THE LIMITED LIABILITY COMPANY AND THE SEARCH FOR A BRIGHT LINE BETWEEN CORPORATIONS AND PARTNERSHIPS

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Despite the potential loss in tax revenue, the Internal Revenue Service (IRS) is making it easier and easier to avoid corporate taxes. Witness the advent of limited liability companies and the proposed "check-the-box" regulations. This article takes a look at the real distinctions between—and policy supporting—pass-through and entity level taxation and draws the conclusion that entity level taxation will probably become limited to publicly traded entities only.

INTRODUCTION

Since 1988, when the Treasury Department issued the landmark ruling allowing for a Wyoming limited liability company (LLC) to be taxed under the partnership model,[1] the LLC has become the form of choice for closely held businesses in the United States. Indeed, by mid-1996 every state had enacted a statute allowing for the formation of LLCs.[2] There is not much doubt about why LLCs have become so popular. They allow a business to obtain the benefits of partnership status for tax purposes while retaining the benefits of limited liability for investors—benefits that traditionally have gone with the corporate form.

The Treasury Department has gone so far as to adopt regulations that allow LLCs simply to elect the tax status they desire.[3] These so-called "check-the-box" regulations[4] do away with the old resemblance

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1. Rev. Rul. 88-76, 1988-2 C.B. 360, 360-61; *see also* Rev. Proc. 95-10, 1995-1 I.R.B. 501, 501-05 (establishing regulations for determining the status of unincorporated entities).

2. [A]ll jurisdictions except Hawaii and Vermont ha[ve] passed LLC statutes. There are Uniform and Prototype LLC laws, a comprehensive Internal Revenue Service (IRS) Revenue Procedure dealing with LLCs, and explicit statutory recognition of foreign LLCs in forty-eight states. Thousands of LLCs have been formed across the country, often at a greater rate than limited partnerships. The LLC has emerged.

Larry E. Ribstein, *The Emergence of the Limited Liability Company*, 51 BUS. LAW. 1, 1 (1995) (footnotes omitted). Hawaii has since adopted a limited liability act, HAW. REV. STAT. § 429-902 (1996), as has Vermont, VT. STAT. ANN. tit. 11, §§ 3001-3154 (Supp. 1996).

3. Treas. Reg. §§ 301.7701-1 to -3 (1996).

4. For a general discussion of the check-the-box regulations, see Victor E. Fleischer,

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test under the "*Kintner* regulations"[5]—which led to much wasteful litigation[6]—and suggest that the corporate income tax has been made virtually voluntary. But not quite. An entity that is in fact incorporated cannot check the box—though rumor has it that the idea that any entity should have the option has been discussed quite seriously at Treasury.

Why did Treasury agree, in effect, to forgo the revenue that goes with the double taxation of income of corporations? The easy answer is that little revenue was lost. Few closely held corporations need to pay corporate income tax. The Internal Revenue Code has long provided for the election of S Corporation status, although such an election carries with it significant restrictions.[7] Even in the absence of such an election, however, it is quite easy for a closely held corporation to zero out its income by manipulating corporate level expenses within broad legal bounds.[8] For example, a corporation may pay generous salaries to its shareholder employees, perhaps partly in the form of bonuses determined shortly before the close of the tax year when it is fairly clear how much is necessary to deplete corporate income.[9]

To be sure, there comes a point at which the closely held corporation has grown to such a size that it becomes difficult to continue with such tactics. At that point, however, the corporation may also be large enough to offer its shares to the public. Offering shares to the public will allow shareholders in the formerly close corporation to sell shares that may be enhanced in value by retained earnings at capital gains rates, and, most important, at a time that is convenient tax-wise for the shareholder.[10]

"If It Looks Like a Duck": Corporate Resemblance and Check-the-Box Elective Tax Classification, 96 COLUM. L. REV. 518 (1996). For a general discussion of how check-the-box regulations will affect LLCs, see William E. Sider, *Check-the-Box Proposed Regulations Make LLCs Even More Appealing*, 3 J. LIMITED LIABILITY COMPANIES 51 (1996).

5. Treas. Reg. § 301.7701-2 (as amended in 1993) (replaced 1996).

6. *See* Daniel S. Goldberg, *The Tax Treatment of Limited Liability Companies: Law in Search of Policy*, 50 BUS. LAW. 995, 1000-02 (1995) (discussing litigation over the resemblance test).

7. I.R.C. §§ 1366-1399 (1994).

8. *See generally* RICHARD L. DOERNBERG ET AL., FEDERAL INCOME TAXATION OF CORPORATIONS AND PARTNERSHIPS 149-209 (1987) (discussing distributions of cash and property from corporations to shareholders and several methods that corporations and their shareholders use to avoid paying taxes).

9. *But see, e.g.*, Hatt v. Commissioner, 28 T.C.M. (CCH) 1194 (1969) (holding that salary paid to an employee was not deductible), *aff'd*, 457 F.2d 499 (7th Cir. 1972).

10. The rule of thumb seems to be that a market cannot be made with less than about $500,000 worth of shares outstanding. If we assume that the shares trade at $20—which is the low end of the traditional target range—and that each shareholder holds one round lot—which may be somewhat unrealistic but which would likely be the case if all investors were rational about diversifying—then a company with $500,000 in stock outstanding would have 250 public shareholders. The NASDAQ SmallCap Market requires only 100,000 public shares with a total value of $1 million and 300 shareholders in order to list a stock for trading. *See* THE NASDAQ STOCK MARKET, 1996 FACT BOOK 204 (1996) (providing requirements for trading on NASDAQ and data on the per-

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Although there is undoubtedly some truth in this explanation for why Treasury threw in the towel, it is not the whole truth. Indeed there is a much subtler and potentially more significant explanation. Simply stated, the explanation is that, since the late 1960s, a much more reliable distinction between corporations and other forms of businesses has evolved than the old resemblance test with its tendency to focus on limited liability. The distinction is between firms that are publicly traded and firms that are not. The public versus private distinction for taxation purposes is a more satisfying explanation that captures the functional distinction between the two and is—to a large extent—self-executing.

I. THE IMPORTANCE OF BEING PUBLICLY TRADED

Despite the check-the-box rules, there remains a serious limitation on the ability of the largest business entities to obtain flow-through taxation. Under § 7704 of the Internal Revenue Code, a company whose ownership interests are publicly traded will be taxed as a corporation.[11] Thus a publicly traded partnership will be treated as a corporation for tax purposes irrespective of whether it has checked the box. Nevertheless, given that § 7704 is not triggered if a company has only publicly traded debt, it would appear that a partnership could issue bonds or even junk bonds and still be treated as a partnership for tax purposes.

The story of § 7704, which was enacted in 1988, is itself an interesting one. Prior to the 1986 tax act, the *Kintner* regulations, which had been devised primarily to discourage the use of professional corporations to obtain retirement benefits, had allowed for the growth of tax shelters by making it relatively easy for a limited partnership to assure itself of partnership status and thus flow-through taxation.[12] Tax shelters were eviscerated, however, by the 1986 tax act which required the matching of income and losses by individuals according to source.[13] Thus, losses from a real estate limited partnership could not be used to offset ordinary income from one's day job.

Somewhat surprisingly, a new use of limited partnerships had grown up in the shadows of tax shelters. Several large publicly traded companies had set up limited partnerships to hold new businesses and had sold interests in public offerings. The idea was that income from such ventures would be taxed only once at the individual level.[14] By

formance of NASDAQ securities).

11. I.R.C. § 7704 (1994). *See generally* William P. Streng, CHOICE OF ENTITY A-38 (BNA Tax Management Portfolio No. 700, 1996) (discussing publicly traded partnerships).

12. *See* Richard A. Booth, *Profit-Seeking, Individual Liability, and the Idea of the Firm*, 73 WASH. U. L.Q. 539, 543-48 (1995).

13. *See* I.R.C. § 469 (1994).

14. *See* Donna D. Adler, *Master Limited Partnerships*, 40 U. FLA. L. REV. 755, 784 (1988) (explaining how a limited partnership that is publicly traded no longer retains

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managing to flunk two of the four *Kintner* tests[15]—usually limited liability and unlimited life—such publicly traded partnerships would in fact be taxed as partnerships.[16] It is fairly clear why a business would choose such a form. It eliminates the corporate level tax altogether and gives the business a distinct edge over competitors who continue to pay the corporate tax.[17]

What is striking about the publicly traded partnership, however, is that investors would buy such securities. After all, if the company declined to distribute dividends, there would be no cash with which to pay the tax. It is unlikely, however, that this scenario would occur; presumably only a business that could more or less assure the payment of regular dividends could sell such securities. Thus, in a very real sense, interests in publicly traded partnerships were very close substitutes for junk bonds, which paid stock-like returns in pre-tax dollars.[18] It is not clear, however, that assurance of distributions is absolutely necessary. If an investor is well diversified, presumably there will be other companies in the investor's portfolio that do pay dividends with which taxes may be paid. Thus, as long as the issuer of publicly traded partnership interests puts the retained funds to good use, most rational investors probably will care little about the taxes attributable to dividends. Indeed, for those who invest through mutual funds, the non-cash income from such partnerships will be no different from dividends reinvested at the fund level, a perfectly common phenomenon in many funds. The phenomenon of publicly traded partnerships strongly suggests that diversified investors would not even object to unlimited liability for corporations.[19]

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the advantage of being taxed only on an individual level since passage of the Revenue Act of 1987).

15. The *Kintner* regulations, based substantially on *United States v. Kintner*, 216 F.2d 418 (9th Cir. 1954), were adopted in 1960 in an attempt to standardize the tax treatment of noncorporate entities. Larson v. Commissioner, 66 T.C. 159, 186 (1976) (Dawson, C.J., concurring). For a general discussion of the development of the *Kintner* regulations and how the four key tests establish whether an entity is to be taxed as a corporation, see *id.* at 171-213.

16. *See* I.R.C. § 7704 (1994) (stating exceptions to general rules concerning when a partnership is treated as a corporation); Adler, *supra* note 14, at 787 (discussing the merits of treating large, publicly traded partnerships as corporations for tax purposes and explaining that the Revenue Act of 1987 still allows "favorable tax treatment to some publicly traded partnerships that are strikingly similar to other publicly traded partnerships and to corporations" because of its reliance on public trading as the key element in classifying partnerships).

17. *See* Adler, *supra* note 14, at 784 (discussing the competitive advantages of a partnership being taxed at only one level).

18. Junk bonds are unsecured high-yield debt instruments. For a general discussion of junk bonds, see Richard A. Booth, *Junk Bonds, the Relevance of Dividends and the Limits of Managerial Discretion*, 1987 COLUM. BUS. L. REV. 553. The use of junk bonds has been severely restricted by the Internal Revenue Code which makes interest non-deductible to the extent it is attributable to unsecured debt issued to finance an acquisition. I.R.C. § 279.

19. *See generally* Richard A. Booth, *Limited Liability and the Efficient Allocation of*

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II. Public Trading in Other Contexts

There are numerous indications that public trading is in fact the most important line of demarcation between partnerships and corporations for tax purposes.[20]

A. S Corporations and Exempt Offerings

The restrictions under which corporations may elect to become S corporations are themselves telling. Until 1996, a corporation with thirty-five or fewer shareholders—none of whom are aliens or non-natural persons—which has no stock outstanding other than voting common stock, may qualify for S corporation status.[21] The thirty-five shareholder limit (which was recently raised to seventy-five) may have been an attempt to determine roughly the line between private and public corporations. Coincidentally, the same number is often used for federal securities law purposes to determine whether an offering is public.[22] Moreover, the preferred stock limitation and limitations on voting rights appear to be designed to exclude sophisticated financial planning—planning that may have been thought to be the exclusive province of the public corporation. On the other hand, it might be possible for public corporations—through the use of such securities—to make significant use of the S corporation election, although the latest revisions allow for S corporations to have subsidiaries that are publicly traded.[23] While the new rules apparently do not allow for publicly traded companies to have S corporation subsidiaries, it has always been possible for S corporations to issue non-convertible debt securities to the public which may, in theory, be traded quite freely.[24]

Although the S corporation rules may be revised further, S corporation status remains—and is likely to remain—rather different from partnership status. For example, in an S corporation, individual recognition of losses is limited to the individual's basis in his or her stock, while in a partnership, all losses pass through regardless of one's investment.[25] The difference can be significant if, as is common in closely held corporations, a shareholder chooses to lend some portion of his or her investment to the corporation.[26] In addition, and probably more

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Resources, 89 Nw. U. L. Rev. 140 (1994) (discussing the economic justifications and benefits of limited liability).

20. *See* Adler, *supra* note 14, at 783-86 (explaining how public trading has been the key element in qualifying partnerships as corporations).

21. I.R.C. §§ 1361-1396.

22. *See* 17 C.F.R. § 230.505(b)(2)(ii) (1996) (setting a limitation on the number of purchasers as a condition for exemption for limited offers and sales of security).

23. *See* Jasper L. Cummings, Jr. & Samuel P. Starr, *The Impact of the New S Corporation Revisions*, 85 J. Tax'n 197, 197 (1996) (discussing the importance of selected S corporation revisions).

24. *See generally id.*

25. *See* Doernberg et al., *supra* note 8, at 263-65.

26. *See* William J. Rands, *The Closely Held Corporation: Its Capital Structure and*

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important, with an S corporation, the corporation must still pay tax on any sale of its assets, whereas in a partnership, the firm may sell its assets or otherwise reorganize without any danger of triggering a firm level tax.[27]

B. Close Corporation Law

As a matter of corporation law, the lack of a public market is the key to close corporation status. Most close corporation statutes impose some form of share transfer restriction, usually a right of first refusal running to the corporation.[28] Undoubtedly, the reason for this is both: (1) that such restrictions are usually desirable from the shareholders' point of view; and (2) that there are dangers—to third parties—in allowing stock that typically carries a highly customized set of rights to trade too freely. As for the common law, most state courts recognize heightened fiduciary duties in the context of closely held corporations.[29] The question, therefore, is how to determine which corporations qualify. Virtually all courts have focused on the lack of a public market for shares, though some courts have also stated that shareholder expectation of participation in management and control is also a factor to be considered.[30] On reflection, shareholder participation in management is not really the key to the distinction between public and private corporations. Indeed, even in some of the cases in which the factor is mentioned, such as *Donahue v. Rodd Electrotype Co.*,[31] the complaining shareholder did not in fact have much expectation of participation in management. There can be some expectation of participation, however, among larger shareholders in publicly traded companies. After all, if a bidder did not expect to be able to name the board of directors, he or she would not likely announce a tender offer. Thus, a closely held corporation is one for which no "active trading market exists."[32] This definition seems to work quite well. There are few re-

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the Federal Tax Laws, 90 W. VA. L. REV. 1009, 1029 (1988) (stating that if interest paid on an investment in a corporation is termed a debt, the taxpayer can receive a tax-free return on capital up to that taxpayer's basis in the security).

27. *See* DOUGLAS A. KAHN & JEFFREY S. LEHMAN, CORPORATE INCOME TAXATION 122-23 (4th ed. 1994).

> [A] corporation that makes a nonliquidating distribution of appreciated property (other than its own stock or obligations) will recognize gain as if it had sold that property for its fair market value. However, if a corporation makes a nonliquidating distribution of depreciated property, the corporation is not permitted to recognize a loss.

Id. at 123.

28. *See, e.g.*, MODEL STATUTORY CLOSE CORP. SUPP. §§ 11-13 (1984), *reprinted in* 4 MODEL BUS. CORP. ACT ANN. CC-1, CC-13 to -21 (3d ed. 1985).

29. *See, e.g.*, Galler v. Galler, 203 N.E.2d 577, 584 (Ill. 1964); Donahue v. Rodd Electrotype Co., 328 N.E.2d 505, 515-16 (Mass. 1975).

30. *See Donahue*, 328 N.E.2d at 519.

31. *Id.*

32. 1 AMERICAN LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 1.06 (1994).

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ported cases in which the courts have struggled with the question whether a corporation is or is not closely held, suggesting that the distinction has been relatively easy to apply.[33] The question remains, however, as it does with any bright-line rule: Why is the line so bright? Although in some cases bright-line rules are simply arbitrary, anything so fundamental and subject to planning as whether one will suffer the corporate income tax is unlikely to work if it is simply arbitrary. If there are not significant forces at work that dictate whether a company does or does not need to be publicly traded, one would expect to see all sorts of shenanigans designed to take advantage of the distinction. After all, the publicly traded partnership was just such a device.

C. Swap Funds

Congress and Treasury recognized the value of public trading in dealing with the phenomenon of swap funds in the mid-1960s.[34] A swap fund is a private investment company in which several shareholders who own appreciated stock contribute the stock to a common fund and take back shares in the fund.[35] Under § 351 of the Internal Revenue Code, as it stood before 1966, such contributions could be tax-free as long as the contributors of property were in control of the recipient corporation, holding at least eighty percent of the voting stock of the recipient corporation immediately after the contribution.[36] In 1966, however, Congress amended § 351 to exclude transfers to investment companies,[37] and Treasury followed with regulations limiting the scope to diversifying transfers.[38] Therefore, the prohibition of tax-free transfers to investment companies was limited to those transfers that resulted in the contributors achieving or increasing the diversification of their investments.

At first blush, it is not at all clear why the fisc would care about such deals. There are two possible reasons. Either the transfer represents a subtle means of avoiding taxes or it constitutes an event that itself is taxworthy. In fact, elements of both reasons are present. The primary benefit of such a transfer is that the transferor can trade a single stock for a diversified portfolio of stocks. The strategy was also

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33. *See, e.g.*, Brooks v. Willcuts, 78 F.2d 270, 273 (8th Cir. 1935) (defining a close corporation as one "in which the stock is held in a few hands, or in few families, and wherein it is not at all, or only rarely, dealt in by buying or selling"); *Galler*, 203 N.E.2d at 583; Wasserman v. Rosengarden, 406 N.E.2d 131, 134 (Ill. App. Ct. 1980) (defining a close corporation as "one in which the stock is held in a few hands, and the common stock is not frequently bought or sold").

34. For a general discussion of swap funds, see S. Jane Rose, *Investing in High Yield Securities: Swap Transactions, in* INVESTMENT COMPANIES: THE CHANGING ROLE OF INDEPENDENT DIRECTORS 189 (ALI-ABA Course of Study, Apr. 23, 1993).

35. JERRY M. ROSENBERG, DICTIONARY OF INVESTING 324 (1993).

36. I.R.C. § 351 (1964) (current version at I.R.C. § 351 (1994)).

37. Act of Nov. 13, 1966, Pub. L. No. 89-809, § 203, 80 Stat. 1539, 1577 (codified as amended at I.R.C. § 351 (1994)).

38. Treas. Reg. § 1.351-1 (as amended by T.D. 6942, 32 Fed. Reg. 20,977 (1967)).

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used to give transferees debt securities at the time, though § 351 has been amended to eliminate the ability to receive debt securities tax-free.[39] It was also possible to contribute debt securities. However, debt securities, at the time, seldom rose enough in value to make the deal worth the expense.

In the absence of a swap fund alternative, underdiversified investors would be required to sell their shares, or most of them, and buy other shares in order to construct a diversified portfolio. If such a transaction is effected in the normal way, by selling and buying, it will obviously generate tax to the extent that the sold shares are appreciated.[40] One could argue that the trade is really stock-for-stock, but corporate securities have always been expressly excluded from like-kind exchange treatment.[41]

In practice, the prohibition of swap funds is aimed at underdiversified investors who own publicly traded stocks.[42] The question is, why do such investors exist? How did they get to be undiversified in the first place? To be sure, a diversified investor could contribute to a swap fund using one or more appreciated stocks from his already well-diversified portfolio, but what would be the point? The only investor who seems to need the swap fund is the undiversified investor. It is possible that some investors simply make a mistake and neglect to diversify at the outset. It is much more likely, however, that such investors are entrepreneurs whose companies have grown into publicly traded companies, successors in interest of such entrepreneurs, or high-level executives of publicly traded companies who have been compensated with stock.[43]

The gain to an undiversified investor seems apparent. Consider the case of the entrepreneur whose company has grown to publicly traded status. In many cases, he or she will be out of his or her league trying to continue to manage the company. It is time to step aside. Yet, to hold so much stock in one company is risky, especially if someone else is in control. The need for diversification is acute. The change in

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39. I.R.C. § 351(a) (1994).

40. *Id.* § 1222 (explaining the rules for determining capital gains and losses). In general, all recognized gains are included in gross income. *Id.*

41. *See id.* § 1031; *see also id.* § 1036 (allowing for tax-free exchange of stock for stock in same corporation).

42. *See Recent Private Letter Ruling Creates Favorable Exception to Swap Fund Rules of Sections 351(e) and 721(b)*, CORP. TAX UPDATE (KPMG Peat Marwick, Washington, D.C.), Sept. 1993, at 4, 4; James H. Nix, *Adding Definition to the Exchange Fund Provisions*, TAX NOTES TODAY, Mar. 19, 1993, *available in* WESTLAW, TNT Library, at *4.

43. It is also possible that the prohibition of swap funds is aimed at corporate investors. To see how such a swap could be beneficial for a corporation, suppose that corporation ABC forms a new corporation, C, tax-free under § 351 to hold one of its lines of business. ABC then arranges for corporation C to be listed on the NYSE, and contributes its shares in C to a swap fund in exchange for shares in a diversified fund. In effect, ABC has divested C in exchange for something very close to cost.

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the nature of the investment is real. There is little justification for allowing it tax-free if other such trades are taxed.

Why does diversification matter so much? Simply stated, an investor can eliminate between seventy and ninety percent of the risk of investing in a single stock by buying as few as twenty different stocks.[44] The only risk left is that the market as a whole will rise or fall. All of the risk attendant to investing in a single company is gone.[45]

To return to the example of the entrepreneur, it seems all the more clear that he or she has swapped two very different kinds of investments. One is a very risky investment in a company in which he or she was an active participant; the other is a relatively safe investment in which the fortunes of individual companies matter little and in which our entrepreneur is simply a passive investor.

Does passivity matter too? Possibly. At the very least, it too has become a factor in drawing some tax lines. For example, since the 1986 tax act, the Internal Revenue Code has treated passive income differently from active income.[46] Is this merely a convenient distinction, or does it matter in some more fundamental way? Although it probably started out as a convenience, the distinction is in fact related to the notion that, in general, passive investments are diversifiable whereas active investments are not. In any event, it seems clear that the entrepreneur's investment in an actively managed company, possibly one built up from scratch, is very different from a passive investment in a mutual fund. The differences are the risks involved, liquidity, and the potential for diversification.

The remarkable feature of the story of the swap fund is that Treasury somehow saw the problem in 1966 when the value of diversification was only a glimmer in the eyes of corporate finance scholars. It must be, as Gordon Gekko suggested, that when money is involved, one sees things more clearly.[47]

Because the regulations regarding transfers to investment companies do not preclude transfers of stocks that are not readily marketable,[48] it should still be possible for a swap fund to hold the stocks of closely held corporations. It might even be possible, after a decent interval, to offer the stock of such a fund to the general public.

The swap fund device is quite similar to a partnership rollup.[49] So why are partnership rollups not a problem under revised § 351? The

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44. BURTON G. MALKIEL, A RANDOM WALK DOWN WALL STREET 185-209 (4th ed. 1985) (noting that a portfolio with 20 equally sized and well-diversified issues of United States stocks reduces the risk by about 70%; the same portfolio, composed of international stocks, reduces the risk by nearly 90%).

45. *See id.*

46. *See* I.R.C. § 469 (1994).

47. *See* WALL STREET (Twentieth Century Fox Film Corp. 1987) (in which a young stockbroker is led to the life of an inside trader by a corrupt mentor named Gordon Gekko).

48. Treas. Reg. § 1.351-1(c) (as amended in 1967).

49. For a general discussion of rollups, see Deborah A. Demott, *Rollups of Limited*

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answer, no doubt, is that typically the assets contributed to a rollup are not appreciated. Thus, there is no need for § 351. If anything, one would want to recognize a loss, and § 351 precludes recognition of a loss.[50]

III. The Demise of Limited Liability

What does all this have to do with shifting the line between partnership and corporation from limited liability to public trading? Plenty. As I have argued elsewhere, limited liability is a doubtful benefit.[51] It matters little to small companies who cannot really have it, and it matters little to big companies who do not really need it. Public trading, on the other hand, is a benefit that is very difficult to resist if it can be achieved. Only if a stock is publicly traded can one achieve diversification in any practical way. Without public trading, investing is simply too risky. There is no ready exit from the investment, and results are tied to the performance of a single company and the good faith of its participants. Where there is more than one "partner" in the private investment, the "partner" with more control may use that control to oppress others with less control. Methods of oppression may include paying or withholding distributions, or more aggressive tactics designed to squeeze others out. Thus, quite apart from the possibility that the company will fall on hard times, public trading offers a much needed escape route for minority investors.[52] One can even think of public trading as a way of dividing the investment into two parts: an active management part and a passive investment part.

It seems quite apparent that public trading is now the key factor in determining whether the corporate tax will apply.[53] Generally, companies that are publicly traded pay the corporate tax and companies that are privately held do not. To be sure, it is not always easy to determine whether a company is publicly traded. There has already been considerable litigation over the point.[54] However, the idea is relatively clear as a concept even if it is difficult to apply. The question for the present is, why does public trading make a difference? To put it another way, the corporate tax has become a tax on access to public financing. Is there reason to believe that this is the right place to draw the line? To put the question in yet a slightly different form, is there

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Partnerships: Questions of Regulation and Fairness, 70 WASH. U. L.Q. 617 (1992).

50. I.R.C. § 351 (1994).

51. *See* Booth, *supra* note 19, at 141-43.

52. *See, e.g.*, Donahue v. Rodd Electrotype Co., 328 N.E.2d 505 (Mass. 1975). In *Donahue*, the minority investor, Donahue, "contended that the [majority investors] were diverting Rodd Electrotype assets for the benefit of the Rodd family [the majority investors]." *Id.* at 579 n.2.

53. For a discussion of how publicly traded companies are taxed, see *supra* Part I.

54. *See supra* note 11 and accompanying text. For cases discussing whether a business has free transferability of interests, see MCA v. United States, 685 F.2d 1099 (9th Cir. 1982); Zuckman v. United States, 524 F.2d 729 (Ct. Cl. 1975); Outlaw v. United States, 494 F.2d 1376 (Ct. Cl. 1974).

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reason to believe that drawing the line at public trading will have a minimal impact on the decision to go public? After all, one of the supposed goals of an income tax is to avoid affecting the transactions that are taxed.[55] In a word, the income tax is supposed to be neutral. Clearly, the taxability of corporations led many companies to opt for partnership status, even though limited liability was forgone. Witness the avalanche of registrations as LLCs in the last few years.[56] Thus, there is reason to believe that the old touchstone of limited liability was not, in fact, neutral.

The question is: does drawing the line at public trading better serve the goal of tax neutrality, that is, of not affecting business decisions? Or does the Heisenberg Uncertainty Principle[57]—that one cannot observe an event without affecting it—apply as a matter of economics as well as physics?

IV. WHY DO COMPANIES GO PUBLIC?

If public trading is to be the new bright line between corporations and partnerships, then we need to know why companies go public. Although the question sounds simple enough, the answers are not at all obvious.

For most companies that are already publicly traded, the sale of stock to the public is not an important source of capital. Indeed, on the average and in most recent years, public companies have bought back more stock than they have sold.[58] However, the fact that more or bigger companies buy back their stock does not mean that those companies that sell their stock have no good reason for doing so. Indeed, it does not even mean that companies that buy back their stock have no real need for the market or that they should go private. They may simply have too much stock outstanding. After all, paying a dividend is roughly equivalent to buying back stock, yet no one would suggest that a dividend payment implies that a company has no need for its public shareholders.

Given the fact that many companies, once public, buy back much of their stock, it seems that the decision to go public in the first place, rather than subsequent sales of additional stock, is the key to under-

55. *See* Daniel N. Shaviro, *An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax*, 48 TAX L. REV. 1, 5 (1992) (noting that "taxes triggered by the act of transfer . . . contravene the efficiency norm of affecting taxpayer decisions as little as possible"). For a general discussion of both efficiency and equity theories of income taxation, see Boris I. Bittker, *Equity, Efficiency, and Income Tax Theory: Do Misallocations Drive Out Inequities?*, 16 SAN DIEGO L. REV. 735 (1979).

56. *See, e.g.*, Phil West, *LLCs Credited for Revenue Boost: Jump in Fee Collections Outpaces Decline*, KNOXVILLE NEWS-SENTINEL, July 30, 1996, at C1.

57. For a discussion of the Heisenberg Uncertainty Principle, see STEPHEN W. HAWKING, A BRIEF HISTORY OF TIME 54-61 (1988).

58. *See Report of the Advisory Committee on the Capital Formation and Regulatory Processes*, [1996-1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) No. 1725, app. A, fig. 1, at 70 (July 24, 1996) [hereinafter *Report on Capital Formation*].

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standing why companies go public. Even if one focuses on initial public offerings (IPOs), however, it is clear that going public is not wholly motivated by a need for the capital.[59] Many companies go public primarily in order to offer a stock option plan to their executives or to allow for funding of a pension plan.[60] In other cases, being public allows for the creation of currency that may be used to acquire other companies.[61] Being public also may be valuable because it allows for the continuous valuation of the company.[62] That is, the stock price is a daily indicator to management, and perhaps outsiders, of how well the company is doing and how disinterested observers view various business decisions.[63] Regarding creditors and other outsiders, the stock price may serve as an important check on management representations and may even be seen as a bonding device.[64] Finally, and closely related, is that being publicly traded imposes the discipline of potential takeover on management.[65] Although a good manager should presumably be self- disciplined, in a larger company with a high degree of specialization and various points of view among its many levels of managers, the market may serve as a unifying source of discipline that is hard to duplicate. In other words, in a large company, the stock price may in fact be the best way of reliably communicating among managers.[66]

None of these reasons for going public are terribly compelling. As for stock options, it would seem that a company could always concoct a profit-sharing plan that replicates the same incentives. The effectiveness of such a plan, however, would depend on how much the subject managers trusted the calculation of income, though such a plan also might raise difficult questions about rewarding managers for short-term results rather than long-term planning. However, basing an incentive system on the vagaries of stock market pricing can be just as troublesome. As for the creation-of-currency argument, it is unclear that stock in a private company will not do just as well in many cases. Indeed, it might be possible to construct a privately held company,

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59. *See* THOMAS L. HAZEN, THE LAW OF SECURITIES REGULATION 61 (3d ed. 1996) (analyzing the many advantages of going public).

60. *See, e.g.,* Kaufman v. Lawrence, 76 F.R.D. 397, 398-99 (S.D.N.Y. 1977) (involving a publicly held corporation's attempt to purchase all of its outstanding stock except shares owned by its directors); *see also* Christopher Drew & David Cay Johnston, *Special Tax Breaks Enrich Savings of Many in the Ranks of Management,* N.Y. TIMES, Oct. 13, 1996, at A1 (discussing heavy use of company stock to fund 401(k) plans and lack of diversification in many such plans).

61. *See* HAZEN, *supra* note 59, at 60-62.

62. *See id.* (explaining that going public may provide the company with an "air of financial success").

63. *Id.*

64. WILLIAM A. KLEIN & JOHN C. COFFEE, JR., BUSINESS ORGANIZATION AND FINANCE 170-76 (6th ed. 1996) (discussing corporate accountability and monitoring theories).

65. *See generally* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 171-74 (1991) (stating that managers reduce chances of takeovers by improving the company's performance).

66. *See id.* (finding that high stock prices dissuade takeovers).

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composed of subsidiaries in several different lines of business, that offers many of the benefits of diversification to its shareholders. To be sure, it appears that the market tends to discount diversification at the company level, but that may be due to the fact that it is cheaper for investors to "roll their own" diversification from among publicly traded companies.

In the end, the most convincing reason for going public may be largely unrelated to benefits to the issuing company. Rather, going public may be primarily motivated by the desire of shareholders to gain access to a public market for their shares in order to cash out some portion of their holdings.[67] If one assumes that most shareholders in nonpublicly traded corporations are largely undiversified, it is likely that they will have a strong interest in selling at least a portion of their shares to eliminate the risk that goes with having all of one's eggs in one basket. A major shareholder who is also involved in the management of the company will usually still have much of his or her fortune tied up in the company. But for such a person diversification may be even more attractive. The beauty of going public is that one can sell off a few shares without giving up control. Indeed, this "have-your-cake-and-eat-it-too" aspect may well be the strongest motivation for going public.

Data concerning market reaction to offerings indicate that secondary offerings cause less of a drop in market prices than do offerings by the issuing company.[68] This suggests that investors find sales by insiders less worrisome than sales by the company even though sales by insiders do not raise capital for the company. It may also be that sales by the company are more often undertaken when prospects are not rosy. Insiders tend to sell when prices are likely to remain firm because they seldom sell all of their shares. In other words, it may be that insiders sell primarily to create and gain access to a public market to facilitate further subsequent sales, whereas companies tend to sell stock when they think they can get top dollar. Moreover, when insiders sell they keep all the money. When the company makes an offering, insiders get only an undivided interest in the capital raised according to their ownership interest after the offering. In any event, the fact that secondary (insider) sales have less of an adverse impact on market price strongly suggests that the market and the investors who compose it find such sales to be quite normal and understandable. In other words, investors see less to worry about in the desire of other investors to gain liquidity and diversify than they do in companies' seeking more capital in the equity markets. Suspicion of equity financing is

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67. *See* HAZEN, *supra* note 59, at 62 (noting that public financing allows shareholders to liquidate).

68. *See* Lyn Perlmuth, *How to Predict a Stock's Decline*, INSTITUTIONAL INVESTOR, Sept. 1996, at 35 (reporting findings by Professor Inmoo Lee that stocks offered in primary offerings underperformed a control group of publicly traded companies while stocks offered in secondary offerings outperformed the control group).

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perhaps only natural. During the period 1992 through 1995, corporations sold about six times as much debt as stock of all kinds; during this period corporations sold about $245 billion in stock—including secondary offerings—and about $1650 billion in debt.[69] Thus, one might legitimately ask why a company would sell equity rather than debt.[70]

The decision to go public is an extraordinary one. There are few reasons for doing so that cannot be explained away. The need for capital cannot explain much of going public. A company that needs capital can always try first to borrow, even by a public offer of bonds. As the market for junk bonds demonstrates, such instruments can be structured so as to mimic stock.[71] Yet under the tax regulations, debt instruments do not count in determining whether a company is publicly traded.[72] The bottom line is that the desire for diversification would seem to be a very strong motivation for going public.[73]

V. THE COSTS OF GOING PUBLIC

Whatever the reason for going and being public, it is clear that companies pay dearly for the privilege. It costs a lot to go public in the first place.[74] It is expensive to put together a registration statement or

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69. *See Report on Capital Formation, supra* note 58, app. A, tbl. 4, at 16.

70. Incidentally, although a large percentage of offerings are secondary, federal securities law has tended to discourage such sales and to favor sales by issuers. *See, e.g.*, 17 C.F.R. § 230.251(b) (1996) (limiting sales of selling security-holders in Regulation A offerings to $1.5 million out of $5 million maximum aggregate offering price). If indeed the more normal reason for going public is to create a market for the benefit of investors, then SEC policies should be rethought.

71. *See* Henry T.C. Hu, *New Financial Products, the Modern Process of Financial Innovation, and the Puzzle of Shareholder Welfare*, 69 TEX. L. REV. 1273, 1289 (1991).

72. The dollar costs of an initial public offering are only a part of the total price.

> [A] significant cost of a public offering is the management time and dollar expense that will be incurred in connection with the offering. The public offering process will demand significant management time, particularly from the chief executive officer, the chief financial officer, and the accounting staff. Dollar costs of the offering include payment of underwriting discounts or commissions to the underwriters in exchange for their services in connection with the offering, accounting fees, and legal fees. There are also additional costs such as the cost of printing prospectuses and stock certificates, costs of retaining a transfer agent, application fees payable to the relevant stock exchange or quotation service, and the filing fees paid to the SEC, the NASD, and various state securities administrators.

Gregory M. Priest, *Practical Aspects of the Initial Public Offering, in* UNDERSTANDING THE SECURITIES LAWS 617, 623-24 (PLI Corp. Law & Practice Course Handbook Series No. B4-7067, 1994).

73. *See* Richard A. Booth, *The Efficient Market, Portfolio Theory, and the Downward Sloping Demand Hypothesis*, 68 N.Y.U. L. REV. 1187, 1197-98 (1993) (describing the benefits of diversification). One potential problem with such an explanation is that a shareholder may diversify even if stock is not publicly traded. *See, e.g.*, Lisa Reilly Cullen, *When You Invest with Angels, the Portfolio Is Never Boring*, N.Y. TIMES, Sept. 8, 1996, at F3 (describing the growth of venture capital funds specializing in nontraded companies).

74. *See* John K. Hoyns, *Deciding Whether to Go Public: Certain Basic Considera-*

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other offering documents.[75] Moreover, in addition to the out-of-pocket expenses, the underwriter will take a percentage of the funds raised as an underwriting discount, in effect charging the issuer a commission for handling the offering.[76] Moreover, most IPOs are underpriced.[77] That is, in most cases the price of an IPO rises in the immediate aftermarket.[78] Thus, it seems as if investment bankers routinely offer the stocks of companies going public for the first time at less than the maximum price that might be obtained.[79] The reasons for underpricing IPOs have been the subject of much scholarship and little agreement.[80] The ultimate question is, why do manager-owners of such companies stand for it? The answer may well be that they stand to gain more than they lose. That is, if they sell less than all their stock, the increase in price in the aftermarket redounds to their benefit to the extent that shares are retained.[81] But again, the more important benefit may be that the public offering affords liquidity, allows for diversification, and provides a readily ascertainable price for the stock that is retained that may be used in obtained loans and in connection with other uses of stock.[82]

Once a company is publicly traded, the cost of preparing and filing yearly, quarterly, and monthly reports with the SEC, as well as proxy materials, is considerable, both in terms of dollars[83] and in terms of the loss of privacy.[84] Moreover, being publicly traded increases the potential for shareholder suits.[85] It also allows for short selling.[86] As far as management is concerned, the potential for takeover that goes with

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tions, *in* HOW TO PREPARE AN INITIAL PUBLIC OFFERING 13 (PLI Corp. Law & Practice Course Handbook Series No. B4-7103, 1995) (estimating that the fees involved in going public could total between $400,000 and $800,000 for a $5 million to $20 million offering).

75. *Id.*

76. *See* HAROLD S. BLOOMENTHAL, GOING PUBLIC AND THE PUBLIC CORPORATION § 1.03 (1986).

77. *See* Booth, *supra* note 73, at 1204.

78. *Id.* at 1206.

79. *See id.* at 1204-06 (stating that underpricing is a result of "rules requiring that IPOs be priced to sell to the investor who places the lowest value on the shares offered").

80. *See id.* at 1204-06 nn.39-43 (collecting sources).

81. *See* Lynn A. Stout, *The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation*, 87 MICH. L. REV. 613, 662 n.258 (1988).

82. For a general discussion of the benefits of initial public offerings, see Priest, *supra* note 72, at 622-23.

83. *See* Hoyns, *supra* note 74, at 13-14; *see also* Carl W. Schneider & Jason M. Shargel, *Now That You Are Publicly Owned*, 36 BUS. LAW. 1631, 1632-36 (1981) (describing the SEC's periodic reporting requirements).

84. *See* Hoyns, *supra* note 74, at 13. *See generally* Schneider & Shargel, *supra* note 83, at 1632-36 (describing the disclosures required by the SEC).

85. *See* EASTERBROOK & FISCHEL, *supra* note 65, at 90-108 (discussing managers' fiduciary duties and shareholders' right to bring derivative suits).

86. For a general discussion of short selling, see HAZEN, *supra* note 59, at 530-34.

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being publicly traded may be the most important cost.[87] Of course, shareholders see the potential for takeover as a benefit, but it is important to remember that it is management that decides to go public in the first place.

Going public is a one-way street from a tax point of view and thus involves significant opportunity costs. Although it is usually possible to turn a partnership into a corporation without paying tax on the transaction even if the assets of the partnership are appreciated,[88] the reverse transaction will almost always trigger the recognition of gain if there is any appreciated property in corporate solution.[89] For example, if the company liquidates and distributes its assets to its shareholders who then contribute them to a partnership, the liquidation is treated as a sale by the company and the receipt of assets is treated as a sale by the shareholders.[90] The result is a two-level tax. Thus, as a practical matter, a company cannot escape the corporate tax by going private.

In the end, it is not clear that we really need to know why companies go public. What is clear, however, is that companies do so despite the considerable costs involved. Therefore, there must be value in being publicly traded. As Professor Ribstein has pointed out in another connection, the costs associated with corporate status are in effect borne by those companies that do not perceive a sufficient benefit from a more customized status.[91] In other words, the corporate tax may be seen as the price of convenience. Although LLCs were once relatively expensive to set up because documentation was required to be drafted from scratch, many LLC statutes now incorporate the provisions of the state's corporation law by reference, even though some commentators have suggested that reliance on corporation law may jeopardize a firm's check-the-box status.[92]

VI. HAS THE CORPORATE INCOME TAX BECOME VOLUNTARY?

At first blush, it would seem that the corporate tax has become more or less voluntary. In other words, drawing the line at public trading may cause some companies to avoid public offerings. It is not entirely clear, however, that a company can necessarily avoid becoming publicly traded if its shareholders want it to be publicly traded. If

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87. *See* EASTERBROOK & FISCHEL, *supra* note 65, at 162.

88. For a general discussion of the incorporation of a partnership, see STEPHEN A. LIND ET AL., FUNDAMENTALS OF PARTNERSHIP TAXATION 354-60 (1994).

89. For example, one commentator has argued that, because of the tax consequences, only a corporation with substantial losses would even attempt to change its form. Mark Golding, *Tax Aspects of Converting a Partnership or Corporation into an Oregon Limited Liability Company*, 73 OR. L. REV. 25, 37 (1994) (discussing the difficulty of liquidating a corporation to change its form to an LLC).

90. *See* I.R.C. § 311(b) (1994) (repealing the "General Utilities" doctrine).

91. *See* Ribstein, *supra* note 2, at 47 (discussing the benefits of corporate centralized management); *see also* Goldberg, *supra* note 6, at 1003.

92. *See* Ribstein, *supra* note 2, at 40-41.

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there is enough stock floating around, a market is likely to arise no matter what the company does to try to prevent it. Witness the ease with which various plain vanilla securities have been broken up or combined with others to form derivative instruments.[93] Although a company may have no interest in its stock being the subject of options trading, for example, there is little the company can do to stop the emergence of such a market. The same may well be true of trading in stock itself. Although most stock offerings are made by the issuing company, shareholders do not necessarily need to ask the company whether they may offer their stock to the public as long as there is no restriction in place in the articles, bylaws, or a private agreement, or as a matter of a close corporation statute. Even if there is some form of restriction in place, a corporation cannot make its stock utterly untradeable.[94]

Of course the shareholders must foot the bill for registration—or dealing with an exemption—if the company refuses to go public on its own,[95] but the company, once it becomes public, will need to comply with SEC regulations regarding periodic reporting.[96] The point is that shareholders have considerable power in dictating whether a company will become public, and it is unclear whether a corporation can long avoid public trading if its shareholders insist.

One reason why shareholders prefer publicly traded companies—aside from simple liquidity—is that, with public trading, one can generate benefits similar to dividend income, even if the company decides not to make distributions, by selling a few shares now and then.[97] Of course, even with a closely held company, one can always borrow using a few shares as collateral. The problem, however, is that a lender cannot determine the value of the collateral unless there is a public market and may be reluctant to accept stock that cannot be easily sold in the event of a default. Indeed, under Federal Reserve Board rules, only certain actively traded stocks of substantial value may be used as security in connection with a margin loan.[98] For example, no stock with a price of less than five dollars per share is marginable.[99] Thus, lender practices seem to dictate that a stock be publicly traded before one can

93. *See* Hu, *supra* note 71, at 1299-1300 (discussing the various methods by which traders attempt to create value by breaking common stock into component parts).

94. *See* MODEL BUS. CORP. ACT § 6.27 (1984) (transfer restriction authorized if supported by reasonable purpose).

95. For a discussion of exemptions from registration, see Eva C. Cicoria et al., *Implications of Using Stock as Consideration: Issues of Federal Securities Law, State Law and Stock Market Regulation*, *in* ACQUISITIONS IN A DELEVERAGING ENVIRONMENT 27, 39-41 (PLI Corp. Law & Practice Course Handbook Series No. B4-7011, 1992).

96. *See* Klaus Eppler, *Introduction and Overview: The Public Company's Year-End Disclosure Obligation*, *in* PREPARATION OF ANNUAL DISCLOSURE DOCUMENTS 9, 13, 34 n.6 (PLI Corp. Law & Practice Course Handbook Series No. B4-6781, 1987).

97. *See* Booth, *supra* note 18, at 559-60.

98. *See* HAZEN, *supra* note 59, at 524-25.

99. *Id.* at 525 n.11.

extract value from it without selling it outright. However, if the stock must be publicly traded anyway, one can always sell a few shares on the market. The bottom line is that, if investors are to have access to and, more important, control over income flowing from shares, the shares must be publicly traded.[100]

In short, tying corporate tax to public trading is not likely to affect the decision of a company to go public. Although it may cause companies to delay the decision to go public a bit, it is unlikely to prevent many companies that require public equity capital from going public at some point.

VII. DEBT AND EQUITY—KNOW THE DIFFERENCE

One distinction that arises repeatedly in the above musings is the distinction between debt and equity. Why is it that Congress and Treasury seem not to be concerned about the possibility of trading in debt securities? The easy answer is that corporations are free to borrow as much capital as they can and may deduct the interest—that is, pay it in single-taxed dollars—as long as the borrowing does not run afoul of the rules against deductibility of interest on junk bonds.[101] It is somewhat less clear why partners so easily escape personal liability under partnership law.

The conventional wisdom is that lenders and other creditors bargain for a fixed return and do not participate in the residual returns that belong to the shareholders, though, of course, preferred shareholders do not participate in residual returns either.[102] Although there is certainly truth in this distinction, again it is not the whole truth. Another reason why return on debt securities is taxed only once, and why debt securities seem to escape many of the prohibitions on the use of stock, is that such securities do not carry much prospect of capital gains. Debt securities do not, in any event, tend to trade very actively, perhaps because they are less volatile than stocks and therefore generate few trading opportunities.[103] It may also be that bond investors simply tend to trade less, perhaps in part because bonds eventually mature and investors can get their money back commission-free on a date certain, which may in turn cause bond investors to structure their portfolios so as to manage maturation dates.

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100. *See id.* at 527.

101. For a discussion of the rules concerning junk bonds, see Michael D. Floyd, Comment, *Junk Bonds: Do They Have a Value?*, 35 EMORY L.J. 921, 959-65 (1986).

102. For a general discussion of preferred stock, see RICHARD A. BOOTH, FINANCING THE CORPORATION § 2.03 (1996).

103. *See* John C. Coffee, Jr. & William A. Klein, *Bondholder Coercion: The Problem of Constrained Choice in Debt Tender Offers and Recapitalizations*, 58 U. CHI. L. REV. 1207, 1218 (1991) ("[T]here is simply not a liquid auction market, or even continuous trading, in debt securities, at least not of the kind that is available for equity securities of the same issuers.").

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One possible argument for the corporate income tax is that a corporation may retain and reinvest its income—and decline to pay dividends—so that if no tax is payable at the corporation level, no tax will ever be paid on that income other than the taxes on capital gains that the shareholders may pay when they choose to sell their shares.[104] Thus, the corporate income tax can be viewed in part as a stopgap measure designed to prevent the possibility that large amounts of income will escape taxation forever. For smaller companies, however, there is a limit to how much income may be retained. If an excessive amount of income is retained—even though the company has no business purpose for doing so—the IRS has the power, in effect, to declare a constructive dividend and the corporation must pay the tax that the shareholders would have paid if they had received the dividend—plus interest and penalties, of course.[105] Moreover, and more to the point, justifying the corporate income tax as a way of preventing tax avoidance by investors does not explain why dividends are taxed when they are declared.

Data regarding investment returns suggest that the distinction between debt and equity may be quite real and quite on point. On the average, return on publicly-traded corporate debt securities—net of inflation—is about zero, whereas return on publicly-traded stocks is about ten percent per year.[106] This suggests that the corporation income tax is in fact a tax on a qualitatively different kind of investment. One might think of it as a tax on growth. Again, if the corporation is not taxed on its income, the capital gains preference—plus the ability of investors to time the recognition of gains—may prevent such gains from ever being taxed at all. Indeed, no one has seriously suggested that the corporation income tax be abolished and a dividend tax retained as a way of integrating the corporation income tax with individual income tax. Still, the question remains: Why do we tax distributions? Is it not enough, even if corporation income is qualitatively different, that we tax the corporation? Not necessarily. Because a diversified investor can sometimes legally avoid paying tax on investment income, the tax on distributions and capital gains could be considered a tax on disinvestment. That is, one might think of the tax on distributions and capital gains as a tax on the decision to cash out—or cash in.

CONCLUSIONS AND SPECULATIONS

The corporate income tax may be around longer than many would have predicted. Although most thoughtful commentators support the integration of corporate and individual tax and reject double taxation

104. *See* KAHN & LEHMAN, *supra* note 27, at 27.

105. I.R.C. §§ 531-537 (1994).

106. *See* JAMES H. LORIE ET AL., THE STOCK MARKET: THEORIES AND EVIDENCE 17 (2d ed. 1985).

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based on the happenstance that a business is held in the corporate form,[107] the analysis here suggests that a publicly traded corporation is a more discrete entity and is more separate from its owners than is often realized.

Publicly traded stock is different from privately held stock.[108] Because rational shareholders diversify, they buy and sell stocks only as part of a portfolio. Thus, the value of a publicly traded stock is only partially tied to the fortunes of the issuing company. Moreover, as a result of program trading and other portfolio-based trading strategies, the price of individual stocks may be affirmatively affected by much broader considerations than the prospects of the issuing company.[109] Indeed, it is at least arguable that managers may be required to manage differently when the stock of their company is publicly traded.[110]

Most commentators would probably agree that the law in the United States has lagged behind that in Europe in developing different forms of organization for public and private companies.[111] The United States has also lagged behind Europe in eliminating business taxes through integration.[112] The two issues should not be confused. There is no *a priori* reason why the decision to offer a bigger menu of organizational forms means that the corporate tax should be eliminated through integration.

This is not to say that the corporate tax is necessarily wise. The decision as to whether such a tax makes sense as a matter of policy is a political one. The only question being addressed here is whether the tax is workable. As a matter of policy, many commentators doubt whether corporation income—or indeed investment income of any sort—should be taxed twice, once at the level of the entity that generates it and once at the level of the passive investor.[113] The simple point being made here is that stock in a publicly traded company is in fact something quite distinct from a mere ownership interest in that company. In other words, publicly traded stock has a life of its own. We tax both corporations and stock because, like Mount Everest, they are there.

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107. *See, e.g.*, Jennifer Arlen & Deborah M. Weiss, *A Political Theory of Corporate Taxation*, 105 YALE L.J. 325 (1995); David Shores, *Repeal of General Utilities and the Triple Taxation of Corporate Income*, 46 TAX LAW. 177 (1992); Alvin Warren, *The Relation and Integration of Individual and Corporate Income Taxes*, 94 HARV. L. REV. 717 (1981).

108. *See* HAZEN, *supra* note 59, at 61-62.

109. *See generally* Richard A. Booth, *The Uncertain Case for Regulating Program Trading*, 1994 COLUM. BUS. L. REV. 1, 15-19 (discussing how program trading may affect the market for individual shares).

110. *See generally* Richard A. Booth, *Stockholders, Stakeholders, and Bagholders (or How Stockholder Diversification Affects Fiduciary Duty)* (forthcoming 1997).

111. *See* Harm-Jan De Kluiver, *Europe and the Private Company, An Introduction*, *in* THE EUROPEAN PRIVATE COMPANY? 21, 33-35 (Harm-Jan De Kluiver et al. eds., 1995).

112. KAHN & LEHMAN, *supra* note 27, at 30 & n.62.

113. *Id.*, at 30.

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If public trading is going to be the trigger for the corporate tax, however, perhaps the tax should simply be assessed on the publicly reported income of the corporation. With a corporate income tax that applies to both public and private companies, there is an obvious need for tax accounting rules. However, if the tax is only to apply to companies that are required to file with the SEC and to follow generally accepted accounting principles, why not follow through on the logic of neutrality—that there are other forces at work that dictate whether a company will be public—and harness those same forces as they work in connection with the company's communications with the public (which are presumably designed to keep the price of the company's stock as high as possible)?

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