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Mitchell L. Engler

Benjamin N. Cardozo School of Law, engler@yu.edu

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A MISSING PIECE TO THE DIVIDEND PUZZLE: AGENCY COSTS OF MUTUAL FUNDS

*Mitchell L. Engler**

INTRODUCTION

Serving to distribute corporate profits to the residual business owners, corporate dividends to shareholders might appear unsurprising at first glance. Deeper analysis, however, has left observers puzzled by the persistence over time of substantial dividend distributions by public corporations, in light of the tax burden of this method of income distribution and the existence of feasible alternatives. In lieu of dividends, public corporations have the option of either (i) retaining earnings or (ii) using profits to repurchase a portion of their stock on the market. In either case, those shareholders who desire their profits share in cash could sell some of their stock—and, for several reasons, both options could result in significantly reduced tax costs.¹ First, stock sales generally are taxed only to the extent the sales proceeds exceed the purchase price of the sold stock.² Related thereto, a loss arises when stock is sold for less than its original purchase price, which might reduce tax on other income. Second, those shareholders who do not desire cash (non-sellers) remain unphased, avoiding any current tax.³ Finally, until this year's tax change, domestic investors generally paid

* Associate Professor of Law, Benjamin N. Cardozo School of Law, Yeshiva University. This paper was presented at (i) the Association of American Law Schools, Business Associations Panel (Annual Meeting, January 2003) and (ii) the Heyman Center for Corporate Governance, Benjamin N. Cardozo School of Law. I thank the participants at these presentations, David Carlson, Terry Chorvat, Elia Fischer, Jeanne Schroeder, Paul Shupack, Linda Sugin, Chuck Yablon, and Ed Zelinsky for their helpful comments and suggestions.

¹ The stock could be sold back to the corporation, in the case of a repurchase, or to others.

² Under the dividend alternative, the full dividend amount must generally be reported. Some investors, such as tax-exempt institutions, do not bear any dividend tax costs. Nonetheless, dividends have generated substantial tax costs given the significant number of taxable stockholders. See discussion *infra* note 48 and accompanying text.

³ As discussed below, shareholders are taxed on dividends even where such dividends are reinvested in the same corporation.

tax at a higher rate on dividends than on stock sale "capital gains."⁴

Attempting to account for this peculiarity of continued heavy dividend distributions, many commentators have attempted to explain their presence over time. As discussed below, however, the existing literature more convincingly explains the decision to distribute profits than the preference of dividends over share repurchases. Thus, the dividend puzzle remains.

After further describing the dividend puzzle through a detailed comparison of dividends, retained earnings, and share repurchases in Section I, this Article makes two new contributions to the dividend analysis. In Section II, a new explanation is provided for the dividend puzzle. This descriptive claim connects two discrete strands of scholarship: the special impact on stock price by institutional investors and the agency costs of the mutual fund investment vehicle. On the one hand, mutual fund managers generally help guide corporate managers to the most efficient corporate policies. On the other hand, mutual fund managers largely ignore their investors' tax costs. As a result, corporate managers inadequately weigh the dividend tax cost to the ultimate shareholders in the corporation.

This Article then recommends, in Section III, a normative proposal consisting of a new withholding tax on mutual funds as a response to the described market failure on investors' taxes. Without substantively changing the amount of tax on mutual fund investments,⁵ this proposal would better align the tax interests of fund managers and their investors. Currently, investors pay taxes on each fund investment from their general assets; accordingly, taxes paid on a particular fund investment do not automatically reduce the assets invested with such fund. Since the manager's fee is based on the fund's asset size, an unfortunate disconnect arises between the investors and their manager. Taxes automatically reduce the investors' profits but not the manager's fee.⁶

The proposed withholding tax implicitly addresses this agency problem: A mutual fund would, in effect, pay each investor's tax on his behalf from assets invested with the fund.⁷ The proposal therefore

⁴ The recent tax bill—the Jobs and Growth Tax Reconciliation Act of 2003—reduced the dividend tax rate to the lower capital gains rate. See Jobs and Growth Tax Reconciliation Act of 1993, Pub. L. No. 108-27, 117 Stat. 752 (2003). The tax rate differential nonetheless remains relevant when analyzing dividend policy in prior years. In addition, the dividend rate reduction is only temporary; it expires in year 2008. Also, as discussed in the text, dividends can raise taxes even without this rate differential.

⁵ Avoiding substantive tax increases is especially important in the mutual fund context given their limited role as financial intermediaries. See discussion *infra* notes 101-04 and accompanying text.

⁶ This is true for the overwhelming majority of investors who choose automatic reinvestment of mutual fund distributions. A very limited exception applies for the small number of investors who choose to receive fund distributions in cash. See discussion *infra* notes 107-08.

⁷ See discussion *infra* notes 107-15 and accompanying text for a more technical analysis of

realigns the tax interests of the investors and their manager: taxes would automatically reduce both investment profits and the management fee. Accordingly, fund managers would have a new incentive to heed their investors' taxes. The proposal's impact is not limited to corporate dividend policy. It also favorably addresses previously-noted tax agency problems within mutual funds such as detrimental short-term trading by fund managers.⁸ Section III also discusses why the withholding tax is preferable to the recent Securities and Exchange Commission ("SEC") tax disclosure rules for mutual funds.

I. DESCRIPTION OF THE DIVIDEND PUZZLE

A. *Dividends Versus Retained Earnings*

To help develop the issues, assume counterfactually that a corporation must either distribute dividends or retain all earnings (and ignore stock trading costs).⁹ Even with such limited options, any dividend payout initially appears irrational. Under the Miller/Modigliani dividend irrelevance theory, the decision between retained earnings and dividends is irrelevant absent tax and transaction costs.¹⁰ Dividend irrelevance arises since investors can achieve any desired payout through their own market transactions. For instance, assuming profit retention by the corporation, any shareholder could create a "home-grown" dividend by selling some stock.¹¹ In the other direction, any shareholder could reverse a corporate distribution of profits by purchasing more stock with the cash proceeds.¹²

This neutrality shifts once taxes are introduced. The home-grown "dividend" option (in other words, retained earnings) becomes preferable on an after-tax basis. Consider first those "taxable" shareholders¹³ who cash in their share of profits by selling some stock.

the withholding tax mechanism and its practical effect.

⁸ As discussed *infra* note 65 and accompanying text, such short-term trading deprives investors of the favorable long-term capital gains rate and accelerates taxes.

⁹ Transaction costs will be discussed in connection with share repurchases. See, e.g., *infra* note 44.

¹⁰ See Merton H. Miller & Franco Modigliani, *Dividend Policy, Growth, and the Valuation of Shares*, 34 J. OF BUS. 411 (1961).

¹¹ See, e.g., Frank H. Easterbrook, *Two Agency-Cost Explanations of Dividends*, 74 AM. ECON. REV. 650 (1984) (using "home-grown" terminology).

¹² This would reverse the cash flow to such reinvesting shareholder. As discussed *infra* notes 19-22 and accompanying text, differences would remain between the retained earnings and dividend options since dividends transfer cash out of the corporation.

¹³ "Tax-exempt" and "tax-deferred" shareholders do not face the tax costs discussed in the text. For a more detailed discussion of the significance of tax-exempt and tax-deferred investors, see discussion *infra* notes 45-48 and accompanying text.

Their amount of taxable income would be reduced from the full cash proceeds to only the gain, if any, on the sold stock. Related thereto, stockholders would report a tax loss if their original purchase price for the sold stock exceeded the sales proceeds. Such loss might reduce the tax on other income. These benefits generally result since the cash proceeds would be received in the form of a stock sale.¹⁴ In addition, until recently a lower tax rate generally applied to stock sales.¹⁵ This rate differential has been significant at various times, for example, a 20 percent capital gains rate versus a 38 percent ordinary rate for a top-bracket taxpayer in 2002.¹⁶ Consider also the potential tax benefits to those shareholders who do not wish to cash in their profit share. Under the dividend alternative, such shareholders must pay the dividend tax even though they reinvest the dividend in the same corporation. Under the repurchase alternative, such shareholders generally would avoid any tax.¹⁷ In sum, the increased tax efficiency of retained earnings calls into question dividend distributions.¹⁸

In response to this inquiry, prior commentary suggests some non-tax benefits of dividends. Consider four prominent justifications for

¹⁴ I.R.C. § 1001 allows tax-free recovery of the stock's purchase price or "basis." The possibility of significantly less taxable income under the repurchase alternative is enhanced by the rule allowing a taxpayer to designate which shares have been sold (when the taxpayer holds shares purchased at different prices).

The selling stockholder might have an offsetting amount of additional income in later years under the repurchase alternative since the basis in the retained stock would be lower than under the dividend alternative. Even so, the taxpayer would benefit under time value of money principles since no interest is charged for the resulting tax deferral. In addition, the stockholder could avoid such later excess inclusion under the repurchase alternative by holding the stock until death. See I.R.C. § 1014 (2003) (resetting recipient's basis to the current fair market value).

For an exception to the stock sale treatment (where the stock sale is deemed too similar to a dividend), see discussion *infra* note 32.

¹⁵ Stock sales qualify for lower capital gains provided the sold stock has been held beyond one year. See I.R.C. §§ 1(h), 1222 (2003). As discussed *supra* note 4 and accompanying text, a recent tax bill reduced the dividend tax rate from the ordinary rate to the lower capital gains rate. The rate differential nonetheless remains relevant for purposes of evaluating dividend policy in prior years. In addition, as discussed *supra* note 4, the dividend rate reduction is set to expire in 2008. Finally, as discussed *supra* note 14 and *infra* notes 17, 48 and accompanying text, dividends currently retain tax disadvantages even without a rate differential.

¹⁶ I.R.C. § 1 (2003).

¹⁷ Such shareholders would not sell any stock in connection with the repurchase, thereby avoiding any taxable transaction. For a limited exception, see discussion of I.R.C. § 305(c) *infra* note 32.

¹⁸ Cf. Miller & Modigliani, *supra* note 10, at 432.

One line of tax scholarship, known as the "new view," posits that the dividend tax cost has been greatly overstated. This follows when retained earnings are eventually distributed as dividends. The time value of money benefit under retained earnings (deferral of the dividend tax) would be offset by the higher eventual dividend tax base. The new view has generally not been accepted, however, especially since repurchases can replace dividends and some dividends are reinvested in corporations. See George Zodrow, *On the "Traditional" and "New" Views of Dividend Taxation*, 44 NAT'L TAX J. 497 (1991). See also the discussion *infra* Section I.B.1 discussing the tax savings of repurchases over dividends.

dividend distributions. First, dividends arguably address the general corporate agency problem, in other words, the potential failure of corporate managers to pursue fully the interests of shareholders. Dividends arguably enhance the market's ability to discipline corporate managers by forcing corporations to seek new capital more frequently.¹⁹ Second, some corporations might earn a sub-optimal pretax return on retained earnings, thereby offsetting the tax savings.²⁰ Related to the first two points, dividends arguably counteract "empire building" by corporate managers.²¹ Finally, dividends arguably add value by signaling management's confidence in the firm's prospects.²²

B. *Dividends Versus Share Repurchases*

Section I.A justified dividends under the counterfactual assumption that corporations otherwise would retain their profits. The dividend puzzle is restored, however, given the third actual alternative of stock repurchases by corporations. Section I.B.1 provides the basics of the puzzle, briefly discussing how share repurchases initially appear to provide (i) comparable non-tax benefits over retained earnings, plus (ii) the more favorable tax treatment accorded stock sales. Section I.B.2 shows how the puzzle remains even after a deeper analysis recaps some potential advantages of dividends over repurchases.

¹⁹ Easterbrook, *supra* note 11, at 652-55. More frequent capital issuances can impose additional discipline through, *inter alia*, the scrutiny of underwriters and the threat of reduced proceeds on the new capital issuances. Dividends also might address the more specific agency problem of management's excess risk-aversion (due to managers' lack of diversification in human capital). Risk-averse managers might excessively retain earnings to cushion against the possibility of a failed enterprise. As a result, the debt-equity ratio falls, causing a wealth transfer from equity holders to debt holders. Dividends can address this agency cost decline to shareholder wealth in two ways. First, dividends by themselves increase the debt/equity ratio. Second, as discussed in the text, dividends can generate new capital issuances. This can further restore the optimal debt/equity ratio given the possible issuance of new debt. *Id.*

²⁰ *Id.* at 650 (stating that dividends make sense for "a change in investment policy—when, for example, . . . shareholders can make better use of the money than managers"). This assumes that the corporation is not simultaneously issuing new equity.

As a related tax point, corporations which retain earnings beyond the reasonable needs of the business could become subject to the accumulated earnings tax. (The accumulated earnings tax is a dividend-substitute tax imposed at the corporate level.) See I.R.C. §§ 531-37 (2003). For a discussion downplaying the risks of such tax for public companies, see RICHARD BREALEY & STEWART MYERS, *PRINCIPLES OF CORPORATE FINANCE* 434 (5th ed. 1996); Fischer Black, *The Dividend Puzzle*, J. OF PORTFOLIO MGMT. 5 (1976).

²¹ See, e.g., Jesse M. Fried, *Insider Signaling and Insider Trading with Repurchase Tender Offers*, 67 U. CHI. L. REV. 421, 438-39 (2000).

²² See, e.g., Paul Asquith & David W. Mullins, Jr., *Signalling with Dividends, Stock Repurchases, and Equity Issues*, FN. MGMT. 27, 35 (1986) (explaining that dividends distinguish the more profitable firms capable of generating the cash needed to pay dividends). For a critique of the dividend signaling theory, see *infra* note 40 and accompanying text.

1. Initial Restoration of the Dividend Puzzle

Share repurchases generally can be divided into open-market repurchases and repurchase tender offers.²³ An open-market repurchase involves the purchase by a corporation of its stock on the market at the prevailing price. The repurchase tender offer involves a bid by the corporation to purchase a number of its shares, typically at a significant premium to the current price. In considering repurchases as a dividend alternative, the following discussion focuses on the less costly open-market repurchases.²⁴

The dividend puzzle arises since repurchases also transfer corporate profits to shareholders, but in the more tax-friendly form of a stock sale. The similar transfer of profits to shareholders suggests initially that repurchases could match the non-tax benefits of dividends over retained earnings. The cash outflow from repurchases similarly could (i) generate more frequent issuances of new capital,²⁵ (ii) stem the accumulation of excess capital inside the corporation,²⁶ and (iii) signal undervaluation of the corporation to the market.²⁷ Furthermore, by adjusting the number of shares acquired, a corporation generally could make any desired level of cash distribution.²⁸

²³ A relatively minor percentage of corporate repurchases take the form of targeted repurchases from a select shareholder (for example, greenmail). Michael J. Barclay & Clifford W. Smith Jr., *Corporate Payout Policy: Cash Dividends versus Open-Market Repurchases*, 22 J. OF FIN. ECON. 61, 61-62 (1988).

²⁴ See Justin Pettit, *Is a Share Buyback Right for Your Company?*, 79 HARV. BUS. REV. 141 (2001); see also Fried, *supra* note 21 (noting lower transaction costs for open market repurchases and therefore analyzing what reasons might support use of a repurchase tender offer over an open market repurchase).

²⁵ In positing the agency cost explanation for dividends, Judge Easterbrook stated that "nothing . . . suggests that repurchases of shares would not do as well or better than dividends." Easterbrook, *supra* note 11, at 655; see also Zodrow, *supra* note 18, at 507 (stating that dividends continue to puzzle "since share repurchases provide a means of . . . limiting managerial discretion that results in a much smaller tax cost").

²⁶ See F.H. Buckley, *When the Medium is the Message: Corporate Buybacks as Signals*, 65 IND. L. J. 493, 519-21 (1990) (noting how both repurchases and dividends enhance value where shareholders would earn a superior rate of return on the corporate retained earnings). As a related point, share repurchases similarly would reduce any accumulated earnings tax concerns. See discussion of the accumulated earnings tax *supra* note 20.

²⁷ For the comparable signaling potential of repurchases, see Laurie Simon Bagwell & John B. Shoven, *Cash Distributions to Shareholders*, 3 J. OF ECON. PERSP. 129, 135 (1989), stating that "signaling models explain cash payout more satisfactorily than they explain the choice between dividends and [share] repurchase[s]", and Zodrow, *supra* note 18, at 507, explaining that justifying dividends is especially "problematic since share repurchases provide a means of signalling profitability . . . that results in a much smaller tax cost than that incurred with the paying of dividends." For a deeper analysis of how dividends and repurchases might send different signals, see *infra* notes 31-40 and accompanying text.

²⁸ Assume Y Corporation has 100 shares outstanding, valued at \$10 per share. Y Corporation is planning a dividend distribution of \$100, in other words, \$1 per share. In lieu of such dividend,

On the tax side, repurchases generally are more efficient than dividends since repurchases take the form of a stock sale. Similar to the retained earnings analysis above, selling shareholders potentially benefit from a lower amount of taxable income and, until recently, a lower tax rate. In addition, non-selling shareholders benefit from the lack of any tax inclusion.²⁹

2. Puzzle Remains Even After Deeper Analysis

Probing deeper, existing commentary provides some potential benefits of dividends over repurchases. As discussed below, however, recent dividend levels appear inexplicably high even after such potential advantages are taken into account.³⁰

Dividends have potential benefits over repurchases in two primary,

Y Corporation could distribute \$100 by purchasing 10 shares (10 shares x \$10 = \$100). At first blush, a shareholder might appear to receive a materially different treatment under the two alternatives. Consider a stockholder (S) who owns 10 shares of stock. Under the dividend alternative, S receives \$10 in addition to retaining the ten shares. Under the repurchase alternative, retention of all ten shares would foreclose any cash receipt, in other words, S decides not to sell any stock. Under certain assumptions, however, S's stock will be worth \$10 more under the repurchase alternative since the stock price should decline by approximately \$1 per share under the dividend alternative, in other words, an amount equal to the per share distribution. Thus, if S desired \$10 cash, S could sell one share. If so, S would have \$10 cash and \$90 stock under either alternative. While the \$1 stock decline might not occur under the dividend alternative (perhaps due to the factors discussed above, for example, signaling), the repurchase alternative could experience a similar favorable reaction in stock price as well. See, e.g., discussion *infra* note 39 (discussing how stock price can increase on the announcement of a repurchase); see also discussion *infra* notes 32-38 and accompanying text (discussing potential wealth shifts).

The SEC's safe harbor exemption from tender offer regulation does impose some limits on open-market repurchases. See *infra* note 42 and accompanying text.

²⁹ Consider the earlier example *supra* note 28. Under the repurchase alternative, selling stockholders would be taxed only on the excess of the \$10 sales price over their purchase price for the sold stock. Furthermore, such gain might qualify for a lower capital gains rate. In contrast, under the dividend alternative, all shareholders would have a taxable dividend of \$1 per share. In addition, until the recent tax change, the dividend would have been taxed at the higher, ordinary tax rate. See *supra* note 16 and accompanying text for the significance of the rate differential. The excess tax cost becomes more dramatic if the dividend distribution assumes some reinvestment through a dividend reinvestment plan ("DRIP"). See *infra* note 43 and accompanying text for a discussion of DRIPs. For instance, assuming a reinvestment of \$20, the taxable dividend amount in the aggregate would be \$100, despite the net distribution of only \$80. In favorable contrast, the repurchase distribution could be limited to 8 shares to match the \$80 net distribution. This would generate an aggregate shareholder tax inclusion of only \$80 less the aggregate purchase price of the sold shares (again, with the additional possible benefit of a lower capital gains rate). This assumes that the repurchase would not be recharacterized as a dividend by the IRS. See discussion *infra* note 32. In addition, some tax-exempt shareholders would not bear any tax costs regardless of the form (and a limited number of shareholders might have a tax preference for dividends over repurchases). See discussion *infra* note 48 and accompanying text.

³⁰ While repurchases have increased over time, corporations still collectively pay significant dividends. See discussion *infra* note 49.

interrelated areas: regularity and wealth shifts. Corporate dividends typically are distributed at fixed intervals over time. The potential advantages of such regularity relate primarily to the signaling function: a policy of regular, ongoing distributions arguably sends a stronger signal of profitability to the market.³¹

Repurchase regularity might be hampered by two factors. First, regularity would increase the risk that the repurchases would be treated as dividends for tax purposes, especially, if accompanied by a public announcement (for signaling purposes).³² Second, the potential wealth

³¹ A regular dividend policy might suggest management's confidence that the profitability will continue over time and/or willingness by management to regularly share profits in lieu of empire building. For the arguable superiority of dividend signaling due to such regularity, see, for example, Asquith & Mullins, *supra* note 22, at 36-37, explaining that dividends have distinct signaling benefit due to more regular frequency. The lack of legal constraints on subsequent reductions to a declared dividend policy arguably undercuts, however, such potential superiority of dividends. On the one hand, legal constraints against dividend reductions arguably are not needed since the marketplace harshly penalizes dividend reductions. This market-based argument, however, better explains steady dividends over retained earnings than the choice of dividends over redemptions. That is, market forces similarly could encourage corporations to redeem stock on a semi-regular basis, even if such corporations avoided formal statements as to a regular redemption policy for the reasons discussed below in the text. See also the critique of dividend signaling *infra* note 40.

Separately, some investors might like a steady income stream. As discussed above, however, investors can create their own desired pattern of cash flow independent of the corporation's distribution scheme. Furthermore, this point loses force when considering investment through mutual funds, the ultimate focus of this Article. As discussed *infra* note 107 and accompanying text, most mutual fund investors automatically reinvest dividends passed through to them by the fund. As a related point, some investors arguably might prefer dividends based on the irrational belief that dividends provide a higher pretax yield than repurchases since the stockholder receives cash without relinquishing any stock. This point similarly loses force in the mutual fund context since professional money managers should not succumb to such fallacy. See also discussion *supra* note 28.

³² Technically, share repurchases will not receive the more favorable sales treatment if they are deemed too similar to dividends under Internal Revenue Code section 302. If so, sales proceeds from repurchases would be treated as dividends to the sellers. In addition, non-selling shareholders could be treated as receiving a fictional taxable stock dividend (explaining their increased ownership in the firm). See I.R.C. § 305(c) (2003); Treas. Reg. § 1.305-7 (2003). Internal Revenue Code section 302 generally has not been viewed as a significant impediment to favorable tax treatment for public company redemptions, however. See Bagwell & Shoven, *supra* note 27, at 136 (explaining how firms have learned over time how frequently they can do redemptions without running afoul of Internal Revenue Code section 302); Barclay & Smith, *supra* note 23, at 63, 69 (stating that Internal Revenue Code section 302 has not been problematic for public corporations; furthermore, risks are more likely for repurchase tender offers than open-market repurchases); Zodrow, *supra* note 18. There probably are some limitations on complete substitution of repurchases for dividends. See BREALEY & MYERS, *supra* note 20, at 431 (speculating that the IRS might go after a firm that eliminates dividends in favor of a regular repurchasing program); Asquith & Mullins, *supra* note 22, at 36 (predicting an IRS response if many firms regularly substituted repurchases for dividends); Buckley, *supra* note 26, at 517. Even so, the question remains why corporations have not pushed the issue more, especially since the IRS might have a difficult enforcement issue in collecting from the myriad public shareholders. Compare the decision to relax the "shareholder continuity" rules whereby sales by public shareholders after a business combination might affect the tax-free status of such combination.

shift under a repurchase arguably impedes regular repurchases. Dividends distribute cash pro rata based on shareholdings, and, do not, by themselves, change each stockholder's percentage share ownership. In contrast, only selling shareholders receive cash under the repurchase; correspondingly, the percentage ownership of the non-selling shareholders increases.³³ In effect, non-selling shareholders implicitly purchase stock from selling shareholders at the repurchase price paid by the corporation.³⁴ As such, wealth is shifted from the non-sellers to the sellers where the stock price is overvalued at repurchase.³⁵ In addition to raising possible concerns in its own right,³⁶ this potential wealth shift arguably impedes regular repurchases.³⁷ For instance, corporate managers' self interest might block repurchases when they believe the

³³ A pro rata distribution would require the sale by each shareholder of a pro rata portion of the repurchased stock. See discussion *infra* note 38 and accompanying text (explaining how management tends not to sell in connection with the repurchases). In the unlikely event of a pro rata distribution, a sale back to the company would be treated as a dividend for tax purposes. See discussion of Internal Revenue Code section 302 *supra* note 32. At least in form, a shareholder can avoid such issue by selling stock to someone other than the corporation.

³⁴ For simplicity, assume X Corporation has only two shares outstanding, one owned by A and one by B. Assume X Corporation repurchases A's share for \$100. This is analogous to a purchase by B of A's share for \$100. In either case, B would own all the shares in X Corporation. While B would avoid the direct \$100 payment under the repurchase scenario, the cash in B's wholly-owned corporation would decline by \$100.

³⁵ Similarly, wealth is shifted from sellers to non-sellers where the stock is undervalued. It has been suggested that open-market repurchases generally benefit non-selling shareholders while premium tender offers tend to benefit selling shareholders. See Victor Brudney, *Equal Treatment of Shareholders*, 71 CAL. L. REV. 1072, 1084 n.28 (1983). This presumably follows from the higher purchase price on self-tenders due to the premium.

³⁶ For a normative argument that repurchases generally should be prohibited due to these wealth shifts, see Brudney, *supra* note 35, at 1106-13, expressing particular concern on wealth shifts in favor of insiders. Several dividend explanations rely on this possible costly shift in value between selling and non-selling shareholders under the repurchase alternative. See, e.g., Barclay & Smith, *supra* note 23; Michael J. Brennan & Anjan Thakor, *Shareholder Preferences and Dividend Policy*, 45 J. OF FIN. 993 (1990); Deborah J. Lucas & Robert L. McDonald, *Shareholder Heterogeneity, Adverse Selection, and Payout Policy*, 33 J. FIN. & QUANTITATIVE ANALYSIS 233 (1998). Dividends continue to puzzle commentators despite these attempted explanations. See, e.g., WILLIAM A. KLEIN & JOHN C. COFFEE, JR., *BUSINESS ORGANIZATION AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES* 384 n. 54 (8th ed. 2002) (characterizing one such attempted explanation as seemingly trivial); FRANKLIN ALLEN ET AL., *A THEORY OF DIVIDENDS BASED ON TAX CLIENTELES*, (Rodney L. White Center for Research Working Paper, 1998) (discussing gaps in each such explanation); Buckley, *supra* note 26, at 546 ("[b]ecause open-market repurchases are made at market price, distributional concerns are negligible"). While repurchases do raise some legal issues, they "ordinarily seem likely to be small in relation to the potential tax advantages of [repurchases] . . ." KLEIN & COFFEE, *supra*, at 384.

As a related point, avoidance of the need to make periodic decisions might be another potential reason why dividends are advantageous to shareholders. In response, however, just like a shareholder could decide at the time of investment to reinvest all dividends through a DRIP—if available, a shareholder could decide *ab initio* to consistently respond whenever the corporation repurchases at the current market price, that is, to either always or never tender depending on whether the shareholder wants periodic liquidations of the investment. Furthermore, this point loses force in the context of investments through mutual funds, the ultimate focus of this Article. In such context, investors hire fund managers to oversee and manage the investment portfolio.

³⁷ See Lucas & MacDonald, *supra* note 36.

stock is overvalued since managers typically do not sell in connection with the repurchase.³⁸ Regularity and wealth shifts, however, do not satisfactorily explain the significant dividend levels over time. First, despite its irregularity, arguably, the repurchase is a superior signal than the dividend in other respects. The above discussion highlights a potential self-enforcing mechanism of repurchases. If management holds stock and does not sell in connection with the repurchase, management implicitly purchases from the selling shareholders. Arguably, management would not initiate a repurchase absent a belief of stock undervaluation. This is especially true when the repurchase is announced in advance since the stock price tends to increase on such announcement.³⁹ In contrast, the dividend signal has been critiqued for the lack of any such self-enforcing mechanism.⁴⁰

This signaling analysis also provides at least a partial response to the more general wealth shift concern. If the repurchase accurately

³⁸ As discussed below, repurchases can send a positive signal to the market. This signaling function is undercut where management participates in the buyback. See Pettit, *supra* note 24, at 143. Separate from their self-interest, corporate managers might be reluctant to favor selling shareholders over those continuing their current investment with the corporation. Compare Jeffrey N. Gordon & Lewis A. Kornhauser, *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U. L. REV. 761, 820 n.158 (1985) (for the related explanation of why the stock price generally falls on a new stock issuance (management, acting for current shareholders, would be reluctant to issue stock when it believes the firm's assets are undervalued by the market)).

As discussed *infra* note 43, the non-tax differences between repurchases and dividends narrow once the dividend is coupled with a DRIP. In this regard, query (i) whether the market should respond negatively to the dividend/DRIP combination where management does not repurchase under the DRIP, and (ii) if so, why that does not impede regular dividend/DRIPs.

³⁹ Buckley, *supra* note 26. In order to avoid the implicit purchase at an excess price, the stock must be undervalued at the announcement time to allow for the expected increase prior to repurchase. As an aside, an overvalued repurchase can harm non-selling management under the assumption that the stock price eventually will reflect their more negative assessment. For the argument that repurchases are stronger signals than dividends, see *id.*, at 539-40. Although Professor Buckley focuses specifically on the premium self-tender at this point in his discussion, his analysis applies as well to open-market repurchases ("OMR"s). As Professor Buckley discusses, the signaling strength comes from the combination of a premium and the lack of tendering by management. While the OMR lacks the full premium, the announcement of an OMR tends to increase the stock price, as discussed above. Furthermore, even without such increase, there would be a shift in wealth away from non-selling management if the stock price were overvalued. The OMR therefore can be a stronger signal than a dividend, which lacks the implicit purchase by management at the repurchase price. As discussed *infra* note 43, the non-tax differences between dividends and repurchases narrow when the dividend is coupled with a DRIP. In this regard, query whether a dividend with a DRIP sends a comparable signal if management reinvests the dividends. The self-tender with a premium can be an even stronger signal than the OMR since the non-sellers are purchasing at an even higher, committed price.

⁴⁰ See, e.g., Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 838 (1992) ("[S]ome companies pay dividends they can't afford in an effort to fool investors about their profitability. . . . Dividend cuts also often lag far behind business reversals."); Easterbrook, *supra* note 11, at 652 ("[D]ividends do not distinguish well-managed, prospering firms from others."); see also Pettit, *supra* note 24 (explaining that institutional investors are unlikely to be swayed by dividend signaling). But see discussion *supra* note 38 (discussing where the dividend is coupled with a DRIP).

signals, it minimizes wealth shifts by reducing stock price undervaluation.⁴¹ In this regard, consider also the SEC's safe harbor exemption from tender offer regulation for small amounts of open-market repurchases, on grounds that "issuer repurchase programs are seldom undertaken with improper intent."⁴² Furthermore, wealth shifts can occur even in connection with (pro rata) dividends. Consider, for example, the coupling of a dividend with a dividend reinvestment plan ("DRIP"), pursuant to which only some shareholders reinvest the dividend in new corporate stock.⁴³ In sum, any non-tax benefits of dividends over repurchases are significantly narrowed relative to the initial presentation at the beginning of this Section.⁴⁴

⁴¹ See Buckley, *supra* note 26, at 513, 541 n.173, for this explanation. See generally Buckley, *supra* note 26, at 502 ("[T]here is little likelihood of shareholder expropriation when the repurchase is made at market price.") and 546 (explaining that there are "negligible" distributional concerns on open market repurchases).

⁴² Exchange Act Release No. 19,244 [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,276, at 85,478 (Nov. 17, 1982).

⁴³ Once a DRIP is introduced, the differences between repurchases and dividends generally narrow. In other words, shareholders who reinvest dividends are analogous to non-selling shareholders under the repurchase alternative. (DRIPs differ in that they typically provide a discount to the current trading price. As such, a more equivalent repurchase alternative would require a repurchase at a price below the current stock price. Nonetheless, as discussed below, similarities remain, for example, a structure which shifts wealth among shareholders—at least in the mind of management—when they believe the stock price stock inadequately reflects its true value.) For a discussion about the prevalence of DRIPs, see, for example, BREALEY & MYERS, *supra* note 20, at 419. The DRIP possibility highlights how new stock issuances more generally raise similar wealth shift concerns. New stock issuances similarly force current shareholders to decide whether to retain their current ownership percentage.

A final wealth shift point involves taxes. As discussed below, shareholders bear disproportionate dividend tax costs based on their specific tax profiles. Dividends thus generate wealth shifts between shareholders on an after-tax basis. It has been argued that these tax differences should be ignored by corporate managers since (i) the cost is shareholder specific and (ii) heavily-taxed shareholders can avoid stocks with high dividend levels. See Brudney, *supra* note 35. This position appeals more under certain market assumptions; for example, where taxable shareholders (i) can sell stock upon an increase in dividend policy without any costs (including taxes), (ii) fully understand the tax implications, and (iii) need not sacrifice diversification in pursuit of tax-friendly stocks. For deviations from such assumptions, however, see for example, the discussions of (i) the tax clientele theory *infra* notes 47-48 and accompanying text, and (ii) the mutual fund tax agency problem *infra* notes 64-67 and accompanying text. A position that shareholder taxes are irrelevant even absent such market conditions suggests a prohibition of repurchases even where desired, on balance, by a more finely-tuned market (for example, where shareholders' excess dividend tax costs dominate any excess repurchase costs to the corporation). See also Brudney, *supra* note 35 (proposing limitations on repurchases to avoid corporate-level costs). Recognition of the imperfect market conditions does not, of course, resolve the difficult question as to management's appropriate balancing of shareholders' divergent tax interests. See also *infra* Section III.C (discussing the balancing by mutual fund managers).

⁴⁴ See, e.g., KLEIN & COFFEE, *supra* note 36, at 384 ("the costs associated with [the] legal problems [of redemptions] ordinarily seem likely to be small in relation to the potential tax advantages"); Barclay & Smith, *supra* note 23, at 67, 77 (explaining that it is unclear whether dividends or open-market repurchases dominate on the basis of out-of-pocket expenses, and therefore "out-of-pocket expenses incurred . . . [under either option] appear to be relatively small."); Black, *supra* note 20, at 6 (same); Zodrow, *supra* note 18, at 508 n.12 (explaining that

Finally, the tax clientele theory also inadequately explains the dividend level over time. The tax clientele justification draws upon the fact that some shareholders do not bear any dividend tax costs, for example, tax-exempt and tax-deferred groups.⁴⁵ Dividends therefore should be attractive to such investors so long as dividends have any net non-tax benefit over repurchases, even if relatively minor. Arguably, corporations distribute dividends to satisfy such shareholder base. As a related point, dividends might not impose excess tax costs since taxable investors can appropriately discount their reservation price for dividend-paying stocks.⁴⁶ Despite some descriptive power, the tax clientele theory has fallen short of solving the dividend puzzle.⁴⁷ The tax clientele theory has particular difficulty reconciling substantial dividends with a significant investor base that has borne high dividend tax costs.⁴⁸

the SEC limits on open market repurchases are not likely to be burdensome).

⁴⁵ Tax-exempt and tax-deferred groups refer respectively to those who never pay tax and those for whom taxes are deferred until a later time. See discussion *infra* note 73 (discussing why tax-deferred retirement accounts, for example, pension funds, should be indifferent between the tax treatment of dividends and repurchases).

⁴⁶ For example, they can discount the price they are willing to pay for the stock by the excess tax costs.

⁴⁷ See, e.g., Dan S. Dhaliwal, Merle Erickson, & Robert Trezevant, *A Test of the Theory of Tax Clienteles for Dividend Policies*, NAT'L TAX J. 179, 179-80 (1999) (discussing how prior tests failed to establish a strong enough link between tax status and the holding of dividend stocks). Possible reasons for the lack of such connection include a diversification desire and trading costs, including tax costs in selling stock. As discussed below, Dhaliwal, Erickson and Trezevant provide support for the clientele theory but only by relying, in part, on the purchase of dividend-paying stocks by mutual fund managers (who represent taxable investors).

⁴⁸ In addition to taxable U.S. investors, foreign investors should prefer repurchases since foreigners generally pay no U.S. tax on capital gains while dividends are subject to a 30 percent withholding tax, subject to possible treaty protection. See also Easterbrook, *supra* note 11, at 652 (explaining that the presence of substantial parties who are indifferent to dividend tax costs still does not explain the adoption of provisions which significantly harm others). Corporations owning portfolio stock in other corporations might have a tax preference for dividends since corporations (i) can exclude a portion of dividends under a "dividends received deduction" and (ii) do not receive a lower capital gains rate on stock sales. Corporations appear, however, to be relatively minor players in the market for corporate stock. See KLEIN & COFFEE, *supra* note 36; see also Black, *supra* note 20, at 6 ("[I]t is hard to believe that [corporate investors] have enough impact on the market to outweigh the effects of taxable individuals"). As a related point, there are clienteles for dividend-paying stocks for non-tax reasons. Certain financial institutions face legal restrictions against owning stocks which do not pay dividends. Trusts also might have a preference for dividends, characterized as spendable "income," rather than capital gains, viewed as "additions to principal." BREALEY & MYERS, *supra* note 20, at 429. See also ALLEN ET AL., *supra* note 36 (arguing that dividends reduce agency costs by attracting more institutional monitors). See also *supra* note 31 (discussing the regularity appeal of dividends). Notwithstanding the presence of some dividend clientele (for tax or other reasons), the question remains: "Why should so many investors want high [dividend] payouts?" BREALEY & MYERS, *supra* note 20, at 435. See *supra* note 47 (discussing the shortcomings of the tax clientele theory). See also KLEIN & COFFEE, *supra* note 36, at 385, 385 n.57 (explaining that trustees who hold dividend-paying stocks so as to generate income—as opposed to stock gain—"merely shift the inquiry, there being no satisfactory answer to the question of why those irrationalities persist[,] and asking 'why do lawyers persist in failing to 'draft around' [such restrictions]'"

In sum, the dividend level has remained substantial despite the increasing popularity of share repurchases over time.⁴⁹ The potential benefits of dividends over repurchases appear insufficient to fully explain the dividend level over time given the significant tax savings for numerous investors.⁵⁰ This is especially so when analyzing dividend policy in recent years, prior to this year's elimination of the higher dividend tax rate.⁵¹ The dividend puzzle therefore is not the presence of any dividends, but rather the high level of issuance over time.

II. MUTUAL FUND AGENCY PROBLEM – MISSING PIECE TO THE DIVIDEND PUZZLE?

The previous Section explained why dividends remain puzzling. This Section suggests a new explanation for the persistence of tax-inefficient dividends over time. As discussed below, the inattention of mutual fund managers to their investors' taxes has contributed to a market failure.

Consider first the stock trading theory regarding the incentives for corporate managers to adopt the most efficient policies. If a corporation adopts an inefficient policy reducing shareholder value, its stock price should decline as investors take such harm into account. The fact that ordinary investors might lack knowledge, or understanding, of inefficient corporate policies does not vitiate this market discipline theory.⁵² Institutional investors, due to their sophistication and large stakes, overcome such ordinary investor impediments.⁵³ Where inefficient provisions are adopted after the initial stock offering,⁵⁴ the

⁴⁹ For a discussion on the increased use of repurchases, see KLEIN & COFFEE, *supra* note 36; Pettit, *supra* note 24; Zodrow, *supra* note 18; Floyd Norris, *Growing Number of Companies Choose Not to Offer Dividends*, N.Y. TIMES, Jan. 4, 2000, at A1. For a discussion of the continued high dividend level, see, for example, KLEIN & COFFEE, *supra* note 36, at 385, stating that "most major corporations continue to pay dividends."; Zodrow, *supra* note 18, at 507; Norris, *supra* stating "To be sure, most companies still pay dividends . . ."

⁵⁰ See, e.g., KLEIN & COFFEE, *supra* note 36, at 385 (stating that there is "no satisfactory explanation" for the dividend level over time). See also *supra* notes 39-40 and accompanying text (regarding the possible superiority of repurchase signaling despite the lack of regularity; and authorities discussed *supra* note 48). See *supra* notes 13-18, 29 and accompanying text for a discussion of the significant tax benefits.

⁵¹ See *supra* note 4 for a discussion of the recent tax bill and its impact on the analysis of dividend policy.

⁵² See, e.g., Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1428-34 (1989).

⁵³ See, e.g., Gordon & Kornhauser, *supra* note 38, at 802 ("Institutional investors hold a large percentage of assets traded on exchanges and represent an even larger proportion of those investors with portfolios of sufficient size to warrant substantial expenditures on research.").

⁵⁴ A similar concept applies to the initial issuance of stock as well. Professional investors help to set the market price on initial offering, with such market price based, in part, on the provisions in the corporate charter. See, e.g., Easterbrook & Fischel, *supra* note 52, at 1430-31.

resulting sell-off by institutional investors initiates a process under which the stock price declines to its new, lower equilibrium.⁵⁵ Lower stock prices, or the threat thereof, can encourage corporate managers to adopt the most efficient policies due to, *inter alia*, possible additional capital issuances in the future,⁵⁶ stock ownership by managers, and the market for corporate control.⁵⁷ Importantly, this stock trading process maintains its general descriptive force despite the lack of absolute precision in all cases.⁵⁸

Consistent with the market incentive to reject inefficient corporate policies, many commentators have searched for offsetting benefits of dividends (or costs of repurchases) to explain the dividend persistence

⁵⁵ See Ronald J. Gilson & Reinier H. Kraakman, *Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 568-79 (1984) (describing various forms of market equilibration depending on the nature of the information). For a limited category of less sophisticated information, all market participants act collectively to set the new equilibrium (uniformly informed trading). For more sophisticated information, trading by market professionals set the new equilibrium, either alone (professionally informed trading) or in conjunction with subsequent trading by other investors who follow the lead of the market professionals (derivatively informed trading).

⁵⁶ This can be particularly relevant as to the profits distribution mechanism given the argument that the distribution's purpose is to place the company back in the new issuance market. See discussion *supra* note 19 and accompanying text.

⁵⁷ See, e.g., Easterbrook, *supra* note 11, at 651 (stating that over time, firms with the most efficient terms will prosper relative to others). See also Barclay & Smith, *supra* note 23 ("[M]arket participants have strong incentives to devise efficient distribution methods."). Other management incentives include the labor market for corporate managers, monitoring by creditors, bankruptcy risk, fiduciary duties (with corollary lawsuits), and cultural norms of behavior. Even if one questions the effectiveness of the stock trading discipline, a special role still can be recognized for institutional investors in shaping corporate policy through the exercise of "voice." See, e.g., Black, *supra* note 40, at 832 ("Capital market constraints are weak for firms that can service their debt and rarely sell new equity" since the other factors described above have weaknesses, for example, corporate control challenges are hampered by high premiums and company defenses), 865 (implicitly assuming corporate managers will care about desires of large institutional investors), 887 ("institutional investors . . . are the market"). The large voting blocks of institutional investors can affect corporate policy through direct voting or dialogues with management. The voice approach might appeal as an alternative to the extent institutional shareholders face difficulties in selling their significant stake without driving down the price. As a related point, this might suggest an additional impediment to the stock trading approach.

⁵⁸ See, e.g., KLEIN & COFFEE, *supra* note 36, at 406 ("One can treat [the efficient capital market hypothesis] as an effective, practical, and useful view of the world despite an awareness of its departure from complete scientific accuracy."); Gilson & Kraakman, *supra* note 55, at 551 n.10 ("[E]ven if problems are finally resolved against current formulations of [the efficient capital market hypothesis], the 'basic insights of the efficient markets literature [would] still remain.") (second alteration in original); Gordon & Kornhauser, *supra* note 38, at 809 ("The modern finance paradigm may be 'wrong' but may nevertheless provide genuine insights into market function, particularly if it seems to organize experience more effectively than existing alternatives."). In particular, the component related to the influence of institutional investors has significant acceptance. For one article questioning the widespread use of the efficient market theory but nonetheless accepting the significant role of institutional investors, see Gordon & Kornhauser, *supra* note 38, at 795, explaining that restricting research by large institutions could have "serious repercussions" for market efficiency. But see Jeffrey N. Gordon, *What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections*, 69 U. CHI. L. REV. 1233, 1236-40 (2002) (questioning the institutional investor role in light of the Enron situation).

in the face of its tax disadvantage.⁵⁹ As discussed in Section I, the current significant dividend level over time has been puzzling due to the meaningful tax benefits of repurchases.⁶⁰ The current section approaches the dividend puzzle from another perspective. Drawing upon existing literature on mutual fund agency costs, this Section suggests that the dividend tax costs have not properly been taken into account by the marketplace.

Mutual fund agency costs are analyzed primarily in the literature on the potential "voice" influence of institutional investors.⁶¹ Institutions might influence corporate policy through either voting or discussions with management, rather than through an "exit" approach of stock trading. While recognizing possible benefits to concentrated ownership by institutions on the one hand,⁶² such scholarship highlights how institutions raise a second-tier agency problem in return. That is, the managers of the institutional investors might not fully pursue their beneficiaries' interests.⁶³

A previously-recognized manifestation of this agency slippage regards taxes and short-term trading by mutual fund managers. Mutual funds generally do not pay any tax at the fund level on their stock gains. Instead, investors in the fund pay tax on their pro rata share of the fund's stock gains.⁶⁴ Short-term trading by fund managers denies investors the lower capital gains rate and accelerates their taxes.⁶⁵ Concern thus has been expressed over the tax harm to fund investors when fund managers frequently trade stocks, with apparent disregard of their investors' tax consequences.⁶⁶ As discussed below, the lack of

⁵⁹ See discussion *supra* notes 31-38 and accompanying text.

⁶⁰ See, e.g., *supra* note 50 and accompanying text.

⁶¹ See, e.g., Black, *supra* note 40; Alan R. Palmiter, *Mutual Fund Voting of Portfolio Shares: Why Not Disclose?*, 23 CARDOZO L. REV. 1419 (2002); Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L. J. 445 (1991). For a brief reference to the mutual fund agency problem in the context of efficient markets, see Gordon & Kornhauser, *supra* note 38, at 805-06, which is discussed in greater detail *infra* note 80.

⁶² Institutional investors might reduce agency costs at the operating corporate level by overcoming shareholder collective action impediments to voice discipline. E.g., Black, *supra* note 40; Rock, *supra* note 61.

⁶³ See, e.g., Black, *supra* note 40, at 815, 817 (explaining that money managers need to watch themselves to ensure that they act in beneficiaries' best interests); Rock, *supra* note 61, at 452-53, 454 n.29, 469-78.

⁶⁴ Funds must distribute such stock gains to their investors to avoid an additional tax at the fund level. The investor-level tax is due even if the investor automatically reinvests all such distributions in the fund. See I.R.C. §§ 851-52 (2003).

⁶⁵ The lower rate applies only if the fund held the underlying stock for more than one year. For the harm from the acceleration of the tax payment on stock gains, see discussion of the benefits of interest-free tax deferral *supra* note 14.

⁶⁶ See, e.g., U.S. Securities and Exchange Commission, Final Rule: Disclosure of Mutual Fund After-Tax Returns, available at <http://www.sec.gov/rules/final/33-7941.htm> (last visited Oct. 10, 2003) [hereinafter SEC Tax Disclosure]; House Commerce Chairman Tom Bliley's Statement on Mutual Fund Tax Awareness Act of 1999, 2000 TNT 52-14 (3/16/2000) (discussing high portfolio turnover rate); Representative Paul Gillmor's amendment to Mutual Fund Tax

direct tax collections from mutual funds significantly contributes to this agency problem.⁶⁷

Finally, connect the earlier theory on the market influence of professional investors⁶⁸ and the agency costs of mutual funds. As discussed above, mutual fund managers—a significant institutional investor group representing taxable investors⁶⁹—largely ignore their investors' tax costs on trading decisions.⁷⁰ This recognized problem on short-term trading should extend, *a fortiori*, to the dividend/repurchase analysis as well,⁷¹ as mutual fund managers have largely neglected the potential tax savings of repurchases to their investors, falsely behaving as if they represent only tax-deferred investors.⁷²

Awareness Act of 1999, 2000 TNT 52-34 (3/16/2000) (providing findings of Congress on high portfolio turnover).

⁶⁷ See discussion *infra* Section III.B.1. Another contributing factor to this agency slippage is that investors typically evaluate funds on a pretax, rather than an after-tax, basis. See David Schizer, *Frictions as a Constraint on Tax Planning*, 101 COLUM. L. REV. 1312, 1343 (2001). This factor suggests a possible solution of enhanced disclosure of after-tax returns. This is the approach recently adopted by the SEC. See SEC Tax Disclosure, *supra* note 66. While it is too soon to gauge the effectiveness of these new rules, they face serious obstacles. See discussion *infra* Section III.B.2.

Separate from taxes, additional agency costs can arise when fund managers trade stocks for cosmetic reasons; for example, to show on reporting dates that they hold certain hot stocks (or do not hold disfavored stocks). See, e.g., Mark Hulbert, *Why Dec. 31 is a Good Day to Stay Out of the Market*, N.Y. TIMES, Oct. 6, 2002, § 3 at 6 (discussing such "end-of-quarter window dressing").

⁶⁸ The tax analysis is more complicated than corporate governance provisions in that the tax harm varies for each shareholder depending on its particular tax status. While dividends do not harm tax-exempt or tax-deferred shareholders, a taxable shareholder's after-tax return could be significantly reduced by dividends. Nonetheless, the market could reach an efficient outcome where shareholders discount their reservation price by the particular harm to them. See *supra* notes 45-46 and accompanying text (discussing the tax clientele theory). For shortcomings in practice, however, see *supra* notes 47-48 and accompanying text.

⁶⁹ While some mutual fund accounts are tax-deferred retirement investments, mutual funds represent significant taxable investors. Approximately 40 percent of the money managed by mutual funds for individuals is through a taxable account. See discussion *infra* note 74. For a discussion of the possible conflict where a mutual fund manager invests on behalf of both taxable and tax-deferred accounts, see *infra* Section III.C.

⁷⁰ Some fund managers pay attention to taxes since some investors take taxes into account when making investment decisions. For instance, even prior to the recent SEC tax disclosure rules, there was a private market for after-tax mutual fund analysis and tax-managed funds. Nonetheless, fund managers currently do not have the incentive to fully weigh investor taxes as many investors do not undertake the sophisticated after-tax analysis. See the discussion *infra* notes 79-81 and accompanying text.

⁷¹ Similar to stock gains, corporate dividends received by mutual funds generally are not taxed at the fund level. Rather, fund investors are taxed on their pro rata share.

⁷² See discussion *infra* note 73 (explaining why tax-deferred accounts should be indifferent to the tax savings of repurchases). The textual point should be relaxed, but not eliminated, to the extent fund managers pay some, but not full, attention to investor taxes (in other words, they falsely behave as if they represent more tax-deferred investors than in actuality). See discussion *supra* note 70.

An empirical study included the purchase of dividend-paying stocks by mutual fund managers as support for a tax clientele theory of dividends. See Dhaliwal, Erickson & Trezevant, *supra* note 47. See also discussion *supra* notes 45-46 and accompanying text (describing the tax

While mutual funds also invest on behalf of tax-deferred investors,⁷³ a significant amount of mutual fund assets are managed on behalf of taxable investors.⁷⁴ By operating as if they represent only tax-deferred investors, price-setting fund managers have skewed the market⁷⁵ in favor of tax-costly dividends.⁷⁶ This is not to suggest that the diverse tax interests of fund investors are easily reconciled by fund managers.⁷⁷ Rather, as a descriptive matter, fund managers have contributed to a market distortion by favoring the tax-deferred

clientele theory's argument that the marketplace will neutralize dividend tax costs as dividend-paying stocks gravitate toward investors who do not bear dividend tax costs). The ironic inclusion of acquisitions by mutual funds as support for the tax clientele theory was based on the assumption that mutual fund managers disregard investors' tax costs. See Dhaliwal, Erickson & Trezevant, *supra* note 47, at 182. See discussion *supra* notes 47-48 and accompanying text (explaining why the tax clientele theory inadequately explains the current dividend level).

⁷³ Tax-deferred investments such as qualified retirement accounts (for example, pensions) should be tax indifferent to the dividend/repurchase decision since neither option generates a current tax liability. No tax is due on the receipt of dividends or repurchase proceeds by the retirement account so long as the payout remains invested in the retirement account. Instead, the retirement beneficiary is taxable when funds are withdrawn from the retirement account. Furthermore, this was true even before the recent equalization of the dividend and capital gains rates since the ultimate withdrawals are taxable at ordinary rates regardless of whether the investment returns in the intervening years were ordinary income or capital gains. The combination of tax deferral and the loss of any capital gains preference establish the tax indifference. In contrast, taxable mutual fund investors can be significantly harmed by the dividend decision given the pass-through tax status of mutual funds described above. Repurchases could reduce their tax bill for the reasons discussed *supra* notes 13-18 and accompanying text.

⁷⁴ SEC Tax Disclosure, *supra* note 66, at n.16 ("[A]most 40 percent of non-money market fund assets held by individuals (\$2.1 trillion) were held in taxable accounts.").

⁷⁵ While the textual discussion focuses on the stock trading aspect, voice monitoring also might be skewed as institutional shareholders show greater uniformity on dividends (in other words, a lack of concern on dividend tax costs) than their beneficiaries. As discussed *infra* note 115, the proposed mutual fund withholding tax could improve both stock trading and voice monitoring on the dividend/repurchase decision.

⁷⁶ This is particularly problematic to the extent dividend analysis, including the tax consequences, falls outside the realm of universally informed trading, as discussed *supra* note 55. If so, institutional investors have a market pricing role above and beyond their own percentage interest. See *supra* note 55 (discussing of professionally informed and derivatively informed trading). Dividends seem likely to fall outside the realm of universally informed trading, especially since a comparison to the more tax-friendly repurchase alternative requires a sophisticated financial interpretation. See Gilson & Kraakman, *supra* note 55, at 569 (placing the analysis of technical accounting information in the professionally informed trading category). If so, the tendency of mutual fund managers to act as if they represent solely tax-deferred investors is particularly problematic since a second prominent institutional investor group—pension funds—already (correctly) act on a tax-indifferent basis. Private hedge funds might provide some counterweight, although hedge fund managers also might fail to consider fully their investors' taxes. Expected tax agency slippage might be less for hedge funds giving the greater sophistication of the typical hedge fund investor. See discussion *infra* note 81. Even if the tax consequences of dividends generated universally informed trading, there would still be a disconnect to the extent of the mutual fund's percentage interest. In addition, there could be a representative distortion on the voice influence given the special voice role of institutions described above.

⁷⁷ See discussion *infra* Section III.C (addressing the difficulty of such task in the context of the proposed withholding tax).

viewpoint to the neglect of their taxable investor clientele.⁷⁸

As a final point, the stock trading theory also helps to explain the persistence of fund manager tax neglect despite the ability of fund investors to withdraw their money from tax-inefficient fund managers.⁷⁹ As discussed above, the market typically relies on sophisticated institutional investors to drive out inefficiencies. Lacking size or sophistication, the typical mutual fund investor is not well equipped to discipline tax-inefficient fund managers.⁸⁰ Despite the presence of some mutual fund investors who overcome such obstacles, the market inefficiency remains.⁸¹

In sum, this Section linked existing literature on how (i) professional investors provide the stock trading discipline on excess-cost policies, and (ii) mutual funds present a two-tier agency problem. Interaction of the two suggests that dividend tax costs have been inadequately weighed by the marketplace. Such insufficient weighting

⁷⁸ Cf. Black, *supra* note 20, at 6 ("[I]t is hard to believe that [tax-exempt investors] have enough impact on the market to outweigh the effects of taxable individuals.").

⁷⁹ For an argument that individuals generally should have greater ease in monitoring mutual fund managers than corporate managers, see Black, *supra* note 40, at 851-52 (stating that mutual fund manager performance is easier to quantify than performance of corporate managers and individual investors have the collective ability to pull their money out of the fund). But for a discussion regarding the particular difficulties in evaluating fund managers on the more complicated after-tax basis, see discussion *infra* note 80.

⁸⁰ See discussion *supra* note 53 and accompanying text (discussing how the size and sophistication of institutional investors allows them to discipline at the underlying corporate level). Consider also the following quote from a comparable inquiry as to whether fund beneficiaries sufficiently regulate potentially wasteful research by institutional investors:

The answer lies in the questionable ability of the beneficiaries of institutional investors to monitor performance. . . . [The market discipline approach] relies on the market to police such research activity; a manager pursuing inappropriate research activity would face, in theory, a decreasing pool of assets. Such policing presumes that investors will be able both to evaluate the disclosed data and to move assets among institutional investors. These presumptions may be open to question. For example, many mutual fund investors invest through such an intermediary precisely because they lack the necessary sophistication to evaluate performance except on crudest terms and their small stake makes it irrational to develop greater sophistication.

Gordon & Kornhauser, *supra* note 38, at 805-06. In this regard, evaluating fund managers on after-tax, rather than pretax, returns goes well beyond "crude." Even assuming an investor understands the importance of focusing on after-tax, rather than pretax returns, after-tax returns vary for each investor based on, *inter alia*, their marginal federal and state tax rates and how long they expect to hold their fund shares. See *infra* notes 120-23 and accompanying text for a more detailed discussion of these complexities. Along these lines, even a savvy investor might avoid such complicated analysis on grounds of rational apathy. See also the discussion *infra* note 125 and accompanying text (explaining the perceived inability of fund investors to regulate the less complicated investment advisory fee structure); Palmiter, *supra* note 61, at 1482 (discussing how institutional investors led to liberation of closed-end funds premiums).

⁸¹ See discussion *supra* note 70 (regarding the private market for after-tax information even prior to the SEC tax disclosure rules). As evidenced by the SEC's recognition of the general tax agency slippage, however, the market discipline approach has come up short due to an insufficient number of informed investors. In this regard, sophisticated individual investors with large stakes might utilize private hedge funds, rather than public mutual funds, as their financial intermediaries.

provides a new explanation for the inexplicably high dividend level over time.⁸²

III. RESPONSE TO THE MARKET FAILURE – A MUTUAL FUND WITHHOLDING TAX

Section II provided a new explanation for the dividend puzzle: mutual fund agency costs. As discussed therein, the agency slippage on dividends is part of a broader problem: the general neglect by fund managers of investors' taxes. The current Section proposes a new mutual fund withholding tax to address the more general problem.⁸³ As discussed below, such withholding tax therefore responds to both the previously recognized short-term trading problem and any remaining slippage on corporate distribution policy.⁸⁴

This Section proceeds as follows. Section III.A briefly describes the proposal. Section III.B then analyzes the appeal of such proposal, including a comparison to the recent SEC tax disclosure rules. Section III.C addresses possible concerns under the proposal.

⁸² Mutual fund agency costs do not, of course, provide a complete explanation for high dividend levels. Other factors contribute as well. See, e.g., *supra* notes 45-46 and accompanying text (discussing the impact of tax-exempt investors). In addition, path dependency also might be a contributing factor (for example, repurchases might be hampered by the market's familiarity with dividends even as repurchases became relatively more attractive over time as markets developed and/or the relative tax advantages became more significant at particular times). Similarly, the fact that dividends predate the current popularity of mutual funds does not undercut the mutual fund agency explanation for the dividend level in recent years. As suggested in this footnote, there are a variety of contributing factors to the dividend level at any point in time (for example, the relative percentages of taxable and tax-exempt market participants, the development of an exchange market, etc.). The key point is that the dividend level would have been lower in recent years if fund managers had fully focused on investors' tax costs.

⁸³ This mutual fund withholding tax therefore differs from the current mutual fund withholding tax on foreign investors. See discussion *infra* note 104.

⁸⁴ Thus, the proposal should be implemented even after taking into account the recent tax bill which (temporarily) reduced the dividend tax rate to the capital gains rate. First, as mentioned in the accompanying text and developed later in this Section, the proposed withholding tax does not specifically target the dividend/repurchase area. Rather, it addresses more generally the mutual fund tax agency problem. Second, as discussed *supra* note 4, dividends retain excess tax costs even after such legislation. While the tax rate cut reduces the tax disadvantage of dividends, failure to adequately weigh the remaining tax differences distorts the optimal dividend level.

Note that shifting to a consumption tax might better address some, or all, of these concerns. Consideration of such major structural reform is beyond the scope of this article. For a more general analysis of the benefits of shifting to a consumption tax, see, for example, Mitchell L. Engler, *A Progressive Consumption Tax for Individuals: An Alternative Hybrid Approach*, 54 ALA. L. REV. 1205 (2003).

A. Description of the Proposal

As briefly discussed above, mutual funds are generally treated as pass-through entities for tax purposes. Mutual funds generally do not pay any tax on corporate dividends or stock gains, provided that such amounts are distributed annually to their investors.⁸⁵ Instead, investors must include such mutual fund distributions (as dividends or stock gain) on their own tax returns. Taxable investors thus pay tax on their pro rata share of a fund's corporate dividends and stock gains. In addition, taxable fund investors report gain or loss on the sale of the mutual fund investment (after taking into account income already reported under the pass-through rules described above).⁸⁶

For reasons discussed below, this Article's proposal does not alter the fundamental pass-through nature of mutual fund taxation. Rather, mutual funds would be obligated to withhold taxes from distributions of either corporate dividends or stock gains to taxable investors.⁸⁷ Thus, withholding would not be required on qualified retirement accounts, which receive tax deferral treatment.⁸⁸ The mutual fund would transfer to the government the taxes withheld from taxable accounts on behalf of the taxable investors. Despite reduced distributions from mutual funds, an investor's tax liability would not increase since a credit would be allowed on the year-end tax return for the withheld amount. This treatment corresponds to the current withholding on wages by employers.

Two additional key points should be highlighted.⁸⁹ First, the withholding obligation would apply only to taxable events occurring "inside" the mutual fund, that is, the receipt by the fund of a corporate dividend or a stock sale by the fund. The withholding obligation would not apply to any additional tax owed on a liquidating sale of the mutual fund investment by an investor.⁹⁰ The second point concerns the rate at

⁸⁵ See I.R.C. §§ 851-52 (2003). While this discussion focuses on the ownership of corporate stock by mutual funds, similar principles apply to the ownership of other investments such as debt instruments.

⁸⁶ Where the sale occurs in the middle of the year before a distribution date, the holder does not report any share of the fund's current income not yet distributed. Instead, the fundholder would report additional gain (or less loss) on the redemption of the mutual fund interest itself.

⁸⁷ The withholding would occur at the time of the mutual fund distribution.

⁸⁸ See discussion *supra* note 73.

⁸⁹ More detailed issues to consider include the following: Would state taxes be withheld in addition to federal taxes? Would withholding apply to all assets owned by the mutual fund (e.g., debt instruments)? For the reasons discussed in this article, the withholding tax appeals irrespective of the resolution of these more detailed questions (although the answer to each is probably yes).

⁹⁰ The exemption for liquidating distributions forestalls two possible objections to the withholding tax. Both relate to the fact that mutual funds currently must report to the IRS each

which taxes would be withheld by the funds. Investors would provide either (i) their prior year's marginal tax bracket each year, or (ii) their most recent marginal tax bracket at the time of the initial investment with the fund, subject to possible periodic updates.⁹¹ Absent significant complexity concerns, the more precise former alternative should be utilized.⁹²

B. *Appeal of the Mutual Fund Withholding Tax*

The appeal of the mutual fund withholding tax proposal will be evidenced in two main ways. First, Section III.B.1 highlights its kinship to prior scholarship demonstrating how a corporate-level tax addresses corporate-level agency tax problems. Then, Section III.B.2 then compares the withholding tax to the recent SEC tax disclosure rules for mutual funds.

1. Kinship to Existing Corporate Tax Literature

The mutual fund withholding tax proposal builds upon existing literature on the agency cost advantages of a corporate-level tax.⁹³ The corporate structure by itself presents an agency tax problem similar to that discussed above for mutual funds. Namely, corporate managers might make decisions with tax consequences that diverge from the after-tax interests of the corporation's shareholders.

investor's share of taxable items triggered inside the fund but not the amount of liquidating gain (although the fact that there has been a liquidation is reported). The limited withholding minimizes (i) the incremental cost of the new regime, *see* discussion *infra* note 132 and accompanying text, and (ii) concerns that investors will have a tax disincentive to use funds *see* discussion *infra* note 106 and accompanying text. In addition, the exclusion of liquidating gains is consistent with the underlying reasons for the withholding tax.

⁹¹ Periodic updating could be done either (i) at the investor's election (with reminders sent by the fund at year end) or (ii) mandatory every five years or so. Note that the original election would not limit the fund to withholding at the rate applicable at such time if the government later changes the rate structure. For example, taxes could be withheld at the current top rate from someone providing an earlier top rate. *See* the discussion *infra* note 92 as to why absolute precision is unnecessary.

⁹² Absolute precision is unnecessary because the correct tax ultimately will be reported regardless of the withheld amount. *See* discussion *infra* Section III.B.1. Furthermore, after the recent shift of the dividend tax rate (to the capital gains rate), a higher percentage of mutual fund income would be taxed at the relatively fixed capital gains rate. Even a rough approximation would significantly improve the current status, under which mutual fund managers largely ignore investors' taxes. *See* discussion *supra* notes 64-71 and accompanying text.

⁹³ The seminal article in this area is Hideki Kanda & Saul Levmore, *Taxes, Agency Costs, and the Price of Incorporation*, 77 VA. L. REV. 211 (1991). *See also* Joseph A. Snoe, *The Entity Tax and Corporate Integration: An Agency Cost Analysis and a Call for a Deferred Distributions Tax*, 48 U. MIAMI L. REV. 1 (1993).

Assume counterfactually that the corporation was treated as a pass-through entity.⁹⁴ If so, the corporation itself would not pay any tax on its profits. Instead, shareholders would pay tax on their pro rata share of corporate profits, based on their particular tax status. Prior scholarship highlights how such pass-through treatment would exacerbate agency tax problems. Placing the tax outside the corporation on each shareholder creates two possible agency cost deviations. First, stock-owning managers would have an incentive to make tax-relevant corporate decisions (such as when to sell corporate assets) based on their own particular tax circumstances rather than the shareholder group at large.⁹⁵ Second, placing the tax outside the corporation increases the likelihood that corporate managers will inadequately consider the tax consequences of their decisions.⁹⁶

Agency tax costs therefore support imposing some portion of the tax on the corporation itself.⁹⁷ Arguably, a corporate-level tax at a rate independent of particular shareholders' tax status addresses both agency cost problems. First, a uniform corporate-level tax minimizes the self-serving concern where the managers' tax rates differ from other shareholders.⁹⁸ Second, managers have a harder time ignoring a

⁹⁴ Under current law, corporations are taxed on their taxable income at the corporate level. I.R.C. § 11 (2003). Taxable shareholders then face a "second-level" tax on the receipt of dividends or the sale of stock at a profit. I.R.C. §§ 1, 61(a)(3), 61(a)(7) (2003). There is a limited exception to this "double tax" regime for Subchapter "S Corporations." See I.R.C. §§ 1361(a), 1363(a) (2003).

⁹⁵ See Kanda & Levmore, *supra* note 93.

⁹⁶ See Snoe, *supra* note 93.

⁹⁷ See, e.g., Kanda & Levmore, *supra* note 93. Moving the full tax to the corporate level is hampered by the fact that different shareholders face different tax rates. The agency cost benefits of having the tax at the entity level must be balanced against the excess tax imposed on investments by tax-exempt (or lightly taxed) investors. In this regard, see *infra* notes 101-03 and accompanying text, for a discussion of the assumed high elasticity of the decision to invest through a mutual fund).

⁹⁸ See, e.g., Kanda & Levmore, *supra* note 93. A reduced version of the problem remains to the extent some portion of the tax is imposed at the shareholder level. For instance, the current tax regime raises such concerns regarding corporate distributions to shareholders. This raises the question as to why corporate managers have not substituted repurchases to a greater extent solely out of self interest. On the one hand, corporate managers appear to have incentives to substitute repurchases if they own stock (to reduce their own taxes on corporate distributions). Incentives also appear where managers hold options since repurchases generally lead to a greater spread between the stock price and the option exercise price, and hence the option's value, in the usual situation where (i) the option exercise price is not decreased for dividends and (ii) dividends reduce the stock price relative a repurchase. See, e.g., KLEIN & COFFEE, *supra* note 36. On the other hand, managers may have insider trading concerns or face other pressures not to sell stock under the repurchase alternative. In addition, some corporate decision makers might have concerns that their sales would be treated as dividends anyway under I.R.C. § 302(b)(1). The favorable ruling that a relatively small decline in the interest of a public company shareholder qualified for stock sale treatment applied to a non-management shareholder owning only .0001118 percent of the stock. Rev. Rul. 76-385, 1976-2 C.B. 92. Resolution of this interesting question—in other words, why *corporate* managers have not substituted repurchases to a greater extent out of self interest—is beyond the focus of this Article.

corporate-level tax than a shareholder-level tax.⁹⁹

The withholding tax proposal builds upon the latter insight, making appropriate modifications. Despite the similarity of the agency tax concerns for corporations and mutual funds,¹⁰⁰ there is a material difference between the two entity forms. Corporations generally conduct real activities, whereas mutual funds serve as financial intermediaries.¹⁰¹ Accordingly, the proposal herein declines recommendation of an actual tax on mutual funds themselves, like a corporate-level tax.¹⁰² This is due, in part, to concerns that such a tax would unduly discourage use of the mutual fund intermediary.¹⁰³

Fortunately, a mere withholding apparatus has real potential to address agency tax costs in the mutual fund context. As a threshold matter, the limited withholding aspect addresses excessive tax concerns since the proposed regime would not increase the tax liability of mutual fund investors. In contrast to the corporate tax, the proposed withholding tax would merely collect taxes otherwise due and payable by fund investors.¹⁰⁴ Any acceleration in the payment date of mutual fund taxes generally should be minor.¹⁰⁵ Furthermore, the benefits of

⁹⁹ Compare Snoe, *supra* note 93, at 16 (explaining that at the corporate level, "[t]axing the [corporate] entity forces the manager to consider the tax consequences of her decisions. Satisfying a tax obligation reduces the assets at her disposal. . ."). Even a loyal, diligent manager has difficulty taking shareholder taxes into account when the shareholders have different tax circumstances. See discussion *infra* Section III.C.

¹⁰⁰ At the corporate level, corporate managers might neglect shareholder taxes. At the mutual fund level, mutual fund managers might ignore fund investors' tax consequences.

¹⁰¹ Some corporations operate as holding companies; special tax rules, however, ameliorate excess levels of tax on tiers of corporations. See, e.g., Treas. Reg. § 1.150-52 (1993) (implementing the consolidated return rules).

¹⁰² Shifting to an entity-level tax would address the current difficulties facing corporate managers in juggling the diverse tax interests of different clients. Compare the discussion at notes 98-99 and accompanying text *supra* regarding the benefits of an entity-level corporate tax. Despite such potential benefit, this Article rejects an entity-level mutual fund tax for the reasons discussed in the text. In addition, as discussed *infra* in Section III.C, the proposed withholding tax should improve upon this difficulty, which currently inheres in the joint investment vehicle.

¹⁰³ Kanda & Levmore, *supra* note 93; Palmiter, *supra* note 61, at 1448 (showing that pass-through tax treatment is needed for "financial viability [of] mutual funds as an investment instrument"). Cf. Rebecca Rudnick, *Who Should Pay the Corporate Tax in a Flat Tax World*, 39 CASE W. RES. L. REV. 965 (1988-89) (arguing that an entity level tax on liquid investments in real businesses is justified). Furthermore, limiting the proposal to a withholding tax avoids consideration of the more difficult issues that would accompany a new substantive tax on mutual funds. Compare the large body of tax scholarship critiquing the corporate-level tax. See, e.g., *Colloquium on Corporate Integration*, 47 TAX L. REV. 427 (1992).

¹⁰⁴ In contrast, the corporate tax can increase the tax burden on equity investments. This is most obvious when considering a tax-exempt or a low tax-bracket shareholder. The lack of any substantive tax increase also differentiates the proposed withholding tax from the current withholding obligation on U.S. mutual funds with foreign investors. The current withholding tax on foreign investors has been criticized since it increases the substantive tax liability (by taxing mutual fund distributions of stock gains that would be tax exempt if realized directly by the foreign investors). See, e.g., Yaron Reich, *Taxing Foreign Investors' Portfolio Investments: Developments and Discontinuities*, 79 TAX NOTES 1465, 1477-78 (1998).

¹⁰⁵ Taxpayers might pay taxes earlier under the withholding regime (at the time of the fund's

the withholding tax to fund investors should more than offset any such timing detriment to them. Fund investors should especially benefit from the expected increased focus on investors' taxes by fund managers, as described more fully below.¹⁰⁶

The withholding regime appeals as a way to improve mutual fund managers' attention to their investors' taxes, despite the lack of any increased tax liability. In favorable contrast to the current status, higher investor taxes on a mutual fund's investments would directly reduce assets invested in the fund. Consider the current lack of any such impact regarding the overwhelming majority of investors who choose automatic reinvestment of fund distributions in lieu of cash payments.¹⁰⁷ Although investors owe tax on the reinvested distributions, the full pretax amount is automatically reinvested in the fund. Thus, a particular mutual fund's assets are not directly reduced by its investors' taxes.¹⁰⁸ This failure is unfortunate given the recognized incentive of fund managers to maximize assets under management, which increase the management fee.¹⁰⁹ Even if a tax-sensitive strategy by a particular fund manager increased overall private investment funds,¹¹⁰ such

distribution rather than possibly as late as April 15th of the following year). Any such time value of money detriment should be slight, however, especially since large distributions from equity funds tend to occur at year-end and taxpayers who delay significant tax payments beyond the tax year can face estimated tax penalties (even if payment is made by the following April 15th).

¹⁰⁶ In addition, the withholding tax could help fund investors avoid potential estimated tax complexities and penalties upon the receipt of significant mutual fund distributions.

Some fund investors nonetheless might oppose the withholding tax on grounds that it would increase their substantive tax liability. Such objections would either (i) be based on a mistaken understanding of the withholding tax, or (ii) highlight undesirable gaps in current tax collections. In any event, the withholding tax is not a dramatic change since mutual funds already report each investor's share of dividends and inside capital gains to the IRS. See Michael J. Graetz, *Implementing a Progressive Consumption Tax*, 92 HARV. L. REV. 1575 (1979) (explaining that information reporting, rather than withholding, is the primary defense against tax avoidance/evasion). Mutual funds, rather than the investors, would have legitimate reasons for objecting due to the increased accountability. For a recent change that overcame objections from the mutual fund industry, see the new disclosure rules for proxy voting. E.g., Jonathon D. Glater, *S.E.C. Adopts New Rules for Lawyers and Funds*, N.Y. TIMES, Jan. 24, 2003, at C1 ("[M]utual fund industry executives were critical of the S.E.C.'s move to require disclosure of proxy votes.").

¹⁰⁷ Over 90 percent of mutual fund investors choose the dividend reinvestment option. See Robert Hershey, *Your Taxes; For Careful Investors, Some Breaks on Capital Gains*, N.Y. TIMES, Feb. 17, 2002 § 3, at 20.

¹⁰⁸ Such assets would be reduced only if the investor later liquidates a portion of his investment in the fund to pay the corresponding taxes. Compare the discussion below of the withholding tax, which would make this happen automatically. Mutual funds currently have some incentive to avoid taxable transactions since (i) a taxable transaction forces a distribution and (ii) not all investors currently reinvest. The current pressure is very slight, however. As discussed above, the overwhelming majority of investors automatically reinvest.

¹⁰⁹ Black, *supra* note 40, at 877 (stating that money managers have incentives to improve portfolio performance to increase asset-based management fees); Palmiter, *supra* note 61, at 1478 (explaining that increasing fund assets is the primary incentive of fund managers, since fees are based on assets under management).

¹¹⁰ Reducing investors' taxes might not increase aggregate private investment, for example,

strategy would not necessarily increase assets invested in such manager's fund.¹¹¹ In fact, the strategy could potentially backfire given the flawed tendency of typical fund investors to focus on pre-tax, rather than after-tax, returns.¹¹² Increasing after-tax returns at the expense of pretax returns could cause a fund to experience a decline in assets under management.¹¹³

In favorable contrast, the proposed withholding tax would automatically correlate a fund manager's tax-saving behavior and the fund's assets. A fund would have to withhold the appropriate tax percentage from the distribution of either corporate dividends or stock gains. Automatic reinvestment by a taxable investor therefore would occur at the lower after-tax amount rather than the full pretax amount. Thus, a fund that receives either corporate dividends or taxable stock gains would automatically experience an asset decline on taxable accounts which reinvest. The proposal therefore draws upon the noted incentive for fund managers to maximize assets under management.¹¹⁴ For instance, fund managers would have an increased incentive to hold stocks which distribute through repurchases rather than dividends. By lowering the required withholding, repurchases would directly increase assets under management.¹¹⁵

investors might consume the savings.

¹¹¹ Compare Rock, *supra* note 61, at 473-75 (showing that peer rankings provide managers with incentives to take only those actions that further their competitive standing).

¹¹² Thus, typical statements regarding the manager incentive to improve performance can be understood as generally referencing pretax, rather than after-tax, performance.

¹¹³ Assume X stock has a lower expected pretax return than Y stock but a higher expected after-tax return for taxable investors (for example, it has a more tax-efficient distribution policy). Purchasing disproportionately more X stock than peer managers would generate a lower (expected) pretax return despite the higher (expected) after-tax return for taxable investors. This would be a losing strategy for the fund manager to the extent taxable investors (incorrectly) choose funds based on pretax returns. (Under perfect conditions, the increased attractiveness to taxable investors would be appropriately balanced against the decreased attractiveness to tax-deferred investors.) In sum, the tendency of even taxable investors to analyze on a pretax basis undercuts one source of potential discipline by mutual funds: market trades away from corporations with inefficient tax policies. The lack of direct connection between investors' taxes and fund assets also undercuts voice monitoring, discussed *supra* notes 61-63. In the absence of agency costs, fund managers would have an incentive to lobby corporate management for more tax-efficient distribution policies. Such voice monitoring on tax costs faces a problem similar to the trading discipline, however. Definite lobbying costs would have to be incurred in hopes that increased cash in investors' hands ultimately would be reinvested in the fund.

¹¹⁴ See discussion *supra* note 109 and accompanying text.

¹¹⁵ In addition to this stock trading discipline, fund managers would have an increased incentive to lobby management to substitute repurchases for dividends (voice discipline). For instance, successful lobbying efforts on share repurchases would generate a direct increase in assets under management, rather than the more speculative indirect possibility under the current structure. See discussion *supra* note 113. Note, however, that voice monitoring might be more difficult for shareholder tax issues than for more typical governance issues. Collective action by institutions underlies the possibility of institutional voice. In contrast to typical governance issues, the interests of institutional investors should diverge on shareholder taxes, based on their investors' profiles (assuming away the tax agency problems described above). Despite such

Importantly, as noted above, the proposal's impact extends beyond the dividend issue. Fund managers also would have an incentive to avoid the previously recognized tax slippage: frequent portfolio turnover without regard to tax consequences.¹¹⁶ This incentive would result from the withholding tax's targeting of the general tax neglect by fund managers, without a specific focus on the dividend/repurchase issue.¹¹⁷

2. Comparison to SEC Disclosure Rules

A comparison to the recent SEC tax disclosure rules furthers the appeal of the proposed withholding tax. The SEC recently promulgated rules requiring additional disclosure of mutual funds' after-tax returns in the hopes of correcting fund managers' tax neglect.¹¹⁸ This disclosure

divergent interests, voice monitoring remains relevant in the tax area as well. First, to the extent the agency disconnect arises, institutional investors might falsely present a unified front on dividend tax costs (in other words, indifference to tax costs). Thus, at a minimum, correcting the agency disconnect could avoid a flawed collective message. In addition, there is the possibility that once mutual funds have management's ear, they can communicate their particular views, even where such views are not uniformly held by all institutional investors. Views contrast on whether institutional investors, especially those utilizing an indexed strategy, would undertake monitoring costs to increase (pretax) returns. Compare Rock, *supra* note 61, at 473-75 (sharing a pessimistic view on institutional shareholder monitoring), with Black, *supra* note 40, at 818 (explaining that diversified institutional investors still have incentive to focus on general process and structure issues, rather than company-specific concerns), 876 (showing that voice monitoring can be effective as long as some institutions become active and others vote carefully when called upon), 879-80 (stating that even index managers have incentives to improve performance—in other words, higher performance within an indexed category draws more overall funds to such category and/or some “index” managers achieve a high enough index correlation without holding all the stocks in the index). The tax problem analyzed in this Article is beyond such potential disconnect on pretax performance; in other words, an additional hurdle arises with regard to the more relevant after-tax return.

¹¹⁶ As discussed *supra* note 65 and accompanying text, this accelerates taxable stock gains and possibly negates the favorable long-term capital gains rate. Mutual fund investors qualify for the capital gains rate only for investments held by the fund for more than one year (even if the investor has held his mutual fund interest beyond one year). In a certain sense, the neglect on dividends connects to the short-term trading problem. Short-term trading largely eliminates the tax advantages of repurchases, for example, any timing benefits on basis recovery are very short lived. The dividend neglect is a broader problem, however, since it can arise even where fund managers hold investments beyond one year.

¹¹⁷ The proposal's impact on all fund investor taxes therefore distinguishes it from the recent legislative decision to tax dividends at the capital gains rate for the years 2003-07. See discussion *supra* note 4. The extended reach of this Article's proposal similarly distinguishes it from another way to address the market failure on dividend tax costs: imposition of a dividend withholding tax obligation at the corporate level, in other words, the initial payor of the dividend. A corporate dividend withholding tax also would address the mutual fund slippage on dividend tax costs. Unlike the proposed mutual fund withholding tax, however, the corporate dividend withholding tax would fail to address mutual fund tax agency costs more generally, for example, short-term trading by fund managers. There are, of course, other differences between this Article's proposal and the two alternatives discussed in this footnote.

¹¹⁸ See SEC Tax Disclosure, *supra* note 66 (explaining that tax disclosure “could . . . caus[e] existing funds to alter their investment strategies to invest in a more tax-efficient manner.”).

approach, however, still relies on individual fund investors to eliminate inefficient fund behavior. While appropriate disclosure might impose some additional discipline,¹¹⁹ it is questionable whether enough mutual fund investors will act on the new information so as to correct the current market failure. Complexities surrounding the after-tax return calculation significantly hamper the disclosure approach. The after-tax return for each fund investor varies based on, *inter alia*, such individual's (i) combined tax rate (federal, state, and local), and (ii) eventual sale date for the investment in the mutual fund (due to the liquidation tax described above).¹²⁰ These individualized variants present a significant impediment to simple and meaningful disclosure of after-tax returns.

The SEC rules deal with the tax rate issue by requiring calculations based on the highest federal rate.¹²¹ The SEC rules deal with the liquidation tax by requiring two separate after-tax disclosures: one which ignores the liquidation tax and a second which applies the liquidation tax at the end of each disclosed investment period (in other words, one-, five- and ten-year investment periods). Despite sacrificing significant precision to reduce complexity,¹²² the disclosure nonetheless still requires some sophistication in application.¹²³ In this regard, recall (i) the market's reliance on informed professional investors as to sophisticated corporate policies and (ii) the typical fund investor's lack of sophistication or size.¹²⁴ Consider also the recognized failure of fund investors to discipline excess advisory fees.¹²⁵

¹¹⁹ Disclosure might appear to lack any downside since increased awareness by investors of the tax consequences should not make funds less tax-conscious. The costs of additional disclosure, however, might outweigh the benefits, if any. See Michael Jensen & William Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 395 (1976) (stating that agency responses are justified only if savings exceed costs). See also SEC Tax Disclosure, *supra* note 66 (analyzing the costs of disclosure rules).

¹²⁰ As discussed *supra* note 86 and accompanying text, a partial or complete liquidation of the investment in the fund is a taxable event for fund investors. Investors report gain equal to the excess of (i) the liquidation proceeds over (ii) their "basis" in the liquidated shares (in other words, purchase price).

¹²¹ No additional adjustment is made for state and local taxes. SEC Tax Disclosure, *supra* note 66.

¹²² For example, the SEC declined to provide a range of after-tax returns based on different tax rates. *Id.*

¹²³ Consider, for example, the provision of dueling after-tax calculations, one of which completely ignores the liquidation tax.

¹²⁴ As discussed *supra* note 80 and accompanying text, even savvy investors with relatively little at stake might neglect to undertake the time-consuming sophisticated tax analysis out of rational apathy.

¹²⁵ See Palmiter, *supra* note 61, at 1463, 1471-72, 1490-91 (explaining that judicial review of advisory fees "is meant as an antidote to . . . market failure . . . of widespread investor insensitivity to the level and nature of advisory fees."). The "imagined story of market responsiveness, though attractive, suffers at a number of levels. Recent studies and investor behavior suggests that fund investors' sensitivity to fund performance is . . . shallow. . . . Studies continue to confirm that mutual fund investors systematically fail to discipline underperforming

Separately, even if fund investors would eliminate the tax inefficiency with more knowledge, it is unclear whether the SEC rules will effectively deliver such information. In addition to the difficulties discussed above, the SEC rules generally require disclosure of after-tax returns in the mutual fund prospectus. The rules have been critiqued on grounds that investors do not read prospectuses even at original investment.¹²⁶ Investors are even more unlikely to read a prospectus subsequent to the initial investment. In particular, consider the significant amounts already invested with mutual fund companies. The withholding tax therefore might further the tax disclosure goal even though disclosure is not its primary objective. Each distribution statement would show the pretax distribution less the actual taxes withheld.¹²⁷

Finally, even if the new disclosure rules prompt investors to shun tax-insensitive funds, an additional obstacle arises for certain existing fund accounts: the tax "lock-in" effect. As noted above, fund investors must pay a liquidation tax when they sell fund shares for more than their purchase price. Thus, the potential new tax-savvy investor could face a difficult decision whether to sell an existing tax-insensitive account.¹²⁸ The suggested withholding tax addresses this concern since, again, it places only secondary reliance on disclosure.¹²⁹

funds or monitor excessive advisory fees." *Id.*

¹²⁶ *Mutual Fund Regulation in the Next Millennium Symposium*, 44 N.Y.L. SCH. L. REV. 463, 480 (2001) (concluding that investors do not read prospectuses, they read ads).

¹²⁷ One advantage over the SEC tax disclosure rules is that the withheld tax amount would be based on the taxpayer's particular tax rate rather than the one rate assumed for all. *See* discussion *supra* notes 121-22 and accompanying text. In addition, taxpayers currently receive year-end statements of their taxable income from the fund, but not the actual tax liability (in other words, taxable income times applicable tax rate). The proposed withholding regime, on a regular basis, would pull together in one document their pretax returns and their estimated tax liability from the fund. On the other hand, the SEC disclosure approach provides an after-tax comparison between funds before the time of original investment. Note that the withholding tax should provide a stronger overall response than the SEC rules even if its disclosure component is weaker (in other words, unlike the disclosure approach, the withholding tax better aligns the fund manager and investor interests, as discussed *supra* notes 104-17 and accompanying text). Furthermore, especially since the SEC rules are already in effect, the withholding tax could be adopted in addition to the disclosure rules.

¹²⁸ That is, selling for reinvestment in a more tax-sensitive account could increase the current year's tax bill. This would not be a problem to the extent the tax-inefficient fund manager had already triggered the tax bill on all of the fund's gains.

¹²⁹ In addition, the withholding tax would avoid the occasional surprise of a significant tax payment owed at year end due to taxable income from certain funds. *See* SEC Tax Disclosure, *supra* note 66 ("tax consequences of distributions are a particular source of surprise to many investors when they discover that they can owe substantial taxes . . . unrelated to the performance of the fund. Even if the value of a fund has declined during the year, a shareholder can owe taxes on capital gains distributions if the portfolio manager sold some of the fund's underlying portfolio securities at a gain."). As discussed *supra* notes 105-06 and accompanying text, this needs to be balanced against a possible time value of money detriment to the investor. As discussed therein, however, the withholding on mutual fund distributions could help deal with estimated tax complexities and penalties as well.

In sum, the proposed withholding tax appeals since it uniquely addresses the tax agency problem from both the agent and principal sides. First, the agents would have a greater incentive to pursue the after-tax interests of their principals. Second, the principals would have more information regarding the performance of their agents.

C. Possible Concerns Under the Withholding Tax

This Section addresses three possible concerns raised by the proposed withholding tax.¹³⁰ First, agency responses should be implemented only if the benefits outweigh the costs.¹³¹ The administrative costs of the new withholding regime appear reasonable in light of the benefits described above. In particular, mutual funds already must report to the government each fund investor's allocable share of corporate dividends and capital gains.¹³²

Second, concern might arise that funds would limit sales of appreciated assets to avoid the decline in assets under management. Notwithstanding legitimate objections to such tax distortion generally,¹³³ this is the tax regime which applies to investors. Thus, this possible concern further supports the withholding tax by demonstrating the better alignment of the interests of mutual fund managers and their investors. Similar to a direct investment by an individual taxpayer, funds would have an incentive to balance the pretax merits of a continued investment against the tax cost of the sale.¹³⁴ Managers would not have an incentive to retain appreciated stock regardless of its pretax merits. A subsequent decline in value would directly reduce assets under management, with possible additional indirect reductions due to a poor pretax investment record.

Finally, concern might arise that mutual fund managers would

¹³⁰ See discussion *supra* notes 104-06 and accompanying text (responding to the additional concern that the withholding tax might unduly discourage use of the mutual fund).

¹³¹ Jensen & Meckling, *supra* note 119.

¹³² See discussion *supra* note 90.

¹³³ See, e.g., Noël B. Cunningham & Deborah H. Schenk, *The Case for a Capital Gains Preference*, 48 TAX L. REV. 319 (1993) (discussing the tax-induced "lock-in" problem).

¹³⁴ Some imperfections remain under the suggested withholding tax; for example, fund managers would not be able to determine the exact deferral value for each investor. As discussed *supra* note 86 and accompanying text, any deferred taxes are triggered when the investor liquidates the fund investment. Thus the value of deferral depends, in part, on each investor's expected holding period in the fund. Despite lacking complete precision, the suggested approach nonetheless would be a meaningful improvement over the current general tax neglect by fund managers. For instance, fund managers could assume a holding period for investors based on prior experience. Also, uncertainty as to the timing of the liquidation tax should be more problematic under the SEC disclosure approach given the lack of sophistication and/or size of the typical fund investor. See also discussion *infra* note 139 (regarding investors in different tax brackets).

have difficulty in reconciling the different tax needs of their investors. As discussed above, a good percentage of assets under mutual fund management are made through tax-deferred retirement plans.¹³⁵ The manager of a mutual fund with taxable and tax-deferred investors would face a conflict to the extent the preferred strategy varied with tax status. The proposed withholding tax, however, is not responsible for such conflict, as it currently exists. Difficulties in balancing the interests of different principals currently inhere in the joint investment vehicle. Encouraging mutual fund managers to juggle investors' varying tax interests is preferable to the current favoring of the tax-deferred group.¹³⁶ The significance of the potential tax savings for the taxable group reinforces the unsatisfactory nature of the current state.¹³⁷

Furthermore, the proposal might accelerate the separation of taxable and tax-deferred investors, assuming the efficiency of such separation.¹³⁸ One potential result of the new tax incentives is that some funds may subdivide into one fund for taxable investors and a second for tax-deferred investors.¹³⁹ Such separation would decrease the managerial burden in reconciling investors' disparate tax profiles.¹⁴⁰

¹³⁵ See discussion *supra* note 73 (discussing how qualified retirement funds are tax indifferent for purposes of this analysis). See discussion *supra* note 74 (providing the breakdown between tax-deferred and taxable accounts).

¹³⁶ See discussion *supra* note 76 (discussing how taxable investors are under-represented while pension funds represent tax-deferred shareholders).

Difficulties in juggling interests occur at the corporate level, as well. See Edward S. Adams & John H. Matheson, *A Statutory Model for Corporate Constituency Concerns*, 49 EMORY L.J. 1085 (2000) (analyzing and advocating consideration of non-shareholder constituency groups); Steven M.H. Wallman, *The Proper Interpretation of Corporate Constituency Statutes and Formulation of Director Duties*, 21 STETSON L. REV. 163, 175 (explaining that a juggling issue arises even if corporate managers take into account only shareholders since shareholder interests can diverge).

¹³⁷ Again, the potential tax savings include the previously-recognized short-term trading problem.

¹³⁸ Some funds currently market themselves to taxable investors. Nonetheless, many taxable investors continue to hold shares in funds which insufficiently weigh the taxes of their taxable investors. See discussion *supra* notes 79-81 and accompanying text. See also *infra* note 141 (discussing the desirability of separate funds for taxable and tax-deferred investors).

¹³⁹ For instance, a separation into taxable and tax-deferred funds might benefit mutual fund companies since, for example, only the tax-deferred fund would acquire investments with expected favorable pretax returns but unfavorable after-tax returns (and vice versa). In making the decision whether to separate, the mutual fund company would balance any offsetting costs etc. from such separation. Such private cost/benefit analysis might be one reason to favor the suggested withholding tax over a government-mandated separation of funds into taxable and tax-deferred groups. The government-mandated separation approach also raises other concerns. For instance, absent an increased incentive to heed investors' taxes, managers of taxable funds still might inadequately weigh investors' taxes. Also, a separation into taxable and tax-deferred groups arguably oversimplifies the issue. In particular, the tax cost to a particular investors varies even within the taxable group. At the extreme, the tax desires of a low-bracket taxable investor could be closer to a tax-deferred investor than a high-bracket investor. In favorable contrast, the proposed withholding tax addresses the noted market failure—mutual fund agency tax costs—and then allows the efficient outcome to develop in the marketplace.

¹⁴⁰ Even a separation into taxable and tax-deferred funds would not eliminate potential tax

Even in the absence of such separation, the proposed withholding tax would improve the status quo on this issue for the reasons discussed above.¹⁴¹

CONCLUSION

The marketplace generally will not eliminate inefficient policies neglected by key institutional players. This Article describes one such market failure that explains, in part, the dividend puzzle. This market failure results from the general disregard by mutual fund managers of their investors' taxes. The recommended new withholding tax on mutual funds targets this agency problem. This Article's proposed remedy implicitly realigns the tax interests of mutual fund managers and their investors. *Ceteris paribus*, lower taxes would increase both the fund manager's fee and investors' after-tax returns. Accordingly, the proposal favorably extends beyond dividend taxes to address other fund investor taxes as well, such as the previously-recognized problem of short-term trading by fund managers.

The proposed withholding tax also provides a stronger response to the mutual fund tax agency problem than the recent SEC tax disclosure rules. The SEC rules rely solely on the questionable ability of fund investors to fully discipline tax-inefficient fund managers. In favorable contrast, the proposed withholding tax attacks the agency problem from the perspective of the fund manager "agents" as well.¹⁴² As described above, the withholding tax would provide such agents with a significant new incentive to follow their principals' interests.

conflicts between different investors. The taxable investor group is heterogeneous: The best after-tax investment decision could vary for different taxable investors, based on marginal tax rates and/or the liquidation date of the fund investment. See discussion *supra* notes 134 and 139.

¹⁴¹ Imposing a single entity-level tax on mutual funds themselves (and eliminating the tax on investors) would remove the tax balancing issue. As discussed *supra* note 102 and accompanying text however, such entity-level tax is unacceptable for other reasons.

¹⁴² Like the SEC approach, the proposed withholding tax also would provide more tax-related information to the investor. Accordingly, the withholding tax also approaches the problem from the principal perspective; in other words, such information might encourage more investor/principals to discipline tax-inefficient manager/agents. As discussed above, however, there are serious impediments to successful monitoring of agents by principals in the mutual fund context.