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The Entity Tax and Corporate Integration: An Agency Cost Analysis and a Call for a Deferred Distributions Tax

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I. INTRODUCTION

The United States income tax law imposes a tax on a corporation's profits and also assesses a tax on dividends shareholders receive from the corporation.¹ This "classical double tax system" has prevailed despite commentators' repeated calls for integration of the individual and corporate tax systems.² The Department of the Treasury and the Reporter for an American Law Institute recently joined those commentators supporting integration.³ This article evaluates the entity tax, the related double tax, and the integration proposals using an agency cost analysis. Further, this article proposes, as an alternative to current integration models, a deferred distributions tax on undistributed profits instead of the current entity tax.

Part II of this article justifies the Code's incorporation of both entity taxation and passthrough taxation under an agency cost analysis. Part II first enumerates the agency costs that occur because the manager acts with an eye toward her personal tax situation as an investor. The article then focuses on the agency costs resulting from the manager acting in her role as manager. These latter conflicts dominate this article's justification of the entity tax.⁴ Then Part II looks briefly at the unique agency costs inherent in tax loss entities. Finally, Part II offers guidelines for determining when an organization should serve as a pass-through entity and when entity taxation is the better choice. The presentation emphasizes the role of investors as managers, laborers, or passive investors, and the nature of entity as capital-intensive, labor-intensive, or merely passive.

The agency cost justification for the double tax is explored in Part

1. I.R.C. § 11 (West 1992) (tax imposed on corporations); I.R.C. § 301(c) (West 1992) (dividend included in shareholder's income).

2. See, e.g., Charles E. McLure, Jr., *Integration of the Personal and Corporate Income Taxes: The Missing Element in Recent Tax Reform Proposals*, 88 HARV. L. REV. 532 (1975); Scott A. Taylor, *Corporate Integration in the Federal Income Tax: Lessons From the Past and a Proposal for the Future*, 10 VA. TAX REV. 237 (1990); Alvin Warren, *The Relation and Integration of Individual and Corporate Income Taxes*, 94 HARV. L. REV. 717 (1981).

3. DEP'T OF TREASURY, REPORT ON INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS: TAXING BUSINESS INCOME ONCE (1992); Alvin C. Warren, Jr., *Integration of the Individual and Corporate Income Taxes*, A.L.I. FED. INCOME TAX PROJECT 1 (1993).

4. Professors Hideki Kanda and Saul Levmore have used agency cost analysis to evaluate the double tax. See generally Hideki Kanda & Saul Levmore, *Taxes, Agency Costs, and the Price of Incorporation*, 77 VA. L. REV. 211 (1991). Two significant differences exist between this article and Kanda and Levmore's piece. First, this article views the major agency cost as resulting from the manager's control of cash distributions needed to pay any resulting tax obligations, whereas Professors Kanda and Levmore consider the financing of the tax liability as a neutral consideration. *Id.* at 236-37. Second, this article concludes that the greatest source of agency cost between the manager and the outside investors occurs when the manager acts in her role as manager, whereas Professors Kanda and Levmore see the conflict as greater when the manager acts with an eye toward her personal tax situation as an investor. *Id.* at 230.

III. This Part recognizes the federal government's interest in collecting tax revenue and its legitimate goal of receiving at least the present value of all outstanding tax obligations. Initially, Part III evaluates the Treasury's current corporation-shareholder integration proposals under agency cost concerns. Next, Part III offers, as an innovative alternative to the Treasury's current integration proposals, a single tax on distributions the investors receive from the firm, coupled with a deferred distributions tax on the realized profits retained in the firm. The discussion characterizes the current tax on earned profits as too imprecise for current tax policies, which demand a stricter adherence to time value of money concepts. Assessing a deferred distributions tax on undistributed profits satisfies time value of money concerns and balances agency cost tensions.

II. JUSTIFICATION FOR ENTITY TAXATION AND PASSTHROUGH TAXATION

After briefly setting out background material and introducing terms and concepts, Part II justifies both the entity tax and passthrough taxation in the same taxing regime under an agency cost analysis. Business organizations are an aggregation of persons who associate with the objective of making a profit.⁵ The business organization as a legal fiction clothes a series of contractual interrelationships.⁶ Many persons have interests in any business organization, including investors, managers, employees, creditors, suppliers, and customers. Each participant views the organization from a different perspective, and each has different, and at times conflicting, objectives.⁷ Often, especially for closely-held organizations, the investors also manage or otherwise labor in the business.⁸ For larger, more complex organizations, the investors are persons different from the managers and other employees, although there may be some overlap. Investors are usually the residual equity holders and are considered the owners of the organization.⁹

Investors historically chose the corporate form to save taxes.¹⁰ Corporate rates lower than individual rates, the corporation's power to defer distributing earnings as dividends, and the shareholders' ability to recognize the retained earnings (and untaxed value appreciation) as tax-favored capital gains by selling the stock often resulted in a lower over-

5. See, e.g., Treas. Reg. § 301.7701-2(a)(2) (as amended in 1983).

6. See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 310-11 (1976).

7. *Id.* at 307.

8. HARRY G. HENN, *LAW OF CORPORATIONS* 694 (3d ed. 1983).

9. *Id.* at 383.

10. Kanda & Levmore, *supra* note 4, at 214.

all tax burden than a single tax at the individual's tax rate.¹¹ Between 1986 and 1992 the tax environment became less friendly to shareholders: maximum corporate rates exceeded maximum individual tax rates¹² and long-term capital gains were not accorded the degree of tax-favored treatment enjoyed prior to 1986.¹³ Congress in 1993 partially restored the pre-1986 situation. For one, maximum corporate rates again are lower than maximum individual rates.¹⁴ In addition, capital gains once again garner privileged treatment.¹⁵

The graduated tax benefit remains a potentially more significant benefit, especially for smaller firms. Corporations pay only fifteen percent of taxable income up to \$50,000 taxable income and only twenty-five percent of taxable income between \$50,000 and \$75,000.¹⁶ Therefore, by incorporating rather than conducting business in a passthrough entity such as a partnership, owners can take advantage of the lower corporate tax rates. Shareholders who are also employees can maximize the advantage of both the graduated corporate tax rate and the graduated individual rate by adjusting salaries and bonuses. Current law restricts the potential for more successful corporations to benefit from the graduated rate by phasing out the graduated rate for corporations having taxable incomes in excess of \$100,000¹⁷ and by denying the use of the graduated rates for certain personal service corporations engaged in health, law, engineering, architecture, accounting, actuarial science, performing arts, and consulting.¹⁸ Manufacturing and sales corporations with taxable incomes under \$100,000 still benefit from the corporate graduated rates.

11. Recognition deferral of dividend income or capital gains resulted in tax liability being delayed. The tax savings calculation made by tax practitioners was to discount to present value the tax liability of deferred distributions and compare that amount to the tax liability if the earnings were currently distributed. See Kanda & Levmore, *supra* note 4, at 214.

12. Compare I.R.C. § 1 (West 1992) (maximum individual rate of 31%) with I.R.C. § 11 (West 1992) (maximum corporate rate of 34%).

13. Compare I.R.C. § 1(h) (West 1993) (taxing capital gains at a 28% rate) with I.R.C. § 1202(a) (West 1985) (repealed 1986) (allowing a 60% deduction on capital gains).

14. Individual rates (39.6%) again will exceed maximum corporate rates (35%). Revenue Reconciliation Act of 1993, Pub. L. No. 103-66, §§ 13202(a), 13221(a), 107 Stat. 312, 461, 477.

15. The maximum rate on net capital gains for individuals is 28%, so a taxpayer in the 39.6% marginal tax bracket experiences an 11.6% absolute savings and a 29% relative tax savings compared with the taxes on ordinary income. This rate differential once more may encourage transmutation of ordinary income to capital gains.

16. I.R.C. § 11(b) (West 1992). An added historical tax benefit for corporations and their shareholders was the waiver of the double tax on distributions in liquidations. However, this is no longer the rule. See BORIS I. BITTKER & JAMES S. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 7.21, at 7-52 to -53 (5th ed. 1987).

17. See I.R.C. § 11(b)(1) (West 1992).

18. See I.R.C. §§ 11(b)(2), 448(d)(2)(A) (West 1992).

A. *Terms and Concepts Defined*

A manager who is also an investor may consider her personal situation in making decisions for the organization as long as the decisions fall within the range of reasonable business decisions subject to the discretion afforded the manager under the business judgment rule.¹⁹ Even if the manager sacrifices her own personal well-being to benefit the business, her decisions could have a disparate impact on the various investors. Individual investors, therefore, could disagree among themselves on actions taken or contemplated by the manager.

Commentators have labelled as "residual loss" the divergence between the benefit the outside investor (principal) would receive if the manager (agent) acts to the investor's optimal benefit and the benefit the outside investor would receive if the manager instead acts to her own optimal benefit.²⁰ Residual loss plus the costs of preventing any loss to the principal is the agency cost.²¹ The term "investors" includes inside investors, who are the managers, and outside investors, who are passive capital providers with no input into management. For tax purposes the conflict between managers and outside investors occurs because the managers make decisions that affect both the managers' and the outside investors' tax circumstances.

One set of management decisions relates to the organization's business operations. These operational or in-firm decisions have been labeled *disposition* decisions or policies.²² Any decision resulting in taxable profits or losses would affect an investor's tax situation if the organization serves as a conduit passing all income and loss directly to the investors' individual tax returns.²³ The agency cost may be especially high if the manager is in a different tax bracket from some or all of the outside investors—this is almost certainly the case in publicly held corporations—and makes business decisions with an eye toward her own tax situation.²⁴

A second set of conflicts, called *distribution* decisions or policies,²⁵ arises when the manager decides whether to distribute money to the

19. See Kanda & Levmore, *supra* note 4, at 230-31.

20. Jensen & Meckling, *supra* note 6, at 308.

21. *Id.* The terminology defines the loss from the principal's viewpoint. The terminology could view the transactions from the manager's point of view and be considered a constituency cost or an outside investor cost. Alternatively, it may be viewed neutrally as cooperative effort cost or cost of conflict. This article prefers "conflict" or "tension" but uses "agency cost" as the dominant label.

22. Kanda & Levmore, *supra* note 4, at 233.

23. Any income passed through to the individual investor would increase the individual taxpayer's taxable income; any loss could reduce the taxpayer's income base.

24. *Id.* at 232.

25. *Id.* at 233.

investors (both inside investors and outside investors). If the managers and outside investors are in dissimilar tax situations and the investors are taxed on the distributions, as shareholders are in corporations, a tension develops concerning the timing and amount of the distributions.²⁶ Some high-bracket investors, for example, may prefer that the manager retain the available funds in the organization, even if the pre-tax return is less than the return from other investments.²⁷ Likewise, conflicts may arise between investors in passthrough entities, such as partnerships, because the investors may want or need distributions to satisfy the resulting tax liabilities.²⁸ The tension escalates if the taxpayers are in dissimilar marginal tax brackets and, therefore, need different amounts to pay the tax on similar amounts of income.²⁹

The conflict concerning distributions on passthrough entities based on the individual owner's tax situation serves to explain a great deal about entity classification and investor choice of organizational form for tax purposes. The conflict arises from the imposition of tax liability on the individual owners, who must pay the tax. Wherewithal to make payment constitutes a concern for both the policymaking government and the taxpaying citizen.³⁰ As between the outside investors and the manager, outside investors reasonably could look to the activity that is the source of income generating the liability to obtain the funds to pay for the increased tax. A conflict occurs when the manager is unwilling to make the necessary distributions or disagrees about the amount of distribution necessary to satisfy each investor's tax liability. The conflict intensifies the difference among each investor's tax and financial situation. For example, a taxpayer in the 15% marginal tax bracket may demand at least \$1500 distribution to pay the tax on her \$10,000 share of the organization's taxable income, whereas a taxpayer in the 39.6% marginal bracket will demand \$3960 to satisfy her liability on her \$10,000 share of taxable income.

Characterizing the manager's decisions as in-firm disposition decisions and distribution decisions serves a limited analytical purpose. Disposition decisions include investment decisions. Managers having finite resources at their disposal often must decide between investing assets in

26. *Id.* at 234.

27. *Id.*

28. *See infra* text accompanying notes 61-76.

29. *See infra* text accompanying notes 30-31 (two taxpayers each with \$10,000 taxable income may owe taxes of \$1500 and \$3960 respectively).

30. As a political matter, Congress would be hard-pressed to impose passthrough treatment upon owners when faced with the image of a retired widow forced to pay the taxes on her share of a firm's income out of her social security check because she did not receive any dividends and was not in a position to affect the firm's decision to make distributions to her.

the firm or making distributions to investors. Rather than attempting to classify this choice as a disposition decision or a distribution decision, this article recognizes the choice simply as one potentially creating a conflict between the manager and the outside investors.

As a matter of tax policy, the government should consider an individual as having the resources to pay the tax on his share of a firm's income only if he receives cash, a cash equivalent, or another asset directly from the firm to pay the resulting tax; if, at minimum, he has the power to effect a distribution to him from the firm; or if for some other articulable reason the taxed individual is deemed to have waived his right to receive distributions.³¹ Managers have the power to control distributions. Passive outside investors do not. Since Congress created this conflict in enacting the tax laws, Congress should be sensitive to ways to reduce the agency costs resulting from the imposition of the tax.

B. *Reducing Agency Costs: The Manager as Inside Investor*

Recognizing the agency costs associated with taxing business organizations is only the first step in the analysis. This Part examines how agency costs affect policy decisions regarding the taxation of business organizations. The significant inquiry considers whether the tax laws should treat all business organizations as taxable entities, whether the laws should treat all business organizations as conduits and impose a tax only on individual owners, or whether the laws should provide for both taxed entities and passthrough entities as it does now.

This Part does not address double taxation of business income,³² nor does it consider the merits of integration proposals.³³ The inquiry here addresses whether and how the tax laws should adjust for the

31. A second approach evaluates the individual's interest in the business or transaction or rights resulting from the transaction to determine if they may be converted to cash within the tax paying cycle. See generally CARL THOMAS DEVINE, *Recognition Requirements—Income Earned and Realized*, in 2 *ESSAYS IN ACCOUNTING THEORY* 57, 62 (1985). If the interest or rights may be converted to cash, arguably the individual should recognize the income. For example, an individual can borrow against a note or sell stock listed on a stock exchange. Yet, in many cases, the individual cannot locate a purchaser or lender for certain assets because the risk of not receiving distributions from the activity is great, the individual cannot locate a willing purchaser easily, or the business arrangement forecloses transferability. Under the conflicts or agency theory, however, the issue turns on the degree of conflict between management and outside investors on distributions from the firm. Reliance on outside or indirect sources of funding does not reduce the conflict significantly, especially if funding the tax liability requires the individual to sell some or all of her interest in the organization. Financing and liquidity are discussed more fully *infra* at text accompanying notes 61-75.

32. See *infra* text accompanying note 118 (agency cost justification for the double tax).

33. See *infra* text accompanying notes 122-144 (evaluating current integration proposals). The article proposes an alternative to current integration proposals and to current double taxation justifications. See *infra* text accompanying notes 145-178 (proposing a deferred distributions tax on undistributed profits).

agency costs resulting from the imposition of the income tax. One assumption made of necessity is that each investor ultimately has a percentage right to the profits and assets of the organization even though the right to current possession is subject to management's discretion.³⁴ An investor owning five percent of an organization under this assumption would be taxed on five percent of the organization's income and have that five percent of income added to the amount she could withdraw from the operations some later time. The organization's income is in fact her income and the organization's assets, though under the management of another, are her assets. As a corollary, any taxes paid are deemed paid on the investor's share of the tax liability.³⁵

As noted, the government should when feasible accommodate the investors' attempts to reduce agency costs arising from the government's imposition of taxes.³⁶ The federal government is directly involved in creating this conflict because of the income tax laws. This strong nexus justifies, or maybe even compels, the government to minimize, or to allow the investors and managers to minimize, the conflict.³⁷ The government's willingness to accommodate stems from the investors' inability to demand immediate distributions to pay resulting tax liabilities. As long as the present value of total taxes paid on the organizational income are at least as great as the taxes paid if the investors report the income directly, the government should be neutral regarding who pays the tax.³⁸

Since under this scenario the government remains neutral, individual investors' decisions about disposition of assets in a passthrough organization would differ according to each investor's individual tax situation, including anticipated changes in individual tax circumstances.

34. Another theory treats the outside investors as little more than special creditors of the firm or of the manager. This theory would eliminate most entities from passing through income and losses to outside investors (although it might permit or mandate passthrough to managers).

35. Theoretically, this deemed payment of the investor's tax liability may be a constructive dividend. To date, however, no tax has been imposed on this type of dividend. Instead, dividends relate to actual distributions to or for the benefit of shareholders, excluding tax assessed against the entity. *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716 (1929), can be distinguished since the payment there was for the tax on a president's compensation.

36. See *supra* text accompanying note 31.

37. Several current provisions tax the entity and refuse to tax the investor until the investor receives a distribution.

38. But see Rebecca S. Rudnick, *Who Should Pay the Corporate Tax in a Flat Tax World?*, 39 CASE W. RES. L. REV. 965, 1074-81 (1989) (noting arguments that corporations should pay an additional tax because corporations have unique attributes that generate excess profits or because a tax on corporations facilitates the allocation and taxation of income from corporations with foreign investors). Professor Rudnick concludes these are not appropriately neutral rationales for a double tax on corporations. *Id.* at 1066. She prefers a power to dispose of income rationale (presumably meaning power to dispose of increased assets). *Id.* at 1081-93. According to Professor Rudnick, the agency cost theory is at the heart of this rationale. *Id.* at 1085-86.

Individual investors' tax circumstances, for example, may be such that some investors would prefer to accelerate or defer disposing of an asset so that the disposition would occur in a more favorable tax year. Further, because many individual investor preferences will be random, any managerial disposition decision will benefit some investors and disadvantage others.

With full knowledge of her own circumstances, of course, the manager could and might act to affect the timing of income or loss to minimize her own tax liability. Taxing the organization as a separate entity, rather than allowing passthrough treatment, would eliminate this conflict because one tax schedule would apply to the entity, and the manager's decisions would be based on the organization's tax circumstances rather than her own.

A second, related suboptimal economic consequence of passthrough taxation eliminated by taxing the organization rather than the individual investors occurs if the manager would make economically inefficient disposition decisions because her personal tax benefits would exceed her share of the organization's economic efficiency losses.³⁹ To illustrate, assume a firm owns an asset with a basis of fifty and a fair market value of 100, and an available asset at a price of ninety substitutes perfectly for the owned machine.⁴⁰ If the firm sells the owned asset and the firm is a passthrough entity, the manager must recognize and pay tax on her share of the gain. The tax owed, compared with the present value of the same tax owed if the asset is sold several years in the future, likely exceeds the manager's economic gain from utilizing the replacement asset currently.⁴¹ She therefore might defer selling the asset to the economic detriment of outside investors who may prosper by selling the owned asset and purchasing the replacement asset. Taxing the organization instead of the investors eliminates the conflict between the manager and the outside investors with dissimilar tax situations. The income tax consequences considered are those based upon the entity's tax situation and not on the manager's or other investors' tax circumstances.⁴²

To summarize, the imposition of the income tax directly on an organization's investors gives rise to agency costs between the manager and the outside investors. The agency costs occurring between the man-

39. See Kanda & Levmore, *supra* note 4, at 230.

40. *Id.* at 230 n.45.

41. *Id.*

42. Taxing the organization does not guarantee that the manager will sell the owned asset and purchase the replacement asset. The manager will decide based on the entity's tax situation, and the entity's tax situation may convert what would be an economically efficient choice into an inefficient one. Taxes affect the decisionmaking process.

ager as inside investor and the outside investors result from the manager's making disposition decisions based to some degree on her personal tax situation and its difference from that of the outside investors. Two predominant decision conflicts occur. First, the manager can affect the amount or character of income of an entity by timing transactions and choosing ones suited to her personal tax situation. Usually this personal situation is contingent upon her marginal tax rate. The outside investors may favor a different decision based on their personal tax situations.

The manager may refuse to make an optimal economic asset disposition because the tax costs to the manager more than offset her economic benefit from the sale of the asset. Some outside investors, on the other hand, would benefit from disposal of the asset. Taxing the organization as a separate entity eliminates this conflict by emphasizing one tax structure, that of the entity, rather than the tax rates of the individual investors.

The above discussion assumes a progressive tax rate structure.⁴³ Today the tax rates range between 28% and 39.6% for those individuals most likely to be investors,⁴⁴ especially for those who are managers of businesses with significant numbers of investors. Therefore, the rate variance could be a possible absolute 11.6% and a relative 29% difference between shareholders. For those managers who reasonably should be in the same marginal tax bracket each year, the incidence of conflict situations affecting timing may be minimized. In addition, because most individual investors will be in the same rate bracket as the manager, the conflicts may not surface.

Taxing the entity rather than the investor may not eliminate all agency costs caused by taxation, however, even if the tax rates were steeply progressive and the manager's tax situation reasonably could be expected to change annually. The tax on the entity merely puts all investors in the same tax circumstance. The cost of this conflict reduc-

43. See Kanda & Levmore, *supra* note 4, at 229.

44. Taxpayers must pay tax at the 28% rate when their taxable income reaches \$36,900 for married persons filing joint returns, \$29,600 for heads of households, \$22,100 for single persons, and \$18,450 for married persons filing separate returns. Revenue Reconciliation Act of 1993, Pub. L. No. 103-66, § 13201(a), 107 Stat. 311 (1993). Many individual shareholders will be subject to the higher 36% bracket (\$140,000 income for married individuals) and 39.6% bracket (\$250,000 income for married individuals). *Id.* At least three exceptions apply. Many tax-exempt organizations may owe no tax on income and hence will always be in a low tax bracket. Congress may change this result by imposing a tax on these entities for income from investments as unrelated business taxable income. See I.R.C. § 511 (West 1992). Additionally, some retired individuals' taxable income may fall below the amount required to be subject to the 28% marginal rate. Finally, corporate investors are subject to a separate rate schedule and may have a higher or lower rate than managers do. The corporate rate differential would be irrelevant, of course, if all income passed through to individual investors.

tion, however, is a change in after-tax return for each investor. If the tax rate on the entity would result in the same amount of tax as assessing the individual investors, then the entity tax would result in a lower after-tax return than would conduit taxation for some investors and a higher after-tax return for others. Those investors receiving a lower after-tax return based on entity taxation should compare that return against the return on passthrough taxation, based upon knowledge that the manager may make business decisions considering the manager's personal situation. For many, the relatively minimal effect of an asset disposition, for example, compared to the recurring operational income, would not justify the loss in after-tax return from the investment taxed as a corporation.⁴⁵

The determinative equation would balance the costs of the entity tax against the individual investors' rates. For those investors subject to a tax rate lower than the corporate rate, the after-tax return with an entity tax would be less than if they were subject to passthrough taxation. The equation is skewed more to a passthrough choice because most firms' operational income and expenses flow from recurring business transactions that are not susceptible to manipulative managerial choices.

For investors to choose an entity tax rather than a passthrough regime, the effective marginal tax rate on the entity cannot be much greater than the lowest rate paid by most individual investors. The rate, however, would be higher than zero. Actual experience would dictate the expected lowest rate experienced by most investors. The entity rate would need to be as low as the marginal rate experienced by a substantial majority of actual investors. The higher the entity tax rate, the more potential investors will opt for conduit treatment. At some point the costs of the entity tax would exceed the savings in agency costs.⁴⁶

C. Reducing Agency Costs: The Manager as Manager

More significant than the conflict between the outside investors and the manager as an inside investor is the conflict between the outside investors and the manager in her role as manager.⁴⁷

45. See Larry E. Ribstein, *The Deregulation of Limited Liability and the Death of Partnership*, 70 WASH. U. L.Q. 417, 471 (1992) (concluding that the combination of circumstances required to justify agency cost analysis is sufficiently unlikely that firms rarely would choose a two-tier tax).

46. The importance of the lower entity rate becomes more significant and will be discussed more fully later in Part III, *infra* notes 145-61 and accompanying text.

47. "Since the relationship between the stockholders and manager of a corporation fit the definition of a pure agency relationship it should be no surprise to discover that the issues associated with the 'separation of ownership and control' in the modern diffuse ownership corporation are intimately associated with the general problem of agency." Jensen & Meckling, *supra* note 6, at 309.

1. OUTSIDE INVESTORS' TAX COST ON MANAGER'S
NONPECUNIARY BENEFITS

The manager may choose to spend the money under her control on nonpecuniary benefits.⁴⁸ The manager, for example, may furnish her office with plush carpet rather than install a tile floor and invest the difference in costs of the two floor coverings in income-producing or debt-reducing activities. The list of nonpecuniary benefits could be extensive: size, location, and furnishing of office, perquisites to employees to foster loyalty or respect, country club membership, prestige automobile, car phone, ability to select friends and family as suppliers, and choice of causes for charitable donations, to name a few.⁴⁹

The nonpecuniary benefits cause a nontax conflict since the man-

48. *Id.* at 312-13.

49. *See id.* at 312. The manager's pecuniary benefits could intensify the conflict. For example, a manager may receive a bonus based on the company's profitability. Assuming part of the company's profitability is derived from invested capital, the manager will share the profitability from assets retained in the company. The manager is better off by withdrawing her bonus annually and investing the funds outside the company. She then keeps the full return on the investment rather than only her profit percentage (plus her share as investor in the company). In addition to the return on her investments from prior years, the manager continues to receive the same bonus percentage from income on the capital retained in the business, including any previously earned and taxed capital. The investors in a passthrough organization, therefore, pay tax on retained income that becomes invested capital directly benefiting the manager rather than the taxed investors.

To illustrate, the following example assumes that the investors have contributed \$1,000,000 to the company, the company reports a pre-bonus profit of 20% of capital, and the manager receives 10% of profits as a bonus and averages a 10% return on outside investments.

	<i>Income</i>	<i>Bonus</i>	<i>Taxable Income</i>	<i>Earnings On Bonus</i>	<i>Manager's Income</i>
YEAR 1	\$200,000	\$20,000	\$180,000	—	\$20,000
YEAR 2	\$236,000	23,600	213,000	2,000	25,600
YEAR 3	\$278,600	27,860	250,740	4,560	32,420
YEAR 4	\$328,748	32,875	295,873	7,802	40,077
YEAR 5	\$387,923	38,792	359,131	11,810	50,002
YEAR 6	\$459,749	45,975	413,774	16,812	62,787
YEAR 7	\$542,504	54,250	488,254	23,091	77,341
YEAR 8	\$640,155	64,015	576,140	30,825	94,840
YEAR 9	\$755,383	75,538	679,845	40,309	15,847
YEAR 10	\$891,352	89,135	802,217	51,894	141,029

In YEAR 1 the manager reports the same income from the bonus as would an investor owning 11.1% of the profits interest in the company. Beginning in YEAR 2 the manager calculates her bonus on returns from all capital, including that taxed to the investors in prior years. For example, the \$3600 increase in the manager's bonus in YEAR 2 is a return on \$18,000 of the profits taxed to investors in YEAR 1. The investors in a passthrough entity would have paid taxes (approximately \$5500 to \$7200) on the \$18,000 that benefits the manager. By YEAR 10 the investors will have paid taxes cumulatively on \$345,675 (or approximately \$107,000 to \$138,000 in taxes) to create a capital base, the return on which benefits the manager. The manager pays taxes on the bonus each year; but in the example, she keeps all returns on the bonus in future

ager bears only a proportionate share of the costs of the benefits she chooses. A manager who owns the entire business makes choices based on the benefit to her against the full cost of the benefit.⁵⁰ If she owns less than 100% of the business, she will balance the benefit against her share of the cost.⁵¹ As the manager's share of equity falls, she will have a tendency to spend larger amounts of the organization's funds on perquisites.⁵² Theoretically, the lower the manager's fractional ownership interest in the organization, the more she will be encouraged to expend more firm resources on her own working perquisites.⁵³ The nontax aspects of nonpecuniary benefits exist for both corporate and noncorporate entities.

The manager's pursuit of nonpecuniary benefits also has its tax conflict counterpart. The funds for the acquisition of the perquisites come from the profits taxed to the investors. To the extent the manager owns less than 100% of the business, the remaining investors are paying tax on the manager's benefits. She enjoys or will enjoy these benefits either personally or indirectly by determining which persons will receive the benefits.⁵⁴ The manager's use of business assets for her nonpecu-

years. This explains why she has \$141,029 income in YEAR 10 while an owner of 11.1% profits in the company would have only \$89,046.

The potential for conflict exists in this situation especially if the manager, and not the investors, determines dispositions and distributions. The manager could make disposition decisions maximizing her bonus without regard to the investors' tax situations. Likewise, the manager would be tempted to retain much of the profits in the business to maximize the amount of profits, and hence her bonus, without concern for how the investors will finance their tax liabilities. One way to minimize the conflict is to distribute cash equal to all taxed income to the investors. Alternatively, the contract with the manager could grant the manager an initial equity interest instead of paying cash annually, could provide that the payments of the bonus amounts be deferred until the manager no longer receives a bonus, or could require a proportionate distribution be made to investors for any distribution made to the manager. Either approach places the manager and the investors in equivalent economic situations.

None of these options, however, may be acceptable. The manager may demand as part of her compensation that she receive payments annually. Distributions of all profits to investors may be financially inefficient for an on-going business. Another option is to tax the company as an entity rather than as a passthrough. The analysis from here duplicates that in the text. By requiring the manager to pay taxes out of business assets, the manager, as the person making both the disposition and distribution decisions, is responsible for financing the tax payment. The reduction of assets moderates the leveraging effect of the transaction and forces the manager to consider the costs of taxes in making any decisions. The investors then are not taxed until they recognize income under some other provision, such as the sale of their interest or a distribution from company.

50. See Jensen & Meckling, *supra* note 6, at 312; discussion *supra* note 49; see also YUGI LJIRI, *THE FOUNDATIONS OF ACCOUNTING MEASUREMENT: A MATHEMATICAL, ECONOMIC, AND BEHAVIORAL INQUIRY* 34-42 (1967) (discussing the effect of balancing the benefit of a decision against the sacrifice necessary to receive the benefit).

51. Jensen & Meckling, *supra* note 6, at 312.

52. *Id.* at 313.

53. *Id.*

54. The manager also can invest the profits in the business. Some investors would prefer that

niary benefits, therefore, may cause conflicts between the manager and the outside investors.

The conflicts may be minimized if the entity can deduct currently the cost of the nonpecuniary benefit. Nonpecuniary benefits qualifying as business expenses offset income dollar for dollar in the year paid.⁵⁵ Investors, therefore, are not assessed a tax for the profits expended. On the other hand, the investors do suffer a tax liability for capitalizable assets. Even if the investors are allowed cost recovery deductions in future years, the present value of those deductions will be less than the current tax costs. As an illustration, assume the organization reports a \$1 million profit, taxed directly to the investors. That same year, because she frequently must travel to New York, Dallas, Chicago, and Los Angeles on firm business, the manager buys and furnishes a condominium in each city in the name of the organization at a total cost of \$1 million. The annual cost recovery deduction under current provisions will be approximately \$32,000.⁵⁶ The current year tax liability (assuming here all investors have same marginal tax rate of 31%) is \$310,000. Tax savings for all years except the first year would be approximately \$9920.⁵⁷ The present value, assuming a conservative six percent discount rate of \$9920 tax savings a year for 31.5 years is approximately \$139,000.⁵⁸ The tax cost to the investors for the four condominiums, therefore, is \$171,000.⁵⁹

The agency cost at issue here depends on cash flow to pay the resulting tax liability and not on tax rates. A manager in a passthrough organization may make disposition and reinvestment decisions based on the economic costs and benefits to her. Since she bears the tax burden

the manager distribute all profits. To these investors, the retention of profits to be used in the business as the manager decides (and not in investments the outside investors choose) could be an agency cost. Since arguably the manager would invest the profits to achieve a return at least as great as on any investment made by the investors, this particular conflict is not considered here.

55. I.R.C. §§ 162(a), 461(a) (1992).

56. I.R.C. § 168(a)-(d) (West 1992) (applicable recovery period for nonresidential real property is thirty-one and a half years). The 1993 Act extends the recovery period to thirty-nine years. Revenue Reconciliation Act of 1993, Pub. L. No. 103-66, § 13151(a) (codified at I.R.C. § 168(c)(1)). In the text example a firm may receive a higher current year deduction for any furnishings that may be recovered over a shorter period of time. The \$32,000 is used in text serves for illustrative purposes; more precise calculations would not change the analysis.

57. Multiplying \$32,000 by a 31% marginal rate results in a tax of \$9920. At the highest rate of 39.6%, the tax savings would be \$12,672.

58. Present worth of an \$9920 annuity at 6% for a term certain for thirty-one years is \$9920 x 13.9291, or \$138,177. For thirty-two years the present value is \$9920 x 14.0840, or \$139,713. At 39.6% rate, the present value will approximate \$177,000. Factors taken from Treas. Reg. § 20.2031-10(f) (as amended in 1984) (Table B showing the present worth at 6% of an annuity for a term certain, of an income interest for a term certain, and of a remainder interest postponed for a term certain.)

59. The tax cost would be \$219,000 if the 39.6% rate is applied.

of only her percentage interest in the business income, the cost to her is only a fraction of the total tax burden, even though she may be the only significant beneficiary in the relevant time frame. Meanwhile, the outside investors must pay their shares of the increased tax liability. Thus, the manager may be inclined to make suboptimal economic disposition decisions because she benefits more than she is burdened. This conclusion follows whether or not the manager is also an investor.

Taxing the entity does not prevent the manager from spending the firm's money on nonpecuniary benefits, of course. Such taxation does insulate the investors from expending their personal funds to pay taxes on the income that will benefit the manager more than it does the tax-paying investors. The proper taxpayer perhaps should be the manager, but the Internal Revenue Code does not impose a tax in this situation. Requiring the manager to use the funds under her control to pay the tax may serve as a reasonable alternative. Although taxing the entity reduces the agency costs arising when taxes must be paid on the income used to acquire the capitalized benefit, it does serve to camouflage the manager's inefficient use of the firm's funds. Arguably, however, investors are more willing to accept the manager's enjoyment of nonpecuniary benefits if they do not pay the tax on her benefits directly, even though the payment of the tax from the firm's assets is an indirect investor payment.

2. MANAGER'S POWER TO COMMIT INVESTORS' NONFIRM ASSETS TO SATISFY THE TAX ON THE FIRM'S INCOME

The greatest conflict, because of the absolute amount of money involved, does not depend on the manager's disposition decisions or on individual investors' tax rates. Rather, it concerns the payment of any tax liability. An investor's annual tax liability for his share of an entity's taxable income could be as high as his initial investment. The conflict comprises two components: control over assets and financing.

a. Control over Assets

For business activities to be successful, investors must transfer to managers the right to use, transmute, and otherwise dispose of assets. Although a manager enjoys management or executive rights, the investors retain most beneficial or economic rights.⁶⁰ A manager, however, acts on behalf of not only investors but also creditors, government enti-

60. A manager enjoys nonpecuniary rights that deplete the investors' economic rights. The manager also shares in economic rights indirectly by receiving salaries, bonuses, or other incentives directly or indirectly based on the firm's financial performance. *See supra* text accompanying notes 48-59.

ties, community organizations, employees, and herself. A manager, therefore, covets sufficient liquid assets in the business for purposes other than to pay taxes or make distributions to investors. The more assets, especially liquid assets, a manager controls, the more options the manager has for adjusting to market opportunities and downturns. Although technically the manager, especially in the corporation-shareholder context, cannot require investors to contribute additional capital to the business activity, she can force investors in a passthrough entity to use outside funds to pay tax liabilities. Thus, she indirectly has beneficial access to these extra assets and can retain assets for use in the business that otherwise would go to satisfy tax obligations.

The assets retained in the firm from profits are generated through a pricing policy that considered taxes. A firm paying the tax at the entity level must factor in the tax effects in its break-even, pricing, and cash flow analyses. A passthrough firm can soften the impact of taxes in its managerial decisionmaking process, but managers will consider their particular tax needs in setting prices. Even firms that do not consciously adjust for taxes compare their prices against firms that do set prices to cover anticipated tax liability and will move their prices toward those charged by competitors, if for no other reason than to maximize profits. Profits for passthrough entities, therefore, should contain planned amounts for taxes. If the manager retains the tax-attributable profits rather than distributing them to investors, the manager has increased the amount of working capital under her control. The manager thus has the power to use the outside investors' financial assets held outside the business to enable her to use all the assets in the organization to her best benefit.

The manager's retaining the tax component of firm profits while not distributing money to investors to cover the tax liability multiplies the funds available to the manager as it decreases the assets under the investors' direct control. Taxing the organization as an entity instead of as a passthrough ameliorates the leveraging elements that contribute to this conflict. Entity taxation reduces an agency cost simply by reducing the assets subject to the manager's use. The manager actually must use the tax component of the firm's profits to pay the firm's tax liability. Taxing the entity forces the manager to consider the tax consequences of her decisions. Satisfying a tax obligation reduces the assets at her disposal and thus circumscribes many reinvestment decisions. A manager not responsible for paying the taxes will tend to enter into more taxable transactions than would a manager responsible for the taxes. As the possible number and frequency of transactions that lose their economic

desirability when the tax costs are considered increases, the agency costs to investors also rise. Entity taxation minimizes these agency costs.

b. Financing the Tax Liability

In a passthrough system, investors must use nonfirm assets to pay the tax liability attributable to the firm's business income. Generally, investors expect firm obligations to be paid with firm assets.⁶¹ Investors with limited liability, such as shareholders or limited partners, are not liable for any firm debts.⁶² Even general partners reasonably can expect the firm to exhaust firm assets to satisfy firm debts before requiring the investors to satisfy firm obligations with nonfirm assets.⁶³ Requiring investors to pay the tax liability on the firm's profits without a concomitant immediate right to the firm's assets abrogates the general rule that the firm's assets should be used to satisfy debts originating in the firm's business.

The explanation for this predicament is relatively simple. Once the executive rights and economic rights to an entity's property are bifurcated, with investors having only residual rights while the manager has executive rights including the rights to distribute property to investors or to retain property in the business, there is no guarantee that the investors who pay the tax can receive distributions from the firm to pay the tax.⁶⁴

For many investors, their inability to demand distributions to satisfy tax liabilities resulting from reporting their share of the entity's taxable income creates a conflict between the investors and the manager. One way to reduce this conflict involves contractually requiring distributions to satisfy any tax liability. But the probability that each investor will incur different rates of tax liability creates yet more conflict over the amount each investor should receive. Requiring the manager to distribute money to each investor of record equal to the maximum tax an

61. Even partners expect partnership debts be paid with partnership assets before resort to partners' separate assets. See 2 ALAN R. BROMBERG & LARRY E. RIBSTEIN, BROMBERG AND RIBSTEIN ON PARTNERSHIPS §§ 5.08(c)-(f) (1991).

62. The shareholders or limited partners, of course, may contract for greater liability, but the general rule is that they limit their liability to their assets held in the organization, including their initial contribution, retained profits, and appreciation in value of firm assets. See MODEL BUSINESS CORP. ACT § 6.22 (1984); REVISED UNIF. LTD. PARTNERSHIP ACT § 303(a) (1976).

63. See, e.g., 2 BROMBERG & RIBSTEIN, *supra* note 61, §§ 5.08(e)-(f).

64. Arguably, the most significant property right for taxation purposes is the right to control the property that is the source of the income or that represents the wealth accretion or profits during the year. That right is controlled by the manager, not the investors. Perhaps we ought to rethink who should be taxed on entity income. Managers could be taxed (assuming we could determine with some specificity for each business entity which managers should be taxed and for how much), and investors could be treated as creditors. Yet the generally accepted premise is that the manager controls the property for the ultimate benefit of the investors and should not be liable personally for taxes on the income generating that property.

investor may owe for his share of the firm's income serves as a viable variation to the solution. Managers might balk at this solution as depleting an excessive amount of the firm's needed finances. Another variation would require the manager to pay the tax on the investors' behalf. The manager would adjust the equity accounts of each investor for taxes paid on behalf of the investor. Administratively, determining the amount of tax owed for each investor may prove impracticable for many widely-held entities.⁶⁵ A final solution is to tax the business entity rather than the investors. Under this analysis, investors would choose entity taxation when the company is expected to retain cash flow in the operations rather than make distributions.

3. IMPORTANCE OF LIQUIDITY

a. Agency Costs and Financing

The emphasis on funding the tax liability centers upon the investor's liquidity and his ability to pay. This article limits the investor's relevant funds available to pay his tax attributable to income from the firm to those funds originating in the firm. Thus, the investor is deemed liquid only if he receives cash, a cash equivalent, or other asset directly from the firm sufficient to pay the resulting tax. If, at minimum, he has the power to effect a distribution to himself from the firm, or if the taxed individual waived his right to receive distributions while accepting the tax consequences of passthrough taxation, the investor is deemed liquid for this purpose. The investor's excess funds outside the investment,⁶⁶ the investor's ability to borrow against his interest in the activity, or the investor's right to sell part or all of his interest are considered irrelevant.

On the other hand, some have argued that financing is not a troubling situation unless the manager makes suboptimal investments.⁶⁷ Until then, financing is a neutral issue. According to this reasoning, an individual investor's net worth is not changed by whether he pays tax directly from his own funds or whether the organization pays the tax or distributes money to the investor to cover the tax liability.⁶⁸ The inves-

65. Currently, a firm's payments of tax on behalf of investors may be taxed as dividends paid to the investors. *See Old Colony Trust Co. v. Commissioner*, 279 U.S. 716 (1929). Under current law this approach is not acceptable unless the organization qualifies as a conduit. Any legislative revision requiring the entity to pay the tax on behalf of the investors should provide that the payment of tax on behalf of the investors is not a dividend but merely a reduction of the investor's basis in the entity.

66. The investor may consent or be deemed to have consented to using outside funds in certain circumstances, such as where the investor is also the manager. The investor's consent cannot be found, however, merely because the investor has access to these supplemental funds. *See infra* text accompanying notes 69-76.

67. Kanda & Levmore, *supra* note 4, at 237.

68. *See id.*

tor's net worth remains the same; only his investment mix is affected. An investor with liquidity problems or who does not want to continue using his own funds to pay the tax liability resulting from the organization's operations can sell his investment or borrow against his increased equity in the business.⁶⁹

Financing the tax liability, however, is not a neutral consideration. Under an agency cost analysis, the issue turns on the degree of conflict between management and outside investors on distributions from the firm.⁷⁰ Finding a source of liquid funds to satisfy the tax liability when the manager refuses to authorize distributions can create a conflict. Reliance on outside or indirect sources of funding does not reduce the conflict significantly, especially if funding the tax liability requires the individual to sell some or all of her interest in the organization or some other nonliquid investment.⁷¹

Borrowing against increased equity may not be an automatic option for many passive investors in nonpublicly-traded businesses.⁷² Taxable income and financial income reflect accounting choices and may not reflect actual changes in the firm's value.⁷³ A passive investor may lack access to sufficiently meaningful data to justify a banker's willingness to lend solely on the firm's balance sheet and income statement.⁷⁴ Likewise, the lender has greater monitoring costs associated with closely held businesses. Minority discounts and marketability discounts also affect the value of a business.⁷⁵

b. Agency Costs and Transaction Costs of Financing the Tax Liability

Even if the manager's disposition and reinvestment decisions are

69. *See id.* at 236.

70. *See supra* text accompanying notes 59-66.

71. If liquidity to pay the tax is irrelevant because the investors are neutral as to form of their wealth and can sell their interests in the entity, the ironic result is that publicly traded corporations with predictable earnings would best be taxed as conduits because little if any conflicts occur, whereas smaller businesses, with interests that have limited or no marketability, would best be taxed as entities. Taking the opposite approach, Professor Rudnick has suggested that liquidity—the ability to sell the interest in an organization relatively quickly and without a significant loss of capital value in the exchange—is the underlying basis for recognizing the entity as a separate taxable person from its investors and also for the taxation of both the entity and its investors. Rudnick, *supra* note 38, at 1127-32.

72. "The value of a partial interest in a business or practice may be equal to, more than, or less than a proportionate share of the value of a 100 percent interest in the business or practice." SHANNON P. PRATT, *VALUING SMALL BUSINESSES AND PROFESSIONAL PRACTICES* 266 (1986).

73. *Cf.* HARRY SIMONS, *INTERMEDIATE ACCOUNTING* 21 (Jay M. Smith ed., 1992) (stating that alternative valuation methods may be interchanged).

74. For some items a lender may consider, see generally PRATT, *supra* note 72, at 28-118.

75. *Id.* at 267.

made without an eye to her personal tax or economic situation and the return from investing the tax liability dollars through the business organization is the same as the return from each outside investor's separate investment, taxing the organization rather than the investors reduces financing costs. If all investors have adequate liquid funds, financing costs would approximate the loss of income from investing the funds. Assuming the business organization would net the same return on investment as the individual investors would, the investors should be neutral regarding entity or conduit taxation if the rates of tax are the same on the entity and the individual. Otherwise, the investors presumably would favor a scheme with the lowest immediate tax liability.

On the other hand, the financing cost may exist. Loan charges or costs associated with the sale of assets may be significant. Likewise, financing the tax liability may create anxiety as well as loss of time. Some investors may approach their credit limits and be forced to forego business or personal opportunities. A manager may not be concerned with investors' financing costs⁷⁶ and may make disposition decisions without concern for the outside investors' tax plight. A manager of a taxed organization, on the other hand, must contemplate financing any tax liability. The emotional and time commitments inherent in financing the tax liability falls then on the manager rather than on the individual outside investors. The most efficient method for resolving the conflict and reducing agency costs involves placing the responsibility for reducing the costs on the person in control of creating the conflict: in this case, the manager.

D. *Agency Costs in Tax Loss Entities*

One theory regarding the management of business entity taxation suggests that investors and managers would prefer any organizational form for tax purposes that increased the investors' net liquidity without restricting the organization's operations. Specifically, investors would benefit by investing in passthrough entities expected to report tax losses.⁷⁷ The tax losses would reduce the investors' total tax liability by offsetting income derived from other sources. This theory blossoms in tax shelter partnerships. Generally, tax shelters recognize for several years tax losses that are often directly related to noncash tax benefits

76. The manager's externalization of the investors' financing problems may not show callous disregard for the investors. In fact, it is difficult to know or to adjust for every investors' personal finances. The more investors in the organization, the more futile would be the manager's efforts to accommodate each investor.

77. Limitations on losses, especially on passive losses, reduce the cumulative benefit of loss investments; but passive loss rules have not foreclosed completely the opportunities to utilize the passive activity losses. See I.R.C. § 469 (West 1992).

such as cost recovery deductions, nonrealization of capital appreciation, and tax credits.⁷⁸ The business activity cannot benefit from the losses and credits because usually the activity has no income or tax liability currently or in prior years and the manager does not anticipate any in the near future. Consequently, the manager is less likely to want the tax attributes for use in the activity and is willing to pass the tax losses through to the investors. The lack of conflict between the manager and the investors minimizes the agency costs of the relationship.

Some agency costs still remain. The manager's disposition decisions still may create a conflict between the manager and the outside investors.⁷⁹ These disposition conflicts usually occur near the end of most tax shelter partnerships, however, because the traditional tax shelter is an investment partnership owning one dominant asset. The major disposition decision is the disposition of the asset, which often results in taxable gains.⁸⁰ For most investment tax shelters, though, the manager will distribute cash soon after disposing of the dominant asset, thereby minimizing any distribution conflicts over the cash needed to pay the resulting tax liability.

This second liquidity corollary operates in the start-up stage of businesses as well. Investors would prefer passthrough treatment during the accounting loss periods. Because the losses create tax refunds or reductions in tax liability for the investors and the business cannot receive the refunds since no taxes have been paid, the parties can reduce total taxes by the adopting passthrough treatment. Once the business activity records taxable profits, the agency cost analysis would predict that investors would favor taxing the entity. At this stage, the managers would reduce agency costs by shifting to an entity-assessed tax classification.

E. *Guidelines for Entity and Passthrough Taxation*

1. GUIDELINES WHEN MANAGERS OWN MOST OF THE INTERESTS IN THE FIRM

Under an agency cost analysis, most business organizations in which all the investors are managers of the business should be passthrough entities. Although managers who are investors must make deci-

78. 2 WILLIAM S. MCKEE ET AL., *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS* ¶ 18.01 (2d ed. 1980).

79. See *supra* notes 39-46 and accompanying text.

80. The gains could exceed the money received on disposition. For example, many investment tax shelters utilize debt to finance the purchase of a depreciable asset, and at point of sale the basis of the asset is less than the outstanding balance of any indebtedness. Frequently, the investors receive enough cash to satisfy any tax liability resulting from the disposition.

sions that either favor the business or favor the manager's other activities, the decision-makers are the same ones who bear the burden or enjoy the benefit. The managers, knowing they must bear the tax consequences, will control dispositions and, more critically, will control distributions to minimize the costs to themselves as investors. Thus, they are more likely to make distributions if they need to pay taxes, or they will expend personal assets to pay the taxes if the financing costs are less than the increased benefit of utilizing the assets in the business.

Unfortunately, agency costs arise any time at least two persons are affected by one decision or activity.⁸¹ Managers in many organizations may be in different tax or economic situations and consequently disagree over firm policies and transactions because of these tax differences. Therefore, they may choose entity taxation to reduce the agency costs. Managers should consider allowing some leeway to choose entity taxation to reduce conflicts among themselves.

If Congress imposes a mandatory classification on these organizations, passthrough treatment seems the better classification. Managers would have input into the firm's disposition and distribution decisions. A manager may be out-voted or for other reasons the firm's actual transactions may be contrary to a manager's preferences, but the manager has input into the decision. This may be enough for Congress to find that passthrough taxation does not cause an unreasonable hardship on a manager. Moreover, conflicts among managers may not be severe enough to offset the costs of entity taxation. Since managers usually receive compensation for services rendered to the business, managers should favor the success of the business as providing both wages and return on capital. Moreover, the limited number of managers in an organization and the interaction among managers creates an environment of flexibility and cooperation to work out problems (although this would be small consolation for an investor-manager who faced financial hardships with no consideration from the other managers).

Current law, which allows Subchapter S corporation elections, may have set a standard of compromise that would work satisfactorily even if the entity classification guidelines change. The Subchapter S corporation election allows passthrough taxation for certain corporations with thirty-five or fewer shareholders.⁸² Another statutory provision in effect between 1954 and 1966 permitted some partnerships with fifty or fewer partners to elect entity taxation if capital was a material income-produc-

81. Jensen & Meckling, *supra* note 6, at 309. Jensen and Meckling observe that even co-authoring a paper creates agency costs. *Id.*

82. I.R.C. §§ 1361-1368 (West 1992).

ing factor in the partnership.⁸³ These compromises offer elective treatment to organizations in which the managers, or the managers and investors, will favor entity taxation in some instances and passthrough taxation in others. Once the number of investors and managers exceeds a certain number, Congress could indicate that the quantity of persons was so great that agency costs in capital-intensive firms could be reduced only by entity taxation.

A compromise zone where investors and managers can elect entity taxation or passthrough taxation helps to resolve another sticky problem. In most organizations some investors participate in the business while other investors are passive investors who put up capital but do not participate in the business. Clearly, in a mandatory classification system, the presence of a solitary passive investor owning a one percent profits interest will not cause entity taxation, nor will one investor owning a small percentage who manages the business justify mandatory passthrough taxation on all investors. The determinative standard should be the relative profits interests held by participating investors and passive investors rather than the number of active investors and passive investors.⁸⁴

83. I.R.C. § 1361 (1964), *repealed by* Pub. L. No.89-389, § 4(b)(1), 80 Stat. 116 (1966). The provision was seldom used and little interest has been shown in re-enacting it. *See* BORIS I. BITTKER & JAMES S. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 2.12 (4th ed. 1979).

84. The policy choice is what profits percentage managers must own before the law mandates equity taxation or passthrough taxation. As an upper limit, 80% ownership by the participating investors should mandate passthrough treatment in all cases. The Tax Code often uses 80% as the equivalent of complete ownership or control. *E.g.*, I.R.C. §§ 165(g), 368(c), 1033(a)(2)(E), 1563(a) (West 1992).

Just as legitimately, Congress could dictate a lower upper limit of 50% profits ownership by the participating investors to permit passthrough taxation. The lower limit for electing entity taxation should be set at 20%. *Cf.* STAFF OF JOINT COMM. ON INTERNAL REVENUE TAXATION, 94TH CONG., 1ST SESS., *TAX SHELTERS: USE OF LIMITED PARTNERSHIPS, ETC.* 4 (Comm. Print 1975) (absence of centralization of management required if general partners own more than 20% of a limited partnership's capital). Requiring at least a 20% profits interest by active investors before the organization can elect not to be taxed as an entity means that the passive investors own less than the 80% profits interest normally constituting complete ownership or control.

The Treasury has indicated that it might accept a 1% rate in certain cases. *See* Rev. Proc. 74-17, 1974-1 C.B. 438. The revenue procedure sets out a requirement that general partners must share in all tax attributes of the business. However, nothing in the revenue procedure indicates that a maximum 1% interest in all attributes would pass review.

The problem of entity classification when some investors participate in the business operations and others do not is discussed more fully in Joseph A. Snoe, *Entity Classification Under the Internal Revenue Code: A Proposal to Replace the Resemblance Model*, 15 J. CORP. L. 647, 679-86 (1990).

2. GUIDELINES WHEN LABORERS OWN MOST OF THE INTERESTS IN THE FIRM

Agency cost analysis would treat labor-intensive businesses (those in which capital is not a material income-producing factor) as pass-through entities if investors labored in the business, whether or not the investors were managers.⁸⁵ In contrast, investors' laboring in capital-intensive businesses (those in which capital is a material income-producing factor) generally would not warrant passthrough treatment.⁸⁶ Laborers do not make disposition and distribution decisions. Investors in labor-intensive businesses, however, do not experience the agency conflicts associated with capital-intensive businesses. The main distinction is that labor-intensive businesses do not need to retain significant amounts of cash to purchase assets. Distributions to investors, therefore, approximate income. Hence the conflict that might arise from managers retaining assets in the business, requiring the investors to turn to other sources for funding the tax liability are minimized. Financing costs are reduced or eliminated, since distributions approximate taxable income. Organizations of doctors, lawyers, engineers, architects, accountants, actuaries, actors, musicians, and consultants⁸⁷ should be taxed as conduits.⁸⁸ Logically, passthrough treatment should extend beyond organizations of the learned professions to all service organizations, such as house-cleaners, repair personnel, painters, or telephone solicitors.⁸⁹

As the business becomes more capital-intensive, agency costs associated with passthrough taxation increase. Managers increasingly will want to retain cash to service asset acquisition indebtedness or to expand plant and equipment. Once enough profits come from capital, managers will make decisions without considering the tax effect on nonmanagement investors, including laborer investors. At some point the full panoply of agency costs come into play, and entity taxation becomes the preferred tax treatment. The investors who labor in the business then

85. Snoe, *supra* note 84, at 675-76.

86. *Id.*

87. See I.R.C. § 448(d)(2)(A) (West 1992) (defining "qualified personal service corporation").

88. Prior to 1921 investors in certain personal service corporations were taxed directly. See, e.g., Revenue Act of 1918, Pub. L. No. 254, § 218(e), 40 Stat. 1057, 1070 (1919), *repealed by* Revenue Act of 1921, Pub. L. No. 98, § 1400, 42 Stat. 227, 320 (1921). Congress has been reluctant to mandate conduit treatment for professional service organizations since then, but several Code sections indicate that personal service corporations are to be taxed differently than other corporations. E.g., I.R.C. § 11(b) (West 1992) (personal service corporations not eligible for graduated tax rates); I.R.C. § 448(b) (West 1992) (qualified personal service corporations not subject to prohibition against cash receipts and disbursements method of accounting).

89. Passthrough taxation of personal service organizations is discussed in Snoe, *supra* note 84, at 677-79, 685-86.

more closely resemble passive investors who happen to be employees and have insufficient input in conflict-creating decisions.⁹⁰

3. GUIDELINES FOR PASSIVE INVESTMENTS

Passive investments derive income from rents, dividends, interest, or increases in market value of the underlying assets.⁹¹ Agency costs may arise if the investors, or at least those holding a significant share of the organization, are not managers of the organization. But this will not be true in all cases. In many cases the managers serve little more than administrative functions or must give the investors the opportunity to receive distributions. The conflict over cash to finance tax liability is not an issue in these entities, and thus passthrough taxation is preferable.

Three organizations under current law—regulated investment companies (RICs),⁹² real estate investment trusts (REITs),⁹³ and real estate mortgage investment conduits (REMICs)⁹⁴—exemplify prototypical passthrough organizations. Each of the three organizations must engage predominantly in passive investments.⁹⁵ The agency conflict is negated because the three organizations must make distributions well above the amounts needed to finance any tax liability resulting from passthrough treatment.⁹⁶ The conflict is minimized further for RICs and REITs because investors recognize income only to the extent of dividends

90. For a more detailed discussion of entity classification of capital-intensive organizations under the wealth enhancement approach, see Snoe, *supra* note 84, at 685-86.

91. HOWARD E. ABRAMS & RICHARD L. DOERNBERG, *FEDERAL CORPORATE TAXATION* 243 (1987).

92. I.R.C. §§ 851-855, 860 (West 1992). Regulated investment companies are commonly known as mutual funds. See STAFF OF JOINT COMM. ON TAXATION, 98TH CONG., 2D SESS., *GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984* 134 (Comm. Print 1985).

93. I.R.C. § 856-860 (West 1992).

94. I.R.C. § 860A-860G (West 1992).

95. I.R.C. § 851(b)(2) (West 1992) (at least 90% of RIC's gross income must be dividends, interest, payments with respect to securities loans, and gains from sale or other disposition of stock, securities, or foreign currencies); I.R.C. § 856(c) (West 1992) (95% of REIT's gross income must be dividends, interest, rents from real property, gain from sale or other disposition of stock, securities, and real property (other than property held for sale to customers in ordinary course of business), abatements and refunds of taxes on real property, income and gain from foreclosure property, and amounts received as consideration to make loans or to purchase or lease real property, or gains from sale of real property held for at least four years and meeting certain other requirements); I.R.C. § 860D(4) (West 1992) (substantially all of REMIC's assets must consist of qualified mortgages and permitted investments).

96. I.R.C. § 852(a)(1) (West 1992) (RIC must pay dividends (as defined in § 561) equal to or in excess of 90% of taxable income and 90% of tax-exempt income); I.R.C. § 857(a)(1) (West 1992) (REIT must pay dividends (as defined in § 561) equal to or in excess of 95% of taxable income, excluding capital gains and 95% of excess gain from sale of foreclosure property over the tax on the gain, minus "any excess noncash income" as defined in the Code); Treas. Reg. § 1.860G-2(g)(iii) (1992) (REMIC can invest excess cash received from qualified mortgages for a maximum of thirteen months before distributing the money to holders of interests).

received.⁹⁷ The entity pays the tax on retained income.⁹⁸ The agency costs are minimized for REMICs since the Code not only limits the REMIC to certain assets but also requires most assets to be acquired at the beginning of the organization.⁹⁹

Ordinary trusts are treated similarly.¹⁰⁰ Ordinary trusts are limited to passive investments.¹⁰¹ The beneficiary is taxed only on amounts that are actually distributed or are required to be distributed to him.¹⁰² The trustee is liable for the tax on undistributed profits.¹⁰³ Under regulations, the trust does not qualify as an ordinary trust if the trustee has a power to buy, sell, and substitute securities since the trust then profits from the rise and fall of securities and is, therefore, a business.¹⁰⁴ Thus, for passive or ordinary trusts, the trustee has limited discretionary powers. This negates the potential for conflict over the amount and incidence of tax and any cash flow to pay any resulting tax liability between the manager and the beneficiaries.

Despite the stringent rules limiting the trustee's discretion, the Code implicitly accepts that trustees in some trusts will accumulate income and invest the accumulated profits.¹⁰⁵ Even then the income for tax purposes flows through to the beneficiaries only to the extent the beneficiary is entitled to receive distributions or otherwise actually receives distributions.¹⁰⁶ The grantor trust rules seem to follow the general rule by taxing any grantor who has certain powers over or rights in a trust.¹⁰⁷ Generally, the provisions require the grantor to control distributions.¹⁰⁸

97. I.R.C. §§ 852(b)(2)(D), 857(b)(2)(B) (West 1992). A regulated investment company is considered as paying dividends by actual distribution. *See* Treas. Reg. § 1.561-1(a) (as amended in 1962). Additionally, the investment company is entitled to a dividends paid deduction if an amount allocated to an investor is credited to a share increase on the company's books or the investor has the unqualified right to withdraw his funds instead of reinvesting in the entity. Treas. Reg. § 1.561-2(a)(4)-(6) (1960); Rev. Rul. 72-410, 1972-2 C.B. 412; Rev. Rul. 65-89, 1965-1 C.B. 265. The investment company can elect to treat certain dividends as paid in the current year even if paid in the next year. I.R.C. § 855 (West 1992). Similar rules apply to REITs. *See* I.R.C. §§ 857(b)(2)(B), 858 (West 1992).

98. I.R.C. §§ 852(b), 857(b) (West 1992).

99. I.R.C. §§ 860D(a)(4), 860G(a)(3) (West 1992).

100. *See* Treas. Reg. § 301.7701-4(a) (as amended in 1986).

101. *Id.*

102. I.R.C. §§ 651, 661 (West 1992).

103. I.R.C. § 641(a)(4) (West 1992).

104. Treas. Reg. § 301.7701-4(c) (as amended in 1986); T.D. 8080, 1986-1 C.B. 371, 371.

105. *See, e.g.*, I.R.C. § 662 (West 1992).

106. *Id.*

107. *See* I.R.C. §§ 671-677 (West 1992).

108. These powers to control distributions include the power to control beneficial enjoyment, the power to purchase any property from trust or to borrow from the trust at less than full and adequate consideration, and the power to revoke the trust. I.R.C. § 674-676 (West 1992).

Although doggedly insuring that the tax laws do not create agency costs, the Code does not offer enough options for investors in organizations that engage in passive investments to be taxed directly. For example, many investors in investment trusts should be taxed directly. The manager's ability to buy and sell securities should not preclude conduit treatment, especially if the investors have the right to demand distributions. Likewise, the manager should not be as limited as the RIC, REIT, and REMIC provisions require for passthrough treatment.

Many personal holding companies, as another example, should be passthrough entities.¹⁰⁹ For a corporation to be taxed as a personal holding company, five or fewer investors must own more than fifty percent of the corporation's outstanding stock and at least sixty percent of the corporation's gross income must be derived from passive investments, from personal service contracts, and from compensation for the use of tangible property by shareholders who own twenty-five percent of the outstanding stock of the corporation.¹¹⁰ Instead of taxing this income directly to the shareholders, present law imposes an additional tax on the corporation above the corporation's normal tax.¹¹¹ The corporation can avoid the personal holding company tax, but not the normal corporation tax, by paying dividends to shareholders.¹¹² Investors can help the corporation avoid the double tax by consenting to be taxed as though dividends were paid to them.¹¹³ Consequently, the investors can elect conduit treatment for the second tax, but they cannot avoid the double tax.

Investors wanting to avoid the tax penalties of the personal holding company and the restrictive contours of trusts, RICs, REITs, and REMICs can hold investments in partnerships, Subchapter S corporations, or limited liability companies, which all provide for passthrough taxation if the investors plan for it.¹¹⁴ Whether the investors choose

109. See Snoe, *supra* note 84, at 670-72. Before 1922, the tax laws required shareholders in personal holding companies to report the corporation's income directly. See Samuel Joyce Sherman, *Taxation of Corporations Used to Avoid Taxes Upon Shareholders - Part I*, 13 TAX MAG. 19, 20-21 (1935). The change to taxing the corporation occurred when Congress questioned whether Congress constitutionally could tax shareholders on the corporation's income. See Harry J. Rudick, *Section 102 and Personal Holding Company Provisions of the Internal Revenue Code*, 49 YALE L.J. 171, 218 (1939). These doubts have been dispelled, but the tax laws continue to tax the corporation. See *Helvering v. National Grocery Co.*, 304 U.S. 282, 288-89 (1938).

110. I.R.C. § 543(a) (West 1992).

111. I.R.C. § 541 (West 1992) (the current rate is 28%).

112. I.R.C. § 545(a) (West 1992).

113. I.R.C. §§ 561(a)(2), 565 (West 1992).

114. The investors must act cautiously to avoid the organization's taxation as a corporation. Publicly traded partnerships, for example, are taxed as corporations. I.R.C. § 7704 (West 1992). Limited liability companies, by having limited liability, possess one of the four characteristics needed for classification as an association taxed as a corporation. See Treas. Reg. §§ 301.7701-2

passthrough taxation or entity taxation depends on which manner of taxation makes the most economic sense to them. The investors must balance any tax premium payable for entity taxation against the agency costs of passthrough taxation.¹¹⁵

Factors favoring entity taxation are managerial discretion on disposition decisions, the need to retain cash in the business, and the investors' need for cash from the business to pay any individual taxes accruing from passthrough taxation. On the other hand, factors favoring passthrough taxation include the likelihood of the manager's paying out substantially all profits to investors, the investment's reporting accounting losses for tax purposes,¹¹⁶ and the investors' willingness to pay tax while the manager reinvests profits in the business.¹¹⁷ Passthrough taxation not only avoids any tax premium Congress may assess for the privilege of entity taxation, it also taxes each investor at his individual rate. If the same amount of taxes will be assessed under entity taxation as under passthrough taxation, entity taxation favors taxpayers whose individual tax rate is higher than the entity rate at the expense of investors whose rate is lower than the entity rate.

III. THE ARGUMENT FOR A DEFERRED DISTRIBUTIONS TAX

Part II addressed the question of whether an entity tax was ever

(as amended in 1983). Subchapter S corporations are limited to thirty-five shareholders and one class of stock, among other restrictions. I.R.C. § 1361(b) (West 1992).

115. See Ribstein, *supra* note 45, at 457.

116. Although beyond the scope of this article, whether losses should pass through to investors remains an issue. In RICs, REITs, and trusts, only profits pass through, while in Subchapter S corporations and partnerships, profits and losses both pass through to investors. I.R.C. §§ 852(b)(2)(D), 857(b)(2)(B), 702(a), 1366(a) (West 1992). The tax laws today are embarrassingly inconsistent. Certainly, the emphasis on individual taxpayer liability provides a persuasive argument that losses should pass through to individual investors, who then would apply their own individual limitations. If the losses are limited by activity, then no loss passthrough seems the better option.

The passive loss rules illustrate the inconsistency. First, passive losses are limited to passive gains. I.R.C. § 469(d)(1) (West 1992). Yet, the gains may come from any passive activity. *Id.* However, losses from a publicly traded partnership can only be offset against profits of that particular partnership. *Id.* § 469(k). A recent Treasury report indicates a preference for no loss passthrough. DEP'T OF TREASURY, *supra* note 3, at 30.

As discussed *supra* text accompanying notes 77-80, managers and investors favor loss passthroughs when the activity does not anticipate any taxable income in near future. On the other hand, denying loss passthroughs should not create agency costs since the manager may have made the disposition decisions based on economic analysis. In fact, a good argument can be made that loss passthrough could create a conflict for the manager if she disposes of an asset solely to pass losses through to investors when the manager otherwise would not want to dispose of or acquire an asset if the passthrough were of credits. Finally, a conflict could occur at the point when an organization changes from passthrough to entity tax if the entity currently reports losses but anticipates profits in the near future.

117. See Kanda & Levmore, *supra* note 4, at 239.

merited and concluded under an agency cost analysis that the entity tax is justified in many situations because it reduces the agency costs associated with the taxing of business income. This Part addresses the issue of whether a double tax system ever is merited.

As an initial observation, investors would not elect a double tax system if the tax cost significantly exceeded the benefits of the system.¹¹⁸ If more than a reasonable premium is charged, the investors will elect passthrough taxation, if possible.¹¹⁹ If investors in limited liability companies continue to have a choice of entity taxation or passthrough taxation,¹²⁰ for example, the investors will begin using limited liability companies to duplicate much of the nontax corporate attributes and still opt for conduit taxation.¹²¹ If, on the other hand, the premium for entity taxation or the double tax is not too great, the preceding discussion indicates that many investors will elect entity taxation. This Part suggests that many investors would choose double taxation if the tax costs did not outweigh the benefits. The agency cost analysis here is more complex because the government should accept alternatives only if the Treasury collects at least as much tax under any entity tax or double tax as it would under a passthrough system.

A. *The Treasury's Integration Proposals*

The Treasury and many commentators have put forth corporation-shareholder integration proposals to eliminate the double tax. Suggestions include taxing only the entity and not taxing the investors on distributions¹²² or taxing the entity initially and then providing some tax accommodation either to the entity or to its investors on distributions to the investors. This subpart evaluates the Treasury's integration proposals using an agency cost analysis. Subpart B develops an approach not discussed by the Treasury whereby entities would pay a deferred distributions tax akin to an interest charge on undistributed profits.

1. DIVIDEND EXCLUSION PLAN

In a 1992 Report,¹²³ the Treasury, after studying several integration

118. *See id.* at 241.

119. Congress or the Treasury through regulations may mandate entity, two-tier, or passthrough taxation, without giving investors the election. Even if investors can elect, the cost of election may deter making the election. For example, an entity subject to the corporate tax must pay a substantial tax on a deemed liquidation to change to passthrough taxation or be subject to the restrictive S corporation provisions. *See BITTKER & EUSTICE, supra* note 16, ¶ 11.03 at 11-3; I.R.C. §§ 1361, 1374 (West 1992).

120. *See* Rev. Rul. 88-76, 1988-2 C.B. 360.

121. *See, e.g.,* Ribstein, *supra* note 45, at 473-74.

122. *See* McLure, *supra* note 2, at 552-53.

123. DEP'T OF TREASURY, *supra* note 3.

prototypes, favored the dividend exclusion plan because of its simplicity.¹²⁴ Under this plan the entity pays a tax and investors receive distributions tax-free.¹²⁵ The Treasury's main concern is that the model creates an incentive for entities to distribute rather than to retain earnings.¹²⁶

Agency cost problems argue against this plan. No immediate disposition conflicts occur because the entity, and not the investors, pays the tax. However, there is a distribution conflict, which itself may lead to disposition conflicts. The distribution conflict occurs because investors do not pay taxes on distributions. Unless the return achieved on the retained earnings is greater than the return on any other like-risk investment, the investor might seek a complete distribution of taxed profits.¹²⁷ Thus, an investor desiring cash would prefer tax-free distributions to selling his interest in the entity. On a sale of his interest, the investor not only no longer owns his investment in the entity, he also must face a potential taxable gain in addition to transaction costs incurred on the sale. For the same reasons, the investor would prefer tax-free distributions to selling his other assets.

The manager, on the other hand, may be more reluctant to commit taxed profits to long-term investments or durable goods for fear of investor demands for distributions. Unfortunately, unlike financial institutions or mutual funds, most business managers maintain relatively low cash reserves or cash equivalents.¹²⁸ The tax on the investors' sales of

124. *Id.* at 17. The most troublesome long-term problem that the Treasury identified was taxation of gains from the sale of stock. *Id.* at 18. The Treasury's suggested resolution would allow dividend reinvestment plans (DRIPs), through which entities could declare deemed dividends and treat the deemed dividends as reinvested in the entity. *Id.* at 82-83. Giving the investors an opportunity to receive stock as dividends implies that the investors will have an option to receive cash instead of stock. *Cf.* I.R.C. § 305(b) (West 1992) (distribution of stock is considered dividend distribution only if shareholders can elect to receive stock or property). The possibility that a large number of investors will prefer distributions exists because they suffer no negative tax consequences for receiving the distributions.

125. DEP'T OF TREASURY, *supra* note 3, at 17. A related form is the comprehensive business income tax (CBIT) that extends the dividend exclusion model to interest payments, thereby treating interest and dividends alike. *Id.* at 39-40.

126. *Id.* at 27.

127. The Treasury model would tax the investors on any distributions out of preference income, including income the entity received tax-free. *Id.* at 19. The formula set out to identify "excludable distributions account" amounts divided the tax paid by .34 (the highest entity rate at the time of the study) and then reduced that number by the amount of any tax paid. *Id.* The excludable dividends received by the entity are then added to the resulting figure. *Id.* Thus, none of the tax reduction benefits an entity enjoys passes through to the investors. For example, a tax reduction due to a tax credit or a graduated rate results in some future distribution being taxed to the investors.

128. 1 ARTHUR STONE DEWING, THE FINANCIAL POLICY OF CORPORATIONS 698 (5th ed. 1953).

the investment but not on distributions from the firm places a premium on a return from distributions.

In addition to the distribution conflicts, the intensified agency costs would create additional disposition conflicts over the mix between long-term investments and liquidity the manager maintains. Some investors want liquidity to maximize distributions, but others prefer the highest return on all assets. Moreover, a manager may make suboptimal disposition decisions either to satisfy distribution demands or to bolster accounting profits. Additionally, the manager may delay selling an asset for fear she could not use the sales proceeds to replace the asset because investors might demand distributions equal to any taxed profits.

The 1992 Treasury Report indicates that the Treasury does not expect wholesale distributions but that it does anticipate a ten to twenty percent increase in the amount of after-tax distributions if an integration plan is implemented.¹²⁹ The Treasury Report argues that encouraging dividend distributions promotes economic efficiency.¹³⁰ The report suggests that the swing from favoring retention of profits to favoring distributions will move the balance closer to an economy undistorted by tax laws.¹³¹ If the Treasury is correct, the shift in the equilibrium is commendable. If incorrect, it would seem to be a better policy to err slightly in favor of retained profits for use in the business. Unfortunately, the dividend exclusion prototype as proposed would encourage distributions in excess of the undistorted optimal efficiency amount.¹³²

Another criticism of the dividend exclusion model is that the single tax on the entity and none¹³³ on the investors benefits high-bracket taxpayers at the expense of low-bracket taxpayers.¹³⁴ This is not a concern when flat individual rates apply, but if Congress returns to progressive rates, lower bracket investors should opt for investments taxed to the individual investor rather than at the entity level.

129. See DEP'T OF TREASURY, *supra* note 3, at 124-25. According to the Treasury, corporations currently pay out 72.8% of after-tax real profits (taking into consideration inflation) and a lower 42.8% of after-tax nominal profits. *Id.* at 125. The Treasury expects the distribution to rise to 80% or 85.9% of after-tax real profits or up to 46.4% of after-tax nominal profits under integration prototypes.

130. *Id.* at 116-18, 124-25.

131. *Id.* at 124-25.

132. *Id.* at 125 (Table 13.2).

133. Investors would recognize income in some situations. See *supra* note 127.

134. See McLure, *supra* note 2, at 552. Professor Warren, as reporter for an A.L.I. study, rejected this alternative specifically because the dividend exclusion plan would preclude the application of graduated rates to individual investors. Warren, *supra* note 3, at 49.

2. IMPUTATION CREDIT SYSTEM

The 1992 Treasury Report rejects an imputation credit system.¹³⁵ In direct contrast, Professor Warren, as Reporter of a subsequent American Law Institute study, favored the imputation credit system.¹³⁶ Under the imputation credit system, the entity initially pays a tax. An investor receiving a distribution treated as a dividend would gross up the distribution by the amount of the tax attributed to the distribution. The gross-up portion would be allowed as a credit against the investor's individual taxes.¹³⁷ The Treasury Report lists separate options allowing investors to use the credit to shelter tax liability from other income or to limit the credit roughly to the tax liability from the dividend distributions.¹³⁸

The same general analysis applied to the dividend exclusion plan applies to an imputation credit system. The imputation credit system, however, resolves the inequitable shift of tax incidence from high bracket investors to low bracket investors that plagues the dividend exclusion prototype. On the other hand, it intensifies the conflict over distributions. Investors with higher personal rates than the tax credit rate on distributions should favor leaving the profits in the business, while investors whose personal rates are lower than the credit rate should favor distributions. Under either of the proposed imputation credit systems, most investors probably will favor distributions since the passthrough credits likely will exceed any tax liability attributed to the distribution and, for many if not most investors, the excess credits reduce tax liability from other income. As investors demand more distributions, managers faced with both paying the initial entity tax and making distributions will incur the same type of agency costs discussed under the dividend exclusion plan; but these costs will be even more intense.

3. SHAREHOLDER ALLOCATION PROTOTYPE

The 1992 Treasury Report submits but does not recommend a model it calls the "shareholder allocation prototype" that taxes the entity and at the same time passes the net income (but not net losses) and a credit for taxes paid by the entity through to the investors.¹³⁹ The investors with marginal rates less than the entity's effective rate could offset the tax against other income.¹⁴⁰ One benefit of the shareholder alloca-

135. DEP'T OF TREASURY, *supra* note 3, at 93.

136. Warren, *supra* note 3, at 47-57.

137. DEP'T OF TREASURY, *supra* note 3, at 93.

138. *Id.* at 95. The Treasury's preferred approach would be to calculate the credit at the individual's maximum rate (currently 39.6%) instead of the entity's maximum rate (34% or 35%).
Id.

139. *Id.* at 27-37.

140. *Id.* at 27-28.

tion prototype is that taxing the investors at their individual rates eliminates the inequitable shifting of tax liability associated with the dividend exclusion model.

Unstated in the proposal but apparent nonetheless is the fact that investors with marginal rates higher than the entity's effective rate must pay the excess taxes from the investors' other assets. The agency costs analysis for passthrough taxation discussed earlier applies, although to a lesser extent than if the entity served as a passthrough and did not pay any tax. Investors may demand distributions to pay any excess tax,¹⁴¹ and in some cases the manager may accelerate or defer disposing of assets based on her personal tax situation.¹⁴² Setting the entity tax rates high enough to guarantee that only a few if any investors would need cash from other assets requires entities to pay more to the Treasury, with higher than needed payments benefiting investors rather than being refunded to the entities. Entities may reduce distributions to offset the extra tax payments, but the shareholder allocation prototype could cause a cash drain on many entities.

4. DIVIDEND DEDUCTION PROTOTYPE

The dividend deduction prototype permits the entity to deduct from income all or some portion of distributions paid to investors.¹⁴³ The dividend deduction prototype equates equity with debt treatment. The proposal authorizes deductions for dividends just as entities currently deduct interest.¹⁴⁴ The rush to distributions tracks the tax rate differential between the entity and the investors. If the investor's rate is less than the entity's for the year, the investor would prefer a distribution. Conversely, if the investor's rate is higher than the entity's rate, the investor would be satisfied to leave his share of the profits in the entity. A conflict occurs when the entity's tax rate is greater than some investors and less than others. What choice a manager would prefer would depend on her personal situation. In some instances a manager may delay disposition activities to keep the entity's taxable income and, more critically, its tax rate low to justify retaining profits in the business.

141. See *supra* text accompanying notes 60-65.

142. See *supra* text accompanying notes 39-43.

143. DEP'T OF TREASURY, *supra* note 3, at 107. The 1992 Treasury Report cites earlier studies recommending a 50% dividends paid deduction and a 10% deduction. *Id.*

144. *Id.* The earlier proposals authorizing only a portion of the dividends as deductions maintained a distinction between dividends and interest. See *id.* at 125 (Table 132). The Treasury favors another prototype that equates dividends and interest by denying a deduction for interest payments. See *supra* note 125; DEP'T OF TREASURY, *supra* note 3, at 39-60 (discussing comprehensive business income tax prototypes (CBIT)).

B. A Deferred Distributions Tax

1. ONE OPTION: A DEFERRED DISTRIBUTIONS TAX ON AN ENTITY'S ANNUAL INCOME

Taxing neither the entity nor the investors on the income from business operations avoids conflicts between managers and the investors. Taxing only the investors and then only when they receive distributions serves as a viable alternative. Thus, if the entity pays no tax at all and the investors pay a tax only on received distributions, the investors never absorb the tax costs of the manager's nonpecuniary benefits.¹⁴⁵ Moreover, because the investors can use the distributed proceeds to pay any taxed owed, the financing costs and conflicts disappear.¹⁴⁶

Taxing investors on distributions and not taxing the entity encourages the manager to reinvest all profits in the organization. Distributions will not be economically efficient for the investors until the return the manager can get on untaxed profits is less than the return investors can receive on after-tax distributions. For a long while, investors will favor the manager retaining all profits. At some point, those investors in the lower tax brackets will favor distributions over retention. At this point the tax rates result in a conflict between the manager and some investors. The manager as investor may want to distribute money to the investors or retain money in the firm depending on her personal tax bracket. The manager as manager and some investors may want to retain capital in the business no matter how small the return.

The Treasury prefers distributions because they result in higher tax collection. To protect the fisc, Congress could (and does) charge an undistributed or accumulated earnings tax or penalty for unreasonable accumulations of profits.¹⁴⁷ To eliminate all conflicts as to whether the manager should retain profits or make distributions, Congress could impose a steep tax penalty. If Congress imposes a draconian penalty, then the penalty rationally should be limited to profits retained to avoid the income tax, with retained profits legitimately reinvested in the business exempt from the penalty.¹⁴⁸

While the accumulated earnings tax significantly reduces the conflict between the manager and the investors and also accommodates the Treasury's objective of preventing undue tax deferral, a second problem

145. See *supra* text accompanying notes 48-59. Conflicts unrelated to tax issues remain.

146. See *supra* text accompanying notes 61-75.

147. See, e.g., I.R.C. §§ 531-537 (West 1992).

148. See, e.g., I.R.C. §§ 533, 537 (West 1992) (evidence of purpose to avoid income tax and reasonable needs of the business, respectively); see BITTKER & EUSTICE, *supra* note 16, ¶ 8.01, at 8-2 to 8-30 (discussing the forbidden tax avoidance purpose of accumulating income and the reasonable needs of the business).

still pertains. This article assumes that the Treasury will collect the same amount of money over time whether the firm is subject to an entity tax or whether the firm is deemed a passthrough entity. Congress, therefore, must account for the time value of any deferred collection. Congress should impose a higher rate on deferred income than on income taxed to the investors in the year the business recognizes it.¹⁴⁹ The higher rate should reflect the time value of money associated with the deferral period.

This complicates matters considerably. For example, to be precise each entity could maintain schedules tracing profits earned but not distributed and would disclose to each investor the year the profits being distributed were earned.¹⁵⁰ Each investor would then calculate an accrued interest on the deferred tax liability attributable to the distribution. For example, an investor receiving a \$1000 distribution of profits attributable to a period ten years earlier first would determine his tax attributable to the distribution—here using \$396 for illustration¹⁵¹—and then calculate the interest on the deferred payment.¹⁵² Using a ten percent interest rate compounded annually, this hypothetical taxpayer would owe an additional \$638 for the deferral privilege for a total payment to the Treasury of \$1028 on his \$1000 distribution.¹⁵³ If the profits had been earned fifteen years earlier, the additional payment at ten percent would be \$1259, for a total payment to the Treasury of \$1655 on his \$1000 distribution.¹⁵⁴

Congress could simplify the procedure by setting one rate for distributions based on the average deferral period for distributions. Much thought and research must go into determining this rate, but for discussion purposes based on the previous paragraph we may assume it would be between eighty and one hundred percent. Compared to the current

149. The rate, though higher than the current rates on the individual or the firm, may be lower than the combined current individual and corporate rates.

150. Presumably profits would be distributed from the earliest years on a first-earned, first-distributed basis. Some leeway exists here to allow, as an example, the distributions to come from current year earnings before reaching back to the earlier time periods.

151. Several options are available for calculating the tax on the distribution. The example took the simplest option of using the highest rate in the 1993 Act applicable to individual taxpayers and assuming the investor was in the highest bracket. Another approach would have the taxpayer determine his average tax rate for the taxable year. A more complex and possibly unwieldy choice is to determine the individual's tax based on rates applicable when the firm first reported the profits.

152. *Cf.* I.R.C. § 453(l)(3)(B) (West 1992) (outlining procedures for determining interest on tax attributable to installment sales of timeshares and residential lots).

153. Even at a more modest 7.5% rate the additional payment would be \$420, for a total payment of \$816. The fact that the shareholder owes more to the Treasury than she receives from the corporation indicates the magnitude of the deferral benefit currently available to shareholders.

154. Using a more modest rate of 7.5%, the additional payment would be \$776 for a total payment of \$1172 on the \$1000 distribution.

highest individual rate of 39.6% on other income, this special dividend or distribution rate is astronomically high and would result in managers only reluctantly authorizing distributions.

Acceptable alternatives can be fashioned. The most practical approach would be to tax distributions at the investor's tax rate and work backward to determine the tax the entity must pay. For example, assuming the Treasury determines that the average time between earnings and distribution is ten years, that a ten percent discount rate is appropriate, and that the maximum rate on individuals is 39.6%, then the law could assess the entity at a 24.5% rate and the individual at a 39.6% rate and the tax would approximate the present value of immediate taxation in the year the profits are first reported.¹⁵⁵ Despite the admitted generality of the equations,¹⁵⁶ the entity tax is about two-thirds of the maximum individual tax. While it may be coincidental, this relationship closely resembles that in effect when the maximum rate on dividends was seventy percent and the maximum rate on corporations was forty-six and forty-eight percent.

This two-tier taxing system reduces some agency costs. First, the entity would pay a tax, so the manager must make disposition decisions taking tax into consideration. Second, investors would not pay any tax on the firm's income until they receive distributions, thereby reducing conflicts over distributions. Third, the investors would pay the same tax rate as on other income, so they would not be prone to prefer distributions from the firm when other investments or personal needs required capital. Fourth, the lower entity rate would encourage investors to favor leaving profits in the organization until the return the manager gets from capital after paying a 24.5% tax is less than the investors could get after paying a 39.6% tax. This latter merit should placate managers who want to retain capital and who want to avoid erratic demands for distributions. Fifth, and although not a conflict between manager and investors but a governmental concern nonetheless, the lower rate on the business would leave liquid reserves in the business, which should aid the business

155. The tax on a \$1000 distribution would be \$396. The present value of \$396 at a 10% discount rate (discount factor of .386) is \$153. Added to the \$245 the entity would pay, the present value is \$398.

156. The numbers and estimates used are very rough and considerable refinement would be necessary. For example, the calculation assumed \$1000 profits and \$1000 distributed. In actuality, of \$1000 profits only \$800 remain to be distributed. Similarly, the calculations are premised on the entity and the investors being in the highest tax bracket. Also, the assumption that firms retain profits for ten to fifteen years may not be correct. See, e.g., *supra* notes 147-48 and accompanying text. Moreover, the rates have not considered at all the effect of capital gains preferences and the stepped up basis on an investor's death which could reduce collections even further.

either to expand or stay solvent.¹⁵⁷ Since the cash is being reinvested in the business and is not accessible to investors for personal use or for passive investments, Congress could favor this two-tier tax on an economic growth rationale.¹⁵⁸

The tax scheme, however, is not precise. Setting the rates themselves assumes a constant period of deferral. Those organizations that pay distributions before the assumed period cause their investors to pay a higher than optimal tax. Likewise, those organizations that delay distributions well beyond the expected deferral time are able to provide interest-free loans for their investors. Those investors who prefer capital reinvestment and who do not need or desire distributions benefit by this scheme. Disadvantaged by the scheme are those investors who depend on regular distributions that approximate earnings.

On the other hand, the two-tier approach favors those industries in which capital reinvestment is the norm. Capital-intensive businesses benefit because these businesses reinvest profits to replace or expand plant and equipment. The firms for which the entity tax is the most appropriate, therefore, are precisely the ones in which the two-tier tax is the most attractive. On the other hand, those firms where labor generates profits, especially where the investors are the labor, and substantially all profits are distributed close to the time of their being earned are those which agency cost analysis indicates should be taxed as pass-throughs and which are penalized by a two-tier tax.¹⁵⁹ The two-tier tax, therefore, gives investors in capital-intensive businesses an incentive to select entity taxation and simultaneously discourages investors in personal services or labor-intensive businesses from entity taxation and towards passthrough treatment.

Another deviation from the ideal is that the entity tax is spread

157. Businesses retaining excessive profits would be subject to an accumulated earnings tax. See *supra* notes 147-48.

158. Although considered meritorious in the text, retaining profits in the firm favors high-income or otherwise wealthy investors relative to low-income investors. Further, retaining profits encourages firms to obtain capital internally rather than by going to capital markets. See McLure, *supra* note 2, at 539. The first consideration, favoring wealthy investors at the expense of low-income investors, is discussed at *infra* text accompanying note 160. The second consideration, encouraging firms to obtain capital internally rather than going to capital markets, seems to be a positive element. Seeking additional equity is an expensive proposition. While some investors who want to invest in firms may be precluded from doing so, these investors can fund new businesses needing the capital. The new firms themselves would benefit by the same tax rules.

159. A firm subject to the two-tier tax that distributes profits one year after reporting them for tax purposes effectively has subjected the investors to an usurious 160% interest charge under the tax system discussed in the text. For example, the \$396 assessment against the investor plus the \$245 collected against the firm is effectively \$245 nondeductible interest for the one-year deferral when \$39 to \$40 would be paid to a lender for a one-year loan. See *supra* text accompanying note 155.

equally among all investors. Thus, the income share allocable to an investor in a high tax bracket is taxed at the same rate as the income share to a low-bracket investor. Low-bracket taxpayers, therefore, pay a proportionately higher tax than they normally would under a pure pass-through system. A significant possibility exists that higher bracket taxpayers pay a lesser tax than they would under pure passthrough,¹⁶⁰ with the lower-bracket taxpayers bearing the higher-bracket taxpayers' share. The flatter the rate schedule, the less offensive the discrepancy. Under a steeply progressive schedule where the marginal rates may register as high as an absolute fifty percent difference, the manager's subjecting the business to an entity tax itself may create conflicts between the manager and the various investors.

To diminish any anxiety about the difference in tax rates between high-bracket taxpayers and low-bracket taxpayers, whether under the agency cost analysis or under a vertical equity analysis, the tax the entity pays may be considered the deferral charge on the entity for retaining profits rather than the tax itself. The tax itself would then be owed only once, upon distribution to the investors, and based on the individual investor's tax situation.

As long as the cost to retain profits is less than the cost of alternative sources of capital and the return on the profits is greater than the cost of retaining them, the manager will pay the assessment to defer the investors' reporting the income. The deferred distributions tax to the manager, therefore, is an expense of doing business as any other business interest expense would be.¹⁶¹

Although potential vertical equity concerns between high-bracket and low-bracket taxpayers apply here as well since the entity's payment of the tax benefits each investor to a different degree, the concerns are minimized somewhat and at any rate are no greater than under current law or any proposed remediation. Initially, the investors would favor the entity's manager paying the assessment since the investors would not be obligated to finance the liability. As long as the return on the retained capital exceeds the amount the investors would receive by investing the profits after paying their individual taxes, they should be content to allow the money to remain in the business.

The potential agency cost overshadowing the transactions is that higher-rate investors benefit more by the entity paying the deferral

160. The rates could be set up to insure that taxpayers in the highest bracket pay the same amount of tax under the two-tier system as they would under the passthrough system. Lower-bracket taxpayers' share of total payments would be higher than they normally would be under a passthrough system, but in many ways they benefit most by entity taxation rather than passthrough taxation because they need cash from the distributions to pay any tax liability.

161. The deferred distributions tax should be a nondeductible expense.

charge than do the lower-rate investors. This concern is offset somewhat because no investor is certain what bracket he will be in when he ultimately is taxed on the distributions. Thus the optimistic possibility exists that each investor will benefit from the arrangement. Second, the rates are set for the average firm so that in any given firm the potential exists that the investors all will benefit at the expense of investors in other firms. Third, the wealth enhancement from the manager's using the profits in the firm ideally results in greater profits for all investors than immediate taxation would.

2. ANOTHER OPTION: A DEFERRED DISTRIBUTIONS TAX ON AN ENTITY'S UNDISTRIBUTED PROFITS

A more precise application of the above principle would tax entities annually on the actual amount of undistributed profits rather than mandating prepayment based on the estimated time until distribution. Under this approach, a deferred distributions tax would be assessed annually on accumulated undistributed profits. A firm that annually distributed cash equal to profits would not be taxed. Those that retained multiple years' profits would pay an assessment on the total undistributed profits.

Under this system, start-up firms would pay significantly less tax than they would under the current two-tier regime since their undistributed earnings equals their income in the first year. For example, a firm in its first year of operation that reports but does not distribute \$100,000 profits is assessed \$3960.¹⁶² In year two, this firm reports but does not distribute \$100,000 and pays \$7920. Several years later, when the undistributed profits are \$5 million and it records a \$1 million profit, the firm's deferred distributions tax would be \$237,600.

At some point, the deferred distributions tax could exceed the entity's federal income tax liability under current law. Although more study and better data is required to reach any legitimate conclusions, financial data indicates that many well-established firms would pay more in deferred distributions taxes than they currently do in income taxes.

For example, Exxon Corporation paid \$639 million in federal income taxes in 1990 and \$700 million in 1991.¹⁶³ Assuming for illustrative purposes that Exxon's retained earnings accurately represent its undistributed profits, the deferred distributions tax for 1990 would have been about \$1.4 billion (or more than twice its actual tax payment) and

162. $(\$100,000 \text{ profits}) \times (39.6\% \text{ maximum individual rate}) \times (10\% \text{ imputed interest rate}) = \3960 .

163. EXXON CORP. 1991 ANNUAL REPORT F19 (1992).

just over \$1.4 billion in 1991 (about twice its actual payment).¹⁶⁴ IBM would have paid a deferred distributions tax of just over \$1 billion for 1990.¹⁶⁵ This is \$600 million more than the \$379 million IBM paid in federal income taxes in 1990.¹⁶⁶ Because the deferred distributions tax is a function of undistributed profits and not the taxable income for the year, many firms with current losses still will be assessed. General Motors, for example, which lost more than \$2 billion in 1990, and nearly \$6 billion in 1991, would have paid a deferred distributions tax of \$841 million in 1990 and \$667 million in 1991.¹⁶⁷ Other companies, such as Safeway, Inc., paid income taxes in 1990 but would not have owed any deferred distributions tax because they had no accumulated undistributed profits.¹⁶⁸ Still other well-established companies, such as Anheuser-Busch Companies, Inc., would have paid less in deferred distributions tax (\$162 million) than they did in federal income taxes (\$387 million).¹⁶⁹

Theoretically, investors should prefer the manager's retaining profits in the firm until the return the manager can get on the retained profits is less than the return the investor can get elsewhere after paying the

164. Federal income tax was calculated by combining current federal income tax and U.S. tax on foreign operations. *Id.* Retained earnings after tax were \$44,286,000,000 in 1990 and \$46,483,000,000 in 1991. *Id.* Retained earnings may not accurately represent undistributed profits since tax accounting conventions differ in many respects from generally accepted accounting principles. The deferred distributions tax concept must be studied further. For example, one issue is the proper treatment of capital invested in subsidiaries. Only one deferred distributions tax should apply. Therefore, Exxon should not pay a tax if the subsidiary pays the charge for the same undistributed profits. It appears, however, that Exxon's consolidated financial statements already have netted out this complication. *Id.*

Deferred distribution taxes are calculated assuming the undistributed profits would be taxed at the highest individual rate, 31% in 1990 and 1991. A hypothetical tax liability is calculated at the 31% rate, which assumes all undistributed profits are distributed. The deferred distributions tax rate—10% is used in text—is applied to the resulting hypothetical tax liability to determine the deferred distributions tax. Under the higher 39.6% tax rate, the deferred distributions tax would increase to \$1.75 billion in 1990 and \$1.8 billion in 1991.

165. MOODY'S INVESTOR SERVICE, INC., MOODY'S INDUSTRIAL MANUAL 329 (1991). IBM's retained earnings for 1990 were \$33,234,000,000. The calculation in the text assumes the 31% maximum individual rate in effect in 1990.

166. INTERNATIONAL BUSINESS MACHINES CORPORATION, 1991 ANNUAL REPORT 42 (1992). The calculation in the text assumes the 31% maximum individual rate in effect in 1990.

167. GENERAL MOTORS, INC., 1991 ANNUAL REPORT (1992) (retained earnings and income tax data). The calculation in text assumes the 31% maximum individual rate in effect in 1990 and 1991. Retained earnings may not accurately reflect undistributed profits. *See supra* note 164.

168. MOODY'S, *supra* note 165, at 6188. Safeway, Inc. recorded a net profit in 1990 of \$195 million, but it still had a negative retained earnings in excess of \$500 million. *Id.* Congress could charge for the current year's undistributed profits consistent with its treatment of earnings and profits, but that would be a variation of the pure deferred distributions tax model.

169. ANHEUSER-BUSCH COMPANIES, INC., 1991 ANNUAL REPORT 45 (1992). Anheuser-Busch's retained earnings for 1991 were \$5.2 billion. It paid \$387 million in federal income taxes in 1991. *Id.* The calculation in the text assumes the 31% maximum individual rate in effect in 1991. Retained earnings may not accurately reflect undistributed profits. *See supra* note 164.

investor's tax on the distribution. The wider the gap between the rate the entity must pay and the rate the investor must pay, the longer the investors are willing to leave assets under the manager's control. The Treasury benefits by encouraging firms to distribute profits. The Treasury, therefore, must monitor firms closely to separate those retaining profits for legitimate business purposes from those taking advantage of the arbitrage in tax rates.¹⁷⁰

The deferred distributions tax has beneficial consequences beyond those related to the agency cost analysis begetting it. The approach would reduce the competitive barriers to entry for new firms. For example, start-up firms pay the then-current rates for rental or purchase of assets including real property. As the firm's longevity increases, especially if inflation pervades the economic environment, the firm benefits through long-term leases or previous property acquisitions by experiencing a reduced cash outlay for the same assets as contrasted with outlays for comparable assets new entrants into the marketplace must incur. The difference in necessary cash expenditures for essentially identical assets favors established firms. A deferred distributions tax lower than the current corporate tax leaves more money in start-up businesses for these higher cash needs.

Start-up firms must utilize equity or debt financing, whereas more established firms historically have retained profits in the business from operations in addition to debt and equity financing.¹⁷¹ Since established firms historically have not paid for the privilege of retaining profits that otherwise would be distributed to investors annually, the government in effect subsidizes well-established firms with large undistributed profits at the expense of start-up firms. Under the deferred distributions tax approach, firms all pay a deferred distributions tax on undistributed profits, not merely on current year's taxable profits. The tax portion of undistributed profits thus is more clearly recognized as a quasi-government loan. Under a deferred distributions tax system, those firms that have retained the most profits over the years pay more as quasi-interest than they do currently as income charges. Those with only a short history to accumulate profits likely will pay less than under current law.

The deferred distributions tax eliminates some sticky problems under current law. Since the firm does not pay a traditional income tax, the distinction between debt and equity and between interest and divi-

170. See *supra* text accompanying notes 147-148 (discussing penalty for unreasonable accumulated earnings).

171. See, e.g., DEP'T OF TREASURY, *supra* note 3, at 8-9 (94.1% of new sources of funds are internally raised funds, contrasted with a decrease in equity issues in virtually every year during the 1980s).

dends¹⁷² becomes irrelevant. Distributions of both interest and dividends reduce the undistributed profits subject to the charge. Likewise, the distinction between dividends and compensation¹⁷³ ceases to be important to the business since both reduce undistributed earnings.

Congress would lose some opportunities to use the tax laws for economic incentives or other public policy purposes but could retain others. For example, fines and kickbacks currently denied as deductions¹⁷⁴ would reduce undistributed profits. Tax-exempt income¹⁷⁵ may become subject to the deferred distributions tax or special provisions could exclude them. Congress also could exclude from the deferred distributions tax amounts paid to qualified retirement plans.¹⁷⁶ Unfortunately, the natural tension between the firm, which wants to qualify for a tax deduction and the recipients of many payments that may or may not be included in income, depending upon how the firm characterizes them, would disappear. For example, the deferred distributions tax would not distinguish compensation from untaxed fringe benefits and gifts. A firm reduces its undistributed profits for both. Therefore, the firm would have less incentive to characterize any fringe benefits as taxable income to recipients.¹⁷⁷

In summary, the deferred distributions tax would not be an income tax on the firm but a charge for the use of the government's tax dollars kept from the Treasury because the manager has not distributed the profits to the investors. The charge for the delay in taxation is placed on the firm because the manager controls the distributions and possesses the assets the profits represent.¹⁷⁸ Start-up companies and businesses that distribute profits soon after earning them would pay less deferred distributions tax than they currently pay in income tax. On the other hand, entities that finance operations by retaining profits, rather than by borrowing or issuing more stock, would pay a higher deferred distributions tax than they now pay in federal income taxes.

172. See BITTKER & EUSTICE, *supra* note 16, ¶¶ 4.01-4.03, at 4-1 to 4-27; see also *id.* ¶ 4.02, at 4-6 ("A 1969 attempt by Congress to pass the definitional buck to the Treasury proved to be a fiasco.").

173. See, e.g., Treas. Reg. § 1.162-7 to -9 (1960).

174. I.R.C. § 162(c) (West 1992).

175. I.R.C. § 103 (West 1992).

176. I.R.C. §§ 401-409 et. seq. (West 1992).

177. See, e.g., I.R.C. §§ 61(a)(1), 117, 119, 129 & 132 (West 1992); Treas. Reg. § 1.61-21 (1989).

178. This deferred distributions tax should be imposed in addition to any entity tax or accumulated earnings tax. This article is premised, however, on the deferred distributions tax being implemented at the same time the current entity tax is removed from the Code. A deferred distributions tax may serve as a substitute for the current double taxation by taxing investors on distributions and not taxing the entity on its income, assessing instead a deferred distributions tax on the entity's undistributed profits.

IV. CONCLUSION

Agency cost analysis sheds light on the entity classification, entity taxation, and two-tier taxation debates. Since the imposition of the tax laws created the agency costs, Congress should permit entity taxation if entity taxation reduces the agency costs. Entity taxation reduces agency costs by forcing the manager to make business decisions based on the entity's tax consequences rather than on her own. Perhaps more importantly, entity taxation forecloses the manager's externalizing all tax considerations in her decisionmaking. Entity taxation also reduces agency costs by requiring the manager, as the person in control of the assets generated by the firm's profitable operations, to pay the resulting tax liability.

Passthrough taxation is appropriate where the investors are also the managers who make the disposition and distribution decisions or where the investors are the laborers in a labor-intensive business so that distributions closely approximate profits. Finally, passthrough taxation seems a preferred option where the firm reports taxable losses that can reduce an investor's tax liability without injuring the firm's cash resources.

The double tax, first on the entity and then on the investors who receive distributions, also reduces agency costs as long as the combined taxes assessed against the entity and the investors are not excessive. First, the entity pays a tax so the manager must make disposition decisions taking tax into consideration. Second, investors do not pay any tax on the firm's income until they receive distributions, thereby reducing conflicts over distributions. Third, a lower entity tax rate encourages investors to leave profits in the organization until the return the manager gets from capital after paying the entity tax is less than the return investors could get after paying the tax calculated at their individual rates. This latter merit should placate managers who want to retain capital and want to avoid erratic demands for distributions. Fourth, the investors pay the same tax rate as on other income so they would not necessarily prefer distributions from the firm when other investments or personal needs require capital. Finally, and in light of the foregoing benefits, the entity tax serves as a charge by the government for the entity's opportunity to defer income recognition by their investors. This reduces the agency costs between the taxpayers and the government in its status as statutory creditor.

Instead of treating the entity tax as a currently assessed income tax, this article recommends substituting a deferred distributions tax for the current entity tax. The deferred distributions tax would approximate an interest charge on the tax that would be assessed against the investors if

the firm distributed its accumulated undistributed profits to its investors. The deferred distributions tax more precisely would be applied against all undistributed earnings rather than solely against the current period's income.