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DOES THE CORPORATE TAX STILL DISTORT ORGANIZATIONAL GOVERNANCE?

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To what extent does the tax system distort the organizational governance of business entities? For private entities, the connection between tax treatment and governance is weak. Tax and governance can be selected independently because of flexible modern limited liability company ("LLC") statutes and the check-the-box tax regime.

But for public entities, tax and governance remain deeply intertwined. Tax law requires that public entities generally be taxed as corporations, with narrow exceptions for master limited partnerships and certain investment companies like real estate investment trusts. This Article explores important governance and tax puzzles related to public entities.

We observe that public entities in general still organize as corporations rather than LLCs. Why is that the case when tax law only dictates that they be taxed as corporations? LLC statutes offer more flexibility, and yet investors and founders eschew that flexibility. Why do we observe so few public entities taking advantage of the flexible passthrough tax regime of Subchapter K? Why are REITs and RICs hugely popular despite the rigid requirements imposed by Subchapter M?

This Article offers a single answer to all these questions. In public entities, it is especially important for ownership interests to be as homogeneous as possible to minimize agency and monitoring costs. Public entities may not want the flexibility offered by modern LLC statutes. But homogeneity extends beyond governance to tax as well. The flexibility of Subchapter K exacerbates heterogeneity among different owners. The more rigid approach of Subchapter M maintains ownership homogeneity for REITs and RICs. These insights have important implications for corporate tax reform and invite a reconsideration of the interaction between agency costs and tax distortions.

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Introduction

Every discussion of corporate tax reform reiterates a familiar list of distortions created by the corporate double tax:[1] (1) the dividend distortion, (2) the debt-equity distortion, and (3) the entity distortion.[2] In turn, the corporate tax discourages the distribution of dividends,[3] encourages corporations to raise capital through the issuance of debt rather than equity,[4] and discourages the use of the corporate form. These distortions are important: they are the economic costs of the corporate double tax. Proposals to reform the corporate tax (including

1. The U.S. corporate tax applies a corporate-level tax when corporations earn income, and then another shareholder-level tax when corporate earnings are distributed. I.R.C. §§ 11, 1(h).

2. These distortions are listed in virtually every casebook, governmental publication, academic article, and congressional testimony discussing corporate tax reform. *See, e.g.*, Robert J. Peroni & Steven A. Bank, Taxation of Business Enterprises: Cases and Materials 16–22 (5th ed. 2023); Jane G. Gravelle, Cong. Rsch. Serv., R44671, Corporate Tax Integration and Tax Reform 1 (2016); U.S. Dep't of the Treasury, Integration of the Individual and Corporate Tax Systems, at vii (1992); Am. Law Inst., Federal Income Tax Project, Integration of the Individual and Corporate Income Taxes 21–50 (1993) (Alvin Warren, Reporter); Michael J. Graetz & Alvin C. Warren, *Integration of Corporate and Shareholder Taxes*, 69 Nat'l Tax J. 677, 677 (2016); Charles E. McLure, Jr., *Integration of the Personal and Corporate Income Taxes: The Missing Element in Recent Tax Reform Proposals*, 88 Harv. L. Rev. 532, 537–42 (1975); Robert H. Litzenberger & James C. Van Horne, *Elimination of the Double Taxation of Dividends and Corporate Financial Policy*, 33 J. Fin. 737, 738 (1978); *Integrating the Corporate and Individual Tax Systems: Hearing Before the S. Comm. on Finance*, 114th Cong. 53–57 (2016) (statement of Steven M. Rosenthal, Senior Fellow, Urban-Brookings Tax Policy Center).

3. There are at least two ways to think about the dividend distortion. First, because the shareholder-level tax is only due when dividends are distributed, there is a distortion against distributions in favor of retaining earnings. Second, when shareholders want to realize corporate earnings, the distortion is against making dividend distributions in favor of redemptions or sales of stock because of the difference in basis recovery and (historical) rates. Peroni & Bank, *supra* note 2, at 197–98. Both distortions have been reduced by the reduced tax rate applied to qualified dividend income. I.R.C. § 1(h)(11). U.S. Dep't of the Treasury, *supra* note 2, at vii.

4. The debt-equity distortion results from the differential tax treatment of interest payments on debt and dividend payments on equity. Interest payments are deductible against corporate income, but dividend payments are not deductible. I.R.C. § 163(a); Peroni & Bank, *supra* note 2, at 197. These tax rules encourage corporations to raise capital by issuing debt rather than equity. The tax distortion is the excessive leverage of corporations. The costs are the marginal bankruptcy and insolvency risk for these overleveraged businesses. U.S. Dep't of the Treasury, *supra* note 2, at vii.

proposals to integrate the corporate tax) are judged on the extent to which these costs are reduced or eliminated.[5]

The entity distortion results from the differential tax treatment of corporations and non-corporate entities. The intuition is that in a world without taxes (or perhaps, more accurately, a world without the corporate double tax), each business would choose an organizational form best suited to the endeavor. Undistorted by tax, that decision would optimize features of entity law: how managers are selected, how much discretion managers are given, investor rights, distribution policy, liability rules, etc.[6] There is a rich literature in corporate governance that explores these questions.[7] But the corporate tax can distort this choice. The tax system may encourage entities to employ sub-optimal governance to achieve better tax treatment. The cost is the additional agency, monitoring, or transaction costs incurred by these businesses.[8]

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5. U.S. DEP'T OF THE TREASURY, *supra* note 2, at vii. Integrating the corporate tax would remove the double taxation of corporate income. There are a variety of different proposals. *See* discussion *infra* Parts VI.A-B.

6. Often, this distortion is described from the perspective of the investor–the incentive to invest in noncorporate rather than corporate businesses. U.S. DEP'T OF THE TREASURY, *supra* note 2, at vii; CONG. RSCH. SERV., *supra* note 2, at 1.

7. *See, e.g.*, Zohar Goshen & Richard Squire, *Principal Costs: A New Theory of Corporate Law and Governance*, 117 COLUM. L. REV. 767, 796–810 (2017); Henry Hansmann, *Corporation and Contract*, 8 AM. L. & ECON. 1, 5–9 (2006); Henry Hansmann, Reinier Kraakman & Richard Squire, *Law and the Rise of the Firm*, 119 HARV. L. REV. 1333, 1350–54, 1388–99 (2006); HENRY HANSMANN, THE OWNERSHIP OF ENTERPRISE (1996) [hereinafter OWNERSHIP OF ENTERPRISE].

8. The entity distortion is sometimes described as the distortion between corporate and noncorporate investment. I prefer the phrase "entity distortion" to focus on the effect of the tax system on the joint decision between managers and investors. Managers want to organize their business in a way that will attract capital at the lowest cost. Thus, the investors influence the choice of entity because of their freedom to invest.

Another way to conceptualize the entity distortion is as a distortion against investing in corporate equities in favor of noncorporate investments. This is a key insight of much of the work on corporate tax incidence literature. The corporate tax distorts the allocation of capital across the economy. *See, e.g.,* Arnold C. Harberger, *The Incidence of the Corporation Income Tax*, 70 J. POL. ECON. 215 (1962). Since corporate earnings are subject to a higher level of tax, there is an economy-wide shift of capital from the "corporate sector" to the "noncorporate sector." Although this perspective was once quite persuasive, a few important changes encourage a shift from thinking about capital distortion to reframing the issue as one involving entity distortion.

First, the corporate form provides a lower tax burden for certain investors, including many tax-exempts and foreign investors. Because of clientele

This Article examines the entity distortion, offering a reconsideration that is long overdue. To what extent, if any, does the tax system influence the choice of entity and its governance?

With respect to private companies, the tax system has very little influence on choice of entity. Because of the increasing flexibility of LLCs and the check-the-box regime, governance decisions and tax treatment have become largely delinked. Consider Table 1. The diagonal cells are uninteresting defaults: corporations are taxed as corporations, while non-corporations such as LLCs and partnerships are taxed as passthroughs.

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effects, some investors will be drawn to the corporate form over passthroughs. In the 1960s, taxable domestic investors owned roughly 80% of U.S. corporate equities. Now, that share has dropped dramatically. Steven M. Rosenthal & Theo Burke, *Who Owns U.S. Stock? Foreigners and Rich Americans*, TAX POL'Y. CTR. (Oct. 20, 2020), www.taxpolicycenter.org/taxvox/who-owns-us-stock-foreigners-and-rich-americans (finding that foreign ownership of U.S. corporate stock has increased from less than 5% in 1965 to 40% in 2019 and that tax-exempt ownership has increased from 15% to 35%). Taxable U.S. ownership of corporate equity has fallen from 80% in 1965 to 30% in 2019. *Id.* The tax preferences of the marginal investor are no longer obvious.

Second, there is a growing consensus that the corporate tax is really a tax on excess returns earned by corporations. Laura Power & Austein Frerick, *Have Excess Returns to Corporations Been Increasing Over Time?*, 69 NAT'L TAX J. 831 (2016) (finding that the fraction of the corporate tax based attributable to excess returns has increased to between 60 and 75%); JIM NUNNS, HOW TPC DISTRIBUTES THE CORPORATE INCOME TAX 1 (2012) (attributing 40% of the corporate income tax base to excess returns). If that is true, then any tax on less than 100% of corporate excess returns would have no effect on the allocation of investment. This shift has changed the consensus on who bears the corporate income tax. If one assumes that the corporate tax affects only excess return, then the burden is born primarily by corporate shareholders. JOINT COMM. ON TAX'N, JCX-14-13, MODELING THE DISTRIBUTION OF TAXES ON BUSINESS INCOME, at 4–6 (2013).

Third, it is less and less obvious what is meant by the "corporate sector" and the "noncorporate sectors." Much of the general equilibrium work on corporate tax incidence (and the deadweight loss of the corporate tax) has treated the establishment of businesses as corporate or noncorporate as exogenous with investors then responding to those choices. However, it is more accurate to say that businesses choose an organizational form in tandem with investors. Although the founders of a business directly control its organizational form (i.e., they choose whether to form an LLC or a corporation), the specter of investors and cost of capital influence that decision. Moreover, we observe in almost all sectors, some combination of corporate and noncorporate business forms. This can partially be attributed to a reduction in the differential tax burden of corporations and passthroughs, but it can also be attributed to a growing flexibility in the rules of organizational law described below. The corporate governance literature would proffer that this decision is made to minimize the tax and governance costs. *See infra* Part VI.A.3.

	Corporate Taxation	**Passthrough Taxation**
Corporate Governance	Available as default	Available to the extent that LLC agreements can replicate corporate governance
Partnership Governance	Available, Check-the-Box	Available as default

Table 1: Governance and tax treatment are independent for non-public entities.

But private businesses can easily opt into hybrids—mixing corporate and passthrough features. Because of the check-the-box regime, noncorporate entities can choose to be taxed as corporations.[9] By filing a check-the-box election, any entity can opt into the lower-left cell, combining partnership governance with corporate tax.

Entities can also opt into the upper-right cell—combining passthrough taxation with corporate governance.[10] Modern LLCs have the flexibility to replicate corporate governance, and as non-corporate entities, their default tax treatment is as a passthrough.[11]

For *private* entities, choice of governance and choice of tax treatment are almost entirely independent. To answer the question posed by the title, tax law does not distort governance for private entities; in other words, there is no entity distortion.

But those choices remain deeply entwined for *public* entities. Public entities are generally organized as corporations and subject to the corporate double tax.[12] In Table 2, public entities like Apple, Walmart, or Nike occupy the upper-left cell.

9. Treas. Reg. §§ 301.7701-3(a), (c).

10. In fact, many LLCs adopt corporate governance features including management by an elected board of directors. Bradley T. Borden et al., *It's a Bird, It's a Plane, No, It's a Board-Managed LLC* (March, 23 2017), www.americanbar.org/groups/business_law/resources/business-law-today/2017-march/its-a-bird-its-a-plane/. Courts have applied corporate law doctrines to LLCs that resemble corporations. *See* Obeid v. Hogan, No. 11900-V CL, 2016 WL 3356851, at *6 (Del. Ch. June 10, 2016) ("If the drafters have opted for a manager-managed entity, created a board of directors, and adopted other corporate features, then the parties to the agreement should expect a court to draw on analogies to corporate law.").

11. *See* discussion *infra* Part I.B.

12. I.R.C. § 7704(a).

	Corporate Taxation	**Passthrough Taxation**
Corporate Governance	Available	Available to RICs and REITs
Partnership Governance	Available to LLCs that submit to the corporate tax	Available to MLPs

Table 2: Governance and tax treatment are intertwined for public entities.

But not every public entity is a corporation subject to the corporate tax. Indeed, there are entities that fall into each cell of Table 2. There are public LLCs that are subject to the corporate tax (lower-right cell).[13] The tax law extends passthrough tax treatment to certain special corporations like regulated investment companies (RICs) and real estate investment trusts (REITs) (upper-right cell).[14] Finally, there are certain publicly traded partnerships called master limited partnerships (MLPs) who combine partnership governance and passthrough taxation (lower right cell).[15]

Each cell in Table 2 raises an important question about the interaction between tax and governance for public entities. The relative prevalence of entities in these cells helps us understand the preferred governance and the preferred taxation of public entities. This Article advances a homogeneity hypothesis to explain the observed pattern of entities—public entities prefer homogeneous interests and therefore gravitate toward governance and taxation regimes that reinforce homogeneity amongst investors.

For example, consider the combination of non-corporate governance and corporate tax (the lower-left cell). Why are there so few entities that choose this combination? Why are there so few public LLCs? Their dearth suggests a rejection of the flexible features of an LLC in favor of the relatively rigid governance of a corporation. For a public entity, homogeneity of interests is desirable. Homogeneity reduces administrative

13. I.R.C. § 7704(a) forces most public entities to be *taxed* as corporations, but the tax law does force public entities to *form* as corporations. Thus, a public entity could form as an LLC. As discussed in Part V, however, the tax code does require RICs and REITs to employ particular entities in order to qualify for passthrough treatment under Subchapter M.

14. I.R.C. §§ 851–856.

15. I.R.C. § 7704(a).

costs, helps manage agency and monitoring costs, and increases liquidity of interests.[16] Public entities do not want much of the flexibility offered by LLCs or partnerships. LLCs and partnerships offer disproportionate distributions, special allocations, and the divergent ownership of capital and profits. All of these undermine investor homogeneity. From the perspective of an investor, these LLC "features" flop as bugs.

Others have noted that the homogeneity of shareholder interest makes the corporation a particularly good fit for public entities from a governance perspective.[17] The basic idea is that assigning the residual value of a firm to shareholders (who are relatively homogenous) reduces agency and monitoring costs relative to other potential stakeholders (like employees or customers, who are relatively heterogeneous).[18] But this Article extends that insight from governance to taxation. Tax systems can also encourage or undermine investor homogeneity. The prevalence of tax regimes amongst public entities can be explained by their consistency with investor homogeneity. The corporate double tax reinforces investor homogeneity in a way desirable from a governance perspective.[19] The corporate tax does not stand in the way of public entities. Instead, it empowers corporations by minimizing agency costs. This contrasts with the generally accepted wisdom of corporate tax as a "toll charge" for accessing public markets.[20]

The homogeneity hypothesis also explains the relative success of those special entities that are granted passthrough tax treatment. There are relatively few MLPs that are subject to Subchapter K, but relatively numerous RICs and REITs that are subject to Subchapter M.[21] The extant literature points to the

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16. Ownership of Enterprise, *supra* note 7, at 39–45.

17. Ownership of Enterprise, *supra* note 7. Investor homogeneity has also featured prominently in discussion of the failure of corporate tracking stock. *See infra* Part III.B.

18. Ownership of Enterprise, *supra* note 7.

19. Levmore and Kanda noted that the corporate tax reduces intra-investor agency costs by homogenizing the tax treatment of gain recognized when a business sells assets. *See* Saul Levmore & Hideki Kanda, *Taxes, Agency Costs, and the Price of Incorporation*, 77 Va. L. Rev. 211, 239 (1991).

20. *See, e.g.*, Mihir A. Desai, *A Better Way to Tax U.S. Businesses*, Harv. Bus. Rev. 3 (Jul. 2012) ("corporations effectively pay a toll to be public").

21. Prior to 1986, the top corporate tax rate was 46%, with dividends being taxed at a maximum rate of 50%. The top rate for partnership income for domestic individuals was 50%. However, publicly traded partnerships did not become popular until 1986 when the Tax Reform Act reduced the top

administrative difficulties of applying partnership tax rules to a public entity,[22] but this is only part of the answer. The homogeneity hypothesis offers an explanation rooted in substantive law. Partnership tax requires special allocations of income, gain, and debt that create tax differences between investors. By instituting differing treatment amongst investors, these tax rules exacerbate the agency and monitoring costs of a public partnership. By contrast, RICs and REITs have a simplified approach to passthrough taxation that maintains (and even reinforces) the homogeneity of investor interests.

This Article is organized as follows: Part I explains how check-the-box and modern LLC flexibility permit independent choices of governance and tax treatment for private entities. Part II describes the tax rules applicable to public entities and sets the stage for analyzing public entities that combine different forms of tax and governance. Readers familiar with the tax rules applying to public entities can skip to Part III.

Parts III through V each explore a different combination of tax and governance rules. Part III considers entities that are not organized as corporations but elect to be taxed as corporations. There are very few of these publicly-traded LLCs. Part III argues that their unpopularity results from the poor fit between public entities and LLC flexibility.[23] Part IV considers public entities that are organized and taxed as partnerships. I argue that the

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individual tax rate to 28% and the top corporate rates was reduced to 35%. H. R. Rep. No. 100-391, at 1065 (1987) ("The recent proliferation of publicly traded partnerships has come to the committee's attention. The growth in such partnerships has caused concern about long-term erosion of the corporate tax base."). It was only when the corporate rate was substantially higher than the passthrough rate that the tax distortion was significant enough to tempt publicly traded entities to tolerate passthrough governance. Congress enacted the publicly traded partnership rules only 14 months after the Tax Reform Act of 1986. Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, 101 Stat. 1330-39 (1987). William M. Gentry, *Taxes and Organizational Form: The Rise and Fall of Publicly Traded Partnerships*, 84 Nat'l. Tax Ass'n. 30, 30 (1991) (stating that there were 85 publicly traded partnerships, or PTPs, on the New York and American Stock Exchanges by 1988).

22. John C. Ale, Partnership Law for Securities Practitioners, § 6:30 (2024) (noting the administrative burdens on MLPs include keeping a list of names and addresses for partners and filing an income tax return and delivering a Schedule K-1 to each partner).

23. The failure of corporate tracking stock, a corporate innovation that parallels the special allocations available in LLCs, reflects the same preference for homogeneity over flexibility. *Tracking Stocks*, U.S. Sec. Exch. Comm'n, www.sec.gov/answers/track.htm (last modified Sept. 3, 2004).

weak uptake of these entities is explained by partnership tax rules that result in investor heterogeneity. This heterogeneity is undesirable for publicly traded enterprises. Part V explores entities that combine corporate organization with passthrough tax treatment. These entities have been very successful when the implementation of passthrough taxation maintains investor homogeneity. One such approach is the dividend deduction approach used by RICs and REITs. The homogeneity hypothesis explains the success these investment vehicles and offers guidance in proposals to integrate the corporate tax into a single-level tax on investor income.

Part VI looks more broadly at the interaction between corporate tax distortions and corporate governance issues. The existing literature largely takes a tax-first perspective. The tax discussion of corporate tax has largely ignored agency costs. Meanwhile, the governance literature has taken tax as a baseline—whether management minimizes tax is evidence of management effectively representing investors. I explore an alternative governance-first perspective that reframes agency costs as primary. Doing so spotlights how tax policy can ameliorate or exacerbate governance costs of business entities and emphasizes the importance of an integrated view of tax and governance challenges.

I.
The Weak Link Between Governance and Tax for Private Entities

This Part describes the entity distortion and its costs as well as the rules around entity formation and taxation. Because of changes in tax and entity law, private entities can now effectively choose their governance and tax treatment independently.

A. *What is the Entity Distortion?*

Why does it matter from a non-tax perspective whether a business is organized as a partnership, LLC, a corporation, or some other entity? Most tax discussions simply state that there may be non-tax reasons for preferring one or another entity type without explaining what those considerations are.[24]

24. U.S. Dep't of the Treasury, *supra* note 2, at 1 (1992) ("The current two-tier system of corporate taxation discourages the use of the corporate

Following the corporate governance literature, we will focus on two important categories of agency costs: (1) the cost of controlling managers and (2) the cost of collective decision making.[25]

The cost of controlling managers results from authority being delegated to managers in any large (publicly traded) entity. This is because owners cannot directly make the hundreds of decisions that are required to run a business. This delegation creates two costs: the cost of monitoring the managers and the cost of managerial opportunism.[26] Note that this cost of controlling managers would exist even if all the investors were identical.

The costs associated with collective decision making are the additional costs created by the heterogeneity amongst investors.[27] Generally, collective decisionmaking is implemented by some voting procedure. The potential costs include inefficient outcomes (where the voting mechanism results in a suboptimal decision for the group) and the costs of the voting process itself (e.g., rent-seeking behavior).[28] One of the key insights of the corporate governance literature is that entity choice can minimize these costs.[29]

The entity choice tax distortion occurs when the tax system changes the decision that investors and management would

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form even when incorporation would provide nontax benefits, such as limited liability for the owners, centralized management, free transferability of interests, and continuity of life.").

25. *See* OWNERSHIP OF ENTERPRISE, *supra* note 7, at 35. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976) (discussing how agents and principals will incur bonding and monitoring costs); Jonathan R. Macey, *Corporate Law and Corporate Governance a Contractual Perspective*, 18 J. CORP. L. 185, 186 (1993) ("Now it seems clear that the role of corporate law is to reduce the costs of entering into [a] business relationship . . . ." (alteration in original)); Oliver E. Williamson, *Markets and Hierarchies: Some Elementary Considerations*, 63 AM. ECON. REV. 316, 319–20 (1973) (providing examples of ways to reduce uncertainty about the information asymmetry about the characteristics of an economic agent); Joan MacLeod Heminway, *Rock, Paper, Scissors: Choosing the Right Vehicle for Federal Corporate Governance Initiatives*, 10 FORDHAM J. CORP. & FIN. L. 225, 343–44 (2005) (discussing the costs with implementing new rules).

26. OWNERSHIP OF ENTERPRISE, *supra* note 7, at 36–37.

27. *Id.* at 39–43.

28. *Id.* at 39–43.

29. The transaction cost approach has been used to explain why for example we see cooperatives in the insurance industry, nonprofits in the medical industry, and partnerships in law. OWNERSHIP OF ENTERPRISE, *supra* note 7.

otherwise make regarding the choice of entity. In a world without tax, we assume that investors and managers jointly make the decision that would minimize the aforementioned costs.[30] For example, suppose that investors and managers of an insurance company want to organize as a cooperative to minimize costs.[31] If the tax code taxed cooperatives more heavily than corporations, and this differential burden caused these insurance companies to instead organize as corporations, this would increase the costs of the insurance company.[32] These increased costs from using the "wrong" entity are the entity distortion. The next section explores the extent to which current tax law influences choice of entity.

B. *LLC Flexibility and Check-the-Box*

For private entities, governance and tax treatment have become increasingly independent from one another due to recent innovations in tax and entity law.

For present purposes, the key entity law innovation is the expansion and increasing flexibility of non-corporate entities that are granted limited liability. Perhaps the most important example is the LLC, which allows organizers of a business significant flexibility in setting the governance rules applicable to their entity.[33] Prior to the enactment of LLCs, state law only

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30. Ownership of Enterprise, *supra* note 7; Goshen & Squire, *supra* note 7, at 771–73 (arguing that investors will weigh principal costs and agency costs when deciding how to allocate control between investors and managers); Oliver E. Williamson, *Transaction-Cost Economics: The Governance of Contractual Relations*, 22 J.L. & Econ. 233, 245–46 (1979) ("The criterion for organizing commercial transactions is assumed to be the strictly instrumental one of cost economizing.").

31. Ownership of Enterprise, *supra* note 7, at 149–67.

32. Presumably, the investors and managers are minimizing the aggregate tax, administrative, and agency costs. *See* further discussion *infra* Part I.A.

33. *See* Daniel S. Kleinberger, *Two Decades of "Alternative Entities": From Tax Rationalization Through Alphabet Soup to Contract as Deity*, 14 Fordham J. Corp. & Fin. L. 445, 453 (2009) ("[LLCs] housed a partnership-like capital structure and governance rules within a corporate liability shield." (alteration in original)); *see also id.* at 462–63 (stating that the Delaware LLC Act provided that member's or manager's liabilities could be expanded or restricted in the LLC agreement and that by 2004 statutory amendments to the Act expressly provided that an LLC agreement may eliminate fiduciary duties); Howard M. Friedman, *The Silent LLC Revolution—The Social Cost of Academic Neglect*, 38 Creighton L. Rev. 35, 44 (2004) ("The limited liability company offers the default rules of partnerships along with limited liability.").

granted limited liability to corporations.[34] In 1977, Wyoming was the first to enact an LLC statute, and by 1996, all fifty states had enacted similar statutes. In addition to limited liability, LLC statutes allow for great flexibility in setting the rules that govern the relationship between investors, management, and the business entity.[35] LLCs are sufficiently flexible that an LLC agreement can be drafted to mimic a corporation, a general partnership, or anything in between.[36]

The key tax law innovation is the check-the-box regime, which permits non-corporate entities to choose their tax treatment. Prior to 1996, non-corporate entities were subject to a corporate resemblance test that considered four different criteria: continuity of life, centralized management, limited personal liability, and transferability of interest.[37] The check-the-box regime substantially liberated the tax treatment from choice of entity. For all noncorporate entities with more than one investor, the check-the-box regulations allow the entity to choose to be taxed as a partnership governed by Subchapter K or a corporation governed by Subchapter C.[38] LLCs, general partnerships, limited partnerships, and other non-corporate entities can simply choose their tax treatment.

C. *Governance and Tax are Disentangled for Private Entities*

The increasing flexibility of modern LLCs and the check-the-box regulations have significantly reduced entity distortion, but choice of entity and choice of tax treatment still remain constrained in some ways. The question thus becomes whether these constraints have led to a tax-induced entity distortion. Suppose that every type of business entity could choose its

34. Partial limited liability was available for limited partnerships, but the general partner still retained liability for the debts of the limited partnership.

35. Larry E. Ribstein, *The Uncorporation and Corporate Indeterminacy*, 2009 U. Ill. L. Rev. 131, 152–56 (2009) (analyzing different Chancery court LLC cases and concluding that the courts have emphasized the controlling effect of operating agreements); Larry E. Ribstein, Robert R. Keatinge & Thomas E. Rutledge, Ribstein and Keatinge on Limited Liability Companies § 12:9 (2025) (stating that LLC members for Delaware LLCs have the ability to limit or expand manager's duties in the operating agreement and that Delaware is not alone in giving primacy to contractual interpretation of the rights among members).

36. Ribstein, Keatinge & Rutledge, *supra* note 35.

37. Treas. Reg. § 301.7701-2 (1961).

38. Treas. Reg. § 301.7701-2(a).

tax treatment. For simplicity's sake, assume there are two tax regimes available: corporate double taxation and passthrough taxation. If the legal regime allowed for a universal check-the-box in which one could always choose their tax treatment, there would be no interaction between tax distortions and governance decisions. A new business would be free to choose its governance structure and separately select its tax regime.[39] As such, there would be no entity distortion.

For private entities, this is essentially the case. Most domestic entities—general partnerships, limited partnerships, limited liability partnerships, limited liability limited partnerships, and LLCs—can choose their tax treatment under the check-the-box regime. Thus, the choice of tax regime and the choice of governance structure are explicitly delinked for these entities.

The exception to this electability is the tax treatment of corporations.[40] If organized as a corporation, the business is subject to the corporate double tax unless it satisfies the requirements to be taxed under Subchapter S.[41]

In other words, the tax system minimally distorts entity choice for private entities as they are essentially free to choose their governance structure and their tax regime independently. The only minimal distortion present comes from entities forced to use Subchapter S instead of the more flexible Subchapter K if they want passthrough treatment.[42]

39. Depending on the flexibility of the corporate/entity laws and the tax rules, this non-interaction could extend to midstream decisions as well. If an LLC finds (e.g., as it grows) that the corporate governance structure would be preferable, it could switch to the corporate form without affecting its tax treatment. If a corporation finds that due to changes in the tax code that switching to passthrough taxation would benefit it, it could do so without affecting its governance structure.

40. Treas. Reg. § 301.7701-2(b) lists a number of other entities that are "per-se corporations" including associations, joint-stock companies, joint-stock associations, insurance companies, state-chartered banks, and business entities wholly owned by a state.

41. Corporations that satisfy the requirements for S corporation taxation and elect S corporation status are taxed as passthroughs. To qualify for S corporation taxation, the corporation must have fewer than 100 shareholders, no foreign shareholders, only individuals as shareholders, and only one class of stock. In addition to the restrictions imposed by the S corporation eligibility requirements (e.g., not having foreign investors), S corporation taxation has two major drawbacks relative to Subchapter K partnership taxation: (1) outside basis of investors is not increased by entity-level borrowing—this reduces the ability of S Corp shareholders to claim tax losses, and (2) S corporation tax treatment is inflexible—all tax items must be passed through pro rata.

42. There are two ways to combine corporate governance with passthrough taxation for private companies. First, the entity could organize as an LLC and

Even this mild inconvenience disappears if corporate governance can be replicated by an LLC with an appropriately drafted LLC agreement. In many jurisdictions, LLC statutes allow for flexible governance rules.[43] In most states, the limitations on liability achieved by organizing as an LLC mirrors that of organizing as a corporation.[44] In theory and increasingly in practice,[45] an LLC can replicate corporate governance. Thus, if a non-publicly traded entity wanted to combine partnership taxation and corporate governance, this can be achieved under modern LLC statutes like Delaware's.[46]

	Corporate Taxation	Passthrough Taxation
Corporate Governance	Available, Default Treatment	Subchapter K available to the extent that LLC agreements can replicate corporate governance Subchapter S available if business qualifies as a "small business corporation"
Partnership Governance	Available, Check-the-Box	Available, Default Treatment

Table 1B: For non-public entities, governance and tax treatment are largely independent.

II.
Governance and Tax Entanglement for Public Entities

The previous Part explains that there is effectively no entity distortion for private entities, but the same is not true for public businesses. This Part lays out the basic tax rules governing public entities and demonstrates how their governance and tax treatment remain deeply intertwined.

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adopt corporate-like governance. That entity would be taxed as a partnership subject to Subchapter K. Second, the entity could organize as corporation and elect to be taxed under Subchapter S. There are several restrictions on this second route. In order to qualify for the Subchapter S election, the corporation must have no more than 100 shareholders and none of those shareholders can be foreigners or (with a few exceptions) entities.

43. Larry E. Ribstein, *The Emergence of the Limited Liability Company*, 51 Bus. Law. 1 (1995).

44. *Id.*

45. *See* Ribstein, Keatinge & Rutledge, *supra* note 35.

46. *Id.*

Generally, public entities are subject to the corporate double tax.[47] This tax rule dictates a *tax* treatment but does not require that public entities be *organized* as corporations. An LLC or a partnership will be taxed as a corporation if its interests become publicly traded.[48]

There are two important exceptions to this general rule, both of which involve public entities that are granted passthrough tax treatment. The first exception is for MLPs, a publicly-traded partnership that must satisfy a number of eligibility rules, including having income that is at least 90% "qualifying income" such as interest, rent, dividends, and other passive income.[49] MLPs are permitted to be taxed as partnerships under Subchapter K even though their interests are publicly traded.[50]

The second exception involves a class of investment vehicles—REITs and RICs—that are taxed under Subchapter M. REITs are corporations or trusts that invest primarily in real estate assets and earn mostly real estate income.[51] In contrast, RICs are corporations that passively own securities in other businesses.[52] REITs and RICs are both subject to a special tax regime under Subchapter M. They must distribute at least 90% of their net income as dividends each year but are permitted a special dividends-paid deduction. Because of this deduction, a REIT or RIC that pays 100% of its earnings in dividends avoids the corporate double tax. Shareholders that receive dividends from a REIT or RIC are instead taxed directly and at ordinary income tax rates.

47. The corporate double tax has been quite accurately referred to as a toll charge for accessing public capital markets. A partnership is publicly traded if its interests are "traded on an established securities market" or if its interests are "readily tradable on secondary market." I.R.C. § 7704(b).

48. I.R.C. § 7704(a)-(b). For tax purposes, the owners of the LLC or partnership will be treated as contributing their interests to a newly formed corporation in exchange for corporate shares. This transfer will usually not result in the recognition of gain because of § 351.

49. *Id.* § 7704(c), (d).

50. Suren Gomtsian, *The Governance of Publicly Traded Limited Liability Companies*, 40 DEL. J. CORP. L. 207, 218–19 (2015) (finding 20 publicly traded U.S. LLCs as of December 2012).

51. I.R.C. § 856(c).

52. I.R.C. § 851(b).

	Corporate Taxation	**Passthrough Taxation**
Corporate Governance	Available	Available to RICs and REITs
Partnership Governance	Available to LLCs that submit to the corporate tax	Available to MLPs

Table 2: Governance and tax treatment are intertwined for public entities.

Table 2 shows the possible combinations of tax treatment and governance of business entities. The following Parts each explore a cell of Table 2. Part III explores the lower-left cell and asks why public entities subject to the corporate tax have not embraced LLC flexibility. Part IV explores the lower-right cell and explains why partnership taxation, contrary to popular belief, partnership taxation has held MLPs back. Part V explores the upper-right cell and explains why Subchapter M is superior to Subchapter K in achieving passthrough taxation for public entities. Together, these Parts underscore the thesis of this Article—investor homogeneity trumps flexibility for public businesses.

III.
Why Are There So Few Public LLCs?

This Part tackles a governance puzzle. The tax code forces public entities to be *taxed* as corporations but does not require them to *organize* as corporations. In practice, however, businesses that were previously organized as LLCs or limited partnerships typically convert to corporations when they go public. For example, after the 2017 Tax Cuts and Jobs Act ("TCJA") reduced the corporate tax rate to 21% from 35%, Ares and KKR, two large hedge funds that were previously *not* organized as corporations, decided to embrace corporate taxation.[53] In making the switch,

53. They made the change in part because the corporate rate cut meant a lower effective rate for their businesses. Melissa Mittelman, *Ares Becomes Litmus Test for Buyout Firms Mulling Tax Change*, Bloomberg: Markets (Feb. 15, 2018), www.bloomberg.com/news/articles/2018-02-15/ares-switches-to-corporation-from-partnership-after-tax-overhaul?embedded-checkout=true.; Joshua Franklin, *Private Equity Firm KKR Opts to Become C-Corp after U.S. Tax Reform*, Reuters (May 3, 2018), www.reuters.com/article/us-kkr-results/private-equity-firm-kkr-opts-to-become-c-corp-after-u-s-tax-reform-idUSKBN1I4164; Kevin S. Kim, *Private Equity Firms Converting to C-Corp with Huge*

both Ares and KKR also converted into corporations for governance purposes.[54] They did not have to do so, as they could have maintained their previous non-corporate structures and simply "checked-the-box" to be taxed as corporations.[55]

There are very few public LLCs taxed as corporations.[56] This rarity is striking—especially when contrasted against the millions of private enterprises organized as LLCs—and it prompts the question of why there are so few public LLCs.[57]

One explanation is inertia—many public entities were organized at a time before LLCs existed.[58] Another explanation is familiarity—corporate law has developed over centuries, and LLC law has only recently caught up.[59] But these are only partial explanations for the LLCs lack of progress in the public domain.

Upside, FORTRA LAW (Sept. 23, 2019), fortralaw.com/private-equity-firms-converting-to-c-corp-with-huge-upside/.

54. *See* Kim, *supra* note 53. (stating that some of the benefits of switching to a corporation for Apollo and KKR included an increased share price resulting from a larger pool of potential shareholders, index eligibility, and fewer complexities surrounding tax reporting).

55. Prior to converting to C corporations, Ares was organized as an LLC, and KKR was organized as a limited partnership. Mary Childs, *Ares Becomes First PE Firm to Convert to C. Corp.,* BARRON'S, Feb. 15. 2018, www.barrons.com/articles/ares-becomes-first-pe-firm-to-convert-to-c-corp-1518724908/; Franklin, *supra* note 53.

56. As of our survey in January 2024, there were only five public LLCs that are taxed as corporations: Enlink Midstream LLC, Kaanapali Land LLC. Five Point Holdings LLC, Grayscale Digital Large Cap Fund LLC, and Compass Diversified Holdings LLC. *See* Enlink Midstream LLC, Annual Report (Form 10-K), at 42 (Feb. 15, 2022); Kaanapali Land LLC, Annual Report (Form 10-K), at 4 (Apr. 11, 2023); Five Point Holdings LLC, Annual Report (Form 10-K), at 2 (Mar. 6, 2023); Grayscale Digital Large Cap Fund LLC, Annual Report (Form 10-K), at 51 (Sept. 1, 2023); Compass Diversified Holdings, Annual Report (Form 10-K), at 22 (Mar. 1, 2023). At the time, there were no public partnerships taxed as corporations.

57. *See* I.R.S., *Partnership Returns, 2022,* www.irs.gov/statistics/soi-tax-stats-partnership-statistics; I.R.S., *S.O.I. Tax Stats—Partnership Statistics by Entity Type,* www.irs.gov/statistics/soi-tax-stats-partnership-statistics-by-entity-type (for tax year 2020-2021, there were over 3.2 million limited liability companies filing tax returns, which accounted for over 76% of all partnerships).

58. Interestingly, the number of public firms has shrunk since the advent of LLCs. From 1976 to 2016, the number of firms publicly-listed on U.S. exchanges shrank from 4,943 to 3,627. RENE M. STULZ, THE SHRINKING UNIVERSE OF PUBLIC FIRMS: FACTS, CAUSES, AND CONSEQUENCES, www.nber.org/reporter/2018number2/shrinking-universe-public-firms-facts-causes-and-consequences?page=1&perPage=50.

59. Even if it is possible to replicate a corporation with an LLC, perhaps it is more costly to do so. The corporate form provides a familiar option. This is a transaction cost argument. Such transactions costs should decrease over

At this point, an alternative *substantive* law hypothesis comes into view—that the very flexibility of LLCs makes them ill-suited for public enterprises. LLCs and partnerships provide flexibility along three dimensions that contrast with the rigidity of the corporate form: dividends can be paid disproportionately, income can be specially allocated (i.e., the income from a line of business or a piece of real estate can be allocated to a particular investor), and rights on liquidation do not have to match rights to current earnings. Each of these features of LLCs undermines the homogeneity of shareholder interest and increases administrative, agency, and monitoring costs.

Recall that one category of agency costs is the cost of collective decision making.[60] That cost is reduced the more homogeneous the investors are in a public enterprise.[61] From the investor perspective, homogeneity reduces agency and monitoring costs. A small investor can generally reduce time and resources spent ensuring that it is being treated fairly relative to other investors if those interests are homogeneous. A small investor can, in theory, free ride on the monitoring of management by larger shareholders, but only if they have the same economic interests. Homogeneity of shareholders also minimizes the agency costs that arise when managers serve different constituencies.

The flexibility of LLCs increases these administrative, agency, and monitoring costs relative to corporate rigidity. These costs can be overcome in private entities with fewer investors. In fact, this flexibility may add value for private entities with fewer investors. For public entities, however, the flexibility of LLC rules is ill-suited, helping explain why new public entities have not adopted the LLC form even as the LLC law has become more fully developed.

A. *Disproportionate Distributions and Rights to Demand Distributions*

In a corporation, dividends are paid when declared by the board of directors.[62] The board of directors has substantial

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time if there was demand for corporation-like LLC entities. But transaction costs may still be substantial in this area of business law.

60. *See supra* notes 27–30 and accompanying text.

61. Ownership of Enterprise, *supra* note 7, at 39–44.

62. Geeyoung Min, *Governance by Dividends*, 107 Iowa L. Rev. 117, 124–25 (2021).

discretion in declaring dividends,[63] but corporate law requires that dividends be paid to all shareholders proportionately.[64] This requirement protects small investors. If a majority shareholder receives a dividend, the owner of a single share receives the same pro rata dividend. This parity affects not just the amount but also the timing of the distribution.

By contrast, unless explicitly specified in their organizational documents, LLCs and partnerships are not required to make simultaneous pro rata distributions. Rather, in most LLCs and partnerships, the entity separately tracks the economic interests of each partner in what is called a "capital account."[65]

A simple example can help illuminate how different LLCs and partnerships are from corporations. In a 50/50 partnership where all tax items are allocated equally, Partner A can receive a distribution even if Partner B does not. Thus, if Partner A were to receive a $100 distribution, there is nothing in partnership or LLC law that prevents Partner B from receiving $0.[66] This differential would simply be reflected in a $100 difference in the capital accounts of A and B going forward. In some future distribution (or on liquidation), Partner B will receive $100 more than Partner A.

In small partnerships, disproportionate distributions are administratively easy to keep track of and do not create insuperable monitoring costs. In the above example, it is relatively easy for Partner B to monitor whether the $100 distribution to Partner A will create a liquidity or other issue. These issues become much more pressing as the number of shareholders increases and ownership becomes dispersed. Thus, the flexibility to pay

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63. *Id.*; Dodge v. Ford Motor Co., 170 N.W. 668, 682 (Mich. 1919) ("The board of directors declare the dividends, and it is for the directors, and not the stockholders, to determine whether or not a dividend shall be declared.") (internal quotations omitted).

64. *See, e.g.,* DEL. CODE ANN. tit. 8, § 170 (1975); N.Y. CODE BUS. CORP. LAW § 510(a) (1963); *see also* Victor Brudney, *Equal Treatment of Shareholders in Corporate Distributions and Reorganizations*, 71 CAL. L. REV. 1072, 1076–77 (1983). Corporate law does permit the shareholders to be given a choice (e.g., between stock and cash dividends) but requires that all shareholders be given the same opportunity to choose. *Id.*

65. I.R.C. § 704(a). The capital accounts keep track of what each partner would be entitled to if all assets were sold at book value and distributed. Treas. Reg. § 1.704-1(b)(2)(iv) (1960).

66. Of course the partnership or LLC agreement could provide that disproportionate distributions are not allowed.

disproportionate distributions could be perceived by many investors as a negative for public enterprises.

Are there any analogues to disproportionate distributions in corporations? The closest is probably the issuance of a dividend that allows shareholders to elect to receive cash or an equivalent value of stock.[67] Superficially, this is similar to a disproportionate distribution in a partnership because some shareholders receive cash while others do not. However, the important difference is that the shareholders who elect to receive stock increase their proportionate ownership of the corporation, and all the shareholders who elect to receive cash decrease their percentage ownership of the corporation.[68] In comparison, disproportionate distribution in a partnership can be made independent of a change in the allocation of economic and tax items going forward.

Disproportionate distributions also undermine liquidity of LLC interests. Because corporate shares are interchangeable and offer a set of fixed rights, potential buyers need not perform much investigation before purchasing. In contrast, the very flexibility of LLC and partnership interests makes them much more difficult to purchase. Returning to our earlier example, consider an equal partnership in which Partner A has received more distributions than Partner B. The capital account of Partner A would be lower than that of Partner B to reflect the previously paid distributions. The purchase price of Partner A's interest would be lower than that of Partner B's interest.

Another inflexible feature of corporate distributions is that they are paid at the discretion of management. Shareholders

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67. Often the stock election is offered at a slight premium to encourage investors to reinvest their dividends.

68. The simplicity of corporate taxation results in some unfortunate inaccuracies in double taxation. For example, the concept of earnings and profits ("E&P") keeps track of earnings to ensure that only distributions attributable to earnings are taxed again at the shareholder level. The concept of E&P is not specific to each shareholder. Consider a corporation that has earned $1 million of E&P prior to the purchase of stock by a new shareholder. The price that the new shareholder pays should reflect the previous E&P. And yet, if a distribution is made by the corporation the day after the new shareholder purchases the stock, the new shareholder will still pay tax on the dividend even though they were not a shareholder during the time when the E&P were earned. This is in contrast to capital accounts, which are kept separately for each partner. For additional discussion of E&P affecting distributions, see Robert Charles Clark, *The Morphogenesis of Subchapter C: An Essay in Statutory Evolution and Reform*, 87 Yale L. J. 90, 100–04 (1977).

in a corporation are generally unable to force distributions.[69] LLCs and partnerships offer much greater flexibility to set distribution rules. In fact, many LLC agreements give investors the right to demand distributions (and the default rule for many partnerships is that partners can withdraw their entire capital at will).[70]

What would an investor want? Because capital accounts keep track of each investor's investment separately, many non-corporate entities also give their owners substantial power to demand distributions.[71] This power might initially sound good to an investor. However, on further reflection, an investor might accept a limitation on their own power to demand dividends in order to apply the same limitation on all other shareholders. If other investors could demand their capital at any time, that would raise the risk of bank-run cascades of distributions and increase insolvency risk. Scholars have argued that one of the key advantages of the corporate form relative to partnerships is capital lock-in: the ability to commit capital to an enterprise without giving investors the right to withdraw, which is particularly important for certain types of investments requiring substantial outlays of capital.[72]

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69. *See, e.g.*, Dodge v. Ford Motor Co., 170 N.W. 668 (Mich. 1919) (explaining the discretion of corporations in making distributions).

70. For example, many partnership and LLC agreements provide for mandatory tax distributions. Since partners are liable for taxes on the income allocated to them from the partnership, most partnership agreements provide that distributions will be paid annually. A typical arrangement will distribute an amount equal to the product of the net income allocated to the partner and an estimated tax rate, often the top marginal tax rate applicable to the partner. Practice Point: Even in a wholly domestic context, partnership agreements often provide for quarterly "tax distributions" during the course of a taxable year in an amount calculated to enable the partners to pay their estimated taxes. Kimberly Blanchard, Bloomberg BNA Portfolio 6680-1st*: Partners and Partnerships—International Tax Aspects*, ¶V.

71. The default rule for Delaware limited partnerships and limited liability companies is that investors can withdraw their capital. *See* DEL. CODE ANN. tit. 6, § 18-606 (West 2025); DEL. CODE ANN. tit. 6, § 17-606 (West 2024). By contrast, in Delaware corporations, shareholders cannot force the corporation to pay dividends. *See* DEL. CODE ANN. tit. 8, § 170(a) (West 2025).

72. A paradigmatic example is the construction of railroad tracks. *See* Steven A. Bank, *A Capital Lock-in Theory of the Corporate Income Tax*, 94 GEO. L.J. 889, 908–09 (2006); *see also* Margaret M. Blair, *Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century*, 51 UCLA L. REV. 387, 442 (2003) (stating that railroads needed to amass capital and required capital lock-in resulting from incorporation).

For distributions by a public enterprise, flexibility in making disproportionate distributions and investor rights in demanding distributions are both arguably undesirable. Therefore, the flexibility of the LLC form offers no advantages to a public enterprise.

B. *Special Allocations—Whatever Happened to Tracking Stock?*

LLC and partnership law allow for incredible flexibility in how tax items—income, gains, losses, deductions, and credits—are allocated.[73] For example, a partnership agreement can allocate income and deductions differently for different sources of income. By way of illustration, consider a real estate partnership that owns among other properties, two pieces of real estate: AppleAcre and BroccoliAcre. Because Partner A will have primary responsibility for managing AppleAcre and Partner B will have primary responsibility for managing Broccoli Acre, the partners agree to allocate the income from AppleAcre 80/20 to Partner A and the income from BroccoliAcre 80/20 in favor of Partner B.[74] A partnership agreement can also allocate different types of tax items differently. Thus, the same partnership could allocate all rental income 50/50 but allocate 100% of the depreciation deductions to Partner A and 0% to Partner B. This flexibility is touted as one of the advantages of partnerships and limited liability companies, and the desire to respect this flexibility is reflected in the drafting of Subchapter K.[75]

But do public enterprises and their investors want the flexibility to make special allocations? The failure of tracking stock suggests that the answer is no. Tracking stock is a special form of corporate equity designed to track the performance of

73. *See* I.R.C. § 704(a) (giving the partnership agreement the ability to allocate tax items so long as the allocation has "substantial economic effect" under §704(b)(2)); *see also* Robert R. Pluth, *Tax Allocations in Limited Liability Companies*, 23 TAX'N FOR LAW. 59, 60 (1994).

74. I.R.C. § 704(a). This freedom to allocate tax items is limited by the "substantial economic effect" doctrine. I.R.C. § 704(b). An allocation has "economic effect" if it affects the amount that a partner will receive on liquidation of the partnership. That economic effect of an allocation is "substantial" if it has a non-tax effect on the amount that the partner is entitled to. Treas. Reg. 1.704-1(b)(2).

75. I.R.C. § 704(a) ("a partner's distributive share of income, gain, loss, deduction, or credit shall . . . be determined by the partnership agreement").

a division or segment of the corporation.[76] The tracking stock trades separately from the traditional common stock of the corporation. Dividends on the tracking stock are tied to the performance of the tracked division or segment.[77] First issued by General Motors in 1984, the 1990s and 2000s saw sporadic issuances of tracking stock, but the experiment was abandoned as a failure.[78]

Tracking stock offered many of the benefits of special allocations in LLCs. Investors could fine-tune their investment in companies.[79] Managers could be compensated with tracking stock that reflected a particular business segment rather than an entire conglomerate.[80] But studies found that tracking stock did not do appreciably better than benchmark portfolio returns, nor did it result in a boost to the performance of the parent company stock.[81] Studies have found that the retirement of tracking stock is associated with a positive price reaction for the parent stock.[82] Unsurprisingly, companies that have abandoned tracking stock pointed to the agency costs and internal accounting issues that tracking stock creates.[83]

Tracking stock is similar to special allocations of income for LLCs. Tracking stock allowed the income from particular lines

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76. *Tracking Stocks*, U.S. SEC. EXCH. COMM'N, www.sec.gov/answers/track.htm (last modified Sept. 3, 2004).

77. *Id.*

78. The last major issuance of tracking stock was AT&T's issuance of tracking stock that was tied to its wireless business. Travis Davidson & Joel Harper, *Off Track: The Disappearance of Tracking Stocks*, 26 J. APPLIED CORP. FIN. 98 (2014); Anand M. Vijh & Matthew T. Billett (Feb. 2001), *The Market Performance of Tracking Stocks*, papers.ssrn.com/sol3/papers.cfm?abstract_id=229549.

79. Joel T. Harper & Jeff Madura, *Sources of Hidden Value and Risk within Tracking Stock*, 31 FIN. MGMT. 91, 93 (2002).

80. Russ Banham, *Track Stars*, J. ACCOUNTANCY (July 1, 1999), www.journalofaccountancy.com/issues/1999/jul/banham.html.

81. Matthew J. Clayton & Yiming Qian, *Wealth Gains from Tracking Stock: Long-Run Performance and Ex-Date Returns*, 33 FIN. MGMT. 83, 84 (2004).

82. Davidson & Harper, *supra* note 79, at 98.

83. Edward M. Iacobucci & George G. Triantis, *Economic and Legal Boundaries of Firms*, 93 VA. L. REV. 515, 542–43 (2007) (stating that a corporation's legal personality prevents tracking stockholders from holding residual claims against the tracked portion of the company and that corporations are constrained in addressing conflicts of interest between classes of tracking stock); *see also* Palash R. Ghosh, *Tracking Stocks Are Now Relics*, WALL ST. J. (Jan. 9, 2008), www.wsj.com/articles/SB119985406966877497 (noting the costs associated with keeping multiple sets of financial statements and the costs associated with the conflicts of interest inherent in tracking stocks).

of business to be specifically allocated to particular investors. Like special allocations in LLCs, tracking stock economic rights were often divorced from voting power and rights on liquidation. The failed experiments with tracking stock suggest that special allocations might encounter similar problems for public entities. Special allocations are another form of LLC flexibility that undermine shareholder homogeneity and exacerbate agency, monitoring, and administrative costs.

C. *Divergence of Economic Rights*

Another key example of LLC flexibility is the profits interest. Conceptually, a profits interest is an interest in the LLC's future earnings and is commonly used in private equity and hedge funds.[84] There are several reasons funds prefer the profits interest to other types of equity compensation. First, as a profits interest is not retrospective, it is better than both vested and unvested corporate stock because it does not confer a share of the existing capital to employees. Second, because it is tied to earnings rather than the firm's overall prospects and does not depend on stock market fluctuations, a profits interest is superior to an option.[85] Lastly, a profits interest is superior to a bonus because it is less discretionary and more closely aligned with the performance of the relevant division or business segment.

The widespread deployment of profits interests in LLCs raises the question as to why similar devices are not used in corporations. For the sake of parallel terminology, let's call it a "profits stock." The technical challenge with a profits stock is that it is difficult to account for changes in the liquidation rights. By definition, on the issuance date, the profits stock would not get a share of the liquidation proceeds of the corporation. But this will not remain true as the corporation earns income, assets increase and decrease in value, and distributions are paid. There are two potential solutions: (1) the corporation

84. Rev. Proc. 93-27 defines a capital interest as an interest that would give the holder a share of the proceeds if the assets of the partnership were sold at fair market value on the date of grant and the partnership were liquidated. A profits interest is an interest that would give the holder nothing in the same hypothetical liquidation. Rev. Proc 93-27, 1993-24 I.R.B. 63.

85. Moreover, when combined with special allocations, profits interests can be based on the earnings of the particular segment or division to which the employee contributes.

could commit itself to paying distributions on the profits stock each year to keep the liquidation value of the profits stock at zero, or (2) the corporation could keep track of the liquidation value of the profits stock for any earned but undistributed earnings.[86] The latter approach would perhaps be workable if all of the profits interests were granted at the same time. But more likely, profits interests would be granted at various times, making the tracking of liquidation value of profits interest look more and more like the capital accounts of partnerships and LLCs. However, these are administrative challenges that seems superable if the instrument were otherwise desirable.

Why then do we not observe profits stock? The answer may be the agency costs that plagued tracking stock. Tracking stock creates heterogeneity among shareholders, as those who own generic shares will have different preferences from owners of tracking stock that track a specific business segment. For example, consider AT&T's issuance of stock designed to track its wireless business. The potential conflicts were rife. Owners of the tracking stock would be keen to see AT&T invest more capital in the wireless business, while owners of common stock would rather management invest its capital in a way that maximizes overall returns. To the extent that AT&T wireless provided or received good or services from the rest of the business, transfer pricing becomes important to properly account for the profits of each segment.

Profits stock would create similar agency costs by creating heterogeneity amongst owners of stock. Tracking stock created business-line heterogeneity between investors in the parent stock and investors in the tracking stock. Issuing profits stock would create temporal heterogeneity between owners of capital stock and profits stock. There would be greatly divergent incentives between the capital stockholders and the profits stockholders regarding maximizing short-term returns and long-term profitability. To see this divergence most clearly consider the example of liquidation. On the date of issuance, liquidation would result in profits stock holders receiving nothing and capital stock holders receiving everything!

Agency costs abound more generally between common shareholders and profits shareholders. By way of example,

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86. This latter approach would be akin to a capital account for all of the holders of profits stock.

picture a common shareholder who owns 50% of corporate earnings but 100% of the corporation's existing capital. Meanwhile, a profits shareholder only owns 50% of corporate earnings. Such a profits shareholder would have a very different risk profile than the common shareholder. Taking on large amounts of debt or engaging in speculative investments would be desirable for the profits shareholder because they are shielded from downside risk, while they would share equally in any profits that those risky investments generated.

D. *Conclusion*

LLC law offers substantially greater freedom for business entities. Given this flexibility, an LLC could combine the desirable features of a corporation with other LLC features that are unavailable for corporations. Why do so few public entities embrace that freedom? The answer is that the flexibility of LLCs is a bad fit for most public entities. The basic corporation has a package of governance features that are generally desirable for most public entities. While it is possible to replicate the corporation by drafting an appropriate LLC, forming a corporation is a commitment device to stay within the narrow boundaries that ensure shareholder homogeneity.

The absurdity of LLC flexibility can perhaps be seen most starkly by translating LLC rules to a public corporation. Consider a public corporation with two classes of common shareholders, Class A and Class B. Class A and Class B each own 50% of the shares. But Class A and Class B do not receive distributions at the same time. If Class A receives a distribution that Class B does not, the corporation makes a note of that disparity and promises to correct that disparity in the future. Alternatively, suppose that Class A gets dividends based on the return to one line of business and Class B gets dividends based on the return to a different business. Or suppose that Class A gets the same dividends as Class B but on liquidation, Class A gets 100% of the net proceeds after assets are sold and debts are paid. As the arrangement becomes more flexible and complicated, it becomes more difficult to say that Class A and Class B each own

50% of the corporation.[87] What does 50/50 mean if there are special allocation rules and disproportionate distributions?[88]

These special allocations and special distributions have a secondary effect for voting rights and governance. If there are disproportionate distributions and special allocations, how should voting rights be allocated? Again, the LLC and partnership entity forms provide a great deal of flexibility in assigning voting rights, so the answer will be whatever the specific language of the LLC or partnership agreement entails. Public companies do not need more flexibility around voting rights. Like the flexibility around allocating economic rights, public companies do not need flexibility around voting rights! The agency costs created by high vote/low vote stock have been extensively studied in the corporate governance literature.[89]

Why have publicly traded LLCs struggled to gain traction? While LLCs offer flexibility in voting and economic arrangements, that very flexibility tends to raise agency and monitoring costs in the public company context. When public corporations have experimented with LLC-style features—such as dual-class stock or tracking stock—the results have generally been poor.

IV.
Public Entities Don't Choose Partnership Taxation Even When They Can

Part III confronted a governance question: public businesses organize as corporations even when they aren't required

87. Subchapter S offers a much less flexible version of passthrough taxation. One of the requirements of Subchapter S is that there be only class of stock. I.R.C. § 1361(b)(1)(D). All tax items must be passed through proportionately to S corporation shareholders. I.R.C. § 1366(a)(1).

88. This is a problem encountered in the Section 704(b) rules. In order for an allocation to be respected, the allocation must have substantial economic effect. This is a two-prong requirement. First, the allocation must have economic effect (which means that the tax allocation must also affect the economic entitlement of the partners). Second, the allocation must be "substantial" which means that it has some affect other than tax reduction. If an allocation does not have substantial economic effect, then Section 704(b) cryptically provides that the item will be allocated "in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances)." I.R.C. § 704(b); Treas. Reg. § 1.704-1(b)(2).

89. Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law,* 26 J. L. Econ. 395, 408–09 (1983); Benjamin J. Barocas, *The Corporate Practice of Gerrymandering the Voting Rights of Common Stockholders and the Case for Measured Reform*, 167 U. Pa. L. Rev. 497, 517–18 (2019).

to. This Part asks a related tax question. Public partnerships can be taxed as partnerships under Subchapter K if nearly all of their income is from passive sources.[90] Why, then, are there not more MLPs?[91]

The traditional explanation is that Subchapter K creates a substantial administrative burden—passthrough taxation is difficult when there are many partners. Subchapter K requires each partner to report their allocable share of income, deductions, gain, loss, and credit.[92] For example, partnerships separately report long-term capital gains, short-term capital gains, and qualified dividends.[93] What's more, the requisite Schedule K-1's are complicated.[94] These challenges are exacerbated with public trading if investors are trading stock rapidly. Consider a hedge fund that owns public stock for a fraction of a second.[95] Under Subchapter C, the business is indifferent to this fractional ownership and it does not create any reporting requirements.[96] In contrast, under Subchapter K, this fractional ownership creates a reporting obligation for the business: it must allocate a fraction of all taxable items to the hedge fund.[97]

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90. I.R.C. § 7704(c)–(d). To qualify as an MLP, at least 90% of the partnership's gross income must be "qualifying income", which includes interest, dividends, rents, and income from oil and gas assets.

91. There are only 57 MLPs. *2025 MLP List: Yields up to 10.1%*, Sure Dividend (July 25, 2025), www.suredividend.com/mlp-list/. There are about 3,700 publicly traded companies, so MLPs make up about 1.7% of listed companies. The aggregate market capitalization of MLPs is roughly $300 billion. *Id.* SIFMA estimates the overall equities market in the U.S. at around $50 trillion, which means that MLPs are less than a percent of U.S. equities. Securities Industry and Financial Markets Ass'n, Quarterly Report: US Equity and Related Markets, 4Q23, at 4 (2023).

92. I.R.C. § 702.

93. I.R.C. § 702(a)(1)–(3).

94. Internal Revenue Serv., U.S. Dep't of the Treasury, Partner's Instructions for Schedule K-1 (Form 1065) (Jan. 16, 2025), www.irs.gov/pub/irs-pdf/i1065sk1.pdf.

95. For example, high-frequency trading hedge funds employe algorithms to execute trades in milliseconds and often hold stock for mere minutes. *See* Bryan Urstadt, *Trading Shares in Milliseconds*, MIT Technology Review (December 21, 2009), www.technologyreview.com/2009/12/21/207034/trading-shares-in-milliseconds/.

96. With respect to dividends, a corporation must report to the IRS the identity of the recipient and the amount of the dividend. I.R.C. §6042(a). In order to fulfill this obligation, the corporation must know its shareholders on the record date of distributions.

97. The corporation's information reporting obligation to shareholders is limited to the reporting of dividends. I.R.C. §6042(a). Under Subchapter C, the corporation is responsible for taking snapshots of its shareholders on the

While perhaps definitive at one point, this administrative explanation is partial at best, given that entity ownership for public entities is now tracked electronically. Thus, this Part offers an alternative explanation rooted in the substantive law of partnership tax. Subchapter K is a poor fit for public entities because the rules required to ensure accuracy and avoid loss shifting also fundamentally undermine investor homogeneity.

A. *Subchapter K Undermines Investor Homogeneity*

Subchapter K increases potential conflicts between investors. This is true even if the entity declines to adopt any of the flexible LLC features described in Part III. Suppose an entity's organizational documents require all distributions and tax allocations to be made strictly pro rata, with no profits interests issued. While this structure avoids certain forms of heterogeneity, tax-related differences among investors remain unavoidable.

The partnership tax rules impose mandatory investor heterogeneity for many of the most basic partnership transactions—when assets are contributed, partnership interests are sold, or when new partners are admitted. No matter how hard a partnership commits itself to maintaining investor homogeneity, investor heterogeneity is inevitable.

1. *Contributing Assets to a Partnership*

Businesses are often capitalized through the contribution of non-cash assets by owners. This can include real estate, intellectual property, and machinery or other equipment. Section 704(c) mandates that any built-in gain or loss at the time of contribution be taxed to the contributing partner when that asset

record date of distributions, see I.R.C. §§ 301(a), 316(a), but the corporation is not otherwise required to keep track of who owns shares for how long. Ale, *supra* note 22, at 1. (noting the administrative burdens on MLPs include keeping a list of names and addresses for partners and filing an income tax return and delivering a Schedule K-1 to each partner). *See* I.R.C. § 706(d), Treas. Reg. § 1.706-4.

is sold.[98] This is a mandatory rule that can only be imperfectly contracted around.[99]

Because of Section 704(c), the contributing partner has very different preferences with respect to the property than all other partners. A contributing partner will often prefer that an asset be retained, even to the point of rejecting purchase offers at a substantial premium. To illustrate, suppose Partner A contributes land to a business in exchange for a 10% partnership interest. Their cost basis is $750,000, and the fair market value of the property is $1 million. Partner A will be worse off if the property is sold for anything less than $1.625 million.[100] If a potential buyer offered to buy the property at a half-million dollar surplus, Partner A would balk while their fellow investors would be thrilled. That conflict of interest only grows as Partner A's percentage ownership decreases. If Partner A owns 1% of the partnership, they will oppose any sale for less than $7.25 million. The intuition is that Partner A gets only a fraction of the surplus from the sale but must bear the entire tax burden for pre-contribution gain. Thus, for a public entity, in which investors own a mere fraction of a percent, the investor heterogeneity introduced by Section 704(c) creates substantial conflicts of interest and agency costs.

98. I.R.C. § 704(c). The partnership tax rules also require that depreciation deductions be allocated in a complex manner to take into account the contributing partner's pre-contribution gain or loss. The regulations describe three different ways in which depreciation deductions from contributed property can be allocated. Treas. Reg. 1.704-3(b)(2) Ex. 1 (the traditional method), (c)(4) Ex. 1 (the traditional method with curative allocations) (d)(7) Ex. 1 (remedial allocation method).

99. Jason S. Oh & Andrew Verstein, *A Theory of the REIT*, 133 YALE L.J. 755 (2024). It is theoretically possible to align the interests of cash and property contributing investors by promising to make the property contributor "whole" in the case the Section 704(c) tax liability is triggered. Should the property contributor be compensated for the entire tax liability or just the value of deferral? If the former, should the property contributor be compensated for the tax consequences of the distribution. If the latter, how much deferral should the contributor be entitled to? If the contributor is only compensated for the value of deferral, substantial heterogeneity will remain between the interests of the contributor and other investors.

100. Assuming that Partner A is in the top marginal tax bracket, the sale will trigger a capital gains tax of $50,000 for Partner A. The asset would have to be sold for $625,000 surplus for Partner A to favor a sale.

2. *New Investors*

Suppose that in addition to mandating pro rata distributions, disallowing special allocations and profits interests, the public entity also mandates that all contributions can only be made with cash to avoid the problems of Section 704(c).[101]

Another source of heterogeneity is the treatment of purchasers of interests. Suppose that Partner A and Partner B form AB LLC with each of Partner A and Partner B being allocated all tax items 50/50. They each contribute $500,000 in cash to capitalize the business. One year later, the business's assets have increased in value by $2 million. Partner C purchases Partner B's interest for $1 million. Partner C's purchase price reflects the increase in the value of the assets. Partner C would be disappointed to find out that they would later be allocated gain from the sale of those assets. Yet, that is exactly what would happen unless the Section 754 election is made.[102]

If the Section 754 election is in place, Partner C avoids taxation on pre-purchase gain, The mechanism is a little complex, but the partnership keeps track of basis that is specific to Partner C.[103] This is a good result from Partner C's tax perspective. If AB LLC sells an asset, they will not be taxed on gain from before they bought into the partnership. Yet, there is an agency cost. The partner-specific basis results in heterogeneity amongst the partners. One might retort, the answer is simply to avoid using the Section 754 election, force homogeneity! These agency costs and potential conflicts of interest explode as different partners buy in at different times. Investors who purchased their interests at different times will have different tax preferences regarding the disposition of assets.[104] For a

101. This last restriction should not be underestimated. Many businesses combinations would not occur but for tax-free treatment on incorporation (or reorganization).

102. I.R.C. § 754.

103. *Id.* § 743.

104. A similar issue arises when a new partner purchases an interest in an existing partnership (as opposed to purchasing an interest from an existing partner). The new partner does not want to pay tax on the built-in gain in pre-contribution partnership assets, and existing partners will not want to share any losses on those assets with the new partner. If agreed to in the partnership agreement, the business can specially allocate those pre-contribution gains and losses to the old partners. Treas. Reg. § 1.704-1(b)(2)(iv)(f)–(h) (providing for the book value of assets to be booked up or down to fair market value upon certain partnership events including the contribution of money or assets to the partnership, the liquidation of the partnership, granting of an interest in the partnership in exchange for services, and the issuance of

public entity, this creates an administrative headache, conflicts of interest, and agency costs.

The public entity can avoid the Section 704(c) problem by forcing all investors to contribute cash. Can we simply force homogeneity by not making the Section 754 election? This would increase the tax cost for new purchasers of interest, but it would homogenize the interests of investors. Yet for businesses of even reasonable size, the Section 743 adjustment is *mandatory* if the business assets have a built-in loss when Partner C or any other new public investor purchases an interest.[105] Heterogeneity amongst investors is *unavoidable*.

3. *Borrowing Money*

When a partnership borrows money, there are complex debt allocation rules that can introduce additional heterogeneity amongst investors. The partnership rules effectively treat all debt of the partnership as if a partner or partners borrowed the money directly and then contributed the funds to the partnership.[106] Liabilities are allocated differently depending on whether the liability is recourse or nonrecourse. Simplifying greatly, recourse liabilities are generally allocated to the partner that bears personal liability if a partnership fails to repay the loan,[107] while nonrecourse liabilities are allocated based on a partner's share of the partnership's profits.[108]

Allocations of partnership debt increase the partner's basis in their partnership interest (i.e., "outside basis").[109] Outside basis increases the distributions that a partner can receive without paying tax and the deductions that a partner can use from a partnership. The partnership liability rules, therefore, create investor heterogeneity for the realization of tax losses and the payment of distributions.

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a noncompensatory option). Although the statute does not mandate these so-called "reverse 704(c) allocations", they are sometimes effectively required for allocations to have substantial economic effect. James M. Greenwell, *Partnership Capital Accounts Revaluations: An In-Depth Look at Sec. 704(c) Allocations*, THE TAX ADVISER (Jan. 31, 2014), www.thetaxadviser.com/issues/2014/feb/greenwell-feb2014.html.

105. I.R.C. § 743(a), (d). As discussed *infra* Part IV.C.1, the tax code is particularly concerned about loss shifting between partners. This asymmetric rule reflects that concern.

106. *Id.* § 752.

107. Treas. Reg. § 1.752-2.

108. Treas. Reg. § 1.752-3.

109. I.R.C. § 752(a).

The repayment of debt also creates heterogeneous tax issues. The tax code treats the retirement of debt as a constructive distribution to the partners who were previously allocated the debt.[110] Distributions in excess of basis can trigger capital gain for those partners.[111]

* * * * *

It is impossible to homogenize the interests of a public entity subject to Subchapter K partnership taxation. Just about every transaction that a business wants to engage in—admission of a new partner for property, sale of a partnership interest, compensating an employee with a partnership interest, borrowing money, distributions, the sale of assets—create schisms among the investors.

This heterogeneity of investor *interests* is layered onto the unavoidable heterogeneity of investors. Investors differ in their risk tolerance, marginal tax rates, and preferences regarding the timing of gains and losses. [112]

It is worthwhile to consider why Subchapter K has so many of these rules because it provides hints as to how passthrough taxation might be made more homogeneous. Subchapter K fundamentally takes an aggressively aggregate view of the business such that the investors in a partnership should be taxed as if they were engaged in the business directly.[113] This approach reduces accidental over-taxation and intentional gain or loss shifting. Section 704(c), reverse 704(c), and 743 all ensure that new partners are not taxed on gain that accrued before they joined the partnership, and perhaps even more importantly, prevent new partners from taking losses they did not economically

110. *Id.* § 752(b).

111. *Id.* § 731(a)(1).

112. This heterogeneity of investors exists for corporations as well. Levmore and Kanda argue that one of the purposes of the corporate tax is to smooth differences in tax rates between investors. This smoothing reduces the conflict of interest between investors on the timing of income. Levmore & Kanda, *supra* note 19. If Levmore and Kanda are right, the corporate tax maintains homogeneity of investor interests, and smooths the heterogeneity of the investors themselves.

113. Subchapter K balances the aggregate and entity approach. For example, the character of income is determined at the entity level. Many elections are also made at the entity level. However, the majority of the rules in Subchapter K (including most of the rules discussed above such as 704(b), 704(c), reverse 704(c)) take an aggregate view of the partners.

suffer. The contribution rule to partnerships is much more flexible than the equivalent rule for corporations.[114]

The alternative "entity" view undertaken by Subchapter C treats the business as a separate entity. This entity approach minimizes the tax-induced heterogeneity, but it increases both incidental over- and under-taxation.

For example, a purchaser of corporate stock via either primary issuance form or in a secondary sale can be taxed on an immediate distribution as a dividend even though the relevant corporate income was earned before the purchaser was an owner of the corporation. The concepts of corporate earnings and profits are not specific to a particular shareholder or a particular share.[115] It is a characteristic of the entity. The corporate-level tax is collected each year as income is earned. There is no effort to allocate the second-level shareholder tax to the owners of the entity at the time the income is earned. This creates the possibility of gain shifting at the shareholder level. Shareholders who pay greater dividend tax than capital gain tax—such as domestic individuals and most foreign investors—can cash in on earnings through sales or redemptions. For those shareholders with reverse tax preference such as domestic corporations, selling to those investors prior to dividends can reduce overall tax burden.[116]

B. *An Iso-Tax-Burden Thought Experiment*

Consider a hypothetical scenario in which a business is deciding whether to organize as a corporation or a partnership *assuming that the tax burdens of the corporate tax and the partnership*

114. *Compare* I.R.C. § 351 (nonrecognition for contributions to corporations), *with* I.R.C. § 721 (nonrecognition for contributions to tax partnerships). The corporate rule requires that the contributor (or contributors in the case of simultaneous transfers) own 80% control of the corporation immediately after the contribution. The partnership rule has no analogous requirement.

115. I.R.C. 312.

116. Because of the preferential treatment of dividends received by corporations, there are two limitations on the dividends received deduction to prevent corporations from engaging in tax arbitrage. There is a holding period requirement for the dividends received deduction: the corporate shareholder must hold the stock for at least 46 days around the ex-dividend date. I.R.C. § 246(c). If the corporate shareholder receives an "extraordinary dividend," their basis in the payee-corporation stock is reduced by the amount of the dividends received deduction. I.R.C. § 1059.

tax are set as equal. The business will distribute all of its earnings each year. All the investors are domestic individuals in the same marginal tax bracket—say 40% for income earned through a passthrough and 20% for dividends received. A corporate tax rate of 25% will result in an equivalent tax burden for the corporate and partnership forms.[117]

Which form would the business and its investors prefer? The tax perspective offers no guidance. By construction, the tax burdens are equivalent. Nevertheless, the investors would probably prefer the corporate form because the corporate tax would reduce the heterogeneity amongst investors going forward. Any quotidian and necessary transactions—such as a new investor acquiring partnership interest, a partner retiring, or an employee receiving equity compensation—would exacerbate differences among investors. Subchapter K sows seeds of future discord between investors, while Subchapter C does not.

Why is homogeneity desirable? It reduces agency and monitoring costs. When faced with a decision in which one set of investors wants one thing and another set of investors wants another, what is management supposed to do? For this reason, Hansmann suggests that it is best when setting up a corporation to allocate voting and residual economic rights to the shareholders rather than other stakeholders. Shareholders are not entirely homogeneous of course: they differ in appetite for risk, tax rates, and investment horizon. But shareholders are relatively homogeneous compared to other potential stakeholders like employees or customers.[118] Shareholders are aligned in their focus on stock value. This alignment reduces agency and monitoring costs. This does not guarantee that management

117. Assume the business earns $100 of income. Under the corporate tax, there will be $25 of tax due at the corporate level and $15 of tax due at the shareholder level when the $75 is distributed. The total tax due is $40. This matches the $40 tax that would be due under the partnership tax.

118. Homogeneity is at the heart of many critiques of stakeholder theory. Simplified, stakeholder theory argues that management should consider the interests of employees, customers and other stakeholders when making decisions instead of focusing just on shareholders. Serving multiple constituencies creates opportunities for management to dissemble, expanding the space of decisions that are arguably in service of one or another group of investors. Comm. on Corp. L., *Other Constituencies Statutes: Potential for Confusion*, 45 BUS. LAW. 2253, 2269–70 (1990).

will always act faithfully, but agency and monitoring costs are a minimization game as opposed to an elimination game.[119]

Consider a corporation that announces it is splitting its stock into two different classes. Class A will get rights to current dividends paid at management's discretion, but nothing on liquidation. Class B will get no current dividends, but will receive a share of assets on liquidation. That no corporation has ever tried such a recapitalization (to this author's knowledge) suggests its folly. Class A and Class B shareholders would have intensely opposing preferences on dividends, reinvestment, and winding down the business. Ironically, the recapitalization would be a "good" thing from a tax perspective because it would create a significant clientele effect— investors could sort based on their tax situation. Investors who prefer dividends, such as domestic corporations, could buy Class A. Investors who prefer capital gains, such as foreign individuals, could buy Class B. Yet this tax advantaged structure would be awful from an agency and monitoring cost perspective.

C. *How to Fix Subchapter K for Public Entities*

What then can we learn from corporate integration to adapt Subchapter K for public entities? This section considers possible adaptations for Subchapter K to make it more accommodating to public trading and reduce both agency and monitoring costs. All of these proposals share a common foundation: they reduce the flexibility of Subchapter K and nudge it towards entity taxation.

There are certain non-mandatory rules and elections that one would expect public entities to make in order to maintain homogeneity of interests and make interests attractive for portfolio investment. For example, even if it were not mandated, most public entities would commit themselves to proportionate distributions. Most public entities would similarly avoid making asset distributions in kind and thereby avoid the issues created by such distributions.[120] Most public entities would not make an

119. Hansmann, *supra* note 7, at 47 ("[T]he efficient assignment of ownership minimizes the sum, over all the patrons of the firm, of the costs of market contracting and the costs of ownership . . . .")

120. Most distributions of non-cash assets are nonrecognition tax events for partnerships. The recipient partner takes a carryover basis in the assets and reduces their partnership basis by the same amount. But the distribution

election under Section 754, thereby avoiding Section 743 and the partner-specific basis adjustments that create heterogeneity amongst otherwise equivalent partners. Most public entities would not make use of special allocations, just as public corporations have abandoned tracking stock.

1. *Homogenizing Interests*

A myriad of rules in Subchapter K attempt to prevent gain or loss shifting, or, equivalently, to tax investors who owned the partnership when the economic income accrued. These rules include Section 704(c), which prevents pre-contribution gain or loss shifting from contributors of property to other investors. Reverse 704(c) allocations prevent the shifting of partnership asset gains and losses to new partners when they contribute money or property to a partnership. Section 743 prevents the same shifting when new partners purchase an interest from existing partners. These rules are mandatory—such as 704(c)—or at least partially mandatory (e.g., Section 743 when there is a substantial built-in loss).[121]

Since these are the primary sources of tax-induced heterogeneity among investor interests, turning these rules off or simplifying them for public entities would substantially improve the utility of Subchapter K for publicly traded interests.

What are the stakes of turning these rules off? These rules exist to prevent gain or loss shifting between partners. Notably, other passthrough approaches don't seem to be as concerned about this problem. Take 704(c), the rule governing the taxation of pre-contribution gain or loss. There is no analogy in REITs or in S corporations for two possible reasons. First, Section 351's control requirement is not as permissive as Section 721, the latter of which allows for broad nonrecognition.[122] Moreover, Section 351(e)(1) essentially makes it very difficult to get

of non-cash assets will be a book recognition event requiring adjustments to capital accounts. There is a special rule in Section 704 to prevent precontribution gain or loss shifting. I.R.C. § 704(c)(1)(B). There is also a special rule to prevent the loss of partnership basis when the basis of the noncash assets distributed exceeds the distributee partner's outside partnership basis. I.R.C. § 734.

121. I.R.C. § 743(a), (d).

122. I.R.C. § 351(a) ("immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation"). Section 721 does not have a parallel requirement.

nonrecognition treatment for REITs under any circumstances.[123] Thus, there is simply less precontribution gain or loss to worry about shifting. Second, for S corporations, the worst kinds of shifting are impossible because the restrictions on S corporations disallow foreign or tax-exempt investors. Thus, the potential for abuse is much lower in S corporations because the prohibition on these types of investors prevents gains from being eliminated from the U.S. income tax base.[124]

What are the ways forward for Subchapter K? Section 704 is a significant barrier to homogeneous partnership interests. We could make nonrecognition treatment more difficult to achieve for partnerships, narrowing Section 721. This would reduce the scope of unrecognized gains and losses. If the concern is greater around loss shifting than gain shifting, another approach would be to use something akin to the hybrid basis rule used with gifts to prevent the shifting of tax losses. Another approach might be to treat public trading of the partnership as a moment to trigger all 704(c) gain or loss and then apply more stringent requirements on nonrecognition of gains and losses on future contributions to the publicly traded enterprise.

The above solution would address the issues of precontribution gain or loss shifting. How about gain or loss shifting between old partners and new partners? Recall that if partnership assets have a built-in gain or loss, it is possible for those gains and losses to be shifted to new partners when they enter the partnership. These shifts were addressed by Section 743 and reverse 704(c) allocations. Both of these rules are usually

123. The lack of availability of nonrecognition treatment partially explains the slow growth of REITs. *See* Oh & Verstein, *supra* note 99, at 811. REITs exploded only when practitioners realized that nonrecognition treatment was possible if partnerships and REITs could be combined in a structure called the Umbrella Partnership REIT (UPREIT).

124. Note that there is nothing preventing an S corporation from gain shifting from domestic individuals with high marginal tax rates to domestic individuals with low marginal tax rates. But similar gain shifting can be accomplished through other means, including the transfer of the property by gift. *See* I.R.C. § 1015(a) (allowing for carryover basis when property is gifted). However, S corporations can also be used to shift losses from individuals with low marginal tax rates to those with higher marginal tax rates. This cannot be accomplished using gifts. *See* I.R.C. § 1015(a) (stepping down basis to fair market value for purposes of calculating the donee's loss). The tax code is generally more suspicious of loss shifting than gain shifting because of the former's greater potential for tax avoidance. *See also* I.R.C. § 743(d) (making mandatory basis adjustments when partnership property has a substantial built-in loss).

optional. The exception is when a partner buys a partnership interest at a time when the partnership has a substantial built-in loss.[125] For publicly-traded entities, we could make these rules fully optional and simply tolerate some loss shifting.

The common thread running through all these changes-turning off Section 704(c), Section 743, and reverse 704(c) allocations - is that they all shift Subchapter K towards an entity view of taxation. With those changes, Subchapter K would be less precise in making sure that income and loss are always allocated to the right partner. This shift toward an entity view would make Subchapter K much more compatible with public trading.

Those changes would bring Subchapter K closer to the entity view already ensconced in Subchapter C. In corporate taxation, we already tolerate "mis-allocation" of income and loss. For example, suppose Shareholder A owns a share of Alphabet for two years. During that time, Alphabet's assets increase in value, but Alphabet does not realize those gains. Shareholder B purchases A's share. If Alphabet sells the assets and realizes a gain, in a sense Shareholder B is overtaxed, but we make no effort to perfect the tax treatment of Shareholders A and B vis-à-vis unrealized corporate gain.

2. *Lessons from Subchapter S*

Subchapter S provides a simplified form of passthrough taxation that follows a similar allocation method as partnership taxation. Subchapter S taxation is only available to electing "small business corporations."[126] Among other requirements, a corporation cannot have more than a hundred shareholders or have more than one class of stock.[127] Because of the shareholder limitation, an S corporation cannot be publicly traded. Ironically, Subchapter S has many features that make it a better fit for public passthrough taxation than Subchapter K.

First, Subchapter S requires that the entity be arranged as a corporation.[128] As discussed in Part III, requiring the use of a corporation dramatically limits the governance flexibility of the business in a way that benefits public enterprises. This can be

125. I.R.C. § 743(a), (d).
126. I.R.C. § 1361(a)–(b).
127. I.R.C. § 1361(b)(1)(A)–(D).
128. I.R.C. § 1361(b)(1).

contrasted with Subchapter K, which allows the entity to form as *any* noncorporate entity.[129]

Second, Subchapter S requires that the corporation have only a single class of stock.[130] This requirement aids in the administration of passthrough taxation because all items are allocated equally among all of the investors.[131] However, this has the additional benefit of further reducing heterogeneity amongst investors. There can only be one class of stock, so all investors have the same economic interests and distributions must be made at the same time.[132] By comparison, Subchapter K attempts to accommodate whatever economic interests are described in the partnership or LLC agreement.

Third, Subchapter S has simplifying assumptions for how to allocate income amongst investors who own interests for only part of a year. S corporations spread tax items across each day of the year equally and do not try to capture intra-day trading.[133] Subchapter K could also adopt simplifying assumptions for public partnerships to allow simpler administration. For example, tax items could be allocated daily based on overnight share ownership. However, this might create tax avoidance opportunities around these allocation dates that the tax system would have to either tolerate or create anti-avoidance rules.

V.
Subchapter M—Homogeneous Passthrough Taxation

Perhaps the problematic fit isn't between passthrough taxation and public entities. Instead, maybe the problem is the fit between Subchapter K's allocation method and public entities. Are there better ways to combine passthrough taxation with public entities?

This Part first considers an alternative approach to passthrough taxation: the dividend deduction. This is the method used by hugely popular investment vehicles, REITs and

129. Treas. Reg. § 1.7701-2(b), -3(a) (defining eligible entities).
130. I.R.C. § 1361(b)(1)(D).
131. I.R.C. § 1366(a).
132. S corporations can have classes of stock with different voting power so long as the economic rights of all the classes are the same. Treas. Reg. § 1.1361-1(l).
133. I.R.C. § 1377(a); Treas. Reg. § 1.1377-1(a)(2)(i)–(ii) (requiring that when stock is sold, the date of acquisition is excluded but the date of disposition is included).

RICs.[134] Why have REITs and RICs succeeded so wildly relative to MLPs despite REITs and RICs being subject to many more restrictions in their governance and their tax treatment? The answer is, once again, the homogeneity hypothesis. Subchapter M applies a much more streamlined, homogeneity-reinforcing form of passthrough taxation. For managing the agency and monitoring costs of a public entity, Subchapter M's dividend deduction approach is superior to Subchapter K's allocation approach.

This Part also extends the homogeneity hypothesis beyond specialized tax entities like MLPs, RICs, and REITs. Getting rid of the distortions caused by the corporate tax has long been a policy goal for legislators and corporate tax experts.[135] "Integration" would subject all business income to a single level of tax and alleviate the distortions caused by the corporate double tax. The effect of the corporate integration on agency and monitoring costs has not been previously studied. From this perspective, we consider two popular proposals for corporate integration: dividend exemption and shareholder imputation.

A. *Dividend Deduction—RICs and REITs*

There are many ways to achieve passthrough taxation. Subchapter K, which covers partnership taxation, uses the allocation method, in which all tax items are allocated to the partners.[136] Subchapter M, which applies to REITs and RICs, employs a different approach—dividend deduction.[137] On the surface, REITs and RICs are corporations, ostensibly subject to the corporate tax.

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134. There are roughly 200 public REITs, with a cumulative market capitalization of $1.37 trillion and roughly $4 trillion of asset under management. NAREIT, REITWATCH (Jan. 2024).

135. AM. LAW INST., *supra* note 2; DAVID F. BRADFORD & U.S. TREASURY TAX POLICY STAFF, BLUEPRINTS FOR BASIC TAX REFORM (2d ed. 1984) (slightly revised edition of 1977 Treasury Report of same name); U.S. DEP'T OF THE TREASURY, *supra* note 2; U.S. DEP'T OF THE TREASURY, A RECOMMENDATION FOR INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS 2–5 (1992) [hereinafter RECOMMENDATION FOR INTEGRATION] (endorsing reinvestment dividend-exclusion plan); U.S. DEP'T OF THE TREASURY, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH 136–37 (1984).

136. I.R.C. §§ 701, 702.

137. I.R.C. § 857(b)(2)(B) (REITs), § 852(b)(2)(D) (RICs).

However, when REITs and RICs pay dividends to shareholders, they are permitted to take a dividends-paid deduction.[138] If a REIT or RIC pays 100% of its corporate income in dividends, then there is no corporate income tax due. In fact, both RICs and REITs are subject to statutory requirements to distribute much of their income.[139]

Dividend deduction is preferable to allocation from an agency and monitoring cost perspective. Subchapter M takes an aggregate approach to passthrough taxation by not trying to track individual investors' economic interests precisely and preventing all shifting of gains and losses.[140]

Again, it is useful to see how Subchapter M solves some of the problems that plague partnership taxation. Recall that Section 704(c) creates heterogeneity to prevent the shifting of pre-contribution gains and losses between partners.[141] Such shifting is only possible because the partnership tax law provides very flexible rules around the nonrecognition of pre-contribution gain when assets are contributed to a partnership.[142] By contrast, the REIT and RIC rules avoid this

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138. I.R.C. § 561 (defining dividends-paid deduction); I.R.C. § 852(b)(2)(D) (allowing RICs to take the deduction); I.R.C. § 857(b)(2)(B) (allowing REITs to take the deduction).

139. I.R.C. § 852(a)(1) (RICs required to distribute 90% of investment company income); I.R.C. § 857(a)(1) (REITs required to distribute 90% of taxable income). Even if RICs and REITs were not required to distribute their income each year, the availability of the dividends paid deduction would result in a single level of tax to the extent that corporate net operating losses ("NOLs") are allowed to be carried back to previous years. If carrybacks are permitted, a corporation could claim a refund of previously paid tax when distributions were paid (and deductions were taken) in later years. Prior to 2017, corporations were allowed to carryback NOLs to the previous two years. I.R.C. § 172 (2014) (current version at I.R.C. § 172).

140. Note that the dividends paid deduction has a significant weakness in its treatment of foreign and tax-exempt shareholders. One of the benefits of the corporate double tax is it allows the US to tax income that is attributable to investors outside of its taxing power. In partnership taxation, the US still taxes income passed through to foreign investors (if the income is "effectively connected income") or to tax exempt investors (if the income is "unrelated business taxable income"). I.R.C. §§ 1446(a), 512(a)(2). The dividends paid deduction has no such mechanism; instead, REIT dividends paid to tax exempts are generally taxed at 0% and REIT dividends paid to foreign individuals are taxed at 15% under most US income tax treaties.

141. *See supra* Section IV.A.1.

142. I.R.C. § 721.

problem by simply requiring the recognition of gain when assets are contributed to a REIT or a RIC.[143]

Recall that partnership law introduced additional heterogeneity to deal with the problem with loss shifting between old and new partners. In RICs and REITs, loss shifting is avoided by simply not allowing REIT or RIC shareholders to be allocated losses.[144] Losses at the REIT or RIC are carried forward as net operating losses.[145] They are available to offset future REIT or RIC income, but they cannot be passed through to investors to offset shareholder income directly.

RICs and REITs also have a straightforward approach to dealing with the administrative challenges of allocating tax items when interests are sold repeatedly.[146] RICs and REITs simply tax the shareholders who receive dividends. Like the corporate tax, Subchapter M does not care when an investor bought their interest or whether distributed income was earned during the investor's ownership. This simplicity comes at the cost of some "mis-taxation" but allows for greater investor homogeneity.

Subchapter M, much like the regular corporate tax, is more rigid and less accurate when compared to partnership taxation. This more rigid and simple approach helps alleviate agency and monitoring costs.

Previous criticisms of applying the allocation method to publicly-traded entities have focused on the administrative burden. We focus on the agency and monitoring costs that accompany the administrative burden. Note that even if allocations were to become totally automated, the agency and monitoring costs would remain. There is no technological solution to those agency costs.

In other work, Andrew Verstein and I argue that there are additional governance features of REITs that make them ideal

143. I.R.C. § 351(e)(1) (disallowing nonrecognition treatment when assets are contributed to an "investment company"). A transfer of property will be treated as to an investment company if the transfer results in a diversification of the shareholders' interests and if the transfer is to a RIC or REIT. Treas. Reg. § 1.351-1(c)(1).

144. This is because the mechanism for "passing through" income is through the payment of dividends. There is no similar mechanism for "passing through" losses.

145. With the exception of the dividends-paid deduction, REITs and RICs are otherwise taxed as corporations. Thus, they keep track of net-operating losses like other corporations. I.R.C. § 172.

146. *See supra* Part II.

for addressing some of the heterogeneity issues introduced by partnership taxation[147] The modern REIT is really a combination of using REIT governance, including its homogeneity, to address a partnership-tax-imposed heterogeneity issue. The additional point here is to contrast more specifically the tax rules of partnerships (Subchapter K) with the tax rules of REITs and RICs (Subchapter M). Subchapter M's entity perspective simplifies taxation and reduces agency and monitoring costs. One reason this is possible is that other tax rules are made more inflexible for these entities. For example, Section 704(c) is designed to prevent the shifting of pre-contribution gains and losses between partners. Such shifting is only possible because partnership tax law provides very flexible rules around the nonrecognition of pre-contribution gain when assets are contributed to a partnership.[148] By contrast, the REIT and RIC rules avoid this problem by simply requiring the recognition of gain when assets are contributed to a REIT or a RIC.[149]

B. *Agency Costs of Corporate Tax Integration*

Corporate tax integration would subject all corporate income to tax at a single level and reduce the distortions created by corporate double taxation. Broadly speaking, there are four major approaches. First, "dividend deduction" would expand the dividend deduction to all corporate entities, not just RICs and REITs. Second, "allocation" would allocate all corporate income and loss as is currently done with partnerships. Third, "dividend exclusion" would exempt all dividends from tax. Fourth, "shareholder imputation" would use the corporate tax as a withholding tax for shareholders who would be taxed on corporate income.

This Part introduces a new perspective on a familiar debate: the homogeneity hypothesis provides useful guidance in designing corporate tax reform without exacerbating agency costs. Before turning to dividend exclusion and shareholder

147. Oh & Verstein, *supra* note 99.
148. I.R.C. § 721.
149. I.R.C. § 351(e)(1) (disallowing nonrecognition treatment when assets are contributed to a "investment company"). A transfer of property will be treated as to an investment company if the transfer results in a diversification of the shareholders' interests and if the transfer is to a RIC or REIT. Treas. Reg. § 1.351-1(c)(1).

imputation, let us briefly consider dividend deduction and allocation. This discussion is brief because it references analysis earlier in the article.

The agency cost perspective on dividend deduction parallels the discussion above regarding REITs and RICs.[150] Dividend deduction scores relatively well on agency costs and homogeneity. However, dividend deduction has been rejected as a general approach to integrating the corporate tax because of the substantial revenue cost.[151]

The allocation method would extend partnership-like taxation to corporations. The previous Part explored the limitations of that approach from an agency cost perspective.[152] Precise allocation increases investor heterogeneity and exacerbates agency and monitoring costs.

1. *Dividend Exemption*

Dividend exemption would integrate the corporate tax by removing the second shareholder-level tax. The corporate tax would still be due (ideally at a higher rate closer to the individual tax rate) but there would be no additional tax when distributions are paid. This approach was seriously considered during the George W. Bush administration,[153] and the Treasury Department produced a report in 2005.[154] Ultimately, Congress

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150. See *supra* Part V.A.

151. One of the benefits of the existing corporate tax is that it raises some tax revenue from tax exempt and foreign shareholders. Integrating the corporate tax using dividend deduction would result in no tax burden for tax exempt shareholders and many foreign shareholders. The revenue cost of integrating the corporate tax through dividend deduction has been estimated at roughly $200 billion per year. RECOMMENDATION FOR INTEGRATION, *supra* note 135, at 22 (recommending dividend exclusion). The tax-exempt ownership of corporate equities has only increased since then, meaning that a move to dividend deduction would cost even more revenue. Steven M. Rosenthal, *Integrating the Corporate and Individual Tax Systems: The Dividends Paid Deduction Considered*, Testimony Before the U.S. Senate Comm. on Finance (May 17, 2016) (Tax Policy Center), www.urban.org/sites/default/files/publication/80646/2000792-Integrating-The-Corporate-And-Individual-Tax-Systems-The-Dividends-Paid-Deduction-Considered.pdf (taxable accounts hold only about 25% of corporate equities)."

152. *See supra* Part IV.A.

153. *The President's Jobs and Growth Plan: The Dividend Exclusion Is Not Complex*, THE WHITE HOUSE, georgewbush-whitehouse.archives.gov/infocus/economy/complexity.html.

154. PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, SIMPLE, FAIR, AND PRO-GROWTH: PROPOSALS TO FIX AMERICA'S TAX SYSTEM 124–25 (2005);

enacted a partial dividend exemption approach by reducing the tax rate on qualified dividends.[155]

From an agency cost perspective, the dividend exemption method is fantastic. The corporate tax is applied to all income, irrespective of identity of shareholders. There is no heterogeneity among shares or shareholders going forward. Moreover, it smooths the differences between types of shareholders on both the desirability and timing of dividend distributions. They are tax-free for all investors, whether domestic or foreign, individuals, corporations, or tax-exempt entities. For this reason, the dividend exclusion approach is even better than the corporate tax from an agency cost perspective. One source of investor heterogeneity (tax rates) becomes irrelevant.[156]

2. *Shareholder Imputation*

Another popular approach to corporate tax integration is shareholder imputation. In shareholder imputation, the corporation pays corporate tax, but shareholders are allocated a credit based on their share of the corporate tax.[157] In essence, the corporate tax acts as a withholding tax for taxes later paid by shareholders.[158] Shareholders with a marginal tax rate above the corporate rate pay the difference in rate.[159] If the corporate tax credit is refundable, then shareholders with a marginal tax rate below the corporate rate receive a refund.[160] This has the advantage (relative to dividend exclusion) of maintaining the progressivity of the income tax.[161] If the credit is nonrefundable for foreign investors and tax-exempts, the shareholder

see also RECOMMENDATION FOR INTEGRATION, *supra* note 135, at 1 (recommending dividend exclusion).

155. I.R.C. § 1(h)(11) (taxing qualified dividend income at long-term capital gains rates).

156. The problem with the dividend exclusion model is that one loses the progressivity of the income tax. All corporate income is taxed at the same rate regardless of the marginal rate of the investor. Given the current distribution of corporate share ownership and the flattening of the progressive marginal rate structure, this concern has become less important.

157. U.S. DEP'T OF THE TREASURY, *supra* note 2, at 27.

158. *Id.* at 95.

159. *Id.*

160. *Id.*

161. *Id.* at 103.

imputation approach has the additional advantage of collecting corporate tax from these otherwise untaxable investors.[162]

In real-world application, whenever a dividend is paid, the recipient of the dividend includes a grossed-up amount of the distribution in income, pays tax on the grossed-up dividend at ordinary income rates, and takes a credit for taxes that the corporation already paid.[163]

Although the shareholder imputation model looks like it might create investor heterogeneity, it does not do so as long as the mechanism does not try to track the economic income of particular shareholders or to attribute corporate tax to transitory holders of the instrument. The credit-imputation mechanism applies to whichever shareholders receive distributions. This demonstrates that some investor heterogeneity—in pursuit of progressivity—can be maintained without introducing interest heterogeneity.

Suppose a corporation earns $100 per share this year. Shareholder A held one share for the first half of the year and sold the share to Shareholder B who held the stock for the second half of the year. The corporation pays corporate tax of $20 with respect to the share of stock and pays a distribution of $80 at the end of the year. Under credit imputation, Shareholder A's ownership is irrelevant. Shareholder B includes the entire $100 of income and is entitled to the full $20 tax credit. This is despite the fact that half of the corporate income was earned while Shareholder A owned the shares.

This doesn't seem particularly problematic until we adjust the facts slightly. Suppose that Shareholder A is in the top marginal tax bracket of 37%, while Shareholder B is in the bottom marginal tax bracket of 0%. Suppose that Shareholder A owns the share for the first 364 days of the year, and sells the share to Shareholder B on the day before the record date for the dividend. Shareholder B receives the dividend and is imputed the $100 income, on which no tax is due. If the tax credit is

162. JANE G. GRAVELLE, CORPORATE TAX INTEGRATION AND TAX REFORM 18 (2016).

163. For example, if the corporate tax rate is 20%, and the investor receives an $80 dividend, the investor will include $100 ($80/(1-.2)) in her income and also be entitled to a $20 tax credit. Assuming her marginal tax rate is 30%, she would then owe $10 ($30 of tax on the $100 of income less the $20 tax credit). The government would have ultimately collected $30 ($10 from the investor, $20 from the corporation) on the $100 of corporate income. Thus, tax is collected at the *investor's* marginal tax rate.

refundable, Shareholder B would actually receive a $20 refund, and $0 of tax would have been collected on the $100 of corporate income. Of course, if Shareholder B had held the stock for the entire year, that is exactly the result that we want. One of the advantages of credit-imputation is that it respects the progressivity of the individual income tax. But the described scheme seems abusive, especially when considering the price that Shareholder A could have charged. Shareholder A could have shared the profits with Shareholder B by selling the stock for $110 and then repurchasing it for $100. In this scenario, both seller and purchaser would be $10 better off.

There are ways to address this transaction. One solution would be to make the tax credit nonrefundable. The downside of this approach is that it would result in overburdening corporate income legitimately earned by lower income investors. It would also place more pressure on selecting the "right" corporate tax rate.[164] Another solution would be to create a holding requirement for the stock in order to claim the corporate tax credit, akin to qualified dividend rate or dividends received deduction.[165]

3. *Lessons from Corporate Integration*

Consider, briefly, what insights may be drawn from the dividend deduction, dividend exclusion, and credit-imputation regimes. Why are all of these approaches more successful than the allocation method from an agency-cost perspective?

Dividend exclusion, dividend deduction, and credit-imputation all use the corporate form. These approaches require dividends to be paid simultaneously, so there is no need to keep track of capital accounts. All of these approaches sacrifice some accuracy in allocating income to the investors. Instead of trying to allocate income to the investors that owned the interest when the income is earned, these approaches instead tax shareholders as distributions are received.[166]

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164. If the credit is fully refundable, then it does not matter what corporate rate is chosen. The corporate tax is just a withholding device.

165. I.R.C. §§ 246(c); 1(h)(11)(B)(iii).

166. Both the dividend deduction and the credit-imputation approach ultimately tax corporate income at the tax rate of shareholders who receive dividends. The dividend exclusion approach only applies tax at the entity-level and does not attempt to tax income at shareholder rates.

Dividend exclusion, dividend deduction, and credit-imputation do not create differences among otherwise identical shares of stock. This reduces administrative complexity but also eliminates potential agency and monitoring costs. Fundamentally, all of these corporate integration approaches achieve passthrough taxation while respecting the *entity* view of the business. The entity can be largely ignorant about its investors, their personal tax situations, and how they acquire/dispose of interests in the business.

VI. REFRAMING THE INTERACTION BETWEEN TAX DISTORTIONS AND GOVERNANCE

This Part reframes the relationship between tax distortions and governance costs. The tax system distorts business decisions: when and how to distribute earnings, how much to leverage, and what entity to form. But from a governance perspective, similar problems arise because decisions are made by managers on behalf of shareholders: managerial interests are imperfectly aligned, monitoring managerial behavior can be costly, and collective action by shareholders can be difficult.[167] An important role in business association law is to manage these costs.

Tax distortions and governance costs share an important feature: they both measure cost from a hypothetical ideal baseline. For tax distortions, the baseline is how the "business" would act in a world without tax. From a governance perspective, the baseline is what the owners would choose in a world without managers and without coordination costs.

A. *How Do Agency Costs Affect Corporate Tax Distortions?*

To further explore this relationship, this Part reconsiders each of the corporate tax distortions and asks how governance issues distort those same decisions. The key conclusion is that even in a world without taxes, distribution, leverage, and entity-choice decisions are infected by agency costs.

167. This separation is one of the key features of the modern corporation. Even corporations with significant controlling shareholders entail principal-agency problems for minority shareholders.

1. *Distribution Policy*

There are serious agency problems that cause managers to distribute earnings less frequently and in smaller amounts than owners would prefer. Managers often hold onto funds beyond what is necessary for working capital and beyond what can reasonably be reinvested for a variety of reasons.

Since managers have a larger share of their personal wealth tied to the success and stability of the firm, they will tend to be more risk averse than shareholders who are well diversified and for whom the firm represents a small fraction of their wealth[168] Managers are also interested in retaining excess capital to pursue empire-building or other projects from which they derive personal benefits.[169] At the same time, managers in a corporation are granted wide discretion to pay dividends. Those decisions are subject to rational basis review under the business judgment rule.[170]

At first blush, this discretion may seem problematic, but there are problems with adopting a rule that forces greater responsiveness regarding distribution policy. If investors were allowed to recall their capital at will, it might undermine the ability of a business to pursue long-term projects.[171] Such investments would be impossible if investors could force distributions at will. The capital lock-in rule therefore manages a coordination cost between investors. The importance of capital lock-in varies depending on the business.[172]

With respect to the payment of distribution, the agency cost and the corporate tax distortion reinforce each other. They both militate toward retaining cash.

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168. For example, this may encourage managers to diversify a corporation's activities even though such diversification reduces firm value. David J. Denis et al., *Managerial Incentives and Corporate Diversification Strategies*, 10 J. App. Corp. Fin. 72, 74 (1997).

169. Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 Am. Econ. Rev. 323, 323 (1986).

170. The author is not aware of any Delaware cases holding that a manager's decision to withhold dividends failed to meet the rational basis standard.

171. Bank, *supra* note 72, at 903–04; Blair, *supra* note 72, at 387.

172. Notably, many non-corporate businesses have no such restriction—for example, a partner in an at-will partnership can withdraw from the partnership at any time. Richard Squire, *Why the Corporation Locks in Financial Capital but the Partnership Does Not*, 74 Vand. L. Rev. 1787, 1830 (2022).

2. *Leverage*

From a governance perspective, there are important tradeoffs to using debt or equity to raise capital. For debt, there is the possibility to exercise a much higher level of control over managers.[173] This control is through specific covenants, the threat of bankruptcy, and the restriction on cash flow due to interest payments. Interest payments on debt are mandatory and not discretionary like distributions of equity. From the investor's perspective, the downside of structuring investments as debt is limited participation in the upside economic growth of the firm.

A useful way to think about the principal-agent problem is to first consider a firm with existing shareholders that needs to raise additional capital. Under what conditions would the shareholders choose to issue stock versus bonds? Will the managers follow that course of action or defect? The Modigliani-Miller theorem suggests that the value of a firm does not depend on its capitalization if there are no bankruptcy costs and interest is not deductible.[174] That theorem assumes a world without taxes or bankruptcy costs. Where interest is deductible (as in the real world), the value of the firm increases by the present value of taxes saved.[175] Financial theory suggests that each firm has an optimum level of leverage at the point where the marginal benefit of leverage—interest deductibility benefit—equals the marginal cost of leverage—the cost of bankruptcy, illiquidity, or financial distress.[176] Managers, however, may have personal incentives to defect from the optimal amount of leverage. Studies have found that company leverage policies are sensitive to managerial incentives—for example, leverage tends to decrease with stock incentives but increase with options.[177] Studies also

173. Philippe Aghion & Patrick Bolton, *An Incomplete Contracts Approach to Financial Contracting*, 59 REV. ECON. STUD. 473, 474 (1992); Douglas W. Diamond, *Financial Intermediation and Delegated Monitoring*, 51 REV. ECON. STUD. 393, 394 (1984); Jensen, *supra* note 169, at 324.

174. Franco Modigliani & Merton H. Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 AM. ECON. REV. 261 (1958).

175. Merton H. Miller, *Debt and Taxes*, 32 J. FIN. 261, 262 (1977).

176. Milton Harris & Artur Raviv, *The Theory of Capital Structure*, 46 J. FIN. 297, 303–05 (1991).

177. Mahmoud Agha, *Leverage, Executive Incentives, and Corporate Governance*, 53 ACCT. & FIN. 1, 1 (2013).

find that leverage is related to executive ownership and the level of corporate governance.[178]

With the capitalization distortion, the relationship between the tax distortion and agency costs cannot be generalized. The tax distortion leads to too much leverage. The agency cost can reinforce that distortion or counteract it, depending on the particular incentives facing the managers.

However, the more interesting observation is how the tax distortion is incorporated into the governance analysis. From the perspective of the firm's owners, the optimal level of leverage actually includes the tax benefit of deductible interest. In other words, the failure from a corporate governance perspective is the failure of managers to optimally solve a tax distorted problem.

3. *Entity Choice*

The governance literature on the entity distortion scarcely contemplates that the decision of which type of entity to organize could itself be infected by agency costs. Much of the literature assumes that the observed business forms are optimal and then seeks to explain why.[179] There is a strong evolutionary bias in the business organization law that is not present in the tax literature centering around the idea that if we observe entities of a particular type in a particular industry, then they must be the most efficient since they outcompeted alternative organizations. Thus, when corporate law scholars observe that cooperatives dominate in insurance, non-profits abound in hospitals, and corporations dominate manufacturing, they assume that the marketplace has figured out which of these business forms is the most efficient in each particular arena. This is not to say that the chosen entities have no principal-agent or monitoring costs, but rather that the dominant entity type *minimizes* costs, including tax and agency costs.

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178. Chrisostomos Florackis & Aydin Ozkan, *Managerial Incentives and Corporate Leverage: Evidence from the United Kingdom*, 49 Acct. & Fin. 531, 531 (2009).

179. *See, e.g.*, Hansmann, *supra* note 7, at 20–23 (arguing that observed organizational forms minimize transaction and agency costs and thus reflect efficient adaptation); Oh & Verstein, *supra* note 99, at 818 (questioning whether REITs are actually efficient rather than artifacts of tax and governance distortions).

As in the prior example of leverage, tax fits into this governance analysis as an input. Tax is another exogenous factor around which the optimal entity choice must be made. The differing tax treatment between entities is akin to a law of nature that affects the relative fitness of different business entities.

B. *A Theoretical Framework*

The preceding discussion of the interaction of governance with tax distortions shows several possible interactions. With distributions, the tax treatment and agency costs tend to reinforce each other—exacerbating the distortion. With leverage, the tax deduction is an input in the governance problem facing firms, managers, and investors. This final section provides a framework for thinking about the interaction between tax and governance.

Consider the following hypothetical where a company is faced with a decision between Action A and Action B. In a world without tax, investors would pick Action A. Suppose a tax rule creates a distortion such that the investors acting on their own behalf would switch to Action B. This would be a tax distortion.

But suppose that the investors are forced to act through a manager. Suppose that agency and monitoring costs are such that the manager chooses Action A. In this example, it is unclear whether there is a tax distortion or an agency cost because the principal chooses what the investors would have chosen in a world without tax. In a sense, the tax distortion and the agency cost have offset.

To make this example concrete, consider a tax shelter example. Action B is investing in a chinchilla farm tax shelter that will yield no economic income. Action A is foregoing the tax shelter. In a world without tax, the principals would forego the tax shelter (Action A). There is no reason to invest in a tax shelter in a world without taxes. But once tax rates are high enough, the principals may prefer that the company invest in the tax shelter (Action B) because they are relatively risk-neutral and willing to brave the audit lottery. The managers, however, choose to forego the tax shelter (Action A) because they are more conservative and unwilling to risk their jobs and reputational harm. It is unclear whether there is a tax distortion or an agency cost. The managers choose the course of action that the investors would have chosen if their preferences were uninformed by tax consequences.

These examples highlight an ambiguity in the definition of the tax distortion. Should it be measured off the baseline of what the shareholders would choose? Or what management would choose in the absence of tax considerations? The right answer is a matter of perspective.

A possible theoretical framework is presented in Table 3.

	The Tax Dimension	
The Management Dimension	(1) what decision the investors would make without taxes	(2) what decision the investors would make with taxes
	(3) what decision the managers would make without taxes	(4) what decision the managers make with taxes (observed)

Table 3: How to combine tax distortions and agency costs.

This Table shows the interaction between how agency costs and taxes change behavior. In the end, we only observe the decision that managers actually make in the real world with taxes (cell 4).

The other cells are hypotheticals. Cell 3 is what managers would have chosen in a world without taxes. Cell 2 is what investors would have chosen themselves in a world with taxes. Cell 1 is what investors would have chosen themselves in a world without taxes. These hypotheticals are important because they are the baseline off which we measure tax distortions and agency costs.

This Table can help clarify how we think about the interaction between tax and governance.

1. *The Tax-First "Traditional" Approach*

One way to think about agency costs and tax distortions is by taking tax "first," working our way clockwise in the chart. We first consider the distortion of the corporate tax (moving from cell 1 to 2) by examining how investor preferences are shaped by it. That tax distortion is an input in the governance problem (moving from cell 2 to 4). This is exactly what is done in the governance literature on leverage. The tax shielding effect of interest deductions is part of the optimization problem facing firms.

2. *The Governance-First Alternative*

However, there is another way to think about the relationship between tax distortions and agency costs. Instead of working our way clockwise in Table 3, we work counterclockwise. We first consider the agency costs affecting a firm and then consider how taxes can influence those decisions. Tax policy can then be reframed as a potential correction to the agency costs created by separation of ownership and management.

Consider this reframing for the distribution distortion. To set the stage: Cell 1 is the distribution policy investors would choose if they directly set distribution policy and faced no marginal tax on the distribution; Cell 2 is the policy investors would choose when a distribution tax is imposed; Cell 3 is the policy managers would choose absent a distribution tax; and Cell 4 is the observed distribution policy that managers adopt in the presence of such a tax.

The tax-first approach is traditional. Tax discussions of dividend policy do not even mention agency costs of distributions. The corporate governance literature asks whether managers are setting the right distribution policy given the tax-inclusive preferences of investors.

How does a governance-first approach differ? We start by asking how and why managers depart from the distribution policy that investors would choose. We then ask how the tax system exacerbates or corrects the agency costs around distribution. This second perspective highlights the opportunities of the tax system to respond to the agency cost of business entities. It also changes the baseline for judging tax systems—instead of minimizing tax distortions, it recognizes the interaction between tax and agency costs. "Removing tax distortions" may not be the best from an overall cost-minimization perspective. The goal, rather, is to minimize the joint distortion of agency costs and tax.

This perspective can also clarify the stakes of various corporate and tax reforms. Compare two corporate tax integration proposals—dividend exclusion and dividend deduction—and their respective effects on the distribution distortion. The tax-first approach would treat these proposals equivalently in terms of their effect on the distribution distortion. The governance-first approach would ask whether we expect there to be an agency cost of managers' retaining earnings in order to grow corporate empires or maintain perquisites.

From this perspective, the two proposals look quite different. The dividend exclusion model and the dividend deduction model (with carrybacks of NOLs) make the decision to pay dividends tax neutral. But that may not be desirable if we are trying to correct an underlying selfish incentive for managers to avoid paying distributions. A partial correction could be to limit the carryback of NOLs in the dividend deduction model, creating a subtle push for managers to currently pay distributions. This would create a tax "distortion" from a purely tax perspective, but would perhaps offset the agency cost of managerial reluctance to pay distributions. Whether this offset is partial or an overcorrection would depend on many firm- and proposal-specific factors, such as the treatment of future distributions under the dividend deduction model.

Tax and governance are so intricately related that perhaps it is best to consider their relationship in parallel rather than in series. Some governance problems are created by tax. In that regard, consider a recent article I coauthored with Andrew Verstein.[180] We argue that one of the REIT's governance features, managerial entrenchment, solves an agency problem created by partnership tax law. That agency problem is the difference in preferences between property contributors and cash investors regarding asset sales, leverage, and other important decisions.[181] But managerial entrenchment creates its own agency costs—managers may be less responsive to shareholders.[182] Tax law steps into the breach to minimize this agency cost, forcing REITs to distribute almost all of their earnings each year.[183] Tax law creates an agency cost solved by entity law, which in turn creates an agency cost solved by the tax law.

Saul Levmore and Hideki Kanda's *Taxes, Agency Costs, and the Price of Incorporation* provides another example of this deep connection between taxation and governance, arguing that the corporate tax functions as a mechanism to address agency costs generated by tax law.[184] They argue that different investors have different preferences regarding the timing of asset sales by a business because of their individual tax preferences.[185] The

180. Oh & Verstein, *supra* note 99, at 755.
181. *Id.* at 830.
182. *Id.* at 810.
183. I.R.C. § 857(a)(1); Oh & Verstein, *supra* note 99, at 831–32.
184. Levmore & Kanda, *supra* note 19, at 229.
185. *Id.* at 213

corporate tax homogenizes the timing preferences of investors (including managers who own a stake in the company) by taxing gain at a fixed rate, thereby reducing agency and monitoring costs.[186] In this conception, the corporate tax moves the situs for investor disagreements from the sale of assets (and the recognition of income more generally) to the timing and form of distributions. This may still be beneficial from an agency-cost perspective because: (1) investors can engage in self-help with respect to the second shareholder-level tax (for example, by selling shares), and (2) corporations can offer non-pro-rata redemptions to accommodate shareholders' individual timing preferences.

If the homogeneity hypothesis is right, the corporate tax's insistence on shareholder homogeneity and willingness to accept certain imperfect tax results is not a distortion. In fact, the tax system forcing public entities into corporate taxation and away from partnership taxation might actually reduce agency costs for entities that might otherwise choose the "wrong" tax system. This is so for two main reasons. First, it is possible that some investors and managers might simply choose the wrong system. The tax system would paternalistically be creating guardrails for public businesses. Second, there are agency costs in choosing a system of taxation. For example, some managers may prefer partnership taxation *because* it increases investor conflicts and makes managerial decisions harder to scrutinize. In sum, partnership taxation creates greater opportunities for investor-managers to serve their own interests at the expense of other investors.

Conclusion

For private entities, tax treatment and governance are disentangled. Thanks to modern LLC statutes and the check-the-box regime, private businesses can mix and match governance and tax rules.

For public entities, tax and governance are much more intertwined. Public entities generally must be taxed as corporations regardless of their governance structure. However, important exceptions exist. Passthrough taxation is extended to certain corporations like RICs and REITs, as well as certain

186. *Id.* at 213.

partnerships that fit within the definition MLPs. This is a complex legal regime with numerous exceptions, all of which have had varying degrees of success.

This Article offers the homogeneity hypothesis as a way to make sense of this complex web of tax and governance rules. Governance structures and tax rules that reinforce homogeneity amongst investors have outcompeted those that offer greater flexibility. Homogeneity is more important than flexibility. This hypothesis explains why we observe so few public LLCs taxed as corporations. It also explains why RICs and REITs have flourished relative to MLPs. The homogeneity hypothesis has important implications for how corporate tax reform should be pursued, favoring entity-based approaches to solving the distortions of the corporate income tax.