra, at 1040. Beatrice Cos. went private in April 1986 with a $6.25 billion LBO price and has sold assets valuing between $8.8 to $10.8 billion. Id. at 28. See also Hector, Are Shareholders Cheated by LBOs?, FORTUNE, Jan. 19, 1987, at 98)(listing changes in market value for selected reverse LBO's none of which had a percentage increase less than 33%). Another example is Boy's Markets, Inc. It is a 54-store supermarket chain that was acquired in April 1986 for $83 million from the founding family by a buyout firm. It went public again in 1987 for $125 million. Grocery Chain in Buyout Talks, N.Y. Times, Mar. 2, 1988, at D5, col. 4.

1041. Similarly, the adoption of liquid ownership may not be permanent. Few firms are continuously traded in a regional sub-market for very long. Successful firms tend to move to the national over-the-counter market and then list on an exchange. Smaller, unsuccessful companies may move from fairly active trading to a point where they have but one or two market-making dealers. Studies of regional and OTC markets have demonstrated a fairly large firm mortality and illiquidity rate. See Senchack & Beedles, supra note 598, at
arises as to whether the preferred stock of these firms, that has no current return but that has a cumulative right to unpaid dividends, should be discounted by the probability that a future corporate tax may be payable, and if so whether possible avoidance devices should be allowed to exist to mitigate against such a discount. The shareholders might try to avoid the discount by causing a firm that was contemplating a public offering to substitute debt for the participating preferred stock. Therefore, restrictions on the use of debt to replace equity must be applied to firms contemplating a public offering or a merger with a public firm, at least for debt issued within a certain time frame prior to that offering. A two or three year restriction would be appropriate. Substituting debt for equity may not be possible given market restrictions and the need for a favorable balance sheet to make a public offering. However, shareholders should be prevented from avoiding a properly imposed double tax on profits and the resultant discount of their shares.

F. Foreign Firms

Inbound foreign investment currently presents classification issues under the publicly traded partnership standard. Under a liquidity standard it presents questions regarding the appropriate characterization of the distributions received by United States and foreign owners. The treatment of firms that have publicly traded equity outside the United States is also an issue. Increasingly, firms that are domestically incorporated and firms incorporated in foreign jurisdictions that have United States taxable income are

130; Queen & Roll, supra note 609 (discussing firm mortality rates). Nonetheless, since the market presumably capitalizes the value of liquidity upon going public, there is no reason to apply a testing period if sufficient liquidity is present on going public.

1042. Under a liquid ownership test the firm would not be subject to the double tax. Presumably the ALI proposal for debt-replacing equity would not be applicable since it ought to be applicable only for firms in a double-tax world.

1043. This mirrors to some extent the current holding period requirements for the transferability of restricted securities. See 17 C.F.R. § 230.144(d) (1988) (holding period for restricted securities under Rule 144 is two years). Restricted securities refers to securities acquired from the issuer in a non-public transaction. 17 C.F.R. § 230.144(a)(3) (1988) (definition section of Rule 144). The resale restrictions of Rule 144 also apply to certain persons who receive securities in mergers or asset acquisitions, although Rule 145 permits the resale of such securities without registration or a holding period provided the quantity and other restrictions of Rule 144 are met. See 17 C.F.R. § 230.145(d) (1988). See also Hicks, supra note 969.
going public outside the United States.\textsuperscript{1044} The need to police trading in foreign public markets could be eliminated by limiting the trading requirement to established security exchanges, and a facts and circumstances liquidity test could be implemented to avoid the use of foreign incorporation to avoid the double tax. Many foreign firms are listed on United States exchanges and NASDAQ, as well as foreign exchanges.\textsuperscript{1045} Since the home jurisdiction may have a very liquid market, the foreign listing should be respected and illiquidity in the domestic market should be overlooked.

While the benefits theory supports extension of the public trading line to firms that are traded in United States markets, neutrality principles dictate extending the double tax line to firms that are traded in foreign markets and that conduct businesses effectively connected to the United States. Therefore, two tiers of foreign corporations could be created, and a look through rule would be required to test whether the firm was in fact public based on ultimate ownership or intermediate ownership.

G. Joint Ventures and Interfirm Investment

Joint ventures between unrelated firms present interesting problems. Joint ventures between public and nonpublic firms generally should be treated as passthrough entities where the ownership interests in the joint venture itself are not publicly traded. However, the increased ability to borrow of a publicly traded firm engaged in a joint venture with a nonpublicly traded firm suggests that the venture should be treated as a double taxed entity to the extent that features of the agreement suggest that it is relying on a liquid equity market for capital.

Interfirm investment will raise problems under the proposed system similar to those present under current law. The most significant of these problems is the treatment of the intercorporate
dividend deduction. Once it has been determined that a firm should be subject to double taxation under the proposed standard, the firm's shareholders should be denied a dividends received deduction for the equity portion of the dividend if those shareholders themselves are double taxed firms.

Public parent firms with liquid equity should treat subsidiary earnings under a consolidated return approach. The question then becomes at what rate should the parent receive a dividends received deduction or otherwise be able to consolidate income with the subsidiary. The standard for consolidation of a liquid parent with liquid or illiquid subsidiaries could be set at the current eighty percent of value requirement. For firms with liquid equity that own less than eighty percent of another firm with liquid equity, the issue would be whether to allow a dividends received deduction. Closely held firms with subsidiaries with a significant portion of liquid ownership would have to be single taxed, but the subsidiaries themselves would be double taxed. The portion of liquid ownership necessary to qualify the closely held parent companies for single taxation would need to be determined under the general evaluation of equity liquidity.

If debt securities are treated as debt, then this issue is also significant for parent corporations tied to subsidiaries through debt. If the debt is high yield and traded, then the issue of liquidity is present. This is the same issue that is present under the general classification of debt and equity. If it is determined that high yield debt is debt, and there is no parallel interest deduction disallowance for instruments that pass the debt classification test, then there is an opportunity for nonpublic parent corporations to utilize the public market for capital through the issuance of debt securities by subsidiaries. This circumvention of the double taxation of equity points to the need for a parallel disallowance of the interest deduction or a revision of the debt-equity classification rules to prevent avoidance of the profits tax. If high yield securities are illiquid, the issue of liquidity value does not arise.

H. Co-ownership and Financial Intermediary Definitions

Co-ownership arrangements that provide for put rights be-

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1046. The resemblance test determines co-ownership arrangements and exempts from partnership or business classification those arrangements that are not the conduct of the business. The ownership of these productive assets should not be treated as meeting the first criterion for a double-tax system: the existence of a business activity. See Treas. Reg.
tween co-owners might fall within a publicly traded or liquid ownership test for the double taxation of profits. If existing definitions of financial intermediaries and income as product are maintained, then co-ownership, as distinguished from a business entity such as a partnership, and the definition of financial intermediaries should be coterminous\textsuperscript{1047} regardless of liquidity arrangements among co-owners.\textsuperscript{1048} Arrangements under which a business is conducted that would be classified under existing rules as a trust should not present concerns even if liquidity is provided.

I. Access to Subchapters S and K and Graduated Corporate Tax Rates

Once the classification issue has been settled, the taxation of firms outside the double tax regime becomes a series of policy choices.\textsuperscript{1049} Commentators have indicated that it would be desira-
ble to expand S corporation status to include firms of up to one hundred shareholders.\textsuperscript{1050} When a numerical limitation is used to determine access to S corporation status care must be taken to maintain the line,\textsuperscript{1061} and the treatment of entities as owners must be given consideration.\textsuperscript{1062} Prior to 1986, Eustice and Kuntz advanced the "publicly traded line as the ultimate boundary."\textsuperscript{1053} Double taxation is only justifiable under normative taxation principles on the basis of a "liquidity" or "publicly traded" line. Numerical limitations lose their magic once it has been determined under a liquidity standard that the firm is not appropriately taxed in a double tax regime. Tax neutrality between limited partnerships and corporations requires that the limitation on the number of S shareholders be abandoned and that the limitations on the character of the shareholders be reevaluated.

The ability of firms to make S elections also raises issues re-
garding the appropriate toll charge for firms moving to passthrough taxation. An S election is a valuable freezing device and motivates transactional planning. While present rules require that gain on the sale of assets be treated as a liquidation of the old corporation, the value of a ten-year deferral, for which selective inroads have been enacted, is great. The S election is not tax neutral between the sale of a business and the continuation of a business with a contribution by new purchasers, since the latter transaction allows elective deferral at the price of a carryover basis. The treatment of earnings and profits upon an S election is also generally favorable. A requirement that S corporations purge their earnings and profits at capital gains rates was proposed and was rejected. In a flat tax world with the repeal of both the General Utilities doctrine and section 337 of the Internal Revenue Code, the case for the technical liquidation of a C corporation upon making an S election is much stronger. In a flat tax world, the problems in the treatment of earnings and profits and appreciated assets of firms making an S election can be viewed as both the failure to collect a shareholder level tax upon the firm’s entry into passthrough taxation, and the failure, in a post-General Utilities world, to tax asset appreciation currently. On the other hand, in a flat tax world other technical

1056. See I.R.C § 1368(a) & (c) (West 1988)(for firms with earnings and profits, distributions first come from any single-level taxed income after the election).
1057. The liquidation analogy applies to shifts from C to S and was proposed in Hearings on the Subchapter S Revision Act of 1982. See 1982 House Subchapter S Hearing, supra note 1049, at 219 (statement of Martin Ginsburg); see also Ginsburg, supra note 153, at 573 (explaining Professor Ginsburg’s testimony at the House Hearing). Purg- ing of the accumulated earnings and profits account could be done if the corporation, when it shifts from C to S status, throws off its accumulated earnings and profits so that they can be taxed to each shareholder as capital gain in the amount by which the proportional part of the corporation’s net asset basis exceeds the shareholder’s basis in his shares. It has been argued that capital gains’ treatment is appropriate because liquidation is the proper analogy. 1982 House Subchapter S Hearing, supra note 1049, at 220-21 (statement of Martin Ginsburg).
1059. Prior law was drafted when a liquidation was allowed to go untaxed at the corporate level under the General Utilities doctrine. While a technical liquidation could have been possible for non-General Utilities gain (recapture, accounts receivable, and the like), that avenue is not pursued.
1060. Whether this is a problem depends upon assumptions on tax capitalization. If the small firms eligible for S elections had not contemplated sales prior to liquidation, then the windfall might be less due to the lack of capitalization of the potential tax.
provisions of the S corporation statute take on less significance.\textsuperscript{1061}

Objections to allowing S corporations to issue multiple classes of stock are based on perceived problems in allocating income and loss among the owners and the potential for income shifting.\textsuperscript{1062} Notwithstanding these objections, a rule could be devised to allocate income to stock based on the underlying right to dividends. An accumulated adjustments account could be maintained for each class of stock to prevent distribution of the earnings attributable to one class of stock to another class of stock.\textsuperscript{1063} Thus, complex income allocation could be maintained under the S model in a manner similar to that used by partnerships. The S corporation regime could also be expanded in other ways to be more like Sub-

\textsuperscript{1061} If S corporations provide a higher individual rate of return after tax than do C corporations (except where the graduated corporate rates apply), shareholders will presumably elect S status. Therefore a majority vote, if provided for in the articles of incorporation, ought to be sufficient for an S election. This would eliminate problems with unavailable or dissident minority holders as well as problems with transfers in violation of shareholder agreements that were not disqualifying but were nonetheless made.


\textsuperscript{1063} For example, assume X corporation has elected S status. It has one class of common stock, two classes of preferred stock and one class of debt. For year 0, X corporation has $100,000 of taxable income before interest payments. It owes $15,000 in interest which is paid to the debenture holders reducing its income to $85,000. The Class A preferred has a right to dividends of $20,000 which is superior to the $10,000 dividend right of the Class B preferred and the common stockholders. Twenty thousand dollars of income is allocated to the Class A preferred and the next $10,000 to the Class B preferred. The remaining $55,000 is allocated and taxed to the common stockholders. Each class of stock has an accumulated adjustments account that equals the income previously taxed while the distributions from that account are tax free. If, however, income is only $20,000 after the payment of interest on debt and there is a distribution to the Class B preferred (assuming it has a zero accumulated adjustments account), it is deemed to come from the accumulated adjustments account attributable to the common stock and then to the superior Class A preferred. This distribution would be taxable to Class B preferred while it would be deductible to the class of stock whose accumulated adjustments account had been reduced. Problems of cumulative preferred could be resolved by first reducing all distributions, even to common shareholders, of the accumulated adjustment account of that class and by taxing the distribution to the recipients. Such a system would require some basic tax avoidance principles based on a modified form of the partnership special allocation rules, would require evaluation of the relative rights to income between the classes of preferred stock, and would put a premium upon payment of the preferred dividend since the preferred shareholders would be taxed on the corporation's income based on relative priorities. A simplified system that can be reconciled with the S regime would put the corporation and the preferred shareholders on the cash method of accounting for dividends and treat the payment of the dividend as a charge against income which would be deductible to the corporation and passed through to the shareholders. This approach would create an excess deduction carry forward instead of a loss and would not affect the accumulated adjustments account. See J. Eustice & J. Kuntz, supra note 6, \S 1.03 [2][6][v], at 1-49 to 1-50.
chapter K.\textsuperscript{1064}

There are many rationales for graduated corporate tax rates. The basic theme of these rationales is the promotion of small business capital formation and the differentiation of the ability to pay a firm level tax for firms with smaller incomes.\textsuperscript{1065} The liquid equity proposal has a different view of the need to promote capital formation for new, small, and risky businesses. First, it exempts these firms from the double tax system and places them in the pass-through system, which eliminates the present corporate bias for small firms and provides a cost of capital wedge for differentiating large firms. Second, it accommodates the cost of capital equalization of graduated rates on an ability-to-pay rationale and the calculation of economic income through a variable interest deduction for smaller firms with liquid equity.\textsuperscript{1066} Elimination of the graduated rates removes the deferral possibilities for profit retention.\textsuperscript{1067} Moreover, strong arguments can be asserted for why pure pass-through taxation should be mandated for closely held firms.\textsuperscript{1068} The maintenance of graduated corporate rates is less justifiable in a flat tax world, and thus should be eliminated.\textsuperscript{1069}

\textsuperscript{1064} For example, Subchapter S could be more closely conformed to Subchapter K by providing a cash method of accounting for dividends on the preferred stock of S corporations, which would tax the preferred stockholder only upon receipt of a dividend while continuing to tax the firm's common stockholders on the corporation's earnings and profits. See also Eustice, supra note 1062, at 412 (Eustice believes that Subchapters S and K should be harmonized. "Today Subchapter S is definitely closer to Subchapter K than it is to Subchapter C. No doubt greater parity can . . . be attained . . . ."); Coven, \textit{Subchapter S Distributions and Pseudo Distributions: Proposals for Revising the Defective Blend of Entity and Conduit Concepts}, 42 \textit{TAX L. REV.} 381 (1987)(As first enacted in 1958, Subchapter S used most of the entity concepts that fashion the taxation of nonelecting corporations.).

\textsuperscript{1065} \textit{TREASURY DEP'T, SMALL BUSINESS, supra} note 712, at 7-8 (graduated rates have a tenuous ability to pay connection since entities do not have ability to pay tax but "seems to have the same fundamental purposes as other tax measures for small business — either to favor small business or to offset its comparative disadvantages" defined annually in the form of net income); H. Groves, \textit{POSTWAR}, supra note 76, at 85-88 (graduation questionable under assumption that small businesses cost government less or receive fewer benefits, but can be justified as a means of controlling monopoly and reducing the differential corporate tax burden between small corporations and partnerships and is a "tool for favoring smallness or penalizing size").

\textsuperscript{1066} \textit{See supra} notes 1017-19 and accompanying text.

\textsuperscript{1067} \textit{See supra} notes 76-77 and accompanying text.

\textsuperscript{1068} \textit{See Brooks, supra} note 76, at 384-85 (closely held corporations should be able to elect taxation as a partnership).

\textsuperscript{1069} This was noted by \textit{2 TREASURY I STUDY, supra} note 8, at 129.
CONCLUSION

This Article set out to fill a void in the existing legal literature by drawing from finance, public finance, and corporate law traditions to explore corporate taxation. A scholarly legal work dealing with the taxation of corporations and shareholders, which advocated an integrated or imputation system, 1070 criticized a proposal by the ALI Reporter that sought to correct the structural biases in the classical corporate tax regime 1071 on the ground that the proposal failed to provide a normative basis for double taxation if firm profits are allowed an interest-like deduction on new equity contributions. The issues raised by this criticism remained unsettled until renewed interest in the double tax system occurred in 1986 with the passage of the Tax Reform Act. Legal scholarship then proposed several corporate tax alternatives within the classical regime without providing a normative basis for any of them, 1072 and the fundamental question posed earlier was left unanswered. A nagging feeling and intuitive argument unsupported by a strong set of rationales persisted in favor of double taxation of large public firms but not of small or private firms. 1073 This Article has attempted to test this intuition under established criteria for tax policy evaluations and within the theory of an income tax. To quiet the concerns of some that the nature of corporations and other entities has not been adequately addressed and to lay to rest the notion that the tax is a tax on legal fictions, this Article also addressed the rationale for the resemblance test.

In order to reach the conclusion that profits taxation is the appropriate model, one must take a stand on a principle of capitalization of taxes and a view of the initial incidence of the firm level tax that may not be accepted by all. This Article comes to the not surprising conclusion that public firms are for tax policy reasons different from private firms, but not for the reasons that might have been expected. It demonstrates that a public-private line can be drawn on a normative ground and that there is a nor-

1070. See Warren, Integration, supra note 1, at 760-61 & n.130; see also Warren, Restructuring, supra note 1, at 720 (“An implicit normative premise can be derived from the proposals — that the corporate tax base should be limited to the return on existing equity plus the excess of earnings on new capital over a specified rate of return — but that premise is neither intended by the project (which is directed only at refining the current regime) nor the most obvious premise on which to base fundamental reform.”).

1071. For the 1979 draft of the ALI Reporter’s proposals, see supra note 54.

1072. See supra notes 672-725 and accompanying text.

1073. See supra notes 398-408 and accompanying text.
mative rationale for a double tax on equity that resolves the entity classification issue. It does not solve the debt-equity classification issue but gives support to the prior suggested solution of strengthening the test based on the risk characteristic differences between debt and equity.

The main thesis of this Article has been that the legal criteria for the imposition of the classical corporate tax under the United States tradition cannot be divorced from a consideration of whether double taxation is itself appropriate and of whether it enhances fairness and efficiency. Part I set forth the competing considerations after the 1986 Tax Act that influence management decisions about an optimal capital structure. Part I then demonstrated that the current legal standard is based on the faulty premise of the fiction of the legal personality of the firm. Part II set forth the structural components of an income tax that would justify the taxation of firms with liquid entity. This justification is based on a modified version of the power over income rationale for an income tax. Part II also set forth evidence on the incidence of the corporate tax which is important in assessing the likely impact of the tax on the global economy. Part III argued that liquidity lowers the cost of capital to a firm. Part III also noted evidence of the increasingly institutional composition of the equity market. Finally, Part III proposed the double taxation of liquidity in the context of market microstructure analysis of liquidity. Part IV set forth present and proposed standards for differences in tax treatment based on the existence of a public market, with a particular focus on the 1987 partnership legislation. Part V examined and rejected a number of other proposed rationales for the double tax. Part VI tested the liquidity proposal against equitable and efficient tax policy criteria. Part VI also offered evidence to support the inelasticity of demand for liquidity, thus demonstrating that the proposal for taxing the value of liquidity as an economic rent is consistent with optimal taxation standards. Part VI also considered the liquidity proposal in light of the proposal of the American Law Institute Reporter for a deduction for a portion of the return on new equity contributions. Part VII raised various issues in the form of an agenda for inquiry that would have to be resolved in order to implement the proposed system.

In the past, the ALI Reporter's new equity proposal was criticized for not making an efficiency argument in favor of profits taxation. One reason for this failure is the fact that the basis for a
double tax system was never explored. I have attempted to formulate a defensible normative rationale for a double tax system that satisfies the understood criteria of fairness and efficiency and the underlying goal of taxing those who have power over income. The decline in savings and the increased trend toward consumption in the United States has been attributed to the increased cash payouts from firms to investors through interest payments and capital gains that are then used for consumption rather than reinvested in savings.\textsuperscript{1074} Directly addressing the issue of the treatment of debt and equity and the biases in the existing system is a high priority. Under a neutral rationale, I am convinced that a double tax that does not distort debt versus equity financing decisions can only be achieved by rewriting the corporate tax as a profits tax to allow an interest component of the return to equity capital to escape double taxation, even if parallel treatment is not achieved by limiting the interest deduction on debt instruments. This proposal could be enacted for only new equity, or enacted for new and existing equity if appropriate transitional relief were provided.

Adoption of the liquidity standard would require revisiting the thorny issues on public trading that were briefly addressed in the 1987 legislation. However, these issues would now be discussed in a manner that would seek to select the firms with liquid equity to which the new standard will apply. One option is to select these firms on the basis of size. The conclusion of this Article is that firms with highly liquid equity can be double taxed without sacrificing the fairness, efficiency, and structural components of an income tax.

A recent development with far reaching economic and legal implications is the trend in the United States toward privatization, with financial institutions playing the leading role long held by public markets. This trend is the reverse of recent events in Japan

\textsuperscript{1074} See G. Hatsopoulos, P. Krugman, & J. Poterba, supra note 833, at 5, 9-11 (advocating elimination of differential tax treatment of equity and debt to reduce the trend of higher cash payments to shareholder and bondholders, and in specific, a proposal for a tax deduction for a percentage of corporate capital). This counters the position advocated by Michael Jensen and others that the forced capital gains from leveraged buyouts, debt-financed takeovers are rechannelled to new productive savings and investment. A counter to the Hatsopoulos, Krugman, and Poterba assertion is that to the extent that the amounts are paid to retirement and pension plans, the form of savings of most individuals, the forced realization and the higher payments cannot be currently used for consumption which forces plan managers to find additional investment vehicles.
where capital markets are providing record amounts of equity capital to Japanese corporations in public offerings. If Rule 144A is adopted by the S.E.C. in its proposed form, the resulting liquidity to institutional investors that hold most of the equity in these privatized companies, which are often huge enterprises like RJR Nabisco, will lead to the imposition of the corporate tax on such companies under my criteria.

While one may disagree with my ultimate conclusion, I believe that this Article sets forth a useful process for choosing which business entities should be subject to double taxation. This process mirrors the recent attention that the legal world and Congress have paid to questions grounded in finance theory, public finance, revenue, and other tax policy considerations when assessing the current United States classical corporate tax regime and the implications of that regime for capital structure that increasingly favors debt. Normative rationales also have their biases and mine are apparent here — progressivity, lower distortions between sectors, and nondistortionary taxation of what I view as pure profits without changing market expectations. The normative argument that I make is based on fairness, ability to pay, horizontal equity, neutrality, and efficiency. The picture I paint in broad strokes in tax, finance, and corporate law theory has familiar resonances. It is an approach to a problem that has been identified many times before and was recently reiterated as follows: "perhaps the best celebration of the twenty-fifth anniversary of Harberger's remarkably influential model would be a rebirth of analytical attention to the questions of what constitutes a corporation and what the corporation income tax precisely does tax." 1075

A liquidity based standard could solve many of the difficult line-drawing efficiency concerns which accompany any form of profits taxation.

1075. J. Gravelle & L. Kotlikoff, supra note 353, at 779.