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I Come Not to Praise the Corporate Income Tax, But to Save It

HERWIG J. SCHLUNK*

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I. Introduction

The tax law in the United States has a puzzling feature. Some income earned by taxpayers directly or indirectly from joint economic activity is subjected to one level of tax, while other such income is subjected to two levels of tax. Whether single taxation or double taxation applies depends on two factors, both of which are to a significant extent under taxpayer control. First, it depends on the structure of the organizational umbrella for the economic activity. If such umbrella is structured so that the tax law does not recognize the presence of an entity, single taxation applies. If such umbrella is structured so that the tax law recognizes the presence of an entity it classifies as a "partnership," single taxation generally also applies. If, however, such umbrella is structured so that the tax law recognizes the presence of an entity it classifies as a "corporation," double taxation becomes a possibility.

Second, assuming that the economic activity is conducted in an entity that is classified as a corporation, whether single taxation or double taxation applies depends both on how the claims against the entity's income originate and on how they are structured. Thus, if a claim originates as a result of the corporation's use of human or nonfinancial capital, single taxation generally applies to any corporate income used to satisfy the claim. If, however, a claim originates as a result of the corporation's use of financial capital, the terms of the

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claim generally will dictate whether single or double taxation applies to the corporate income used to satisfy it. Thus, if the claim promises payments that either are fixed in amount or will become so at reasonably determinable points in time, and if the owner of the claim is given sufficient remedies to enforce this promise, single taxation generally applies to the income used to satisfy the claim. If, however, a claim does not promise such payments (that is, it only promises "residual" payments), or if it does promise such payments, but the owner of the claim is given insufficient remedies to enforce the promise (that is, the payments are "discretionary"), double taxation generally applies to any income used to satisfy the claim.

In recent years, taxpayer control of the first of these factors has become essentially complete, at least in the case of joint economic activity that is not conducted under the umbrella of a pre-existing entity and that is not conducted by taxpayers who desire near-term access to public equity markets. That is, a newly-formed entity generally will be subject to "check-the-box" entity classification,[1] pursuant to which it can elect whether to be taxed as a partnership or a corporation. It follows that income generated by identical economic activity will be either singly or partially doubly taxed, based on a historical accident (a pre-existing entity structure), a practical consideration (the perceived desirability of publicly traded equity) or an election: three things that have little, if anything, to do with the economic activity itself.

Of course, the difference between single and partial double taxation is not always as great as one might think. This is because taxpayers retain considerable control in determining the origin and structure of the claims against a corporate entity's income, and a judicious manipulation of these can reduce the scope of double taxation significantly. For example, taxpayers have much flexibility in designating the origin of the income a corporation distributes to any taxpayer who holds multiple claims against the corporation's income. In particular, to the extent a corporation formally pays a taxpayer for the use of something other than the taxpayer's financial capital, double taxation generally is avoided. Moreover, even if a corporation pays a taxpayer for nothing but the use of the taxpayer's financial capital, a portion of its payments can be made to flow with respect to claims that are not structured as equity claims, again avoiding double taxation. Indeed, since there is no theoretical limit to this portion,[2] double taxation of corpo-

[1] See Reg. § 301.7701-3, which superceded the truly silly Reg. § 301.7701-2 (repealed 1997).

[2] Herwig J. Schlunk, Little Boxes: Can Optimal Commodity Tax Methodology Save the Debt-Equity Distinction?, 80 Tex. L. Rev. 859, 861 (2002) [hereinafter Little Boxes].

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rate income, at least in theory, can be wholly avoided. But, as a practical matter, it cannot be wholly avoided.[3] The result is that income generated by identical economic activity will be either singly or partially doubly taxed, largely based on taxpayer skill in disguising the origin of the claims against such income and in engineering the structure of the claims against such income: two things that have little, if anything, to do with the economic activity itself.

In this Article, I attempt to find order in this apparent chaos. First, I ask whether there is any colorable theoretical justification for taxing twice some, but not all, of the income generated by joint economic activity. Second, I ask whether there is any colorable justification for taxing twice exactly the income that the current U.S. corporate income tax regime taxes twice. My answers to these questions may come as a surprise: I find that double taxation does have a colorable theoretical justification (indeed, many such). But I also find that there is no colorable justification for the double taxation scheme currently imposed in the United States.

These answers lead to an observation and a proposal. My observation is that there is no need for embarrassment on the part of anyone who supports the concept of double taxation. That is, notwithstanding the intellectual weight behind proposals for corporate integration,[4] and notwithstanding the political weight the Bush administration has given one such proposal,[5] double taxation can be justified. In other words, the conclusion that the current U.S. manifestation of double taxation is wholly irrational does not inexorably lead to the further conclusion that the entire enterprise of double taxation is irremedia-

[3] Congress, Treasury, the Service, and the courts have all imposed impediments to such avoidance. Thus, taxpayers seeking to reduce the scope of double taxation of corporate income must maneuver successfully around the various interest expense disallowance rules, e.g., IRC §§ 163(e)(5), *(l)*, the debt-equity guidelines, e.g., Notice 94-47, 1994-1 C.B. 357; Notice 94-48, 1994-1 C.B. 357, the conduit financing regulations, Reg. § 1.7701(l)-3, the rules allowing the reallocation of income of related parties, IRC § 482, and various recharacterization rules, such as those going under the names of assignment of income, e.g., Lucas v. Earl, 281 U.S. 111 (1930), disguised dividends, e.g., Neonatology Assocs., P.A. v. Commissioner, 299 F.3d 221 (3d Cir. 2002), and unreasonable compensation, e.g., Exacto Spring Corp. v. Commissioner, 196 F.3d 833 (7th Cir. 1999).

[4] See generally Treasury Dep't, Report on Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once (1992) [hereinafter Treasury Integration Report]; Michael J. Graetz & Alvin C. Warren, Jr., Integration of Corporate and Individual Income Taxes: An Introduction, 84 Tax Notes 1767 (Sept. 27, 1999).

[5] President Bush proposed corporate integration by means of a dividend exclusion coupled with a basis adjustment for undistributed corporate income. John D. McKinnan, Greg Hitt & Shailagh Murray, Leading the News: Bush Offers Huge Change in Taxes-Ending "Double Taxation" of Dividends Is Goal of President's Proposal, Wall St. J., Jan 8, 2003, at A3. In defense of this proposal, he observed that double taxation is "unfair" and that it "doesn't make any sense." Elisabeth Bumiller, Bush and the Economy: Genesis of a Plan; Nurturing the Tax Cut Idea Since the Era of Reagan, N.Y. Times, Jan. 7, 2003, at A16.

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bly flawed. It can lead instead to the alternative conclusion that a rationalization of the current manifestation is in order.

My proposal is precisely such a rationalization. Thus, I assume that the Untied States wishes to keep a modicum of double taxation, but also wishes to base such double taxation on a colorable justification. If so, it could do worse than to replace the current hodge-podge scheme for taxing entities with what I call the entity income tax. This alternative—which is really nothing more than an extension of the current scheme for double taxation to its logical limits—would lack, of course, the various aforementioned "arbitrary" distinctions that plague current law. In particular, the entity income tax would tax all "entity income" alike, irrespective of the structural trappings— classification of the entity, characterization of the claims against the entity's income—accompanying such income.[6] Capital structure, in the very broadest sense of the term, would become entity tax irrelevant.[7]

The Article proceeds as follows. In Section II, I posit that a sovereign, when enacting any tax, is motivated by a desire to raise revenue, a desire to modify taxpayer behavior, a desire to defray the costs or confiscate part of the value of some governmentally provided benefit, or a combination of these. I further posit that a benevolent sovereign only will enact taxes that are not unnecessarily distortionary. Given these premises, I ask whether the current scheme for the taxation of income from joint economic activity (henceforth the corporate income tax regime) is a scheme that a benevolent sovereign could enact. I conclude that it is not. I further conclude, however, that this failure is a result of defects in the current corporate income tax regime, and not a result of any inherent problem with the enterprise of levying an in-

[6] This Article focuses solely on the extent to which income from joint economic activity is subject to double taxation, and moreover focuses solely on the portion of such taxation imposed directly on the organizational umbrella housing the activity, that is, the entity. Thus, it does not discuss any distinctions currently made in the taxation of an activity's participants, such as the distinction between wage income and capital income, or between ordinary income and capital gains, or between active business income and passive income. The reason for my narrow focus is not that I endorse any of these distinctions, but rather that I believe there is much merit in first eradicating the distinctions at the entity level. In particular, a tax regime drawing distinctions only at the level of an activity's participants generally will have considerably fewer distinctions than a tax regime drawing distinctions both at the entity level and at the participant level, in part because it will lack the compounding of distinctions that is likely to follow from the interaction of distinctions at the two levels. Moreover, and for the same reason, a tax regime with distinctions only at the level of an activity's participants will be transparent: If the sovereign wants to aim a tax provision at a given constituency, it will have no choice but to do so in a direct and visible way. Finally, to the extent that my ultimate goal is to eradicate all tax distinctions at both the entity and the participant levels, it is necessary to begin somewhere. After all, Rome was not built in a day.

[7] Thus, this Article is the long-promised sequel to Herwig J. Schlunk, The Zen of Corporate Capital Structure Neutrality, 99 Mich. L. Rev. 410 (2000).

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cremental tax on some or all income generated by joint economic activity. Thus, my conclusion offers no succor to proponents of integration. Finally, I offer a wholly new justification for the incremental taxation of income generated by joint economic activity, indeed, the broadest possible justification. This justification, which is based on the theory of the firm, is the foundation for my proposed alternative "entity income tax."

Section III begins the explication of my entity income tax by identifying those taxpayers whose participation in an economic activity is sufficiently great that it makes sense for the tax law to (indirectly) incrementally burden their returns from the activity. The current corporate income tax regime limits its incremental burden to corporate shareholders. Thus, it does not incrementally burden the returns of any participant in a noncorporate entity, no matter the magnitude of her participation. And it reduces the aggregate incremental burden imposed on the returns of a corporation's participants to the extent that such corporation enters into sharing arrangements with participants (some of whom may participate greatly) other than shareholders. In contrast, my entity income tax would tax alike economic activity conducted by noncorporate and corporate entities. Moreover, by broadly defining who is a participant in an entity, it would impose an incremental tax burden that does not depend on the nature of the sharing arrangements made by the entity's participants.

Section IV outlines the mechanics for calculating an entity's taxable income under the entity income tax. In broad strokes, this calculation would extend to all entity participants the methodology the current corporate income tax regime applies to corporate shareholders. Thus, an entity's taxable income generally would be calculated by ignoring payments received by the entity from any participant (current corporate taxable income ignores payments received by a corporation in exchange for its shares or as contributions to capital) and payments made by the entity to any participant (current corporate taxable income ignores payments made by a corporation in exchange for its shares or as dividends).

In Section V, I ask: What should constitute an "entity" for purposes of the entity income tax? In particular, I discuss how much joint economic activity is necessary before an entity income tax becomes justifiable and I thus present a principled argument for exempting "small entities" from the reach of the tax. In addition, I discuss large entities and offer both a reason and a methodology for limiting to one the number of incremental taxes placed on any returns generated in entity solution. Finally, I discuss certain activities, such as hedging, conducted by taxpayers outside the confines of an entity that, for the sake

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of robustness, must be treated as if they were conducted within the entity.

Section VI addresses the impact of my proposed entity income tax on two potentially vocal constituencies: tax-exempt organizations and financial intermediaries.

Section VII compares my proposed entity income tax to other possible entity income taxes, including CBIT.[8] In addition, it discusses a significant ancillary benefit of my proposal: the dramatic lowering of nominal corporate income tax rates. It then produces a rough estimate of the tax rate necessary to produce revenue neutrality (that is, to replicate with the proposed entity income tax the revenues currently generated by the corporate income tax). It also notes that the actual required tax rate likely would be lower still, since the reduction in the marginal corporate income tax rate would be sufficiently large that it would remove much of the incentive for corporations to engage in corporate tax shelters.

Section VIII is a brief conclusion.

II. Why Tax Corporations?

Consider a typical sovereign managing a typical state. The sovereign has a variety of projects that it would like to pursue. These in general require revenue, and one way to raise revenue is to impose taxes.[9] The sovereign also has some views as to how its subjects should behave. It can implement such views in a variety of ways, including, for example, coercive regulation. But it also can encourage behavior modification by changing the costs of certain behaviors, and one way to accomplish this is to impose taxes on those engaging in the behaviors. Finally, the sovereign has certain services that it can offer its subjects and certain benefits that it can bestow on them. Some, like national defense, it cannot reasonably restrict to merely a subset of its subjects. But others, like admission to the Smithsonian Institute, it can restrict to only those subjects who sufficiently value the service. Thus, for these services or benefits, the sovereign can extract a payment that reflects the value of the service or benefit to those who make use of it, and one way to do this is to impose a "tax" on such users.[10]

[8] See Treasury Integration Report, note 4, at 39-60.

[9] I place no limit on the way these revenues are deployed (national defense, public works, income redistribution, and the like, are all the same within my analysis).

[10] Note that a given tax can serve more than one purpose. Indeed, any tax that is intended primarily either to modify behavior or to extract a portion of the value of some governmentally provided benefit also necessarily raises revenue. This observation does not alter the analysis in the text. It simply means that one always must be cognizant of the

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Whatever the sovereign's goal when enacting a given tax, whether revenue raising, behavior modification, or extraction of value, the tax itself may or may not be a particularly good way to accomplish the goal. That is, the chosen tax may have more attendant deadweight loss than some other tax (or regulation) that also would accomplish the goal. For example, an *ideal* revenue-raising tax is one that does not affect any taxpayer's behavior; an *optimal* revenue-raising tax is one that does affect such behavior, but to the least extent possible. And an *ideal* behavior-modifying tax is one that modifies certain taxpayer behavior without affecting any other taxpayer behavior; an *optimal* behavior-modifying tax is one that does affect some such other behavior, but to the least extent possible. And an *ideal* fee is one that extracts from taxpayers exactly their "consumer surplus" with respect to some governmentally provided service or benefit; an *optimal* fee is one that overcharges or undercharges certain taxpayers, but to the least extent possible.

While by definition it would be optimal for a sovereign to accomplish its goals by means of optimal taxes, this is not generally practical. In matters of taxation, as in horseshoes, "close enough" is the best one can expect. In part, this is because anything better generally requires prohibitively costly empirical analysis that must be continuously updated. Thus, any attempt to get too close to the "optimum", would be nothing more than a recipe for perpetual inaction. Moreover, there is a second problem that will keep the optimum forever out of range. All language, and therefore all law, and therefore in particular all tax law, is inherently imprecise. Thus, any law, no matter how carefully drafted and how intricately qualified, will be overinclusive or underinclusive or, more likely, both. But the mere fact that it is impractical or even impossible to achieve the optimum does not mean that a sovereign should be excused for enacting a suboptimal tax. The question, rather, is whether the allegedly unintentional distortions caused by such tax are so predictable and significant and easy to rectify that their existence and the sovereign's toleration of them completely undermines the sovereign's stated or presumed goal in enacting the tax.

Thus, the question I pose is whether the current corporate income tax is "close enough" to being an optimal tax that a benevolent sovereign could impose it. To answer this question I must identify the goal behind the tax and then determine whether the effects of the tax are such that the tax is a reasonable way of accomplishing the goal. The most obvious place to begin, of course, is with a legislative declaration

possibility that something that appears to be a tax aimed at a single end in fact may be a tax aimed at multiple ends.

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of the goal. But there is none.[11] But that does not mean that such a goal does not (or could not) exist. I simply need to find it.

Absent an affirmative declaration that the corporate income tax is intended to somehow modify taxpayer behavior or to charge taxpayers for their enjoyment of some governmentally provided benefit, the most logical assumption is that it is intended primarily to raise revenue. But could a benevolent sovereign plausibly choose to raise revenue with this tax? Not without more. As already noted, the corporate income tax distorts taxpayer behavior: It encourages taxpayers to shift economic activity to entities that are not subject to the tax, and it encourages them to alter the structure of their claims against the income of entities that are subject to the tax. Moreover, these behavioral effects are predictable and significant and are ones that the sovereign could easily rectify. That is, it would take but a sentence of code to extend the reach of the corporate income tax to encompass partnerships and limited liability companies, and but another sentence of code to extend the reach further to encompass the returns payable to entity debtholders. While these modifications would not eliminate all distortionary taxpayer behavior with respect to the structuring of joint economic activity, they would eliminate much of it. That these modifications have never been seriously considered forces the conclusion that the current corporate income tax cannot be a tax solely intended to raise revenue.[12]

Thus, I must seek alternative justifications for the tax, or more correctly for the scope of the tax: its inclusions and exclusions. I limit myself to those found in the tax literature (under the assumption that most everything plausible should be contained therein).[13] Following such literature, I divide my discussion of possible justifications of the current corporate income tax into two parts. First, I analyze so-called

[11] Steven Bank argues persuasively that the current entity tax structure, with the double taxation of certain corporate income, is largely the result of historical accident. Steven A. Bank, Rethinking Double Taxation's Role in Dividend Policy: An Historical Approach, 56 Tax L. Rev. 463 (2003). That such structure has been retained over the years is probably due to a combination of a desire on the part of the government to maintain corporate tax revenue, a general lack of understanding that the corporate tax is ultimately borne by individuals, and a lack of interest on the part of managers in the repeal of such tax. Jennifer Arlen & Deborah M. Weiss, A Political Theory of Corporate Taxation, 105 Yale L.J. 325, 327, 332 (1995).

[12] I already have noted that the corporate income tax might be intended to promote multiple goals. Thus, the immediate rejoinder to the observation that it is deficient as a pure revenue-raising tax is that it also is intended to promote a secondary goal, such as to subsidize small business (with the subsidy delivered in the form of an exemption from the tax). This view, however, would fail to explain the taxation of small C corporations, the exemption from tax of large partnerships, the debt-equity distinction, and much more.

[13] For an alternative discussion of various theories that might support a corporate income tax, see generally Rebecca S. Rudnick, Who Should Pay the Corporate Tax in a Flat Tax World, 39 Case W. Res. L. Rev. 965 (1989).

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benefits justifications. These justifications posit that certain entity organizational structures allow participating taxpayers to achieve benefits that could not be achieved (either at all or at comparable cost) absent the utilization of the structure. But the structure, and hence the benefits, arise by grace of the sovereign, either in a direct sense (legislation enables the structure and its benefits) or in an indirect sense (the structure and its benefits are contractual, and the sovereign enforces contracts). Thus, the sovereign is justified in imposing a fee on those who take advantage of the benefits, and the chosen fee can be imposed directly on the entities through which taxpayers realize such benefits. My analysis, of course, focuses on the question of whether the corporate income tax is a plausible fee for a benefit.

Second, I consider possible justifications for the corporate income tax that lack the quid pro quo nature of the benefits theories. In general, the lack of a necessary relationship between the corporate income tax and a specific benefit makes it harder to dismiss such justifications as nonsensical. For example, it is impossible to dismiss the tautological justification that the goal of the current corporate income tax is to tax all entities exactly in the manner set forth in the Code. This tax probably would be best viewed as a tax designed primarily to modify taxpayer behavior (but that raises considerable revenue along the way). And, trivially, it would modify taxpayer behavior only in intended ways. Unfortunately, this tautological justification does not begin to tell a story as to *why* a benevolent sovereign would want to modify taxpayer behavior as such behavior is currently modified: encouraging the use of LLCs rather than corporations, encouraging the use of debt rather than equity, and so on. It simply leads back to square one.

A. *Benefits Theories*

1. *Limited Liability*

Perhaps the most obvious benefit that the corporate organizational form provides to some of its participants, the shareholders, that historically they could not achieve easily absent such form is limited liability.[14] Since the sovereign enacts the legislation that makes such

[14] See Joseph A. Pechman, Federal Tax Policy 98 (1966) ("[a] special tax on the corporate form of doing business is considered appropriate because corporations enjoy special privileges and benefits . . . [which] include perpetual life, limited liability of shareholders and liquidity of ownership . . ."); Alvin C. Warren, The Corporate Interest Deduction: A Policy Evaluation, 83 Yale L.J. 1585, 1600 (1974) ("[a] separate tax on corporate income is sometimes considered appropriate because of the privileges and benefits granted corporations by the state, such as limited liability for investors . . ."). But see Richard A. Musgrave & Peggy B. Musgrave, Public Finance in Theory and Practice 294 (2d ed. 1976) (the institu-

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limited liability possible,[15] it conceivably could levy a tax, perhaps even an income tax, as a "fee" for the provision of such benefit.

For example, consider an economy with neither limited liability nor a corporate income tax. In such economy there is a project that costs $100 to undertake and that produces, with 90% probability, a gross return of $150 and, with 10% probability, a gross return of -$200. The expected return from engaging in such project is 15%; the variance of the returns from such project is quite high. If the economy is solely populated with sufficiently risk-averse entrepreneurs, this project might be much less desirable than the marginal alternative, perhaps a risk-free project yielding 10%. Thus, the project will not be undertaken. But this will not be the socially optimal result if the economy is sufficiently diversified to be more or less globally risk-neutral. Thus, to achieve the socially optimal outcome, the sovereign offers limited liability. Subject to this modification, the project now has an expected return of 35% (the gross return in the bad state of the world is now zero instead of -$200); moreover, the variance of the returns has greatly diminished. If 25% were the expected return required by an entrepreneur to undertake a project with such diminished variance, the project will be undertaken. The offer of limited liability will have achieved its goal.

But it also will have achieved more. Assume that there is a second project to which any grant of limited liability also will apply (since, for example, it is cost prohibitive for the sovereign to cherry-pick projects). This project also costs $100 to undertake, but it produces, with 90% probability, a gross return of $150 and, with 10% probability, a gross return of -$50. Thus, the expected return from engaging in the project is 30%; the variance of the returns is relatively moderate. Given the investment opportunities available in the economy, it is conceivable that 30% is an appropriate return for a project of such variance, and that an entrepreneur will undertake it without more. But suddenly there is more: limited liability. Once the project is given limited liability, its returns become identical to those of the first project; its expected return will rise to 35% and its variance will fall. This change does not affect whether the project is undertaken; it is undertaken in any event. But it does affect the distribution of the

tion of limited liability is practically costless to society and hence does not justify imposition of a benefit tax).

[15] I put to one side the fact that, in the United States, limited liability generally is a creature of state law rather than of federal law. This suggests that states, rather than the federal government, should impose any attendant fee. But this is only a suggestion: The multistate nature of most corporate activity would make it reasonable for states to use the federal government as a collection agent for their fee.

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social returns from the project; the entrepreneur has been granted a windfall.

A benevolent sovereign might respond by enacting a tax on the benefit of limited liability: a tax that ideally will not discourage the undertaking of socially beneficial projects, but that will eliminate some or all unnecessary transfers of wealth to entrepreneurs. Thus, in the case of the first project above, if 25% is the required expected return once limited liability is introduced, an expected tax of $10 would be ideal. And in the case of the second project, an expected tax of $5 would be ideal, since such tax would offset the windfall generated by limited liability but otherwise would leave the entrepreneur's returns unaffected. Of course, the sovereign will never be able to enact this ideal tax: it will never have enough information to calculate that expected taxes of $10 and $5, respectively, would be ideal.

But the lack of perfect information does not mean that the sovereign has no useful information whatever. In fact, it knows that its ability to confiscate a portion of the fruits of limited liability will be greatest in states of the world where the shield of limited liability is not actually invoked and least in states of the world where the shield is invoked. This suggests that the tax should be correlated with some measure of ex post profitability.

Moreover, the sovereign has some reason to suspect that the benefits of limited liability will be greater for larger enterprises. For consider two firms, one large and one small. If the large firm is identical to the small firm except that each of its projects has greater scale, then the large firm will reap greater absolute, albeit identical relative, benefits from limited liability than the small firm. And if the large firm is identical to the small firm except that it has undertaken more projects than the small firm, then the large firm generally will reap greater absolute, albeit smaller relative, benefits from limited liability than the small firm. The exact magnitude of the benefits will depend upon the extent to which the returns on its various projects are correlated with one another.[16] Thus, taken all in all, it would not be unreasonable for the sovereign to behave as if the benefits from limited liability are greater for larger enterprises. Since enterprise size is positively correlated with expected profitability, and hence with actual profitability, it again would not be unreasonable for the sovereign to base its assessment for the benefit of limited liability on ex post profitability.

Thus, the sovereign might consider enacting a tax on the profits of firms benefiting from limited liability. In my example, it might enact a 20% nonrefundable tax on income (as defined under current law). If

[16] Almost all projects have returns that are to some extent positively correlated with the economy as a whole, and hence with one another.

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so, each firm would pay $10 of tax in the good state of the world, or 90% of the time. This tax would leave each project with a 26% expected rate of return, provided such projects were undertaken with limited liability. In the case of the first project, the combination of limited liability and income tax leaves a small "unnecessary" transfer of wealth to the entrepreneur (a 25% expected return would ensure the project is undertaken; indeed, since the income tax reduces the variance of the project's returns, a return even lower than 25% might be acceptable). In the case of the second project, the combination of limited liability and income tax actually reduces the expected return from the project. Thus, the income tax may seem like an unwarranted confiscation by the sovereign. But it is not. The entrepreneur did not need limited liability to undertake the project, and will, if she is rational, continue to undertake the project without it.

Since there is nothing untoward in these results, I conclude that a sovereign could enact a corporate income tax as a way to tax those who reap a benefit from its grant of limited liability.[17] But that is not the question at hand. That question, rather, is whether a sovereign could use this justification to enact the current corporate income tax. And the answer is that it could not.

Under current tax law, noncorporate entities called limited liability companies are exempt from the corporate income tax even though they are able to achieve precisely the same degree of limited liability protection for their members as C corporations are able to achieve for their shareholders. Moreover, even certain corporations—S corporations—are exempt from entity-level tax, but their shareholders do not suffer one jot of diminution of their liability protection as a result. Finally, certain families of corporations, so-called consolidated groups, while not being exempt from the corporate income tax, are exempt from paying multiple levels of such tax,[18] notwithstanding the fact that they are able to achieve for their shareholders liability protection that exceeds the more generic limited liability protection provided by a single corporation: Subsets of the group's assets are protected from the liabilities generated by other of the group's assets. Thus, the corporate income tax entirely misses many taxpayers who in fact benefit

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[17] A parallel analysis would conclude that the sovereign's tax with respect to limited liability is not actually a benefits tax but rather a tax intended to modify taxpayer behavior. That is, limited liability results in the imposition of costs on those who have no ability to protect themselves (for example, certain tort creditors). Thus, a sovereign *should* charge a fee to ensure that an entity taking advantage of limited liability takes these costs into account. Hal R. Varian, Microeconomic Analysis 433 (3d ed. 1992). Since these costs are generally identical to the "unnecessary transfer of wealth" mentioned in the text, albeit viewed from a different baseline, an identical tax would result despite the sovereign's ostensibly different goal.

[18] IRC § 1502.

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from limited liability, and additionally fails to take into account the extent to which different taxpayers in fact may benefit.

In addition, under current tax law, there are equity participants in some entities who do not enjoy full limited liability protection—general partners in publicly-traded partnerships[19] and shareholders in closely held C corporations who have agreed to guarantee some of such corporations' debts—but whose equity interests in such entities nonetheless are fully burdened by the corporate income tax. Thus, the corporate income tax fully hits a number of taxpayers who in fact do not fully benefit from limited liability.

As already noted, it is in the nature of things that legal categories are always somewhat imprecise, and hence that any tax (including any fee for benefits) to some extent will be both underinclusive and overinclusive in its application. So the relevant question is whether the underinclusiveness and overinclusiveness in the instant case is one that the sovereign could easily rectify. And the answer is, yes, at least to a significant extent. For while it would be a nontrivial matter to "fix" the current corporate income tax so that it perfectly functioned as a tax on the benefit of limited liability,[20] it would be a trivial matter to improve its fit. For example, the sovereign could simply extend the current corporate income tax to limited liability companies and S corporations and the share of limited partnership income allocable to limited partners. Thus, as currently structured, it is impossible to conclude that the corporate income tax is intended to be a fee for the benefit of limited liability.[21] Moreover, there is no movement afoot to make it so.[22]

[19] IRC § 7704(b).

[20] Among other things, the sovereign would need to determine the proper tax treatment of more subtle liability-limiting structures, such as the limited partnership with a general partner who, under relatively foreseeable circumstance, might become insolvent and hence judgment-proof.

[21] One could again attempt a two-part justification for the structure of the tax. Thus, the corporate income tax could be intended as a fee for the benefit of limited liability, but the sovereign also could want to subsidize limited liability companies, S corporations, and limited partners. The problem with this justification is that the subsidized constituencies are sufficiently disparate in their membership that there appears to me to be no particularly good reason for subsidizing them as a group. Moreover, to the extent that a subsidy in fact is desired, it is not particularly logical to tie such subsidy to the fee that otherwise would be imposed on the benefit of limited liability. Thus, I reject the two-part justification.

[22] Indeed, the most recent relevant tax law changes, the check-the-box regulations and the liberalization of the requirements for S corporation qualification, have moved in precisely the opposite direction.

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2. *Liquidity*

A second benefit that the corporate form can provide that is not otherwise generally achievable with similar ease is liquidity.[23] Liquid capital markets greatly reduce the costs of contracting, monitoring, and the like that otherwise must be incurred with respect to capital investments.[24] A reduction in these costs allows taxpayers making such investments to earn higher risk-adjusted returns than they would from illiquid investments. Since the sovereign facilitates such benefits through the maintenance and regulation of financial markets, it conceivably could impose a tax, perhaps even an income tax, as a "fee" for its services.

For example, consider a project that requires a number of investors to each contribute $100 of capital and that produces a single payment of $120 per $100 invested. Thus, if there were no transaction costs, the project's return would be 20%. But there are always transaction costs. Suppose, in a world without liquid capital markets, that the contracting costs faced by potential investors—due diligence investigation and the like—amount to $5 per $100 invested. And suppose that the monitoring costs faced by investors—those costs designed to ensure that their money does not fund a lavish hideaway in the Caribbean—also amount to $5 per $100 invested. From the perspective of each investor, the project in fact does not require an investment of $100 and produce a payment of $120; it requires an investment of $105 and produces a payment of $115. The 20% return has fallen to 9.5%. And that might be enough to prevent the project from being undertaken. So the potential investors might lobby the sovereign to establish and maintain the infrastructure necessary for the development of a liquid capital market. If it complies, and if such market begins to operate in

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23 Other commentators have argued that the corporate income tax is evolving into a tax solely on publicly traded entities. William A. Klein & Eric M. Zolt, Business Form, Limited Liability, and Tax Regimes: Lurching Toward a Coherent Outcome?, 66 U. Colo. L. Rev. 1001, 1015-17 (1995) (several considerations support the use of liquidity as a means of distinguishing between entities); Jerome Kurtz, The Limited Liability Company and the Future of Business Taxation: A Comment on Professor Berger's Plan, 47 Tax L. Rev. 815, 824-25 (1992) (public versus private is both a simpler and a more logical place to draw the line between flow-through and separate entity taxation); Larry E. Ribstein, The Deregulation of Limited Liability and the Death of Partnership, 70 Wash. U. L.Q. 417, 471-73 (1992) ("[t]he classification system appears to be moving toward a liquidity-based distinction that may be preferable to the current corporation-partnership distinction . . .").

24 Liquidity is related to limited liability in the sense that the former is not in general achievable without the latter. But see Henry Hansmann & Reinier Kraakman, Toward Unlimited Shareholder Liability for Corporate Torts, 100 Yale L.J. 1879, 1903-16 (1991) (capital markets, and in particular the stock market, would continue to function efficiently with unlimited shareholder liability). In any event, liquidity has other requirements as well—in particular the existence of well-functioning avenues for disseminating information.

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its intended fashion, each investor's contracting and monitoring costs will fall, for each investor is able to rely, to some extent, on the contracting and monitoring activities undertaken by other investors. Thus, suppose that contracting costs per $100 invested fall from $5 to $2, and that monitoring costs per $100 invested similarly fall from $5 to $2. Now the project, from each investor's perspective, requires an investment of $102 and produces a payment of $118. This 16% return is not quite what could be attained in a frictionless world, but it is quite an improvement over what could be attained without liquid capital markets.

As did the sovereign's grant of limited liability, so will the sovereign's facilitation of liquid capital markets have the twin effects of enabling certain projects to be undertaken that otherwise would not be undertaken and of providing incremental returns[25] to those projects that would be undertaken in any event.[26] Even a benevolent sovereign may desire to confiscate a portion of the incremental returns it has made possible. Thus, using as a baseline the return available in the illiquid world—here 9.5% (assuming the project would have been undertaken even absent liquidity)—the sovereign could charge a fee of up to $6 per $100 of investment. Assuming such $6 fee, each investor would make an investment of $102 and receive a payment of $112, for a return of slightly in excess of 9.5%.

Of course, the sovereign generally will not know precisely the amount of incremental return that liquidity makes possible. But it can hazard some guesses. First, it could reasonably assume that there can be no significant incremental return to any project that does not make use of liquid capital interests. Second, it could reasonably assume that the incremental return to any project making use of liquid capital interests flows largely to the holders of such liquid capital interests. Third, it could reasonably assume that the incremental return to any given project making use of liquid capital interests will be greater if

[25] In equilibrium, particularly when the discussion is one of liquid capital markets, it is tricky to speak of incremental returns. Quite simply, there are none. Rather, all such returns are immediately capitalized into asset prices. Thus, the introduction of a benefit, such as a liquid capital market, would cause asset prices to change, resulting in transitional windfalls and losses. A sovereign could try to minimize such windfalls and losses. Thus, at the same time that it built the infrastructure necessary for the development of a liquid capital market, the sovereign could impose a tax on all of those who take advantage of the capital market. This tax would reduce the magnitude of the windfalls otherwise reaped by those who take advantage of the liquid capital market.

[26] The distributional concerns raised by the introduction of liquid capital markets are less significant than those raised by the introduction of limited liability. In the case of liquid capital markets, the incremental returns come not at the expense of potential tort claimants and the like, but at the expense of those who are employed in various transaction costs industries. Presumably, those individuals can find other gainful employment.

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the number of investors is greater and in particular if the number of "small" investors is greater.[27]

Thus, a sovereign desiring to confiscate a portion of the incremental return reaped by enterprises making use of liquid capital interests could consider enacting a tax on enterprises with liquid capital interests, and could further consider structuring such tax so that it (at least optically) indirectly burdens only the owners of such liquid capital interests, and finally could consider structuring such tax so that the indirect burden imposed on small investors is greater than the indirect burden imposed on large investors. Likely, the sovereign would dispense with this last consideration. Accommodating it would require resolving difficult definitional issues (what is small? what is large?) and, perhaps more importantly, would lend the tax a possibly politically unappealing regressive air (at least as between small and large investors). If so, the sovereign might well enact a type of corporate income tax: a tax on entities with liquid capital interests where the tax base is the share of the entity's income ultimately payable to the owners of the liquid capital interests. But that is not the question at hand. That question, rather, is whether a sovereign could use this justification to enact the current corporate income tax. And the answer is that it could not.

Under current law, there are owners of liquid equity interests in certain entities—publicly traded partnerships with qualifying income[28] and real estate investment trusts,[29] to name just two—who are largely or completely unburdened by the corporate income tax even though they surely benefit from access to liquid capital markets. In addition, all owners of liquid debt instruments are so unburdened,[30] even though such owners surely benefit from the liquidity of their debt instruments. Finally, there are owners of certain quasi-liquid equity interests in corporations—grantees of nonqualified stock options that will blossom into liquid stock on exercise, and grantees of restricted stock that will blossom into liquid stock on the lapse of the relevant restrictions—who, while nominally burdened by the corporate income tax prior to the advent of true liquidity, ultimately often are burdened by a negative amount of corporate income tax.[31] Such owners, not-

[27] Large investors can spread largely identical amounts of contracting and monitoring costs over a much larger investment base, thus incurring lower relative costs.

[28] IRC § 7704.

[29] IRC §§ 856, 857(b)(1).

[30] This is because interest payable by any entity to an owner of a debt instrument generally is deductible against the entity's taxable income. There are some exceptions, such as IRC §§ 163(e)(5), *(l)*, 279, but none that matter to my argument.

[31] For example, suppose that restricted stock is granted at such time when the stock price is $50. Had unrestricted stock been granted instead, the corporation would have received an immediate compensation deduction of $50. IRC § 83(a). Absent a § 83(b)

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withstanding their lack of immediate access to liquid capital markets, nevertheless benefit from the presence of such markets, since the value of their options or stock is derivative of the value of fully liquid options or stock. Thus, the current corporate income tax misses a host of taxpayers who clearly benefit from liquidity.

In addition, under current law, there are owners of illiquid corporate equity interests—stock in closely held C corporations and very large blocks of stock in publicly traded corporations—who nevertheless are fully burdened by the corporate income tax. Thus, the corporate income tax hits some taxpayers who in fact do not benefit from liquidity.

Again, the fact that the current corporate income tax, viewed as a tax on the benefits of liquidity, is both somewhat underinclusive and overinclusive in its scope is not necessarily fatal to the proposition that such tax is intended to be a tax on the benefit of liquidity. What is fatal, however, is that while it would be a nontrivial matter to "fix" the corporate income tax so that it perfectly functioned as a tax on the benefits of liquidity,[32] it would be a trivial matter to improve the tax's fit. For example, the sovereign could extend the corporate income tax to such entities as publicly traded partnerships and REITs,[33] could

election, however, the grant of the restricted stock is a nonevent for corporate income tax purposes. IRC § 83(h). Prior to lapse of the restriction, suppose that income allocated to the restricted stock—that is, the share of the corporate income allocable to such stock under the assumption that such stock is outstanding—is $10. In that case, the corporation pays tax on $10 of income allocable to the restricted stock. Suppose that the stock price is $100 at the time the restriction lapses. At that time the corporation receives a compensation deduction of $100, which is $50 more than it would have received had the stock been granted without the restriction. IRC § 83(h). Thus, from the time the restricted stock is granted to the time that it becomes outstanding stock for corporate income tax purposes, the corporation has net taxable income of -$40 indirectly or directly attributable to such stock.

[32] Among other things, it would be necessary to determine what it means for an interest to be liquid. Current tax law contains definitions for the phrases "publicly traded securities" and "marketable securities," which may or may not appropriately capture who are the beneficiaries of liquidity. See, e.g., IRC §§ 453(f)(2), 731(c)(2)(A), 1044(c)(1). Alternatively, the concept of free transferability might be closer to the desired mark. See Reg. § 301.7701-2 (repealed 1997). Of course, since none of these terms has any platonic content, the law ultimately would be required to accept a more or less arbitrary definition. Moreover, temporal questions also would need to be resolved. Thus, if the chosen definition was that an entity had to have at least a certain number of equity owners (for example, a partnership is not a publicly traded partnership unless it has more than 100 partners, Reg. § 1.7704-1(h)(1)(ii)), or that a certain fraction of its equity changed hands in a given period (for example, a partnership is not a publicly traded partnership if less than 12% of its total interests trade in a given year, Reg. § 1.7704-1(g)(2)(vii), -1(j)), an entity subject to tax in one tax period (or portion thereof) might not be subject to tax in a second tax period (or portion thereof). Thus clarifying and complicating rules would quickly multiply.

[33] At least with respect to these types of entities, one again could attempt a two-part justification for their current tax treatment. Thus, the corporate income tax could be intended as a fee for the benefit of liquidity, but the sovereign also could want to subsidize

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eliminate the interest deduction for publicly traded debt, and could exempt closely held C corporations from the tax. Thus, as it is currently structured, it is impossible to conclude that the corporate income tax is intended to be a tax imposed on the benefit of liquidity. Moreover, there is no movement afoot to make it so.[34]

3. *Agency Costs*

Another possible justification for a corporate income tax is that it eliminates certain agency costs.[35] Thus, under a pass-through tax regime, the disparate tax postures of various equity owners may affect their view of the desirability of certain entity-level activities.[36] For example, if the entity is approached regarding the possible sale of an asset, and if such sale would produce a large taxable gain, equity owners who would pay no tax—tax-exempt organizations, those with losses that can offset the gain, and the like—generally would want the sale to be consummated, while equity owners who would pay tax may be less enthusiastic. Assuming that the entity's managers are also eq-

investments by "small investors" in certain passive activities (qualifying income generators) including real estate. Moreover, while the investors in publicly traded partnerships and REITs are by no means all "small," it would not necessarily be unreasonable for the sovereign to deem them to be so, perhaps as a matter of administrative convenience. Nevertheless, a problem remains with the nature of the intended subsidy: There is no logical reason to tie the subsidy to the fee that otherwise would be imposed on the benefit of liquidity. But that is perhaps a detail. Still, even if one accepts this two-part justification as adequately explaining the corporate income tax treatment of publicly traded partnerships and REITs, the liquidity justification for the corporate income tax will continue to fall on the sword of publicly traded debt instruments and closely held C corporations.

[34] Legislation in 1987 extended the corporate income tax to certain publicly traded partnerships (those without so-called qualifying income). Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, § 10211, 101 Stat. 1330, 1330-403-5 (adding § 7704). However, there has been no subsequent movement to further extend corporate income tax treatment to publicly traded entities. Moreover, there has been no particular interest in ameliorating the incremental tax burden currently imposed on closely held C corporations (which admittedly are largely creatures of historical accident). For example, rules for reducing the tax costs of converting such entities to S corporations have not been forthcoming. Indeed, President Clinton's 2000 budget proposal (not enacted) would have greatly increased the tax costs of such conversions by generally treating them as taxable liquidations, with immediate gain recognition to both the corporation and its shareholders. Treasury Dep't, General Explanations of the Administration's Revenue Proposals 143 (1999), available at http://www.treas.gov/press/releases/docs/grnbk99.pdf.

[35] See Hideki Kanda & Saul Levmore, Taxes, Agency Costs, and the Price of Incorporation, 77 Va. L. Rev. 211, 227-33 (1991); Joseph A. Snoe, The Entity Tax and Corporate Integration: An Agency Cost Analysis and a Call for a Deferred Distributions Tax, 48 U. Miami L. Rev. 1, 12-15 (1993).

[36] The unrelated business taxable income rules to some extent ameliorate the agency cost in the partnership context. See IRC § 512. Such rules impose tax on otherwise tax-exempt partners, thus placing such partners on a similar tax footing with their taxable comrades. Such rules, however, in general do not apply to sales of capital assets used in a business, IRC § 512(b)(5), and so leave considerable scope for divergence of interest.

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uity owners, it takes little imagination to guess which interests are most likely to be accommodated. Placing all equity owners on an equal footing, by subjecting them only to an identical indirect tax levied at the entity level, removes the potential conflict.

Thus, the corporate income tax could be seen as a tax imposed by a benevolent sovereign in exchange for providing a mechanism that eliminates certain agency costs. Indeed, this justification could explain why only a single varied category of entities—C corporations—is subject to the tax. Untaxed entity structures must be available for taxpayers who are indifferent to the agency-cost concern. Nonetheless, this justification leaves much to be desired, for it only makes sense if the choice of C corporation tax status is elective.[37] But it is not. Perhaps the lack of choice is not a fatal flaw in the case of publicly traded corporations; perhaps a sovereign could reasonably believe that any corporation with a sufficiently large number of shareholders is apt to have agency problems that only the sovereign can remedy. But why would the sovereign discourage, through the imposition of a double tax toll charge, a taxed close corporation from converting itself into an untaxed entity if the owners decide they no longer are concerned by agency costs?

Moreover, the proposition that agency costs related to owner taxes can be best overcome by a corporate-level income tax is itself dubious. For example, suppose, as is generally the case, that the corporate income tax is levied at roughly the highest rate that would be applicable to any owner if the entity were taxed on a flow-through basis. In that case, the sale of an entity asset results in an immediate aggregate tax bill that is at least as high in the corporate context as it is in the flow-through context. Thus, in the flow-through context, the owners could agree contractually to distribute an amount of cash equal to the tax that would have been paid were the entity taxed as a corporation. Such distribution would leave the flow-through entity with exactly the same assets as it would have had were it a corporation, and will leave the owners with either sufficient cash to pay their separate tax bills (in the case of the highest marginal tax rate owners) or more than enough to pay such bills (in the case of all other owners). The economic results produced by this contractual arrangement, a so-called "tax distribution" arrangement, strictly dominate the results achievable by subjecting the entity to the current corporate income tax. Thus, there is no need to so subject the entity if the sovereign's goal really is to enable the owners of entities to overcome the agency costs created by differences in their tax rates.

[37] Ribstein, note 23, at 470.

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Finally, an additional significant problem plagues the agency-cost justification. While the corporate income tax may eliminate one agency cost arising from the different tax postures of a corporation's owners, it creates another. That is, under the current corporate income tax, a second tax is imposed when the corporation distributes its after-tax income. The amount of this tax depends on the tax posture of the owner receiving the distribution. Thus, the second tax creates a new agency cost, again based on the different tax postures of the corporation's owners, that is fundamentally identical to the agency cost the corporate income tax was supposed to eliminate. Owners who face a high rate of tax on distributions will seek to have distributions deferred; owners who face a low rate of tax on distributions will seek to have distributions accelerated. Why this agency cost is more tolerable than the one eliminated by the corporate income tax is unclear.[38] Perhaps the reasoning is that a cost deferred is a cost eliminated. But this strikes me as unsatisfying. Thus, all in all, I find it implausible that the current corporate income tax is intended to be a tax on those reaping a benefit from the elimination of agency costs.

B. *Other Theories*

1. *Withholding Tax on Equity*

If a sovereign, such as ours, chooses to treat certain juridical persons as separate taxpayers, it must take care if it wants to ensure that all cognizable income[39] generated by such taxpayers is currently (or even ultimately) taxed. One way to ensure this is by requiring all such income to be allocated currently to those associated with such juridical persons: Subchapter K (for partnerships) and subchapter S (for S corporations) operate in this way. A potential gap in coverage arises, however, when less than all cognizable income generated by a juridical person currently is so allocated. For example, the C corporation tax regime allocates much income generated by corporate economic activity to taxpayers associated with the corporation as such income is earned. Employees are allocated income in the amount of wages they receive, lenders are allocated income in the amount of interest ac-

[38] It is likely that eliminating the tax on corporate distributions would significantly increase the pressure on corporate managers to make such distributions. Indeed, this fact may explain why publicly traded corporations have not lobbied for the elimination of such tax. Arlen & Weiss, note 11, at 368. Thus, the current corporate income tax regime, far from eliminating agency costs, probably exacerbates the single greatest corporate agency cost—that related to the separation of corporate ownership and control.

[39] Cognizable income, of course, may be less than economic income, whether due to the presence of specially enacted incentives (for example, accelerated depreciation) or due to the presence of administrative rules of convenience (for example, the realization requirement).

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crued on their loans, lessors are allocated income in the amount of rent they receive, licensors are allocated income in the amount of royalties they receive, and so on. After all such allocations of income generated by the corporation's economic activity have been made, however, there may be, and the shareholders and other taxpayers associated with the corporation hope there will be, some residual amount of income that is not immediately allocated to anyone. One could say that this income "belongs" to shareholders—indeed, in the S corporation context it would be allocated to shareholders—but this characterization is at best premature, since absent a dividend distribution or a repurchase of shares by the corporation, the income subsequently can be reallocated to others. In any event, current tax law does not allocate this income to anyone. Thus, but for the corporate income tax, it would not be subject to any income tax as it is earned. Moreover, again but for the corporate income tax, it theoretically could escape income taxation forever.[40]

Thus, a sovereign desiring to enact an individual income tax conceivably could enact a corporate income tax as a way to ensure that no currently unallocated income of any juridical person escapes immediate income taxation.[41] Of course, it would only need to do so if it also believed that there was sufficient administrative benefit to be gained from taxing corporate equity income by means of a corporate income tax rather than by means of a tax imposed directly on shareholders after an allocation of corporate income to such shareholders. But that is a plausible belief, particularly if the number of shareholders of a corporation is large and the turnover of shares is frequent.

But while a sovereign's desire to enact an individual income tax could lead to the enactment of a complementary corporate income tax, it could not lead to the current corporate income tax. The goal, after all, is simply to ensure that all income generated by corporate economic activity is taxed once, preferably as it is earned. Thus, a sovereign making this use of the corporate income tax would not make the tax an incremental tax, or a double tax, on income nominally allocable to corporate equity. Instead, it would make the corporate income tax a sort of withholding tax, a prepayment of the

[40] This would occur under current tax law if the income were reinvested in perpetuity by the corporation, and if the shareholders transferred their shares in such corporation only immediately after death. IRC § 1014.

[41] Pechman, note 14, at 99 (the corporate income tax is necessary to prevent individuals from avoiding the individual income tax by accumulating income in corporations); Steven A. Bank, Entity Theory as Myth in the Origins of the Corporate Income Tax, 43 Wm. & Mary L. Rev. 447 (2001) (historical support for viewing the original corporate income tax in precisely this way).

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ultimate shareholder tax.[42] Since, the current corporate income tax is manifestly an incremental tax, it is impossible to justify as a mere mechanism to ensure that no income generated by corporate economic activity escapes the individual income tax.[43]

2. *Achieving Regulatory Goals and Other Policy Objectives*

In theory, a corporate income tax could be used by a sovereign to modify taxpayer behavior in some desirable way. For example, a sovereign might consider using such tax to restrict the absolute size and/or power of firms or to selectively encourage new investment by or otherwise lower barriers to entry for certain firms. But without repeating the by now familiar analysis, it seems implausible that the current corporate income tax is intended to accomplish such goals.[44] Thus, for example, there are plenty of C corporations with neither size nor power; and there are plenty of partnerships with both.[45] Why would a sovereign, even a very paternalistic one, conceivably want to discourage new investment by small C corporations in favor of new investment by large partnerships? And similarly, why would a sovereign conceivably want to raise barriers to entry for large C corporations, when they may be the only ones with sufficient capital to make entry possible?[46] Finally, even if some plausible regulatory reason for incrementally burdening C corporations did emerge, what would be the reason for taxing such corporations differently with respect to their debt and their equity capital?[47] After all, debt capital, just like equity capital, can purchase political power or fund new investment, including investment related to the entry of new markets.

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[42] If the sovereign wanted all such income to be taxed at the shareholder's marginal income tax rate, it might allow a corporate deduction when a dividend is paid or a share is redeemed. Alternatively, but at the cost of greater complexity, it might allow the recipient of a dividend a tax credit in the amount of the corporate tax paid with respect to such dividend and allow the seller of a share, whether or not such share is sold back to the corporation, a similar credit to reflect the corporate income tax paid on the undistributed corporate income earned during the seller's period of ownership. Finally, if the sovereign abandoned the wish to have all such income taxed at the shareholder's marginal income tax rate, but merely retained the wish that all such income should be taxed exactly once, it might enact a dividend exclusion coupled with a shareholder basis adjustment for taxed, but undistributed, corporate income.

[43] Cf. Warren, note 14, at 1598-99 (it is incorrect to conceive of the corporate income tax as an adjunct to the personal income tax so long as the treatment of dividend payments does not mirror that of interest payments).

[44] Musgrave & Musgrave, note 14, at 294-95.

[45] Ribstein, note 23, at 452 n.151.

[46] Actually, it is not at all clear that the current corporate income tax raises barriers to entry for large C corporations, since such corporations generally are able to offset other taxable income with certain of their start-up losses.

[47] Warren, note 14, at 1601.

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Alternatively, a sovereign could consider a corporate income tax to be a tool of fiscal policy: Such tax helps to stabilize the level of economic activity by removing far more cash from the economy during economic booms than it does during economic busts. While the effectiveness of this tool would be the subject of much debate,[48] I have no doubt that a sovereign could make a colorable claim as to such efficacy. But what the sovereign could not do, I think, is provide a colorable basis for exempting partnerships or limited liability companies from such tax. During booms, do they not earn income? During busts, do they not bleed?[49]

Alternatively, a sovereign conceivably could attempt to use a corporate income tax as a means to expropriate corporate windfall profits, including, for example, profits arising during periods of economic crisis.[50] Such a tax would function purely as a revenue raiser, since by definition windfalls are impervious to incentives (they are unexpected, and hence cannot be sought). The problem, as usual, is that the current corporate income tax is not a plausible way to impose a tax on windfalls, unless the sovereign has both a reason to believe that windfalls are more likely to occur with respect to economic activity conducted by corporate entities than with respect to economic activity conducted by noncorporate entities, and a reason to believe that windfalls are highly correlated with corporate taxable income (as defined under current law). The second proposition is highly dubious, for although it is the case that the receipt of a windfall generally increases corporate taxable income, it seems unlikely that windfalls in the corporate sector are so prevalent that corporations generate windfall income in amounts roughly proportional to non-windfall income.[51] And

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[48] Warren notes that the impact of the corporate tax on stabilization is probably not great. Id. at 1602 (citing J. Due & A. Friedlaender, Government Finance: Economics of the Public Sector 337 (5th ed. 1973); Kust, Appraisal of the Corporate Income Tax, in Alternatives to Present Federal Taxes 17, 20 (Tax Inst. of America ed., 1964)).

[49] The goal of promoting economic stability probably supports treating corporate interest and corporate dividends differently. If current law is taken as the baseline, ending the disparity by allowing a corporate dividend deduction would add more cash to the economy during booms than during busts, since dividends are generally higher during booms. On the other hand, ending the disparity by disallowing the corporate interest expense deduction would remove more cash from the economy during busts than during booms, since interest payments increase as credit quality declines (that is, during busts). In either case, the net effect on economic stabilization of ending the disparity between corporate interest and corporate dividends would likely be negative.

[50] In practice, windfalls may be extremely difficult to identify, for it is not the case that an extraordinarily high return on an investment necessarily indicates the presence of a windfall. Such return may simply reflect the positive outcome of an extraordinarily risky investment. Taxing such return would provide a disincentive to engage in such investment, but without producing any offsetting social benefit.

[51] If windfalls were that prevalent, they would not be windfalls at all, but merely an expected component of normal competitive returns.

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the first proposition is patent nonsense. Partnerships and limited liability companies engage in the same sort of economic activity as do C corporations; if windfalls find the latter, they will find the former as well.

Finally, a sovereign conceivably could consider using a corporate income tax as a means to expropriate rents or monopoly profits. Unlike a tax aimed at windfalls, which by definition has no ability to affect taxpayer behavior, the tax on rents—defined as incremental, noncompetitive returns on investment—will affect taxpayer behavior, since taxpayers can and do expend resources seeking to obtain rents. Thus, a benevolent sovereign, convinced that most rent-seeking expenditure is socially wasteful, could seek to discourage it by means of a tax. And in the case of corporate rent-seeking, it could seek to discourage it by means of a corporate income tax. The reason is that corporate rents, under reasonable assumptions, will be fully subject to a corporate income tax.[52] Of course, such tax will not merely tax the rents earned by corporations, but also the entire competitive return allocable to equity. But perhaps this is an acceptable shortcoming. What seems unacceptable is the current corporate income tax regime's limitation of the corporate income tax to corporations. After all, partnerships and limited liability companies surely seek and earn rents as well.

3. *Tax the Rich*

Another possible justification for a corporate income tax is as a way to add progressivity to an income tax regime, a way to tax the rich.[53] Indeed, a corporate income tax would serve this function if its inci-

[52] The necessary assumption is that the entire rent is allocable to equity owners. See, e.g., Myron S. Scholes & Mark A. Wolfson, Taxes and Business Strategy: A Planning Approach § 18.2, at 377 (1992). In particular, and arguably implausibly, none of such rent can be allocable to bondholders receiving contingent interest, licensors earning contingent royalties, and managers earning bonuses based on corporate income (and hence, indirectly, in part on successful rent-seeking).

[53] Arlen & Weiss, note 11, at 331-32. Cf. Klein & Zolt, note 23, at 1024-25 (integration efforts fail partly because of the public perception that the corporate income tax is a tax on the wealthy); Marjorie E. Kornhauser, The Morality of Money: American Attitudes Toward Wealth and the Income Tax, 70 Ind. L.J. 119, 131-65 (1994) (examining how Americans' conflicting views about wealth and equality have played themselves out in income tax laws); Daniel Shaviro, Beyond Public Choice and Public Interest: A Study of the Legislative Process as Illustrated by Tax Legislation in the 1980s, 139 U. Pa. L. Rev. 1, 60 (1990) (the public wants wealthy individuals to "pay their 'fair share' of tax").

For a provocative argument supporting a disproportionate tax on the rich, see Reuven S. Avi-Yonah, Why Tax the Rich? Efficiency, Equity, and Progressive Taxation, 111 Yale L.J. 1391, 1412-13 (2002). Avi-Yonah argues that wealth confers power beyond its consumption value. Concentrations of such power are inherently undemocratic. Thus, a tax that reduces such concentrations is a positive good.

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dence were largely on shareholders and if there were a significant correlation between share ownership and either income or wealth. The first premise is dubious, although it has much optical appeal.[54] The second premise is less dubious, even in an age where the "common man" has an ever increasing share of his retirement funds invested in the equity markets. Nevertheless, a closer analysis suggests that the corporate income tax is sufficiently poorly tailored to the goal of incrementally taxing the rich that that goal is not an adequate apology for most of its features.

For example, there would be no reason to impose the corporate income tax only on equity owners of C corporations, unless shares of C corporations are more disproportionately owned by "the rich" than are shares of S corporations or the equity interests of partnerships or limited liability companies. Given how much wealth is generated by so-called small business—much of which, of course, is not so very small at all—the opposite is probably true. In addition, there would be no reason to exempt from the reach of the corporate income tax equity interests in private equity funds, hedge funds, and real estate limited partnerships, all of which invariably are owned by what might be called the "super rich," and none of which are ever currently subject to the corporate income tax.

Moreover, even looking solely at C corporations, there is no particularly good fit between the current corporate income tax and the goal of increasing progressivity. For while it may be true that most corporate shares are owned by those who might be considered "rich," the very same is surely true of most corporate debt, and yet the corporate income allocable to such debt generally escapes the corporate income tax net.[55] Finally, there is a class of C corporation "participants" whose members are systematically "richer" than are generic shareholders: management and other highly compensated employees. Nonetheless, corporate income allocable to such participants is never subject to the corporate income tax.[56] Thus, it is implausible that the

[54] Although the corporate income tax nominally falls (indirectly) on shareholders, the tax burden almost surely shifts, in part or in whole, from shareholders to employees, customers, and nonequity capital providers. Thus, its actual incidence is uncertain. See, e.g., Alan J. Auerbach, Taxation and Corporate Financial Policy (NBER Working Paper No. 8203, 2001).

[55] There are instances where corporate interest is swept into the corporate income tax base. See, e.g., § 163(e)(5) (partially disallowing interest deductions on certain high-yield debt instruments), § 163(*l*) (disallowing interest deductions on certain equity-linked debt instruments), and § 279 (partially disallowing interest deductions incurred with respect to certain corporate acquisitions). These instances do not draw any distinction that plausibly could aid in the goal of taxing the rich.

[56] Not quite never. See IRC § 162(m) (disallowing deductions for certain compensation in excess of $1 million per annum for the five most highly compensated officers of publicly traded corporations).

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goal of the current corporate income tax really is to increase progressivity.

4. Miscellaneous Justifications

Other possible justifications of the current corporate income tax can receive short shrift. The tax raises much revenue, but that fact alone cannot justify its structure, and in particular its various exclusions. Perhaps a subversive justification can do the trick. That is, of all possible revenue raising taxes, the corporate income tax may be the one that best allows a sovereign to hide the ball, since the taxpaying public arguably fails to perceive that it is they who ultimately pay the tax.[57] Of course, such a justification hardly can be considered a recommendation, and it is unlikely it would carry much sway with a benevolent sovereign. But the reality is that our sovereign may occasionally deviate from the utopian ideal of a benevolent sovereign. Even so, however, this cynical justification cannot save the current corporate income tax. For any more generally applicable, and hence less distortionary, entity income tax—perhaps one applicable as well to flow-through entities, or one disallowing the corporate interest deduction—would hide the ball equally well, but by virtue of having a broader tax base, would make raising revenue that much easier.[58]

Another possibility is that the corporate income tax can be justified under the legal fiction that corporations are in fact persons separate from their owners, and that all persons should pay their fair share of tax.[59] But why would a benevolent sovereign countenance this fiction, even if the taxpaying public generally believed it. Moreover, even if the sovereign did countenance such fiction, this justification again would fail to explain certain exclusions under the current corporate income tax. For it is surely the case that certain partnerships and limited liability companies—for example, the large accounting firms, law firms, and investment banks—are just as likely to be perceived to be persons separate from their owners.

[57] Arlen & Weiss, note 11, at 331-33; see also Kanda & Levmore, note 35, at 228 (a separate corporate income tax exists because it is largely invisible to the electorate); Edward J. McCaffery, Cognitive Theory and Tax, 41 UCLA L. Rev. 1861, 1883-86 (1994) (the corporate income tax is attractive precisely because it is hidden by its uncertain incidence); Shaviro, note 53, at 60-61 (the public misconceives the incidence of the corporate income tax).

[58] See Warren, note 14, at 1601 (if revenue-raising is the only rationale for the corporate income tax, one should simply deny all deductions).

[59] See Shaviro, note 53, at 60-61 (the misconception that a corporation is a distinct individual, rather than a legal entity owned by individuals, helps to explain the outrage when corporations pay zero tax).

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Finally, the current corporate income tax might function merely as a tool that allows the sovereign to exploit what it perceives to be a special interest group.[60] It hardly needs saying that a benevolent sovereign would not engage in such exploitation. Nevertheless, even the current perhaps less-than-fully benevolent sovereign could not use this basis for justifying the current corporate income tax for the same by now familiar reason: This justification provides no basis for excluding partnerships and limited liability companies from the reach of the tax.

C. An Alternative Justification

1. The Quest for a Justification With a Robust Tax Base

Two conclusions, in particular, flow from the foregoing discussion. First, there are a number of possible colorable justifications for a corporate income tax. Second, none of them is a plausible justification for the current corporate income tax. And yet the current corporate income tax has long been and still is a reality: The Code imposes it; it raises much revenue; efforts to repeal it generally have received at best tepid support.[61] Thus, I conclude that an affirmative desire exists to impose such a tax. But beyond that, I know nothing.

Well, not quite nothing, for the fact that the tax, despite its manifest shortcomings, raises revenue—indeed much revenue[62]—is a fact that contains within it additional information. To uncover such information, I ask: Why does this tax, which appears to be so easily avoidable, succeed in raising so much revenue? First, it must be the case that the demand for conducting economic activity in taxable corporate form is at least somewhat inelastic. That is, for some subset of economic activities, the benefits to be derived from conducting such activities in corporate form must outweigh the incremental tax that results from conducting them in such form. There are two types of activities for which this most frequently appears to be the case. The first is activities that place sufficient value on current or future access to public equity markets. The second is activities that are trapped within ex-

[60] See Richard L. Doernberg & Fred S. McChesney, On the Accelerating Rate and Decreasing Durability of Tax Reform, 71 Minn. L. Rev. 913, 931-46 (1987); see also Barry E. Adler, Financial and Political Theories of American Corporate Bankruptcy, 45 Stan. L. Rev. 311, 345 (1993) (politicians may maintain the corporate income tax so that they can demand political support from management in exchange for favorable changes to such tax).

[61] This may finally be on the verge of changing, given the current President's dislike of the tax.

[62] IRS, Statistics of Income 1999: Corporation Income Tax Returns 1 (2002) (reporting total income tax of $193 billion paid by corporations with accounting periods ending July 1999 through June 2000).

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isting C corporations, and for which the immediate tax (and other) costs of extracting them from taxable corporate solution exceed the net present value of the future tax savings to be gained from conducting them outside of taxable corporate solution.

Second, it must be the case that, for any given C corporation, the demand for equity claims in such corporation is at least somewhat inelastic. That is, for some subset of claims against a given C corporation's income, the benefits to be derived from structuring such claims as equity must outweigh the incremental tax resulting from such structuring. One reason this is likely to be true is that a corporation generally has more flexibility in determining whether and when to make payments to equity holders than in determining whether and when to make payments to other types of claimants. Thus, it benefits from maintaining an equity cushion, which reduces the expected costs of financial distress. A second reason this might be true is that the immediate tax (and other) costs associated with converting corporate equity claims into more tax efficient claims may exceed the net present value of the future tax savings to be gained from such conversion.[63] In particular, profitable C corporations, which inexorably experience increases in the quantity of their equity claims over time (due to the retention of economic earnings), can be expected to have excess equity.

It is possible, based on the foregoing observations, to divide income generated by joint economic activity into three categories. The first category is what might be called the heart of the current corporate income tax base: income generated by any publicly traded corporation to the extent that such income is allocable to that portion of its equity that is equal to the greater of the amount of equity necessary to maintain sufficiently liquid shares or the amount of equity necessary to provide an adequate cushion against financial distress. The second category is what might be called the accidental corporate income tax base: income generated by any nonpublicly traded corporation, and income generated by any publicly traded corporation to the extent that such income is allocable to that portion of its equity that exceeds the greater of the amount of equity necessary to maintain sufficiently liquid shares or the amount of equity necessary to provide an adequate cushion against financial distress. (I will refer to equity that produces income in the second category as "trapped equity.") The third category is the noncorporate income tax base: all income gener-

[63] Conversion generally accelerates shareholder taxation. In addition, the expected value of corporate interest expense deductions associated with significant conversions, so-called "corporate equity reduction transactions," is somewhat lower than the expected value of corporate interest expense deductions generally. See § 172(h).

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ated by joint economic activity that is not currently subject to the corporate income tax.

One can ask, but not receive a wholly adequate answer to, the question: Why would a sovereign want to incrementally burden income in the first category? It is true that demand for the equity that produces such income is likely to be highly inelastic. And perhaps that is enough. But puzzles abound. What connection exists between the amount of equity necessary to maintain sufficiently liquid shares and the amount of equity necessary for a publicly traded corporation to provide an adequate cushion against financial distress, such that a sovereign would want to tax those equally? And if there is some basis for taxing the income produced by the amount of equity necessary to provide an adequate cushion against financial distress, why potentially exempt such income when it is generated by an entity that is not publicly traded?

Moving on to income in the second category, one again can ask: Why would the sovereign want to incrementally burden such income? And now there is no answer other than opportunism, which for a benevolent sovereign is no answer at all. In the case of trapped equity, taxpayers will, but for the costs of converting such equity into comparable claims that produce untaxed income in the third category, always prefer alternative comparable claims that produce such untaxed income. Thus, they will go to heroic lengths, and will incur significant socially wasteful expenses, to find ways to reduce the costs of converting trapped equity into comparable untaxed claims. These heroic lengths are exactly the sort of behavioral distortions that a benevolent sovereign, when implementing its tax regime, would try to make unnecessary.

How could a benevolent sovereign solve the problem of trapped equity? One possibility is to narrow the corporate income tax base to a tax base that is more robust: presumably income in the first category. Unfortunately, as just noted, there is no good theoretical justification for incrementally burdening such income. Moreover, in the real world of U.S. income taxation, there would be a practical problem with such approach: Narrowing the corporate income tax base would require, assuming such change were accomplished in a revenue neutral manner, higher corporate income tax rates. Higher rates would increase the payoff from corporate tax sheltering activities, and thus would increase the incentives for taxpayers to engage in other forms of distortionary behavior.

Thus, a benevolent sovereign intent on solving the problem of trapped equity might consider a second possibility, to expand the corporate income tax base. In order to minimize behavioral distortions,

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it would seek an expanded tax base that was as robust as possible. Thus, the tax base would include exactly all income generated by a set of claims the demand for which is likely to be highly inelastic. Of course, it would be nice if the sovereign also could find a theoretical justification for incrementally burdening income in the chosen tax base. Perhaps surprisingly, an expanded tax base that satisfies these criteria actually exists.

2. *The Theory of the Firm*

Consider a joint economic activity that is to be conducted by an entity subject to the current corporate income tax. The fact that the activity is to be so conducted generally means that the taxpayers who will conduct it have made the considered decision that the value of the portfolio of benefits made possible by conducting the activity in the chosen entity form outweighs the incremental corporate income tax incurred as a result of using such entity form. But the choice may well have been a close one, for there will be entity forms, not subject to some or all of the corporate income tax, offering alternative portfolios of benefits that largely overlap that of the chosen entity form. Moreover, the choice may well not be a static one: Future circumstances may arise that change the relative preference. Thus, from the vantage of some future point in time, the value of an alternative entity form's largely overlapping portfolio of benefits may outweigh the value of the chosen entity form's portfolio of benefits, at least when the cost of incremental corporate income taxes is taken into account.

On the other hand, the choice of the taxed entity form would not have been a close one, and the choice to remain with some type of taxed entity form will be a static one, if every entity form offering a portfolio of benefits that to any extent overlaps with that of the chosen entity form is subject to the identical amount of corporate income tax. And that is the secret of a robust corporate income tax: The tax cannot be imposed on entity forms that offer the taxpayers making use of them certain portfolios of benefits, while leaving untouched alternative entity forms that offer the taxpayers making use of them quite similar portfolios of benefits. Rather, it must tax all portfolios of benefits alike, thus making the tax an irrelevant factor in the taxpayers' choice. And at the end of the day, that means that the tax must be identical, irrespective of the entity form chosen for conducting the activity.

Such a tax, an entity tax levied on the income generated by any joint economic activity conducted in entity form, can be justified by a benevolent sovereign as an incremental tax levied only on taxpayers who avail themselves of certain governmentally provided benefits,

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namely those that flow to those conducting their joint economic activity in entity form. That is, it is the sovereign that enacts the enabling legislation that makes entities possible; it is the sovereign that directly (through legislation) or indirectly (through enforcement of contracts) determines the scope of the rights and duties of such entities; and it is the sovereign that grants the activities of such entities legal status.

And there can be no question that manifest benefits must exist for taxpayers who conduct their joint economic activity in entity form. That is, taxpayers, being rational economic actors, would never choose to conduct their joint economic activity in entity form, unless such form is preferable to—that is, provides them with greater economic benefits than—the alternatives. This wonderfully tautological observation is, of course, nothing other than a restatement of the "theory of the firm," which asserts that an entity will arise to conduct a given economic activity if and only if entity form is the most efficient way to conduct such activity.[64] Thus, conducting the activity in an entity must either lower the cost of conducting the activity or, what is equivalent, increase the return from conducting the activity. It is precisely the existence of this economic benefit that ensures that a tax on all joint economic activity conducted in entity form will raise revenue: Whenever the economic benefit of conducting an activity in entity form outweighs the cost of the entity tax, an entity will be formed and tax revenue will follow.

It is possible to give a less tautological content to the "benefits of entity form." Consider a would-be entrepreneur who has an idea with lots of economic potential. She might ask certain other individuals, a venture capitalist, a manager, and some laborers, to help her to bring the idea to fruition. In the normal course of things, the venture capitalist will help her form an entity, and the entity will hire the manager and the laborers, and then the entity will conduct the activity. But there are alternative ways to bring an idea to fruition. Thus, if the entrepreneur has sufficient access to funds, and sufficient physical energy, she might attempt to go it alone. That is, she could attempt to do her own "managing," and she could attempt to provide her own labor. Of course, even for an energetic entrepreneur, a go-it-alone strategy will mean forgoing many possible growth opportunities. Moreover, to the extent that the venture is one that could benefit from economies of scale, the entrepreneur will be unable to take advantage of these benefits. Finally, even a multitalented entrepreneur is unlikely to be the best possible provider of funds to the venture, the best possible manager for the venture, and the best possible source of

[64] R.H. Coase, The Nature of the Firm, 4 Economica 386, 389 n.3 (1937).

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labor for the venture. Thus, a go-it-alone strategy would entail a loss of potential efficiencies.

Fortunately, there is a nonentity organizational scheme that allows the entrepreneur both to increase the scale of her venture and to reap some benefits of the division of labor. Thus, the entrepreneur could enter into a series of contracts with the venture capitalist, the manager, and the laborers. Each contract would set forth what the entrepreneur and the other contracting party will provide to the venture, and what each will take away from it. If the venture optimally requires n participants (for example, the entrepreneur, one venture capitalist, one manager, and n-3 laborers), the entrepreneur would incur n-1 sets of contracting costs: due diligence investigation, negotiation and drafting, monitoring, and so on with respect to each other participant. But there is a problem. Each participant's return from the venture will depend not only on the identity and performance of the entrepreneur, but also on the identity and performance of each other participant. Thus, each participant must not only investigate, negotiate and contract with, and monitor the entrepreneur, but each other participant as well. Thus, each participant also incurs n-1 sets of contracting costs. That means that the venture, in the aggregate, will require n*(n-1) sets of contracting costs. If, instead, an entity were formed to conduct the activity, many of these costs would fall away. For although the entity would incur n sets of contracting costs, one with respect to each participant, each participant would simply incur one set of contracting costs, for she would only need to investigate, negotiate and contract with, and monitor the entity. Thus, if the venture were conducted by an entity, there would be a total of 2*n sets of contracting costs. Whenever n is greater than three, this means that there will be some savings in contracting costs by conducting the activity inside an entity.[65]

But that is not the end of the contracting-type benefits resulting from conducting economic activity in entity form. An additional benefit is incremental flexibility in the deployment of assets. That is, it rarely would be possible to structure the contracts among a venture's many participants in such a way that they would afford the same degree of flexibility as can be achieved in an entity setting. For example, a typical venture will face all manner of unforeseen problems or opportunities. These will make it desirable to deploy assets in unfore-

[65] For example, a 10-participant project requires 10 contracts if conducted inside entity form, compared with 45 if conducted outside it; a 100-participant project requires 100 contracts instead of 4,950; and a 1,000-participant project can proceed with 1,000 contracts instead of 499,500. And it is worth noting that the number of participants in an entity like Wal-Mart is a lot higher still: several million shareholders, several hundred thousand employees, various creditors, lessors, and so on.

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seen ways. In the context of a nonentity venture, some participant must own every asset. Thus, when the desire to redeploy an asset arises, some participant will possess hold-up power. This will make redeployment of the asset expensive. On the other hand, an entity faced with similar unforeseen contingencies generally will not miss a beat, since the entity's management almost always will have command-and-control power over the deployment of the venture's assets. Thus, even a radical change in the venture's direction generally can be accomplished with as little as a conversation.

Finally, difficulties can arise in the nonentity context even if unforeseen problems or opportunities do not confront the venture, but merely the participants in the venture. For example, suppose that the venture requires an expensive piece of equipment and that the piece of equipment is owned, as it must be, by some participant. In that case, the entire venture may fall victim to the whims or the misfortunes of such participant. In particular, in the event of the participant's divorce, death, or bankruptcy, it is possible that the asset would cease to be available to the venture either entirely or on economically acceptable terms. In contrast, if an entity conducts the venture, the entity could, and presumably would, take title to the asset. In that event, the whims or misfortunes of any particular participant will never have an effect on the entity's continuing ability to make use of the asset.[66] Instead, the entity would simply find itself with a new participant: the ex-spouse or heir or creditor of its whimsical or unfortunate former participant.

Thus, and very importantly, the business of an entity-based venture will be able to outlast the participation of any given participant in the venture. That, in turn, means that it will be able to invest in and reap returns from intangible entity-based assets such as goodwill, reputation, and firm-specific human capital. This will encourage lenders, suppliers, and most significantly human capital providers to commit their assets to the venture, confident in the knowledge that their returns from such commitment will not depend on something as fickle as a single participant's participation. And thus, the venture will be able to grow.

3. *Measuring the Benefits*

Imagine an economy that is identical to the current U.S. economy, but for the very significant fact that entity organizational forms are nonexistent. I focus on four individuals in such economy, *A*, *B*, *C*, and

[66] This is called "affirmative asset partitioning." Henry Hansmann & Reinier Kraakman, The Essential Role of Organizational Law, 110 Yale L.J. 387, 393-95 (2000).

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D. These individuals own assets that produce, in their highest and best use, annual returns of $2, $4, $6, and $8, respectively. Suppose that, as a result of lobbying or whatnot, the sovereign enacts legislation that makes entity organizational forms available. Following such change in law, *A*, *B*, *C*, and *D* form an entity, which makes use of their various assets. Due to the efficiencies made possible by the entity, *A*, *B*, *C*, and *D* find themselves in the enviable position of having an aggregate annual return of $40 to divide.

A sovereign with perfect information would know that the aggregate benefit produced as a result of the entity-enabling legislation is an incremental annual return of $20. It could take this increment as its entity tax base, and impose a tax of up to 100% on such base without stifling entity formations or their attendant efficiencies. Unfortunately, perfect information is lacking, and so a proxy is necessary. A good proxy need not be one that the sovereign believes accurately measures the benefits of entity form; it need only be one that the sovereign reasonably believes is correlated with such benefits.[67]

One possible proxy is entity income. A significant problem with this proxy, however, is that, absent an explicit definition, it has no content. That is, for any taxpayer, income, or rather "taxable income," is the excess of tax-cognizable inflows and deemed inflows, or gross income, over tax-cognizable outflows and deemed outflows, or allowable deductions. The question of whether an inflow should be included in gross income is not terribly problematic: All inflows theoretically should be included.[68] The question of whether an outflow should be allowed as a deduction, in contrast, is quite difficult. In the case of a human, one answer is that an outflow should be allowed as a deduction if it is sufficiently closely connected to the production of inflows.[69] This answer, of course, leads to largely intractable problems in the case of outflows that are helpful for the production of inflows but that also maintain or improve the quality of the relevant human's life.[70] In the case of an entity, however, no intractable problems arise: Every outflow must be sufficiently closely connected to the produc-

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[67] If, for example, the sovereign's proxy consistently overstated the benefits by 100%, a tax imposed on such proxy at a rate of 50% would be equivalent to a 100% tax imposed solely on such benefits.

[68] There are, of course, debates on this front, such as those involving the propriety of realization accounting. See, e.g., David J. Shakow, Taxation Without Realization: A Proposal for Accrual Taxation, 134 U. Pa. L. Rev. 1111, 1113 (1986); David A. Weisbach, A Partial Mark-to-Market Tax System, 53 Tax L. Rev. 95, 96 (1999).

[69] Even when it is conceded that an outflow is sufficiently closely connected with the production of inflows that a deduction should be allowed, there can be considerable debate as to when the deduction (cost) should be allowed (recovered).

[70] See, e.g., Reg. § 1.274-1 (disallowing in whole, or in part, certain expenditures for entertainment, gifts, and travel that otherwise would be allowable).

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tion of inflows, since it cannot meaningfully be connected to anything else. That is, an entity does not have a quality of life to maintain or improve.[71] But that means that every outflow should be deductible. Thus, at least when viewed over its entire life, an entity should have no net taxable income. This is certainly a defensible result, linguistically and theoretically, but it is not one that provides the sovereign with much of a proxy for anything.

Of course, there is no reason why a sovereign must define entity income as I have just defined it. Rather, the sovereign should apply the name "entity income" to whatever proxy it believes best correlates with the benefits produced by the use of entity organizational form. Thus, if I were the sovereign, I would construct my proxy, and hence my definition of "entity income," as follows. First, I would identify the set of all taxpayers who realize or who reasonably may be deemed to realize benefits from the use of entity organizational form. Second, I would attempt to identify the amount of benefit any such taxpayer derives from the use of entity organizational form, or alternatively, would articulate a theory that plausibly explains how such benefit might be related to some other metric that I could better measure. In the former case, I would define entity income as the sum, taken over all taxpayers, of the amount of the benefit they derive from the use of entity organizational form; in the latter case, I would define entity income as the sum, taken over all taxpayers, of the chosen metric.

Unfortunately, there is no a priori way of knowing exactly which taxpayers will actually share in the benefits derived from the use of entity organizational form, or of knowing exactly how those taxpayers will share such benefits. Thus, in my example, it is obvious that the incremental annual return of $20 will be divided in some manner by *A*, *B*, *C*, and *D*, but it is not at all clear in what manner. In general, the actual manner of division will depend on a combination of the relative bargaining power of *A*, *B*, *C*, and *D*, and their relative skill in bargaining. In general, bargaining power will turn on the uniqueness of the bargainer's asset; skill in bargaining will not. Since *D* owned the most valuable, and presumably most unique, asset prior to entity formation, she probably would have the greatest amount of bargaining power, and so, absent inferior skill in bargaining, would be expected to reap the greatest share of the incremental annual return created by the use of entity form. *C*, who owned the second most valuable asset, probably would have the second greatest amount of

[71] This observation can lead to the conclusion that the concept of income, when applied to an entity, is nonsensical. See Victor Thuronyi, The Concept of Income, 46 Tax L. Rev. 45, 78 (1990) ("[a] corporation cannot have income, any more than it can have a blood type").

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bargaining power, and so generally would be expected to reap the second greatest share of the incremental annual return created by the use of an entity. And so forth. Even lowly *A*, who owned the least valuable asset and therefore probably would have the least amount of bargaining power, might reap a smidgeon of incremental annual return, albeit probably the smallest smidgeon. For even *A*'s asset, once deployed by the entity, will develop a modicum of uniqueness, for it will be the only asset of its type that can be deployed by the entity without the need to engage in an incremental costly transaction (that is, finding and retaining an equivalent asset).

Based on the foregoing, a sovereign could hypothesize that a plausible (though by no means inevitable) division of the incremental annual return made possible by the use of entity organizational form is in proportion to the value of the assets that were contributed to the entity. If such division in fact took place, then absent any entity tax, *A*, *B*, *C*, and *D* would reap incremental annual returns of $2, $4, $6, and $8, respectively, from their participation in the entity. And they would reap total annual returns of $4, $8, $12, and $16, respectively, from their participation in the entity. In this case, the sovereign might define the entity's income to be the aggregate total return reaped by the entity's four participants from the entity. Then, if the sovereign decided to confiscate, say, one-half of the incremental annual return it has made possible, or $10, it could, as illustrated in Table 1, levy a 25% tax on amounts the entity otherwise would pay to any of *A*, *B*, *C*, or *D*.

Table 1
Tax Correctly Assumes Broad Participation

	A	*B*	*C*	*D*
Distribution without taxes	$4	$8	$12	$16
Indirect tax burden	1	2	3	4
Actual distribution	$3	$6	$ 9	$12

Of course, the fact that entities are intermediaries means that the actual structure of the tax, aside from optics, will be less important than one might suppose. Thus, for example, suppose that the sovereign's assumption as to participation in the benefits of entity organizational form is wrong. Suppose, in fact, that only *D* reaps such benefits. Thus, absent a $10 entity tax, *A*, *B*, *C*, and *D* would earn returns of $2, $4, $6, and $28, respectively, from their participation in the entity. With a $10 entity tax, on the other hand, they would earn $2, $4, $6, and $18, respectively. What is the effect of an entity tax imposed under the sovereign's broader assumption of universal participation?

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If the tax were styled as a 25% withholding tax on payments to all participants, it would *appear* to burden all participants, even though it actually burdens only *D*. The reason, of course, is that the pre-withholding tax payments to all participants would be adjusted, *in ways they would not have been adjusted, but for the withholding tax*, to ensure that each participant receives the proper after-withholding tax amounts. Thus, as illustrated in Table 2, participants who would not actually participate in any of the incremental returns created by the use of entity organizational form would appear to do so! And the same would be true in the case of an entity income tax that defines its tax base as the aggregate amount of entity income payable or allocable to a given set of participants, since such tax is equivalent to a withholding tax on payments to such participants. Thus, the sovereign's assumption of a too broad class of participants occasions absolutely no harm: Only the participants who actually enjoy the benefits of entity organizational form, in fact, would be burdened.

TABLE 2
TAX INCORRECTLY ASSUMES BROAD PARTICIPATION

	A	*B*	*C*	*D*
Distribution before withholding tax	$2.67	$5.33	$8.00	$24.00
Withholding tax	0.67	1.33	2.00	6.00
After-tax distribution	$2.00	$4.00	$6.00	$18.00

Finally, suppose the sovereign incorrectly believes that fewer participants enjoy the benefits of entity organizational form than actually do. For example, suppose that each of *A*, *B*, *C*, and *D* participates proportionally in any incremental return, but that the sovereign believes that benefits inure solely to *D*. In particular, the sovereign believes that, absent an entity tax, D would receive a payment of $28. If so, the sovereign might raise its desired $10 of revenue either by imposing a 36% withholding tax on payments to D, or equivalently by imposing a 36% tax on entity income defined as gross entity income less all entity payments made to taxpayers other than D. Of course, the sovereign would be disappointed. Since A, B, C, and D only care about the division of after-tax incremental returns, they would adjust the payments they receive from their entity as set forth in Table 3.

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TABLE 3
TAX INCORRECTLY ASSUMES NARROW PARTICIPATION

	A	*B*	*C*	*D*
Distribution before taxes	$3.27	$6.55	$9.82	$20.36
Taxes	0	0	0	7.27
After-tax distribution	$3.27	$6.55	$9.82	$13.09

And matters could easily get worse for the sovereign. Thus, *A*, *B*, *C* and *D* might enter into a side agreement pursuant to which *A*, *B*, and *C* nominally receive greater payments from the entity, but then make side payments to *D*. Table 4 illustrates how this might work.

TABLE 4
TAX INCORRECTLY ASSUMES NARROW PARTICIPATION;
TAXPAYER ENGINEERING

	A	*B*	*C*	*D*
Distribution before taxes	$5.30	$10.50	$15.80	$8.40
Taxes	0	0	0	3.00
After-tax distribution	$5.30	$10.50	$15.80	$5.40
Side payment	(1.60)	(3.10)	(4.70)	9.40
Ultimate net receipt	$3.70	$ 7.40	$11.10	$14.80

Of course, such a bald side agreement would be unlikely to withstand scrutiny under audit. But variations on the theme might have a real chance for success. Thus, tax reduction likely would be possible so long as *A*, *B*, *C* and *D* were able successfully to argue that the asset contributed by *D* was, at least to some extent, like the asset contributed by *C*. Or, if they chose to focus on relationships rather than assets, to argue that *D*'s relationship with the entity was, at least to some extent, like *C*'s relationship with the entity.

Since the mere possibility of such arguments would undermine the entity income tax, the sovereign should err on the side of assuming that more, rather than fewer, taxpayers participate in the benefits made possible by the use of entity organizational form, and should further err on the side of assuming that more, rather than fewer, types of entity payments may carry embedded inside them a portion of such benefits. If it does this, it will leave taxpayers relatively powerless to avoid, or even to reduce, their entity income tax burden.

III. WHO ARE THE PARTICIPANTS IN AN ENTITY?

So who are these taxpayers, henceforth "participants," who plausibly benefit from the fact that economic activity is conducted in entity

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organizational form? It is possible to argue that they are everyone. To illustrate, suppose the entity under consideration is Wal-Mart.[72] It is conceivable that every purchaser of consumer goods in the United States, whether or not such purchaser is a patron of Wal-Mart, benefits from Wal-Mart's mere existence. The reason is that Wal-Mart, as the largest purveyor of consumer goods in the United States, surely affects the retail prices of such goods and presumably affects such prices in a way that increases each consumer's total purchasing power. Similarly, it is conceivable that every manufacturer of consumer goods in the United States, whether or not a supplier of Wal-Mart, benefits from Wal-Mart's mere existence. The reason is that Wal-Mart is a sufficiently large purchaser of consumer goods that it affects the demand curve for such goods, thus allowing all manufacturers to realize higher selling prices for their goods than they would in its absence. Nevertheless, it seems silly to say that a consumer who buys a toaster from Target is a participant in Wal-Mart, simply because she pays—or rather might pay—a lower price than she would if Wal-Mart did not compete with Target for the sale of toasters. And it seems silly to say that a manufacturer who sells toasters to Target is a participant in Wal-Mart, simply because she receives—or rather might receive—a higher price for such toasters than she would if Wal-Mart did not compete for the purchase of toasters with Target. Finally, an entity income tax that attempted to take into account the myriad of wholly speculative benefits accruing to those who have no direct interaction with Wal-Mart would fail to be administrable. Thus, I ignore such benefits.

Similarly, it seems prudent for an entity income tax to ignore certain wholly speculative benefits accruing to those who do have direct interaction with an entity. Consider a consumer who purchases a toaster from Wal-Mart. At a first cut, her actual economic benefit from the existence of Wal-Mart is identical to that of the consumer who purchased the toaster from Target: She presumably pays a lower price than she would have paid but for Wal-Mart's existence. But who is to say for sure?[73] And consider the manufacturer of toasters, who sells her toasters to Wal-Mart. At a first cut, her actual economic ben-

[72] That Wal-Mart would be an entity under almost any conceivable definition of entity should be beyond dispute. I take up this matter, however, in Section V.

[73] Suppose an omniscient sovereign knew that the toaster would cost $20 in market equilibrium but for Wal-Mart's presence in the market; it actually costs $18 at Wal-Mart. In that case, there is a benefit of $2 to the purchaser due to Wal-Mart's existence. One way for a comprehensive benefits-based income tax to treat the purchase of the toaster would be as a deemed purchase for $20, followed by the purchaser's receipt of a $2 "benefits distribution" from Wal-Mart. If the distribution were not tax deductible—by virtue of being a distribution to a "participant" in Wal-Mart—the net effect would be to add $2 to Wal-Mart's taxable income.

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efit from the existence of Wal-Mart is identical to that of the manufacturer who sells toasters to Target: She presumably receives a higher price than she would have received but for Wal-Mart's existence. But who is to say for sure?[74] And again, an entity income tax regime that attempted to reach such wholly speculative benefits would fail to be administrable. Thus, at least in the cases above, where purchases from and sales to an entity are at arm's length and are instantaneously consummated, my entity income tax ignores any entity benefits that may be transferred to the purchaser or the seller.

In fact, however, administrability is not the best reason for ignoring any entity benefits that may accrue to an arm's length purchaser from or seller to an entity. A better reason is that the purchaser and seller benefit from the relevant entity's organizational form, if at all, only incidentally. That is, the premise of the theory of the firm is that various taxpayers join together to conduct economic activity in entity form because doing so allows them to create and share some incremental return that could not have been created and shared had they not joined together. A taxpayer whose interaction with the entity is over in an instant cannot reasonably be said to have "joined" the entity. Nor can her interaction with the entity possibly create a theory-of-the-firm type incremental return. Thus, she will receive a theory-of-the-firm type benefit if, and only if, such a benefit is unilaterally passed on to her by the entity. Of course, the entity will never unilaterally pass such a benefit on to her unless it is forced to do so by competitive pressures. Thus, to the extent that she receives such a benefit, it is not really correct to say that she receives it as a result of the entity's organizational form. Rather, she receives it as a result of the existence of a competitive market. And that is a very different thing.

One identifying feature, then, of those who plausibly share in the incremental return made possible by entity organizational form is that they must interact with the entity for more than an instant in time. Thus, the broadest reasonable definition of a participant in an entity is any taxpayer who transfers any asset to the entity for the entity to use (in some manner that implies a modicum of discretion on the part of the entity), provided that some part of the consideration for the trans-

[74] Suppose a sovereign knew that the manufacturer would receive $18 for a toaster in market equilibrium but for Wal-Mart's presence in the market; she actually receives $20 from Wal-Mart. In that case, there is a benefit of $2 to the manufacturer due to Wal-Mart's existence. One way for a comprehensive benefits-based income tax to treat the toaster sale transaction would be as a deemed sale for $18, followed by Wal-Mart's payment to the seller of a $2 "benefits distribution." If the distribution were not tax deductible—by virtue of being a distribution to a "participant" in Wal-Mart—the net effect again would be to add $2 to Wal-Mart's taxable income.

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fer is not immediately received by the transferor. And, indeed, there is a strong reason to treat every such taxpayer as a participant. The reason is each such taxpayer receives consideration from the entity that consists of two components: the value of the asset transferred and an investment-type return that compensates her for the fact that such value is not received immediately. The investment-type return itself has two components: one that reflects the fact that future value is generally less desirable than current value (that is, the time value of money), and one that reflects the risk inherent in the promised return. The first component of the investment-type return is conceptually identical for all taxpayers who do not receive all of their consideration immediately, and hence provides no principled basis for distinguishing one transferor from another.[75] And while the second component of the investment-type return varies from taxpayer to taxpayer, depending on the terms of the promised return, this variation cannot be robustly used as way of distinguishing taxpayers, since the characteristics of the variation are entirely within taxpayer control.[76] Thus, I tentatively adopt the broad definition of participant as any taxpayer who transfers an asset to the entity in exchange for consideration, not all of which is received immediately.

A. *Providers of Nonhuman Capital*

I noted above that the definition of participant should not include a taxpayer (a customer) who provides capital (the purchase price of a toaster) to an entity (Wal-Mart) in exchange solely for consideration that is received immediately (the toaster). But, as a theoretical matter, it should include a customer who receives her consideration with even the smallest lag. This customer still provides capital (the purchase price) to Wal-Mart in exchange solely for a toaster. But the purchase price, in general, will be infinitesimally lower than it would have been were the toaster received immediately. And that means an infinitesimally small portion of the toaster will be received not in exchange for the apparent purchase price, but rather in exchange for allowing Wal-Mart to deploy such apparent purchase price as Wal-Mart in its sole discretion sees fit pending Wal-Mart's delivery of the toaster. Thus, the simple purchase transaction now has an implicit investment component, and the return on that investment component may very well include an amount of the infinitesimal incremental

[75] It would provide, however, a host of unprincipled bases for distinguishing transferors. For example, transferors could be distinguished on the basis of whether or not all of their promised consideration will be received in less than five years.

[76] See Schlunk, Little Boxes, note 2.

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profit that Wal-Mart is able to earn solely because it is able to use the customer's capital as it sees fit, anywhere within Wal-Mart.

Of course, administrative cost considerations may lead a sovereign to choose to ignore such truly minute amounts of participation, but as a theoretical matter, they should be taken into account. And any decision to ignore them will involve a difficult line drawing: For the customer under consideration might be a chain of restaurants, the prepaid item might be many thousands of toasters, and the time lag for providing the toasters might be months or even years. In such case, the prepayment may well be sufficiently large that the customer would affirmatively behave as if it were an "investor" in Wal-Mart, demanding a purchase price discount that reflects both the delivery lag and the risk of Wal-Mart's financial distress. And, in such case, Wal-Mart may well include in its "payment" to such customer a portion of the now more-than-infinitesimal incremental profit it earns from its adept use of the customer's prepayment, a use that directly benefits from Wal-Mart's entity organizational form.

In addition to those who receive a portion of their consideration for providing capital to an entity with a lag, one might argue that the definition of participant should include those who will not necessarily receive a portion of their consideration with a lag, but who, under certain circumstances, might do so. For example, if a customer buys a toaster from Wal-Mart and is disappointed with its performance, the customer may seek and receive additional consideration from Wal-Mart: cash, goods, or services, in the form of a refund, a replacement, or a repair, respectively. As in the case of any other type of consideration received with a lag, the customer's receipt will reflect both the time value of money and the risks inherent in Wal-Mart's business.

Indeed, one can model the customer's transaction with Wal-Mart to explicitly isolate the possibility of a deferred receipt. Thus, one can imagine that the customer purchases from Wal-Mart not one item, but two: the toaster and a guarantee that Wal-Mart will stand behind the toaster. The first of these is a pure spot market transaction without any element of investment. The second of these, however, is a purchase of insurance, and so plausibly can be viewed as an investment. The customer provides cash to Wal-Mart for Wal-Mart to use as Wal-Mart sees fit and Wal-Mart in exchange promises the customer a future payment that is contingent on the performance of the toaster. As usual, Wal-Mart's ability to pay will be enhanced by its ability to efficiently deploy the customer's cash, an ability that directly depends on Wal-Mart's use of an entity organizational form. Thus, the customer's expected return might well include an element of the benefit that Wal-Mart reaps from its entity organizational form.

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Still, if every purchaser of a toaster from Wal-Mart were treated as a participant in Wal-Mart, simply because she might call upon Wal-Mart in the future if the toaster disappoints, the notion of participation would be stretched to near breaking. Moreover, the looming administrative burden would be nearly insuperable. For example, taxpayers and tax administrators would need to divine separate prices for every toaster and every guarantee, even though the two items are never sold separately. In light of this, it seems prudent to attempt to draw the line on participation somewhat short of potential recipients of low- probability payments.

Perhaps the best way to draw this line, and so to distinguish a potential recipient of a low-probability payment from a more classical "investor," is that the former, while perhaps implicitly making a sort of "investment" in the entity, has no real wish to participate in the future fortunes of the entity: She would prefer that her toaster functions properly. That is, the arguable investment is incidental to what is fundamentally a spot market transaction.[77] Thus, I limit the definition of participant so that it includes a nonhuman capital provider only if such provider willingly provides to the entity one or more assets for the entity to use (in a manner that implies a modicum of discretion on the part of the entity), and in exchange receives one or more payments from the entity, at least one of which is a future payment of non-negligible probability.

[77] Indeed, there is an alternative way to model the toaster purchase transaction that does not involve an explicit investment in Wal-Mart. Thus, the customer merely purchases one item in a spot market transaction: the toaster. If and when the toaster disappoints, the customer has a potential legal claim against Wal-Mart. At this point, the customer begins to have what might be considered to be a participatory interest in Wal-Mart. But she has arguably not as yet had a relevant (second) interaction with Wal-Mart. That first occurs when she enters into a settlement agreement with or wins a judgment against Wal-Mart. The settlement or judgment, when it occurs, can be viewed as a transaction in which the customer provides an asset to Wal-Mart, namely her legal claim, and receives in exchange a payment, either immediate (in which case the transaction creates no participation) or not (in which case it does). And, of course, a similar analysis can be applied to third-party tort creditors. Thus, prior to settlement or judgment, they also would not be considered participants in the entity that injured them.

Unfortunately, this alternative characterization of a purchase transaction has its defects. Frequently, a customer's purchase decision is based in part on the vendor's reputation for "service." Indeed, for many products, such reputation for "service" is of paramount importance. Thus, the guarantee may well be something implicitly bargained for by the customer. Moreover, even if the guarantee is not sufficiently important to be implicitly bargained for, once the customer has a claim, even if inchoate and disputed, she clearly has an interest in the financial health of the vending entity. Such an interest, which may manifest itself in monitoring and the like, is at least arguably a form of participation. One need look no further than to entities with large inchoate tort claims—for example, related to asbestos—to convince oneself of that.

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B. Providers of Human Capital

Before considering taxpayers who provide "solely" human capital to an entity, it is worth noting that many taxpayers provide both non-human and human capital to an entity in exchange for payments, "at least one of which is a future payment of non-negligible probability." They are, of course, participants in the entity by reason of their provision of nonhuman capital to the entity. But if they were not also participants in the entity by reason of their provision of human capital to the entity, the tax law would be faced with a quandary.

For example, consider a software designer who places a nonhuman capital asset (a copyright) at the disposal of an entity in exchange for future payments of non-negligible probability (royalties) and simultaneously enters into an agreement to provide human capital (technical support) to the entity in exchange for additional future payments of non-negligible probability (wages). If the entity is interested in acquiring adequately supported software, it generally will care about the aggregate cost of the designer's nonhuman and human capital, but not about the allocation of such aggregate cost between the designer's nonhuman and human capital. Similarly, if the designer is interested in selling adequately supported software, she generally will care about the aggregate amount that she will receive for her nonhuman and human capital, but not about the allocation of such aggregate amount between her nonhuman and human capital. Thus, the contractual allocation of payments between those for the use of nonhuman capital and those for the use of human capital is likely to be a poor indicator of whether such payments are really made in consideration of her contribution of nonhuman or in consideration of her contribution of human capital.[78]

Similarly, consider the sole equity owner of a typical small business.[79] She receives payments from the business that arguably can be in consideration of the business' use of any one of three assets: her explicitly contributed nonhuman capital (her equity), her explicitly provided human capital (her services as key employee), and her not-explicitly-contributed capital (her know-how, which she has not bothered to license to the entity, but which is sufficiently unique to support such a license). Again, the sole equity owner generally will not care (but for taxes) whether any given payment from the business is made

[78] At one extreme, the designer might enter into a licensing agreement that entitles her solely to the receipt of royalties but that also calls on her to provide not-separately-compensated technical support services. At the other extreme, the designer might enter into a guaranteed employment contract and simply make the software available without separate compensation as part of such contract.

[79] In Section V, I address the question of whether and when small businesses should be treated as entities for purposes of the entity income tax.

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for its use of her nonhuman capital or for its use of her human capital.[80]

One might think that this dilemma—is a payment related to nonhuman capital or is it related to human capital?—is limited to those relatively obvious situations just illustrated. But it is not. A conceptually similar conflation of payments can arise even when an employee does not explicitly appear to contribute any nonhuman capital to her employing entity. Consider first the case where the employee and the entity create a recognizable "asset" that makes possible the production of incremental joint income. Thus, consider an employee who generally could earn $100 per year in a spot labor market. If, however, an entity makes its training and customer list available to the employee, her services will grow more valuable over time. Now suppose that the extra value is partially portable. Absent a mechanism to prevent her from doing so, the employee can carry away some of the extra value to another firm, causing the entity harm.[81] In such case, an optimal employment agreement might "bind" the employee to the entity by means of a covenant not to compete. As illustrated in Table 5, such covenant, which is arguably a nonhuman capital asset,[82] allows the employee and the entity to generate and share an incremental amount of income.[83] So long as the employee's share of such incremental income is greater than zero, it is proper to view her "wage" as deriving in part from such nonhuman capital asset and in part from her human capital.

[80] Arguably, no contractual allocation of payments has any greater theoretical claim to "rightness" than any other, since what the taxpayer provides and what the business acquires is a single package of assets, none of which has much value without the others. But see Exacto Spring Corp. v. Commissioner, 196 F.3d 833, 838-39 (7th Cir. 1999) (there is in fact a partial allocation that has a claim to rightness; so long as nonhuman capital earns a reasonable rate of return, all remaining returns, no matter how apparently "excessive," must belong to human capital).

[81] An example is a partner in a law firm. Her skills are valuable in their own right, but are more valuable when coupled with long-term relationships with specific clients. Moreover, absent a mechanism to prevent her from doing so, she can carry some of her clients with her to another firm.

[82] The tax law treats a covenant not to compete as an intangible asset. IRC § 197(d)(1)(E).

[83] How this incremental income will be shared is a matter of bargaining power and bargaining skill. If the employee has truly unique skills that make the creation of a large amount of incremental income more likely, she generally will reap a larger share; if the entity could make the opportunity available to a number of other employees who are largely interchangeable with the employee, it will reap a larger share. Table 5 arbitrarily assumes that the employee receives 40% of the incremental income and that the entity receives the remaining 60%.

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TABLE 5
COVENANT NOT TO COMPETE

Year	Entity gross profit if employee never hired	Entity gross profit if employee hired/ leaves	Entity gross profit if employee hired/ stays	Employee spot wage	Incre-mental income	Entity possible share of incre-mental income	Entity possible share of incre-mental income
1	$0	$ 0	$100	$100	$ 0	$ 0	$ 0
2	0	–10	150	100	50	30	20
3	0	–20	200	100	100	60	40
4	0	–20	200	100	100	60	40
5	0	–20	200	100	100	60	40

Moving from the sublime to the mundane, conceptually similar (albeit smaller) amounts of incremental income will be generated in almost any employment context. Thus, consider a rank-and-file employee whose work enables her to develop both non-firm-specific and firm-specific skills. As modeled in Table 6, her productivity increases by $1 every year simply due to her increase in work experience; her productivity increases by an additional $1 every year due to her development of firm-specific human capital.

TABLE 6
RANK-AND-FILE EMPLOYEE

Year	Entity gross profit if employee never hired	Entity gross profit if employee hired	Employee spot wage	Incre-mental income	Entity possible share of incre-mental income	Entity possible share of incre-mental income
1	$0	$10	$10	$0	$0.0	$0.0
2	0	12	11	1	0.6	0.4
3	0	14	12	2	1.2	0.8
4	0	16	13	3	1.8	1.2
5	0	18	14	4	2.4	1.6

Under these assumptions, the employee and her employing entity reap a collective and ever-increasing amount of incremental income from maintaining their relationship (which will likely nonetheless be structured as employment at will). And they will likely each receive a part of such incremental income.[84] In the pre-§ 197 world, one would

[84] How the incremental income will be divided is again a function of bargaining power and bargaining skill. Thus, the employing entity would have the upper hand. Nonetheless, the entity will not want to reap all the incremental income, for if it does, it will more likely

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attribute this incremental income to a firm-specific intangible asset called "good supplier relationship" or "workforce in place" or "going concern value." To be sure, this asset is more amorphous than an employee's covenant not to compete. But like such covenant, it comes into existence solely because an employee forgoes her mobility. Thus, by virtue of her continuing decision to remain in an employment relationship with the entity, the employee can be viewed as "contributing" to the entity "her" undivided share of such intangible asset. And her contribution is in exchange for an enhanced wage. But that just means that a part of her "wage" is really a payment for her provision to the entity of a nonhuman capital asset.

From the foregoing, it should be clear that, when it comes to providers of human capital, there is generally more going on than meets the eye. Properly viewed, they are almost always also providers of assets that can be considered to be nonhuman capital assets. Thus, they would almost always be treated by the entity income tax as participants in the entities that employ them. This fact greatly reduces the stakes in the more general participant classification of human capital providers that I now propose.

Consider an employment relationship that involves "solely" the exchange of labor for wages without the creation of any firm-specific capital or the like. For a host of reasons, such relationship may be structured in part very much like a traditional nonhuman capital investment, with a significant portion of the employee's payments being deferred.[85] In such cases, the employee makes an asset, her human capital, available for the entity to use and receives in exchange consideration that includes future payments of nonnegligible probability.[86]

lose the employee and hence its share of such incremental income. Table 6 arbitrarily assumes that the employee receives 40% of the incremental and that the entity receives the remaining 60%.

[85] Why is this structure so prevalent? One reason is that the employee, knowing that her employment will not continue indefinitely, would like to make a provision for retirement. Deferred compensation from the entity is arguably an efficient way to achieve this. Another reason is that the entity, knowing that there is a lag between the time that the employee provides her services and the time that it reaps the profits generated by such services, would prefer not to borrow to pay the employee's wage. Deferring compensation until the relevant profits are realized is arguably the most obvious way to achieve this. A third reason is that there might be some disagreement between the employee and the entity as to the value of the employee's services: Perhaps such value will become apparent only in the future. Deferring compensation until more information becomes available is arguably a way to overcome such disagreement.

[86] Since wages typically are paid periodically while labor typically is provided continuously, an employee almost always will provide some small amount of "float" to her employing entity. My concern here is not with such float, but with explicitly deferred compensation.

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Such an employee, in form, is very much a "participant" in the entity.[87]

For example, consider an employee whose compensation package contains "restricted" financial instruments, that is, financial instruments that are identical to those acquired by nonhuman capital providers (generally in exchange for cash), except that they are subject to vesting or other transferability restrictions. The current tax law generally treats an employee who receives such restricted financial instruments as if she earns nothing but wages.[88] In particular, it does not consider the restricted financial instruments to be "investments." Nonetheless, as an economic matter, an employee's restricted stock or nonqualified stock options or stock appreciation rights provide the same degree of participation in the entity as do identical financial instruments purchased by a nonhuman capital provider.

Of course, even in the recently-ended age of high technology mania, most compensation packages did not contain stock or options or other classical financial instruments. But such instruments are not required to turn an employee into an investor in her employing entity: Any mundane type of deferred compensation will do. Thus, a rank-and-file employee, who has no hope of ever seeing "equity compensation," generally has at least a probabilistic chance of receiving a year-end bonus. The possibility of such bonus implies the existence of an investment. That is, the employee, on a paycheck-by-paycheck basis, has been paid somewhat less than the full fair market value of her labor. The difference, the "unpaid-for labor," is an asset provided by the employee to the entity in exchange for a probabilistic year-end payment—a bonus. How does the entity determine this payment? Typically, the bonus depends both on the entity's perception of the employee's performance (that is, her performance review) and on the

[87] While they do not have in mind participation as I have defined it, certain jurisdictions explicitly recognize the "participation" of human capital providers in their employing entities by, for example, giving such providers a voice in management. Thus, for example, under Germany's two-tiered board system, employee-elected and shareholder-elected representatives make up equal shares of the supervisory board of a corporation. Lawrence A. Cunningham, Commonalities and Prescriptions in the Vertical Dimension of Corporate Governance, 84 Cornell L. Rev. 1133, 1140-41 (1999). Despite the lack of such a statutory right in the United States, a similar result recently was achieved by Enron workers when a court allowed them to form their own creditors' committee in Enron's bankruptcy proceedings. See Rebecca Smith, Enron Employees, in a Court Victory, Are Permitted to Form Creditors' Panel, Wall St. J., Feb. 19, 2002, at A6.

[88] IRC § 83(a). The single Code provision that treats certain compensation as if it were equity participation, that is, that denies a corporate deduction for such compensation, generally does not apply to compensation delivered by means of restricted stock, nonqualified stock options, or stock appreciation rights. IRC § 162(m)(4)(A).

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entity's overall financial performance.[89] If the bonus could be disaggregated, the portion paid on the basis of the employee's performance would have an investment character much like debt and the portion paid on the basis of the entity's overall financial performance would have an investment character much like equity. That is, the former portion must compensate the employee for the time value of money and for the risk that the employee, in certain states of the world, may be unable to recover her investment, notwithstanding the fact that she has performed her labors well. And the latter portion must compensate the employee for her participation in the "corporate adventure."[90]

Finally, I consider whether a laborer who has no hope of even a year-end bonus nevertheless should qualify as a participant in the entity for which she labors. To answer this question, I distinguish two types of laborers: one who provides labor to multiple entities by means of a series of spot market exchanges and receives all her compensation sufficiently instantaneously so that such compensation contains no discernible time value or risk component (certain industries, like construction, are largely populated with such laborers), and one who provides labor on a more-or-less continuous basis to a single entity by means of an informal at-will employment relationship. I do not make this distinction because of its resonance with current tax law, which generally would classify a laborer of the first type as an independent contractor and a laborer of the second type as an employee.[91] Rather, I make it because it is suggested by the theory of the firm.

Thus, if a labor market is characterized by a series of spot market exchanges, the interaction between the laborers and any entity cannot generate the benefits associated with an entity organizational form. That is, each encounter between a laborer and an entity requires a

[89] Perfect incentive compensation, of the type designed to combat agency problems, would base the bonus solely on the employee's performance ("effort"). That, however, is rarely observable. See Varian, note 17, at 441. Hence, bonuses generally are based in part on more observable criteria, such as the employer's performance.

[90] United States v. Title Guar. & Trust Co., 133 F.2d 990, 993 (6th Cir. 1943). It would be interesting to know how the marginal dollar of profit or loss from any given business is allocated among the businesses' various participants. Anecdotal evidence from the air transport industry suggests that employees in such industry may be allocated a considerable share of such dollar. That is, during periods of high profitability, pilots, mechanics, and flight attendants typically command significant wage increases; during periods of low profitability, they give large amounts of such increases back. Thus, their participation in the corporate adventure would appear to be considerable.

[91] Under current tax rules, 20 factors are used to determine whether a laborer is an independent contractor or an employee. These factors focus largely on the degree of control that the employer exerts over the laborer and the allocation of economic risks between the employer and the laborer. Rev. Rul. 87-41, 1987-1 C.B. 296, 298-99.

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fresh "employment" contract;[92] an entity has no flexibility to deploy a laborer in any way other than that permitted in the current contract; an entity can engage in no significant long-term planning that is dependent on a given laborer, since the laborer may or may not return for subsequent employment after the contract expires, and so on. This is not to say that spot market laborers do not benefit from the existence of the employing entity and from the existence of entities in general. Each entity generates incremental income that would not be available in an entityless world; a part of such incremental income may be paid to spot market laborers due to competitive pressures. But, as already noted, this kind of "participation" in the incremental income generated by entity organizational form is not the kind that justifies participant characterization.

Suppose now that a labor market is characterized by longer-term, more-or-less continuous at-will employment relationships. In that case it is surely correct to say that benefits flow from the longer-term relationship structure: Otherwise the longer-term relationships would be superceded by a more efficient spot market. Of course, the benefits superficially appear to consist of nothing more than that the employee and the entity can avoid the considerable costs of seeking an alternative employer or an alternative employee, respectively. But the inertia caused by such costs creates a certain flexibility. The entity can give the employee longer-term instructions and have some relatively high degree of expectation that they will be executed; the entity can attempt to deploy the employee as it sees fit and have a relatively high degree of expectation that the employee will acquiesce in such deployment. But this means that the relationship between employee and entity is likely to generate precisely the sorts of benefits that are unique to economic activity conducted in entity form. Moreover, there is every reason to believe that a portion of the incremental income associated with such benefits inures to the employee, for otherwise there would be nothing to keep the employee from seeking alternative employment, and the relationship would lose its longer-term character. Hence, one can say with considerable confidence that even the most generic employees "participate" in their employing entity.

Finally, there is an additional and decisive reason why any longer-term employee, whether she is endowed with a large amount of firm-specific human capital or with none at all, can and should be viewed as a participant in her employing entity. Borrowing the participation

[92] The fact that such contracts generally are offered to laborers on a take-it-or-leave-it basis does not mean that there are no incremental contracting costs: The contracts constantly must be adjusted as industry or other economic conditions change.

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definition for nonhuman capital providers, the relevant question must be: Does an employee provide her human capital to an entity in exchange for one or more payments, at least one of which is a future payment of nonnegligible probability? The answer for any longer-term employee is most emphatically yes. The asset that she transfers to the entity is her stock of human capital. The payments she receives in exchange are certain periodic payments and, at the termination of the employment relationship, one very substantial deferred payment: the return of her stock of human capital, possibly depreciated, but hopefully appreciated, to be redeployed elsewhere as she sees fit. That is, a significant part of an employee's return from any longer-term employment relationship is the change the relationship causes in the value of her stock of human capital. Thus, the employee behaves towards her employing entity in very much the same ways as does any more typical investor in the entity. She will vigilantly monitor her relationship with the entity to make sure that such relationship provides not only the explicit return (current and deferred wages) she expects in exchange for her human capital but also provides the implicit return she expects in the form of experience, training, and the like. And, as will any other investor, she will vigilantly monitor other possible investments (that is, other employment opportunities) in an attempt to make sure that her human capital cannot be invested more favorably elsewhere.

Some examples help to illustrate the scope of, as well as the lingering ambiguities in, the participant definition as applied to human capital providers. Suppose that Wal-Mart hires a plumber to fix a specific drain in a given store. The plumber provides Wal-Mart with a single item (a fixed drain) and receives in exchange a more-or-less immediate cash payment. She does not intend to make an investment in Wal-Mart (in spite of her possible provision of an infinitesimal amount of float), and her relationship with Wal-Mart is not of the type that would be expected to result in the generation of any entity-type benefits. Hence, she is not a participant in Wal-Mart. Would a different result follow if the plumber were called whenever a given Wal-Mart store had a problem with a drain? In that case, after a while, Wal-Mart would be able to dispense with a contracting concern (is this a competent plumber?) and the plumber would be able to do her job more efficiently because, for example, she would know the exact location of the drains and how they feed into the plumbing system as a whole. Thus, there would be efficiency gains, and these would result in some incremental income that both parties would share. But this incremental income is arguably more the type generated by any longer-term contractual relationship, and not every such relationship

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constitutes (participation in) an entity. For example, and very importantly, it is not at all clear that the management of Wal-Mart has any even extremely circumscribed ability to flexibly deploy the human capital of the plumber, or to control the way that the plumber does whatever it is that the plumber does, and the like. Under these circumstances, it would not be incorrect for a sovereign to decide, either as a matter of principle, or as a matter of administrative convenience, that the plumber is not a participant in Wal-Mart.

Suppose, now, that Wal-Mart hires outside legal counsel to handle a single project. Despite the larger dollar amount presumably involved, an analogy to the plumber who is called to fix a single drain seems apt. After all, the transaction has many of the indicia of a spot market transaction. But it also has one difference: The length of time required to execute the project often will be significant. Thus, and perhaps importantly, the outside counsel may make a (substantial) temporary investment in Wal-Mart, given the usual lag between performance and payment. And, even more importantly, considerable coordination of assets—in particular, the outside counsel's human capital and the human capital of various Wal-Mart employees—will be necessary to produce the desired outcome. Nonetheless, while Wal-Mart generally controls the human capital of its employees, it is unlikely to have any even extremely circumscribed ability to control the human capital of the outside counsel, or to control the way that such counsel does whatever it is that she does. Thus, a sovereign generally should decide that the outside counsel involved in a single project is not a participant in Wal-Mart.[93] A different result probably should follow, however, if the outside counsel is on retainer and stands ready and willing to handle a variety of legal problems for Wal-Mart. In that case, entity-type benefits would appear to be generated. Thus, over time, the outside counsel would develop a wealth of Wal-Mart specific experience and knowledge that would allow her to provide more valuable service than could another lawyer. In addition, Wal-Mart management at least arguably would have some of the requisite flexibility with respect to deploying such counsel.

It should be obvious that a single bright line will not resolve all participant classification issues in the realm of human capital provid-

[93] This answer probably should remain unchanged, even if Wal-Mart compensates the outside counsel on a contingency fee basis. In that case, both the outside counsel and Wal-Mart invest in a joint project. That is, the outside counsel contributes human capital, Wal-Mart contributes its claim, and both may contribute some additional capital (that is, cash). And the returns from the joint project are divided based on some formula. Under this circumstance, it may be correct to view the joint project as an entity in its own right (perhaps managed by the outside counsel, perhaps managed by Wal-Mart), but it is probably not correct to view the outside counsel as part of Wal-Mart.

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ers. But this should not be a cause for alarm. Workable solutions abound. In the case of individuals who directly provide their human capital to an entity, such as the plumber, the entity income tax could choose to piggyback on the employee-independent contractor distinction, which the current tax law provides for reasons having nothing to do with entity income taxation.[94] In the case of individuals who indirectly provide their human capital to an entity (that is, who are employed by a different entity that is, in turn, hired to provide services to the entity in question), there is no comparable precedent. But in such case, as becomes clear in Section V.B., a reasonable set of rules designed to prevent the untoward multiplication of entity-level income taxes means that nothing is really at stake in the classification of the human capital provider.

IV. How Should a Universal Entity Income Tax Be Structured?

As already noted, the greatest difficulty or the greatest opportunity, depending on one's point of view, in structuring an incremental entity income tax is the absence of a robust concept of entity income. This allows the sovereign to (arbitrarily) choose a definition that comports with its particular goals. A definition that comports with my particular goal, that is, to incrementally burden theory-of-the-firm type benefits, is all entity gross income that is paid or allocated by an entity to any of its participants, provided that a suitable allowance is made for the recovery of such participants' capital. This definition is analogous to that employed by the current corporate income tax, which defines corporate taxable income essentially as all corporate gross income that is paid or allocated to a corporation's equity owners, after making a suitable allowance for the recovery of the equity owners' capital. The "allocation" is, to be sure, a fictional and temporally contingent one. That is, amounts are allocated to equity owners, and hence are subject to the corporate income tax, so long as they have not been conclusively allocated to anyone else; subsequent events can cause such amounts to be reallocated to others (resulting in negative income).

[94] The distinction is important for its withholding tax implications. Note, that nothing would prevent the sovereign from enacting simplifying bright line rules. For example, it could deem a person to be a per se employee of any entity for which she works at least 500 hours in a year. Of course, to the extent that employing entities would prefer nonparticipant tax treatment, such a rule might lead entities to go to some lengths to keep human capital providers below such a threshold. But in most cases, I would expect the incremental costs occasioned by such efforts to outweigh the benefits, for the same reasons that such costs currently tend to outweigh the benefits of converting most employees into independent contractors.

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My definition of entity taxable income, of course, produces a far broader tax base than the current definition of corporate taxable income. As discussed in Section III, the number of taxpayers who can and should be considered to be entity participants is much larger than the number who are corporate equity owners. And from this flows a great benefit. An entity participant could not profitably (viz the tax man) restructure her relationship with an entity unless she was prepared, as a result of such restructuring, to cease to be an entity participant. That is, an entity participant who would willingly denominate her share of entity returns as wages, rents, royalties, interest, dividends, or Boston Baked Beans, provided only that such denomination produced an entity income tax advantage, would find that mere willingness to fleece the tax collector is not enough. But even more is true. A group of entity participants could not collectively profitably (viz the tax man) restructure their relationships with an entity unless they were prepared, as a result of such restructuring, to cease to be entity participants. That is, my definition of entity income not only treats all allocations of entity gross income to a single participant alike, it treats all allocations of entity gross income to any participant alike. Thus, a reallocation of gross income among participants would have no effect on the tax base. This fact has an important corollary: Gross income, once allocated, however tentatively, to a participant, would not ex post turn out to have been incorrectly included in the entity income tax base simply because it subsequently was reallocated to another participant of a different type.[95] Such intertemporal robustness is lacking in the current concept of corporate income.

It is worth noting that my definition of entity taxable income appears to implement a specific theory as to the division of the benefits derived from an entity's organizational form. That is, it appears to assume that participants receive such benefits in the same proportion that they receive other "income" from the entity.[96] And, of course, it

[95] If the gross income ultimately is reallocated (paid) to a nonparticipant, its inclusion in the tax base would have been premature. But the very broad definition of participants means that such instances should be rare.

[96] The appearance is deceptive, since the actual incidence of the tax likely will differ from its apparent incidence. That is, just because an entity income tax appears to burden a certain participant in a certain way is not a guarantee that it actually does so as an economic matter. See, e.g., Auerbach, note 54. Indeed, so long as the amount of tax confiscated by various tax schemes from a given entity is fixed, it should never matter which participants any given tax scheme appears to burden: The allocation of returns among the entity's participants simply would be adjusted so that all participants realized exactly the same after-tax returns under each scheme. Thus, defining an entity income tax, as I have, so that it appears to burden specific participants, is arguably a matter of irrelevant optics. But it is not actually so. First, as a political matter, optics generally will be important. Second, the better the optics are aligned with reality, the smaller will be the asset price changes necessary to yield the participants' required after-tax returns. In an economy

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is not inevitably correct that this will be the case. Nevertheless, it is a reasonable assumption for the sovereign to make, so long as no other division of the benefits derived from entity organizational form can lay any greater theoretical or empirical claim to being correct. And to the best of my knowledge, none can. Moreover, it is an administratively desirable assumption for the sovereign to make: Any alternative assumption would entail far greater complexity. Thus, in spite of its undoubted imperfection, I proceed with this assumption and hence with my definition of entity taxable income.

Moving to actual mechanics, the trick is to isolate the share of an entity's gross income that is paid or allocated to the entity's participants, after making a suitable allowance for the recovery of the participants' capital. My strategy is to mimic the rules that implement the definition of corporate taxable income under the current corporate income tax. Thus, I simply extend the rules that currently apply to corporate shareholders to all entity participants:

- *Rule 1.* An entity's taxable income would be increased by any payment that the entity receives from any person who is not a participant in the entity. An entity's taxable income would be reduced by any payment that the entity makes to any person who is not a participant in the entity. Both the increases and the decreases required under this rule would be subject to the timing rules that exist under current tax law.[97]
- *Rule 2.* By analogy to § 1032, an entity's taxable income would *not* be increased by any payment that the entity receives from any person who is a participant in the entity.
- *Rule 3.* By analogy to the current law's tax treatment of dividends and stock redemptions, an entity's taxable income would *not* be reduced by any payment that the entity makes to any person who is a participant in the entity.

To demonstrate the functioning of these rules in a simple context, consider again the customer who purchases a toaster, together with an implicit guarantee, from Wal-Mart, but suppose, contrary to my decision in Section III, that this customer is characterized as a participant in Wal-Mart to the extent of her "investment" in the guarantee. Thus, the customer wears two hats: As the purchaser of the toaster without

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where not all assets are housed in entity solution, keeping asset price changes to a minimum is not unimportant. Third, if the optics lead to the creation of a broad tax base, the tax itself can be levied at a relatively low rate. This may make the tax politically more palatable. Moreover, it will produce another advantage as well: a lower tax rate will reduce the incentive for taxpayers to engage in distortionary behavior.

[97] This rule also would apply if a payment involved neither a nonparticipant nor a participant. For example, the entity could find treasure trove (includible) or suffer a casualty loss (deductible).

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a guarantee, she is a nonparticipant, and as the purchaser of the guarantee, she is a participant. Since nonparticipant tax treatment would apply to the payment made for the purchase of the toaster without the guarantee, Wal-Mart would include this payment in its taxable income (Rule 1). Of course, Wal-Mart generally would have a corresponding deduction (based on some method of inventory accounting) to reflect its cost of the toaster (which presumably was purchased from a nonparticipant) (Rule 1). Since participant tax treatment would apply to the payment made for the guarantee, the amount of such payment would be excluded from Wal-Mart's taxable income (Rule 2). Similarly, if and when Wal-Mart expended resources as required under the guarantee, such expenditure would be a payment to a participant and so would not be deductible (Rule 3).

How does this tax treatment compare with the treatment I settled upon, where the customer is wholly characterized as a nonparticipant? There would be no difference with respect to the "toaster without guarantee" piece of the transaction: Under either characterization, that would be treated as a transaction between an entity and a nonparticipant. Thus, the entire difference in tax treatment would result because, under the wholly nonparticipant characterization, the amount paid to Wal-Mart for the guarantee also would be included in Wal-Mart's taxable income and any amount expended by Wal-Mart under such guarantee correspondingly would be deductible (Rule 1). But, under a relatively reasonable assumption as to how a not-separately-purchased guarantee would be deemed to be priced, this "difference" in fact would make no real difference at all: not to the customer, or to Wal-Mart, or to the sovereign.[98] Thus, basing the cus-

[98] The assumption is that, on an expected value basis, and taking taxes into account, Wal-Mart makes neither profit nor loss on the guarantee. Thus, suppose first that the customer is wholly characterized as a nonparticipant in Wal-Mart. If X was the amount paid for the guarantee, X would be includible in Wal-Mart's taxable income when the guarantee is purchased (Rule 1). Thus, Wal-Mart would pay tax of tX, which would leave it with $(1 - t)X$ to invest, pending making a payment with respect to the guarantee. If Wal-Mart's pretax rate of return was r, this investment would yield a fully taxable return of $r(1 - t)X$. It follows that Wal-Mart could pay $r(1 - t)X + X$ with respect to the guarantee and still break even. The reason is that the guarantee payments would be deductible (Rule 1). Thus, Wal-Mart could subtract these payments from its investment income when it computed its taxable income. Such taxable income would be a net loss of X, and hence would entitle Wal-Mart to a refund to tX. When the invested amount, the pretax investment return, and the tax refund are added together, it becomes clear that Wal-Mart would have exactly the cash required to make a payment of $r(1 - t)X + X$ on the guarantee. Note that the net tax effect of the nonparticipant characterization is that Wal-Mart would make an interest-free loan in the amount tX to the sovereign.

Now suppose that the customer is partly characterized as a participant in Wal-Mart. If X is again the amount paid for the guarantee, then Wal-Mart would have this entire amount to invest, since a receipt from a participant would be excluded from taxable income (Rule 2). Since Wal-Mart's pretax rate of return is r, this investment yields a fully taxable return

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tomer's characterization as a nonparticipant partly on administrative convenience leads to no relevant entity income tax effect.

An important observation bears making, however. The fact that a characterization has no relevant entity income tax effect does not necessarily mean that it would have no relevant tax effect at all. That largely will be a question of the extent of the coordination of the income measure employed in the entity income tax regime and the income measure employed in the individual (participant) income tax regime. In general, I do not assume coordination: Each tax regime has a different goal that arguably supports the use of a different income measure. Thus, the characterization of a customer for purposes of the entity income tax need not, and probably should not, carry over to the characterization of the customer for purposes of the individual income tax. In particular, the current individual income tax treatment of the customer, which is essentially as a nonparticipant, need not and probably should not be changed. Thus, the customer could continue to have neither income nor deductions as a result of the guarantee.[99]

A. *Participants Who Provide Nonhuman Capital*

1. *Investments, Contributions, and Distributions*

Consider a participant who invests cash in an entity: She transfers $100 of cash to the entity and receives in exchange an instrument that promises one or more future cash payments, possibly unspecified as to timing and amount. Thus, under current parlance, her instrument could be either debt or equity (it does not matter which). Now suppose that the instrument ultimately is redeemed for a single cash payment of $150. The participant has earned an economic return of $50 on her investment,[100] and the entity's taxable income correspondingly

of rX. It follows that Wal-Mart again could pay $r(1 - t)X + X$ with respect to the guarantee and still break even. The reason is that guarantee payments now would not be deductible (Rule 3). Thus, Wal-Mart's net entity taxable income would be rX. Accordingly, Wal-Mart would pay tax of trX. When the invested amount and the pretax investment return are added together, and the tax payment is subtracted from the total, it becomes clear that Wal-Mart would have exactly the cash required to make a payment of $r(1 - t)X + X$ on the guarantee. Note that the tax payment, rtX, is the amount of interest forgone by the sovereign as a result of not having received an interest-free loan from Wal-Mart in the amount of tX. This fact explains why the sovereign should be indifferent as to the customer's characterization.

[99] Purchasing a toaster is nondeductible consumption. The purchase price includes a prepayment for future services to be received under any guarantee. Those services, when received, are deemed to be equal in value to the amount paid for them. Thus, the receipt of services under the guarantee does not result in taxable income. Alternatively, if cash is received under the guarantee, such cash represents a purchase price adjustment. Again, the receipt under the guarantee is not taxable.

[100] This is not necessarily correct as a matter of economics. Her economic return includes not only the incremental $50 she receives from the entity over and above the return

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also should be $50, at least at first blush.[101] Do the rules I set forth above achieve this result? To answer this question, consider the possible sources of the incremental $50 returned to the participant. One such source is nonparticipants: The funds were received from the entity's customers.[102] Thus, one can imagine the following sequence of transactions: The participant transfers $100 to the entity, the entity uses the $100 to purchase some inventory from a nonparticipant, the entity sells the inventory for $150 to some other nonparticipant, and the entity transfers $150 to the participant. The transfer of cash to the entity would have no effect on entity taxable income (Rule 2). The purchase of the inventory would produce a basis of $100 (Rule 1). The sale of the inventory would produce gain of $50, that is, the excess of the proceeds received for the inventory over the entity's basis in the inventory (Rule 1). The transfer of cash to the participant would have no effect on entity taxable income (Rule 3). Netting these items indeed would produce the desired $50 of entity taxable income.

But there is a second possible source of the incremental $50 returned to the participant: The funds could be derived from another participant. That is, the entity could take $50 received from some other participant and simply transfer it to the first participant. In such case, it would be incorrect to say that the $50 return earned by the lucky participant represents that participant's share of the economic income generated by the entity: There is no such economic income.

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of her investment, but also includes any change in value of the returned investment as well. That is, the $100 of cash that she transferred to the entity may not have the same value as the $100 of cash that she receives from the entity due, for example, to inflation or currency fluctuations. Still, since the current tax law does not take such changes in the value of a participant's functional currency into account, I do not take them into account either.

Note that the existence of such gain or loss in the value of a returned investment is a pervasive phenomenon which, in other contexts, one may not want to ignore. For example, suppose the investment is made in the form of land. If the land is contributed when its value is $100 and is returned when its value is $150, one could argue that the investor has earned no return. After all, the same land that was contributed is returned. On the other hand, one could argue that the investor earned a return of $50, reflecting the increased value of the land. This latter choice is not inconsistent with ignoring "similar" changes in the value of currency. For in the case of the investment made in the form of land, there might be, after converting the value of the land into currency, an additional gain or loss based on the change in value of the currency. It is that additional gain or loss that consistency demands be ignored.

[101] This would not be true under current law. Thus, if the participant's instrument were corporate debt, her income would not be replicated at the corporate level due to the interest expense deduction. IRC § 163(a).

[102] At the most basic level, everything that flows into an entity, over the life of the entity, must flow out again. Thus, to the extent that there is a net outflow to participants (that is, participants earn an aggregate positive return), there must be a net inflow from nonparticipants. And to the extent that there is a net inflow from participants (that is, participants earn an aggregate negative return), there must be a net outflow to nonparticipants.

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Rather, the return represents nothing but a redistribution of wealth among the entity's participants. Thus, notwithstanding the lucky participant's positive return, the entity should not have $50 of taxable income, but rather no net taxable income at all. And indeed it would have none, for neither the receipt of funds from the divested participant (Rule 2) nor the payment of such funds to the lucky participant (Rule 3) would have any effect on entity taxable income.

Note that the successful operation of the rules does not depend on whether or not the participant has a positive return. Thus, suppose that the participant's instrument ultimately is redeemed for a single cash payment of $50. Since she has incurred a loss of $50, the entity, absent a mere redistribution of wealth among participants, should have a corresponding loss of $50.[103] And it does, for such a loss could arise only if the "missing" $50 found its way into the hands of nonparticipants. Thus, one can imagine the following sequence of transactions: The participant transfers $100 to the entity, the entity uses the $100 to purchase some inventory from a nonparticipant, the entity sells the inventory for $50 to some other nonparticipant, and the entity transfers $50 to the participant. As above, the transfer of cash to the entity would have no effect on entity taxable income (Rule 2). The purchase of the inventory would produce a basis of $100 (Rule 1). The sale of the inventory would produce a loss of $50, that is, the excess of the entity's basis in the inventory over the proceeds received for the inventory (Rule 1). And the transfer of cash to the participant would have no effect on entity taxable income (Rule 3). Netting these items indeed would produce the desired entity taxable loss of $50.[104]

Consider now a participant who transfers nonhuman capital to an entity in the form of an asset other than cash. Under current tax law, such a transfer will fall into one of three categories. First, there are transfers that are not treated as transfers at all since the transferred asset ultimately will be returned to the transferor. Thus, the transferor does not have a realization event at the time the asset is transferred to the entity and the entity, since it is not deemed to be the owner of the asset, receives no basis in the transferred asset. These transfers generally are called leases or licenses, and are considered in

[103] Under current law, the participant's loss would not be replicated at the corporate level if her instrument were debt, since the corporation generally would be required to recognize cancellation of indebtedness income. IRC § 61(a)(12).

[104] As before, there is a second possible source of the participant's loss, namely a redistribution of her wealth to other participants. Since such a loss does not reflect the entity's business misfortunes, it should not manifest itself in an entity taxable loss. And indeed it would not, for neither the receipt of funds from the unlucky participant (Rule 2) nor the payment of such funds to some other luckier participant (Rule 3) would have any effect on entity taxable income.

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detail in the next Subsection. Second, there are transfers that are treated as transfers but that are not taxed currently. Thus, the transferor has a realization event but is able to hide behind the curtain of nonrecognition. In these cases, the entity generally is forced to adopt the transferor's basis in the asset.[105] Third, there are transfers that are treated as transfers and that are taxed currently. Thus, the transferor generally recognizes all gain or loss inherent in the asset at the time the asset is transferred to the entity and the entity receives a fair market value tax basis in the transferred asset.[106]

My entity income tax regime does not aspire to change the current law's tax treatment of nonentities, and hence of participants who transfer assets to entities. Thus, I accept the current sovereign's willingness to give participants choices with respect to such tax treatment: nonrealization, realization without recognition, and full recognition. Presumably these choices make potential participants more willing to make their assets available for entity use.[107] My entity income tax regime, however, would need to change the current law's tax treatment of an entity that receives an asset from a participant, for such tax treatment must be robust. That is (and ignoring until the next Subsection the peculiarities arising in the lease/license context), there is no reason to believe that an entity will generate greater or lesser benefits from its use of the entity organizational form simply because it receives a given asset in a nonrecognition as opposed to in a recognition transaction.[108] Thus, the entity should generate identical amounts of entity taxable income in either case. And that means that the current law's dichotomy of carryover and fair market value basis must be abandoned.

It actually means more. Of these two, only a fair market value basis can possibly produce a robust entity income measure. The reason is that an entity in need of a particular asset can obtain it (if it is a readily available asset) either from a participant or from a nonparticipant. If it chooses the former, it may be confronted with a host of possible participants, each with her own peculiar basis in the asset. If it

[105] E.g., IRC §§ 351, 362 (transfers to corporations), §§ 721, 723 (transfers to partnerships).

[106] IRC §§ 1001, 1012.

[107] Other considerations, such as a transferor's liquidity, also might contribute to the sovereign's willingness to make alternative tax treatments available.

[108] Under current law, a participant's tax treatment can appear to affect her returns from participating in an entity. That is, an asset with a stepped-up fair market value basis is typically more valuable to an entity than an asset with a lower carryover basis. Accordingly, the entity will pay more for the former than the latter: The additional amount it will pay is the capitalized value of the additional tax basis. This phenomenon, however, only affects the participant's returns prior to her participation in the entity, not her returns from participating in the entity.

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chooses the latter, it will be confronted with a market and a market price. Once the asset enters entity solution, by either route, the entity will find itself in the same posture: It has the asset and is able to deploy it as it sees fit. Thus, in either case, the entity-type benefits that will be generated by virtue of having brought the asset into entity solution will be the same. And so both cases must receive the same tax treatment. Given the absence of a single obviously correct way to tax the first case (that is the lesson of current law), the entity income tax must extend to such case the tax result of the second case. And that means that the entity's basis in the asset must be the asset's fair market value at the time it is transferred to the entity, even if the asset is acquired from a participant in a nonrecognition transaction.[109]

To illustrate, suppose a participant transfers an asset with a tax basis of $10 and a fair market value of $100 to an entity. Sometime later, the entity sells the asset to a nonparticipant for $150, which it then distributes to the transferring participant in full redemption of her interest in the entity. Under these facts, there would be no entity tax effect at the time the asset was transferred to the entity (Rule 2), and the entity would take a basis of $100 in such asset. When the asset was sold to the nonparticipant, the entity would recognize taxable income of $50 (Rule 1, if no depreciation deduction was allowed in the interim), which is the excess of the sales proceeds received by the entity over the entity's basis in the asset. Finally, the entity's distribution of the sales proceeds to the participant would produce no additional entity tax effect (Rule 3). Netting these items, the entity would have taxable income of $50. And that is at least plausibly the amount of return the participant receives by virtue of her participation in the entity (even if it is not necessarily the amount of taxable income she would recognize as a result of such participation).

Note that a largely symmetrical issue arises whenever an entity transfers an asset other than cash to a participant. Thus, the fact that the entity would not receive a deduction for such transfer (Rule 3) does not answer the question of whether it should recognize any gain or loss on such transfer and, if so, how much. Current law offers no definitive answer: In the corporate context, gain (meaning the excess of the fair market value of the transferred asset over its basis) but not loss is recognized when an asset is transferred to an equity owner;[110] in the partnership context, neither gain nor loss is recognized with re-

[109] Note that my decoupling of entity tax basis from transferor recognition is not as strange as it might appear; even current law contains instances of it. Thus, if a transferor transfers an asset to an entity in an installment sale, the entity receives a fair market value (cost) basis even though the transferor receives a kind of nonrecognition treatment (she receives the equivalent of a carryover basis in the installment note). IRC §§ 453, 1012.

[110] IRC § 311.

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spect to such transfer.[111] But as in the case of a transfer of an asset into entity solution, a transfer of an asset out of entity solution should produce a single entity income tax result, irrespective of to whom such transfer is made. That is, there generally will have been no difference in the amount of entity-type benefits generated by the asset's presence in entity solution, simply because the asset ultimately is transferred out of entity solution to a participant rather than to a nonparticipant.[112] And since the entity's tax result in the case of a transfer of the asset to a nonparticipant is clear, and is a result that cannot be excluded, such result must apply as well to the case of a transfer of the asset to a participant. Thus, an entity must recognize gain or loss, in an amount equal to the difference between the fair market value of an asset and its tax basis, whenever (and however) such asset is transferred to a participant.

2. *Leases and Licenses*

The final transactional structure to consider is that in which the transferor of a nonhuman capital asset other than cash will receive a return of such asset at some future point in time. Thus, suppose an individual owns an asset with a fair market value of $100. The individual enters into a contract with an entity pursuant to which she transfers the asset to the entity and the entity, in exchange, promises on the first anniversary of the transfer to pay her $33 of cash and on the second anniversary of the transfer to pay her $36.30 of cash and to return the asset to her. Of course, this contract would turn the individual into a participant: She has transferred an asset to the entity in exchange for consideration, not all of which is received immediately. Could it be that the individual reaps a return of $69.30 (assuming all payments are made as promised) over the life of her participation in

[111] IRC § 731(b).

[112] Indeed, if there were such a difference, it would result from the fact that transaction cost savings plausibly could be realized by disposing of an asset to a participant rather than to a nonparticipant. To the extent, however, that such savings are savings that the entity income tax should be concerned about (a dubious proposition, since entity-type benefits flow from an entity's flexibility to deploy an asset, and its ability to give assurances that it has an unfettered right to use the asset, neither of which will continue to be relevant if the entity is disposing of the asset), the measure of entity taxable income should be *higher*, all else being equal, in the case of a transfer to a participant than in the case of a transfer to a nonparticipant. And to the extent that the transaction costs savings arise from lower deductible costs (for example, legal costs for outside counsel), it would be. But, of course, this is the opposite result from that which ordinarily would flow from any sort of nonrecognition treatment: If the transferred asset has a basis that is lower than its fair market value (the usual case, given accelerated depreciation and the expected appreciation of nondepreciable assets over time), nonrecognition treatment would result in lower entity taxable income if the asset was transferred to a participant.

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the entity? After all, at the end of two years she has $69.30 of new cash and she still (or once again) has her asset. Applying the entity income tax rules set forth above, this result indeed seems to be produced on the entity's income tax return. In some set of transactions that, without loss of generality, are fully taxable, the entity would collect net cash and hence recognize net taxable income of $69.30 (Rule 1); the entity then would transfer the cash sans deduction to the participant (Rule 3); the transfer and the retransfer of the asset would have no tax effect (assuming the entity income tax law, like the current tax law, were fooled by nonrealization). But this would be wrong.

What explains the terms of the lease? Presumably, when depreciation of the asset is taken into account, the expected value of the asset at the end of two years is less than its $100 value at the inception of the lease. Indeed, suppose this expected value is $48.40. If the relevant discount rate is 10%, this residual value has a net present value of $40 at the time the participant transfers the asset to the entity. Moreover, using the same discount rate, each anticipated cash payment has a net present value of $30. Thus, as illustrated in Table 7, the aggregate net present value of the future payments to be received by the participant from the entity is $100, which is exactly the fair market value of the asset at the time of its transfer to the entity.

TABLE 7
LEASE

	Year 1	*Year 2*	*Residual Value*	*Aggregate*
Expected returns	$33.00	$36.30	$48.40	$117.70
Net present value	30.00	30.00	40.00	100.00
Actual returns	33.00	36.30	55.00	124.30

Under these facts, it would be incorrect to measure entity (or for that matter participant) income under the assumption that the "same" asset that is transferred to the entity ultimately is returned to the participant. Neither the entity nor the participant shares this assumption. Rather, the income measure should take into account some or all of the change in the value of the asset during the period the entity has possession and control[113] of the asset. Thus, if the actual residual value turns out to equal the expected residual value, the most logical income measure would be $17.70 over the life of the lease. And if, as in Table 7, the actual residual value turns out to be $55, or $6.60 more

[113] I do not use the word "ownership," since title to the asset generally will remain with the participant.

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than the parties expected, an entity income measure that showed $24.30 of taxable income over the life of the lease surely would be defensible. After all, the participant received cash of $69.30 and an asset worth $55 in return for her original investment (based on fair market value) of $100.

The entity income tax rules do indeed produce this result, provided that the transfer of the asset from the participant to the entity and the retransfer of the asset from the entity to the participant are both treated as true transfers. In that case, the entity, upon receipt of the asset, would take a fair market value basis of $100 in such asset, and upon return of the asset, would be treated as disposing of the asset for its fair market value of $55, thereby recognizing a $45 loss.[114] When this loss is netted with the $69.30 of income previously calculated, $24.30 of net entity taxable income would result.[115]

Is there any reason to tamper with this result? But of course! In particular, one can question whether it is really defensible to model a leasing or licensing transaction as a transfer and retransfer of the leased or licensed asset. One could just as naturally, perhaps even more naturally, model such a transaction as a transfer not of the asset itself, but merely of a temporally limited right to use the asset. Under this view, the owner of the asset transfers to the entity the right to use the asset for two years and receives in exchange solely future cash payments. Thus, she is clearly again a participant in the entity. What is the effect of this characterization? From Table 7, it follows that the right to use the asset for two years has a fair market value of $60. Thus, the participant's investment in the entity would be $60 rather than $100. In return for making such investment, the participant receives (if all goes well) cash payments totaling $69.30. Thus, the participant's aggregate return from participating in the entity would be $9.30. And the entity income tax rules indeed would produce this result. When the temporally limited right to use the asset was transferred to the entity, the entity would receive a fair market value basis of $60 in such right. Over the two-year period, the right expires, entitling the entity to cost recovery deductions totaling $60. Finally, the entity would still need to generate $69.30 of cash to make its payments under the lease, and such amount (without loss of generality) would

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[114] This calculation assumes, without loss of generality, that there is no intervening cost recovery. To the extent that intervening cost recovery is allowed, the entity would be entitled to deductions that would reduce its basis in the asset dollar for dollar. Thus, on disposition, the loss of $45 would be reduced by exactly the amount of the prior cost recovery deductions. Hence, the net effect would be the same aggregate amount of income as when there is no intervening cost recovery.

[115] See Table 8 (Model 1).

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be generated in a fully taxable way. Netting the deductions and inclusions, the entity's taxable income would be $9.30.[116]

Thus, the sovereign is in a quandary. It has two models that assume different transactional structures and that yield different amounts of entity taxable income: $24.30 under the first model (Model 1) and $9.30 under the second model (Model 2). Is either preferable? Both have shortcomings. The first might be considered to entail a sneak attack on the realization requirement[117] and so might be seen as contrary to a fundamental principle of current tax law.[118] The second raises in perhaps too pregnant a form the thorny question of the proper tax treatment of temporal carve-outs.[119] Thus, a third model (Model 3) might be considered. Note that the difference in the income measures in the first two models is composed of two distinct parts: A part of the difference (that is, $8.40) arises because Model 1 but not Model 2 takes into account the expected change in the value of the residual interest in the asset; the remainder of the difference (that is, $6.60) arises because Model 1 but not Model 2 takes into account the unexpected change in value of such residual interest. There is, of course, no reason why a tax regime must treat these two parts alike. Thus, including the former, but not the latter, in the entity income measure is perhaps the strategy most in conformity with current income tax principles.[120] And it is not difficult to justify doing this based on the nature of the interaction between the participant and the entity. Thus, the lease implicitly contemplates that the participant is to receive the benefit or burden of both expected and unexpected changes in the asset's residual value. The former arguably are within the control of the entity. That is, the expected changes generally will accrue so long as the entity takes due care in using the asset. On the other hand, the unexpected changes arguably are beyond the control of the entity. They result from unanticipated changes in the supply of or demand for the asset. Thus, "delivery" of the expected, but not of the unexpected, changes in the residual value of an asset can be

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[116] See Table 8 (Model 2).

[117] As always, I assume that an altered entity tax treatment would not force a change in current participant tax treatment. Thus, the treatment of an entity as first receiving a transfer of an asset and as then retransferring such asset would not require parallel treatment for the participant, and thus would not force the participant to seek the shelter of § 351 or § 721 to overcome the recognition treatment that would otherwise flow out of § 1001. Still, the mere fact that the entity tax regime would insist that there was, for its purposes, a transfer, would create the possibility that the sovereign some day might conclude that such transfer should be an occasion for participant realization as well.

[118] Whether or not the realization requirement is a good or a bad thing is another question entirely.

[119] See IRC § 167(d), (e).

[120] Investors frequently are taxed on unrealized expected price changes, but rarely are taxed on unrealized unexpected price changes. See IRC §§ 1271-1275.

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viewed as a part of the consideration that the entity promises under the lease. Model 3 takes this consideration into account. Thus, the participant's expected loss is $51.60 (the difference between the asset's expected residual value of $48.40 and its initial value of $100). Netting this loss with her cash receipts of $69.30 produces net income of $17.70.

TABLE 8
THREE LEASE MODELS

	Model 1 *Entire asset in and out*	*Model 2* *Leasehold in and out*	*Model 3* *Participation includes only expected gain*
Year 1 income	$33.00	$33.00	$33.00
Year 2 income	36.30	36.30	36.30
Loss on disposition	(45.00)	(60.00)	(51.60)
	$24.30	$ 9.30	$17.70

Before proceeding, I note that each of the three models suffers from the same administrative problem: Each requires knowledge of the generally unobservable fair market value of the asset, a value that there is much incentive for the participant and the entity to distort. Thus, for example, in Model 1, there is little to prevent the participant and the entity from claiming that the asset has a fair market value of $110 at the time of its transfer to the entity and a fair market value of $45 at the time of its transfer from the entity. If so, two-year reported entity taxable income would fall from $24.30 to $4.30.[121] Similarly, in Model 2, there is little to prevent the participant and the entity from claiming that the right to use the asset has a fair market value of $80 at the time of its transfer to the entity. If so, reported entity taxable income would fall from $9.30 to -$10.70. Finally, in Model 3, the parties with relative impunity could assert that the asset has a fair market value of $110 at the time of its transfer to the entity and that its expected residual value is $38.40. Again, the net effect would be to reduce reported entity taxable income by $20, from $17.70 to -$2.30.

[121] This valuation difficulty is wholly different in kind than the difficulty that accompanies a more generic transfer of an asset into or out of entity solution. For in the generic case, an unrealistic fair market value ascribed to the asset will create undesirable economic consequences for other entity participants. Thus, for example, a too-high fair market value on transfer of the asset into entity solution in exchange for entity equity interests means that a disproportionate share of equity will be issued to the transferor. Other participants generally will not tolerate this. And a too-low fair market value on the transfer of an asset out of entity solution in redemption of an equity interest means that the redeemed participant will be overcompensated for her equity interests. Other participants generally will not tolerate this either. There is no similar check on misvaluation when it is solely with respect to an asset that is contributed by and will be returned to a single participant.

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Since my aim in this Article is to design a theoretically justifiable and robust entity income tax regime, I do not place too much importance on such administrative problems. Still, the mere existence of these problems suggests that it may be prudent to continue the search for alternative models. And such models do exist. For example, current tax law answers the question of how much income a participant garners from leasing or licensing an asset to an entity by reference to the participant's tax basis in the asset. If this amount of income truly reflected the participant's return from her interaction with the entity, it is the amount that should be reported on the entity's income tax return. Thus, Model 4 defines the entity's income as the excess of the amounts paid to the participant over the amount of cost recovery the participant is allowed with respect to the leased or licensed asset.[122] Thus, for example, suppose the Code allowed 40% of the asset's basis to be recovered in the first year, 30% in the second year, 20% in the third year, and 10% in the fourth year, and suppose further that the participant acquired the asset for $150 exactly one year before she enters into her lease with the entity. In that case, at the time she enters into the lease, the participant would have a basis of $90 in the asset (even though the asset has a fair market value of $100).[123] Under the depreciation schedule, she and the entity would be allowed cost recovery deductions of $45 ($150 x .3) in the first year of the lease and $30 ($150 x .2) in the second year of the lease, resulting in net income of -$12 and $6.30 in those years, respectively.[124]

How does Model 4 differ from the first three? It differs solely in that it bases the entity's aggregate cost recovery (depreciation or amortization) on a mechanical schedule set forth in the Code, rather than on unobservable fair market values and actual or expected changes in such fair market values. That is, Model 1 allowed the entity aggregate cost recovery in the amount of the actual but unobservable decline in the asset's value over the term of the lease (so-called economic depreciation); Model 2 allowed the entity aggregate cost recovery in the amount of the actual but unobservable decline in the value of the leasehold over the term of the lease; and Model 3 allowed the entity aggregate cost recovery in the amount of the expected but unobservable decline in the asset's value over the term of the lease (expected economic depreciation).

Unfortunately, in the process of solving an administrative problem, by granting entities objectively determinable cost recovery deductions, Model 4 creates a different and far greater problem for the en-

[122] IRC §§ 167, 168, 197.

[123] $90 = [$150 - ($150 x .4)].

[124] See Table 9 (Model 4).

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tity income tax: It shatters all hope for robustness. That is, an entity's taxable income would depend on its lessors' tax bases. The very same dependency already was rejected as unacceptable in the not wholly dissimilar context of a nonrecognition transfer of an asset into entity solution. Now it must be rejected again, and for the same basic reason. That is, there is no reason to believe that an entity will generate a different amount of incremental theory-of-the-firm type benefits simply because it leases an asset from a taxpayer who has a high basis in such asset rather than from a taxpayer who has a low basis in such asset.

Although Model 4's nonrobustness leads to its rejection, the model did have a feature that is worth pursuing. That is, it is the first model that answered the second order question of how the aggregate amount of entity taxable income recognized over the life of a lease should be spread over the lease term. I now superimpose that answer on another model. Thus, tentatively assume that the sovereign settles on Model 1 to determine the aggregate amount of entity income over the life of the lease. And suppose further that the Code contains the cost recovery scheme for four-year assets set forth above. In that case, the entity would receive a $100 basis when the asset is transferred to it, and should be allowed cost recovery with respect to such basis. Since, at the time of transfer, the asset had already been in service for one year, it would have a remaining statutory useful life of three years. Thus, it would be logical to allow the entity cost recovery deductions of 50% of the asset's basis in the first year of the lease and 33.3% of the asset's basis in the second year of the lease.[125] Thus, as shown in Table 9 (Model 1A), the entity would appear to have taxable income of -$17 and $3, respectively, during the two years of the lease.

But this cannot be right: The aggregate entity income under Model 1 was supposed to be $24.30, not -$14. Fortunately, it is easy to get to this result. For if, as under Model 1, the entity receives basis in the amount of the asset's then fair market value when the asset enters entity solution, it also must lose basis in the amount of the asset's then fair market value when the asset leaves entity solution. Thus, if the entity is allowed cost recovery deductions of $50 and $33.30 during the two-year life of the lease, it will have a tax basis in the asset of $16.70 at the end of the lease. But at such time, the asset's fair market value

[125] These cost recovery percentages are based on the deductions normally allowed during the final three years of a four-year asset's depreciable life. For example, at the beginning of the second year, 60% of the asset's original basis has not been recovered. During the second year, cost recovery of 30% of such original basis is ordinarily allowed. Dividing 30% by 60% produces a second year cost recovery allowance of 50% of the asset's basis at the start of the second year. A similar calculation (20% of 60%) produces a third year cost recovery allowance of 33.3% of the asset's basis at the start of the second year.

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is $55. Thus, as shown in Table 9 (Model 1B), at the end of the lease, the entity should realize a "disposition" gain of $38.30 with respect to the asset. If so, it indeed would have the appropriate amount of aggregate income, namely $24.30, over the life of the lease.

TABLE 9
DEPRECIATION MODELS

	Model 4 Participant's depreciation	*Model 1A Fair value depreciation*	*Model 1B Depreciation with true-up*
Year 1 income	$33.00	$33.00	$33.00
Year 1 depreciation	(45.00)	(50.00)	(50.00)
Year 2 income	36.30	36.30	36.30
Year 2 depreciation	(30.00)	(33.30)	(51.30)
Year 2 disposition gain	0.00	0.00	38.30
Aggregate income	($ 5.70)	($14.00)	$24.30

Before revealing the only robust way to tax a lease, and hence the way in which the entity income tax will tax a lease, I consider an alternative transaction that bears great similarity to a lease—a financing. Thus, suppose a participant loans $100 to an entity with the understanding that the funds will be used to purchase the asset under discussion. Suppose that the loan bears interest at the same 10% rate implicit in the lease.[126] Suppose, further, that the loan requires a payment of $33 at the end of the first year ($23 of which is principal and $10 of which is interest) and a payment of $36.30 at the end of the second year ($28.60 of which is principal and $7.70 of which is interest). How would the entity be taxed? First, the entity receives a $100 basis when it acquires the asset; it thus receives depreciation deductions of $50 in the first year and $33.30 in the second year (assuming it is entitled to apply the final three years of the four-year-asset depreciation schedule, based on the asset's remaining three-year life). In addition, the entity must generate $33 of cash to pay the first year's principal and interest and $36.30 of cash to pay the second year's principal and interest. Without loss of generality, I assume it generates such cash in fully taxable transactions. Finally, the receipt of cash from and the payment of cash to the lender would not affect the entity's taxable income, as both are transactions with a participant. Putting the pieces together, the entity's taxable income would be -$17 in the first year and $3 in the second. The financing thus appears to rep-

[126] If the loan has the same level of risk as the lease, it should bear interest at the same rate. Since my assumptions will guarantee that it has the same risk, this rate assumption is appropriate.

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licate the tax results shown, but rejected, for the so-called "true lease" in Model 1A.

But it does not quite do so. In the case of the true lease, the entity was out of the picture at the end of year two. In the case of the financing, the entity is at such time the owner of an asset with a tax basis of $16.70 and a fair market value of $55. Moreover, the entity still has an outstanding loan of $48.40. I assume, since the entity initially chose a lease transaction instead of a financing, that it has no interest in being the residual owner of the asset (and concomitantly, that it prefers not to be saddled with debt) at the end of the two-year period. To move in the direction of achieving these ends, the entity, at the time it purchases the asset, could enter into a forward contract to sell the asset at the end of the two-year period for its then fair market value (such contract, at its inception, has a fair market value of zero). This strategy is not perfect: It eliminates the possibility of residual asset ownership but not the possibility of residual debt (since it is conceivable that the asset's value at the end of the two-year period will be less than the then remaining principal on the loan). Nevertheless, if the entity follows this strategy, it realizes an additional capital gain of $38.30 ($55 - $16.70).[127] Thus, over the two-year period the entity would generate aggregate entity taxable income of $24.30.[128]

Alternatively, the entity, at the time it purchases the asset, could enter into a forward contract to sell the asset at the end of the two-year period for the asset's then expected value of $48.40 (such contract, at its inception, also has a fair market value of zero). This strategy achieves all of the entity's ends: It eliminates the possibility of residual asset ownership and the possibility of residual debt. In this case, the entity's sale of the asset pursuant to the forward contract would produce additional capital gain of $31.70 ($48.40 - $16.70). Thus, ignoring the possibility (taken up in Section V) that the counterparty to the forward contract should itself be treated as a participant in the entity, the entity's ownership of the asset would generate aggregate entity taxable income of $17.70.[129]

Finally, the entity, at the time it purchases the asset, could arrange for the seller to sell to some third person the right to use of the asset after the second year. Since this remainder interest has a fair market value of $40, the sale should generate cash proceeds of $40. Thus, the entity would need to borrow only $60 to finance the purchase of its two-year interest in the asset. Moreover, since loan payments of $33 and $36.30 over the two-year period would exactly retire a $60 loan,

[127] The entity also has a terminal unexpected cash horde of $6.60.

[128] See Table 10 (Model F1).

[129] See Table 10 (Model F3).

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the entity will achieve all of its ends. As for entity income taxation, the entity would receive a basis of $60 in the two-year interest in the asset. Assuming the applicability of the second and third year allowances from the statutory depreciation schedule, it would be entitled to depreciation deductions of $36 and $24, respectively, in the two years that it uses the asset.[130] Thus, as shown in Model F2 in Table 10, it would have aggregate entity taxable income of $9.30.

TABLE 10
FINANCINGS WITH TERMINAL ASSET DISPOSITION

	Model F1 Forward sale at fair value	*Model F2 Current sale of remainder*	*Model F3 Forward sale at expected value*
Year 1 income	$33.00	$33.00	$33.00
Year 1 depreciation	(50.00)	(36.00)	(50.00)
Year 2 income	36.30	36.30	36.30
Year 2 depreciation	(33.30)	(24.00)	(33.30)
Disposition gain	38.30	0.00	31.70
	$24.30	$ 9.30	$17.70

Note that the three financing models correspond, in terms of aggregate entity income, if not quite in terms of timing, to the first three leasing models. That is, with financings, as with leases, there are at least three plausible entity income tax outcomes. What is the sovereign to do? I submit that the sovereign must, in each case, choose that plausible outcome that is robust. That is, if the upshot of the relationship between a participant and an entity is that the entity, for a two-year period, is able to use a given asset, then the same amount of entity taxable income should result, irrespective of how the parties formally structure their relationship. The reason for this conclusion is the usual one. The benefits from having the asset in entity solution during the two-year period arise simply because the asset is in entity solution; they do not depend on how the asset got there, or on how it gets out again.

But which outcome is robust? The answer is that outcome that the sovereign cannot exclude. And which outcome is that? It is the outcome that obtains from the most basic transaction: a simple purchase

[130] The statutory scheme allows 50% of a four-year asset's basis to be recovered during the second and third years of the asset's life, with 30% being recovered in the second year and 20% being recovered in the third. Dividing 30% by 50% produces a 60% allowance in the entity's first year of use. Similarly, the entity would receive a 40% allowance in its second year of use.

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of the asset from and sale of the asset to a nonparticipant, without any additional frills. Thus, the asset is purchased for $100, generates fully taxable cash flows of $33 and $36.30, respectively, during the two-year ownership period, depreciates in amounts of $50 and $33.30, respectively, during the two-year ownership period, and is sold for $55, producing a taxable capital gain of $38.30. This transaction (which is just the financing illustrated in Model F1) would yield aggregate entity taxable income during the ownership period of $24.30. Thus, $24.30 must be the amount of entity income that results from every other possible transaction structure discussed above.

Model 1, of course, already produced this result, but Models 2 and F2 and 3 and F3 did not. But with a small change in perspective, they would have! That is, the difference between the robust measure of entity taxable income and all of the other measures results from shortcomings in the models that produced such other measures. For example, consider Model 2, which involved the participant's transfer to the entity of only a leasehold interest, and Model F2, which involved a financing with an immediate sale of the right to use the asset after a two-year period. Both of these models would yield entity taxable income of only $9.30. But there is a problem with these models: While it is possible, on paper, for someone other than the entity to "own" a residual interest in the asset, such ownership interest is in reality meaningless. That is, during the two-year period that the entity makes use of the asset, the entity in fact controls the entire asset. Thus, the lessor or the purchaser of the residual interest, as the case may be, depends on the entity for her return (both expected and unexpected) with respect to such residual interest. This is arguably simply a type of participation in the entity, and hence one that the entity income tax regime should not be ashamed to acknowledge and tax. Not surprisingly, the value of this participation, or $15 (that is, the excess of the value of the residual interest at the end of the two-year period over the value of the residual interest at the beginning of such period), is precisely equal to the difference between the amount of entity taxable income as measured by the robust income measure and the amount as measured by Models 2 and F2.

Consider now Model 3, which included in entity taxable income the expected gain in the value of the lessor's residual interest, and Model F3, which involved a financing with a forward sale of the residual interest at its future expected fair market value of $48.40. Both these models would yield entity taxable income of $17.70. But both share (a part of) the shortcoming just described with respect to Models 2 and F2: Both ignore the fact that, but for the entity, the unanticipated change in the value of the residual interest will never accrue to its

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owner. Thus, the incremental $6.60 of income, earned by the lessor or the forward contract counterparty, as the case may be, is logically participation in the entity, and thus should be included in entity taxable income. If it is, aggregate entity taxable income of $24.30 indeed would result.

B. *Participants Who Provide Human Capital*

Probably the most significant asset, in terms of value, made available for entity use by entity participants, is human capital. Thus, suppose, as illustrated in Table 11, that a newly-minted business school graduate is about to enter the workforce. Assuming a 10% discount rate is appropriate, the graduate's human capital is an asset with a fair value of $500 (based on her expected future productivity assuming her expected career path). If the graduate makes this asset available to an employer, she will receive a first-year wage of approximately $15, reflecting her expected first-year productivity. She also will receive training and experience that will increase her future productivity. Thus, the value of her asset, her store of human capital, will increase, in this case by roughly $35. In theory, and often in fact, the employee can reap some or all of the benefit of this increased value even if she ceases to work for her current employer. But that means the employer has "distributed" such increased value to the employee. Since entity taxable income generally would include any amount distributed by an entity to a participant, the increased value should be included in entity taxable income. It follows that the entity should have taxable income of $50, rather than only $15, as a result of its employment of this graduate.[131]

[131] When possible, employers prefer that their employees develop firm-specific human capital. Any increase in the value of the graduate's human capital that is due to the development of such firm-specific human capital cannot be said to have been "distributed" to her. It has been "allocated" to her, however. While an allocation of income to a participant generally is a sufficient basis for including such income in the measure of entity taxable income, it would not be in this case, since the realization requirement would intervene. That is, the increase in the value of firm-specific human capital is like any other increase in value of an entity-owned asset: It would not result in entity gross income until the occurrence of a realization event. Hence, it could not result in entity taxable income either.

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TABLE 11
EXECUTIVE HUMAN CAPITAL

Year	Value of human capital	Actual productivity	Appreciation/ amortization	Total return to human capital
–	$500.00			
1	534.90	$ 15.11	$ 34.89	$ 50.00
2	570.26	18.13	35.36	53.49
3	605.53	21.75	35.27	57.03
4	639.99	26.10	34.45	60.55
5	672.66	31.32	32.68	64.00
6	705.47	34.46	32.81	67.27
7	738.12	37.90	32.65	70.55
8	770.24	41.69	32.12	73.81
9	801.40	45.86	31.16	77.02
10	831.10	50.45	29.69	80.14
11	858.71	55.49	27.62	83.11
12	883.54	61.04	24.83	85.87
13	904.76	67.14	21.21	88.35
14	921.37	73.86	16.62	90.48
15	932.26	81.24	10.89	92.14
16	940.18	85.31	7.92	93.23
17	944.63	89.57	4.45	94.02
18	945.04	94.05	0.41	94.46
19	940.79	98.75	– 4.25	94.50
20	931.18	103.69	– 9.61	94.08
21	915.43	108.88	–15.76	93.12
22	892.65	114.32	–22.78	91.54
23	861.88	120.04	–30.77	89.26
24	822.03	126.04	–39.85	86.19
25	771.89	132.34	–50.14	82.20
26	716.75	132.34	–55.15	77.19
27	656.08	132.34	–60.66	71.67
28	589.35	132.34	–66.73	65.61
29	515.95	132.34	–73.40	58.94
30	435.20	132.34	–80.74	51.59
31	353.00	125.72	–82.20	43.52
32	268.87	119.44	–84.14	35.30
33	182.29	113.46	–86.58	26.89
34	92.73	107.79	–89.56	18.23
35	0.00	102.00	–92.73	9.27
Lifetime		$2,964.63	($500.00)	$2,464.62

I want to emphasize that I am not proposing that the individual income tax regime should saddle the employee with this same incremental $35 of income. As usual, there is no need for the participant's individual income measure to conform to the entity's income measure. In this particular case, there actually would be a very good reason for nonconformity. That is, the employing entity arguably has more fully

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realized the income than has the employee. It has paid for the employee's training and has suffered the opportunity costs of providing her with experience; it cannot recover these amounts. The employee, however, despite having enjoyed an increase in the value of her fully portable human capital, has yet to convert this increased value into cash or the like.[132]

Of course, a certain degree of administrative difficulty will attach to identifying the amount of increased human capital value received by an employee from an entity or, alternatively, the amount of the entity's expenditures related to providing such increased value.[133] There are instances in which the entity will make a dedicated expenditure, such as purchasing a training manual or sending the employee to a conference. Since such expenditures generally would involve payments to nonparticipants and thus, in the first instance, would result in entity deductions (Rule 1), the law, at a minimum, must reverse these deductions. More generally, however, the entity will provide training and experience to its employees by simply "forgoing" income. It will allow a less experienced employee to perform functions that could be performed more efficiently by a more experienced employee. In such case, there would be no actual deduction for the law to reverse. There would be, however, the tax law equivalent of a deduction: income earned in a way that the law does not recognize.[134] Since the entity's ability to earn such income and allocate it to the employee is generally an essential part of the employee's participation in the entity,[135] the

[132] Current law contains at least one similar divergence of entity and employee "realization" in the human capital context: its treatment of employee health care expenditures. Thus, when the entity pays an employee's health care costs, it increases the employee's stock of human capital (relative to the pre-expenditure baseline). Moreover, once the payment is made, the entity loses all control over this increased value of human capital. The employee can take her improved health to any other employer. Thus, the entity has "realized" all the effects of its expenditures, and is entitled to a deduction under § 162. (Under the entity income tax, there would be no deduction, of course, since the expenditures are made for the benefit of a participant.) The employee, while enjoying the benefit of the entity's expenditures, has yet to convert her increase in human capital into cash or the like, and so fails to satisfy the requirements for realization. Thus, the employee is allowed to exclude the entity's payments of her health care costs from her income. IRC § 105(b).

[133] There is no similar difficulty in measuring an entity's expenditures with respect to an employee's health. See note 132.

[134] In my example, the entity perhaps could have allowed an experienced employee perform a certain function. Had it done so, it might have generated an additional $35 of gross income. If the entity then used this $35 of gross income to fund the business school graduate's training, $35 of entity taxable income would result. But robustness demands that this same outcome should obtain if the graduate's training is provided by having the graduate perform the certain function. In that case, the additional $35 is just as effectively earned and transferred to the graduate.

[135] For example, employees typically bargain over their access to "opportunities for advancement."

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entity income tax should endeavor to find a reasonable way to measure it and take it into account.[136]

Is there a reasonable way to measure increases in the value of an employee's human capital? A cursory glance at Table 11 reveals that this is hardly the correct question. For consider the final year of the employee's career. At the beginning of such year, the value of her human capital is approximately $93. Her expected productivity during the year is $102, and that is also her expected wage. Of this amount, very little—only $9—represents a return she earns from the entity with respect to her human capital. All of the rest is a payment by the entity to the employee in lieu of a meaningful return of her human capital. Conceptually, this latter portion of the employee's wage is identical to the portion of a lease payment that represents the economic depreciation of the leased asset. As noted above,[137] such portion is not properly a part of the return a participant receives from her participation in the entity.[138] Hence, it should not be included in the taxable income of the entity either. Thus, instead of not being allowed any deduction with respect to its payments to the retiring employee (Rule 3's apparent mandate), the entity should be allowed to deduct that portion of its payments, or $93, that do not represent a return earned by such employee.[139]

I want to emphasize that I am not advocating allowing the employee to take a corresponding deduction. In particular, the individual income tax regime could continue to take the view that, from an employee's vantage, human capital is a nonbusiness asset.[140] And it could continue to take the view that even if such asset is a business asset with a provable basis, the asset generally has no reasonably ascertainable useful life.[141] Hence, wage payments from the entity

[136] One could argue that current tax principles do not support taxing an entity's "forgone" income because such income is essentially imputed income. While I agree with the premise, I disagree with the conclusion. It is true that current law does not tax imputed income as it is earned, but it may tax the fruits of such income when they are transferred to another. It follows that if an entity simply earned imputed income, there would be no basis for taxing it. But when the entity transfers the fruits of the imputed income to another (in this case the graduate), taxation becomes a possibility.

[137] See Section IV.A.2.

[138] Current law excludes statutory depreciation rather than economic depreciation, but the idea is the same: Gross payments under the lease, by themselves, do not represent the lessor's income with respect to the leased asset.

[139] In the case of human capital, the Code makes no current provision for depreciation. Hence, the sovereign can feel free to choose a depreciation measure that is as closely aligned as possible with economic depreciation.

[140] See, e.g., Reg. § 1.162-5(b)(1) (stating that certain educational expenditures are not deductible as ordinary and necessary business expenditures).

[141] But see Sharon v. Commissioner, 66 T.C. 515, 531-32 (1976) (permitting amortization of costs associated with admission to practice before the U.S. Supreme Court over petitioner's life expectancy).

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would continue to be included in an employee's income in their entirety. The employee either would lack any basis with which to offset such wage payments or would lack a mechanism for using her basis to offset such wage payments.

Should similar considerations stand in the way of giving an entity cost recovery deductions with respect to its employees' human capital? Not necessarily, for the analysis is different. From an entity's vantage, there are no nonbusiness assets.[142] Thus, human capital is a business asset, and as such, should be accorded the same tax treatment as any other business asset. In particular, when human capital is transferred to the entity, the entity should receive a fair value basis in the human capital. Moreover, unless there is a good reason for denying them, the entity should be permitted cost recovery deductions with respect to the human capital. What would constitute a good reason? In general, such deductions are only denied for assets that lack a reasonably ascertainable useful life.[143] Is human capital such an asset? And as just noted, the answer is yes from the employee's perspective: Until she is dead, it will never be clear that her human capital has been exhausted. But the answer is no from the entity's perspective: It can quit itself of any one employee's human capital (something the employee cannot reasonably do), and it can statistically determine the rate at which it will quit itself of human capital in general.[144] Thus, an entity would have a theoretical argument, perhaps even a good one, that its human capital assets have a reasonably ascertainable useful life. It follows that appropriate cost recovery deductions with respect to such assets should be allowed.

The problem remains, however, that even if it is clear that both the appreciation and the depreciation in the value of an employee's human capital should be taken into account in determining entity taxable income, there is no simple way to measure such appreciation and depreciation. As Table 11 illustrates, over a 35-year executive career, 35 different amounts result. And as illustrated in Table 12, different amounts would arise in the case of a more generic rank-and-file employee.

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[142] This is slightly overstated for rhetorical purposes. See, e.g., IRC § 274(g) (providing an example of an entity-owned asset that is treated as a nonbusiness asset).

[143] See Reg. § 1.167(a)-1(a), -1(b).

[144] The pre-§ 197 ability of entities to amortize "work force in place" was based on this kind of analysis.

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TABLE 12
RANK-AND-FILE HUMAN CAPITAL

Year	*Value of human capital*	*Actual productivity*	*Appreciation/ amortization*	*Total return to human capital*
–	$100.00			
1	103.82	$ 6.18	$ 3.82	$ 10.00
2	107.41	6.80	3.58	10.38
3	110.67	7.48	3.26	10.74
4	113.51	8.23	2.84	11.07
5	115.81	9.05	2.30	11.35
6	117.89	9.50	2.08	11.58
7	119.71	9.98	1.81	11.79
8	121.20	10.48	1.50	11.97
9	122.32	11.00	1.12	12.12
10	123.01	11.55	0.68	12.23
11	123.18	12.13	0.17	12.30
12	122.77	12.73	–0.41	12.32
13	121.67	13.37	–1.09	12.28
14	119.80	14.04	–1.87	12.17
15	117.04	14.74	–2.76	11.98
16	114.01	14.74	–3.04	11.70
17	110.67	14.74	–3.34	11.40
18	107.00	14.74	–3.67	11.07
19	102.96	14.74	–4.04	10.70
20	98.51	14.74	–4.44	10.30
21	93.62	14.74	–4.89	9.85
22	88.25	14.74	–5.38	9.36
23	82.33	14.74	–5.91	8.82
24	75.83	14.74	–6.51	8.23
25	68.67	14.74	–7.16	7.58
26	61.53	14.00	–7.14	6.87
27	54.39	13.30	–7.15	6.15
28	47.19	12.64	–7.20	5.44
29	39.90	12.01	–7.29	4.72
30	32.48	11.41	–7.42	3.99
31	25.47	10.26	–7.02	3.25
32	18.78	9.24	–6.69	2.55
33	12.34	8.31	–6.44	1.88
34	6.09	7.48	–6.25	1.23
35	0.00	6.70	–6.09	0.61
Lifetime		$409.99	($100.00)	$309.98

Since each employee's wage in some years understates her return from participating in the entity and in other years overstates such return, one might argue that the benefit from attempting to determine an entity compensation deduction that reasonably accurately measures changes in the value of human capital cannot possibly outweigh the costs of attempting to determine such changes in value. But I re-

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ject this argument. My reason is that the pattern of human capital appreciation and depreciation is utterly predictable. Early in a career (the first 18 years in the case of the executive, the first 11 years in the case of the rank-and-file worker), an employee's wage systematically understates her return from participating in the entity (since the benefits of training and experience outweigh the detriments of a shorter remaining working life); late in a career (the last 17 years for the executive, the last 24 years for the rank-and-file worker), an employee's wage systematically overstates such return (since looming retirement more than offsets the benefits of additional training and experience). Thus, an entity income measure that ignores the appreciation and depreciation of human capital would understate entity taxable income early in an employee's career and overstate it late in an employee's career. Given the time value of money, this pattern of errors would appear to produce an unwarranted reduction in the net present value of entity income tax payable.

But of course this analysis is exactly backwards. Viewed over the span of an employee's career in the workforce, her entire store of human capital is used up. In the case of the executive employee illustrated in Table 11, this means that on average there will be $14.30 ($500/35) of annual depreciation with respect to her human capital; in the case of the rank-and-file employee illustrated in Table 12, there will on average be $2.90 ($100/35) of annual depreciation with respect to her human capital. Thus, if all executive workers look exactly like the employee in Table 11, and if all rank-and-file workers look exactly like the employee in Table 12, except that such employees are uniformly distributed with respect to their age, an annual depreciation allowance of $14.30 per executive and $2.90 per rank-and-file employee would be appropriate. Or to restate these amounts in a way that the entity income tax could apply, approximately one-sixth of an entity's executive wages (based on $500 of initial human capital value producing $2,965 of lifetime wages) and approximately one-fourth of an entity's rank-and-file wages (based on $100 of initial human capital value producing $410 of lifetime wages) represent a return of capital, and hence should be allowed as a deduction. Of course, not all executive employees look exactly alike, and not all rank-and-file employees look exactly alike, and the age distribution of employees at any entity is unlikely to be uniform. Thus, a certain amount of statistical analysis would be required to fine-tune these estimates.[145]

[145] The sovereign's ultimate deduction scheme need not (and cannot) be perfectly precise. Rather, a cost-benefit analysis should guide the sovereign to an optimal level of precision.

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Finally, I want to return to my conclusion in the prior Section that not all providers of human capital should be deemed to be participants. The relevance of this conclusion is that the entity income tax would treat differently the wage paid to a "day laborer" and that paid to a rank-and-file employee. The former would be deductible in its entirety (Rule 1) and the latter would be deductible only in part (Rule 3, as modified by the foregoing discussion). Thus, one could expect entity employers to increase their reliance on day laborers.[146] To the extent that entity employers would pursue this strategy—and it is an empirical question whether there are many jobs that would offer an employer a sufficient benefit in terms of tax reduction to offset the increased costs that would result from constant negotiation, diminished operational flexibility, diminished ability to make long-range plans, and an inability to develop and exploit firm-specific human capital—the number of low wage employees without the least increment of job security (not even that increment provided by employment at will) would increase. As increasing this number represents dubious social policy,[147] the sovereign could choose to dispense with the difference in tax treatment of day laborers and employees by allowing entities a partial deduction for the compensation even of day laborers.[148]

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[146] Note that this is a different phenomenon than that commonly referred to as out-sourcing. By out-sourcing, an entity seeks to take advantage of the lower labor costs that another entity can provide. In such structure, the actual laborers are not participants of the entity doing the out-sourcing, but they are participants of the entity to which the labor is out-sourced. Thus, the income of the laborers would remain in the entity income tax base.

[147] In theory, such "employees" should be compensated at least partially for their job insecurity in the form of a higher wage. That is, the increased cost imposed on such employees by converting them to day laborer status should decrease the amount of labor such employees are willing to supply at any given wage. Moreover, the incremental tax savings occasioned by converting employees to day laborer status should increase the demand for such labor at any given wage. Putting these factors together, wages for employees converted to day laborer status should increase. Despite this theoretical increase, I stick to my view that it is dubious social policy to enact tax legislation that would decrease the generally already tenuous job security of low wage workers.

[148] Note that eliminating the need to classify workers as participants or nonparticipants would decrease the administrative burden imposed by the entity income tax. And although in general I eschew decisions made on the basis of administrative convenience, in this case a theoretical argument would bolster the decision. That is, human capital providers can provide human capital for periods of time ranging from a nanosecond to a lifetime. If a nanosecond corresponds to a nonparticipant, and a lifetime to a participant, somewhere on the spectrum is a point that separates the nonparticipant from the participant. I have assumed that a day laborer, or a sufficiently short-term contact laborer, is on the nonparticipant side of the spectrum. I also have assumed that a serial day laborer, or a serial short-term contract laborer, is on the participant side of the spectrum. But I admit to having no real idea where the point that separates one side of the spectrum from the other lies. Thus, without a huge amount of embarrassment, the sovereign could simply push the point entirely to the nonparticipant end of the spectrum with the result that all human capital providers would be treated as participants.

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V. What Is an Entity?

So far, this Article has provided a justification for why a sovereign might impose an entity income tax and, based on such justification, has derived the measure of entity income that should be subject to such tax. Thus, the sovereign might want to impose a tax that indirectly charges entity participants for the incremental returns they are able to derive by conducting their economic activity in entity form, incremental returns that the sovereign, after all, makes possible. In order to impose this tax, the sovereign must be able to identify an entity's participants and either the amounts of their incremental returns or a proxy for such amounts. But it also must be able to identify one thing more. It must be able to identify those instances in which it is appropriate to impose its tax in the first place. That is, it must be able to identify an entity.

A definition of entity that comports with the desire to tax incremental, theory-of-the-firm type returns might go something like this: An entity is a legally recognized organizational form through which multiple participants conduct an economic activity that requires some duration to complete.[149] There are three vital elements. First, the organizational structure must be legally recognized.[150] Why? Because informal structures, no matter how well designed, will not allow participants to partition the activity's assets, and hence will not allow them to earn the incremental returns that such partitioning makes possible. Second, multiple participants are required. Why? Because economic activity, no matter how complicated, conducted by a single individual, never (except in the presence of a multiple personality disorder) requires coordinating contracts, and hence such activity will not be able to generate the incremental returns made possible by economizing on the number (and hence the cost) of such contracts. Third, duration is required. Why? Because economic activity, no matter how complicated, concluded at a single moment in time, has no

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Nonetheless, I caution that doing this would mask a distinction that at least theoretically matters. That is, while I believe that many and even most human capital providers "participate," however minimally, in the benefits made possible solely by organizing economic activity in an entity form, I do not believe that all of them do. Thus, while a longer term interaction between a human capital provider and an entity almost by definition will lead to some level of participation, an instantaneous interaction by definition cannot do so.

[149] Coase defines a firm as a relationship in which the allocation of resources is governed contractually rather than by means of a market price mechanism. Coase, note 64, at 388; see also Oliver E. Williamson, Transaction-Cost Economics: The Governance of Contractual Relations, 22 J.L. & Econ. 233 (1979) (discussing the impact of transaction costs on economic organization and structure).

[150] The requirement is not that the sovereign recognizes the entity as a juridical person, although that would help. Rather, the sovereign must provide the activity with the exclusive right to use its assets, pending completion of the activity.

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need for flexibility, and hence the participants engaging in such activity cannot earn the incremental returns that are made possible only by the ability to flexibly deploy assets.

How does the definition of entity under current law compare with my definition? Under current tax law,[151] "[a] joint venture or other contractual arrangement *may* create a separate entity for federal income tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom."[152] Thus, the absence of a juridical person does not necessarily imply the absence of an entity. The same generally would not be true under the entity income tax. That is, if the sovereign provided legal protection to an economic activity such that the activity could make use of its assets pending completion of the activity, then I would allow such activity, even if not conducted within the framework of a juridical person, to be treated as an entity for entity income tax purposes. But I believe that the sovereign only rarely provides such legal protection.

In addition, under current tax law, an organization with a single (equity) owner may constitute an entity.[153] This would be possible under the entity income tax as well, since an organization with a single equity owner can have more than one participant. For example, a sole proprietorship structured as a limited liability company and having

[151] One also could consider entity "definitions" from other areas of the law. Thus, for example, both tort law and criminal law occasionally wrestle with the question of whether an act of an individual should be attributed to an entity. Answering this question produces a definition of "entity." Thus, for example, suppose an employee of an entity engages in an act that is outside the scope of her employment. The law nevertheless may conclude that this act should be attributed to the employing entity and so make the entity liable for the consequences of the act. In that case, the law effectively has defined the term entity to include the employee and her act. Alternatively, the law might conclude that the act is not to be attributed to the entity, and so exonerate the entity from liability for the consequences of the act. In that case, the law effectively has defined the term entity to exclude the employee and her act. (Identical issues also arise in corporate fiduciary duty law. For example, the corporate opportunity doctrine sweeps into an entity certain ventures that as a technical matter are conducted outside of the entity.)

Conversely, tort law also occasionally wrestles with the question of whether a sin of an entity should be attributed to an individual. Thus, for example, an equity owner of an entity, under certain circumstances, may be held liable for such sins. If the equity owner is a general partner, liability follows as a matter of course; if the equity owner is a stockholder, it only follows if a plaintiff successfully can pierce the corporate veil. But, in either case, the law, by holding the equity owner liable, effectively has defined the term entity in the given context to include the equity owner and her separately-held assets.

While these definitions of entity are surely helpful in the cases to which they apply, they are not congruent with a theory-of-the-firm based definition of entity, which places primacy on the ability of participants to earn incremental returns by making use of entity organizational forms. Nothing in the tort law, criminal law, or corporate law definitions is dependent on the ability to earn such incremental returns.

[152] Reg. § 301.7701-1(a)(2) (emphasis added).

[153] Reg. § 301.7701-1(a)(4).

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numerous lenders, lessors, and employees would derive the theory-of-the-firm type benefits I ascribe to entity organizational form.

Further, under current law, "a joint undertaking merely to share expenses does not create a separate entity."[154] This would be true under the entity income tax as well, since a mere sharing of expenses does not mean that any economic activity is being conducted, and without such economic activity, there can be no relevant incremental returns. And, under current law, a "mere co-ownership of property that is maintained, kept in repair, and rented or leased does not" create a separate entity either.[155] This proposition also would apply to the entity income tax. For if *Mom* and *Pop* jointly own a two-flat and lease one unit to their daughter, the law would indeed be an ass to treat such arrangement as an entity.

Finally, under current tax law, the fact that local law recognizes an arrangement to be an entity separate from its owners does not necessarily make such arrangement an entity for income tax purposes.[156] If, however, the arrangement is actually incorporated under state law, it will be an entity for income tax purposes.[157] The first proposition would be true under the entity income tax; the second would not. That is, the mere presence of a separate juridical person, even a state law corporation, is not necessarily indicative of the presence of significant theory-of-the-firm type benefits. For example, a corporation that houses the economic activity of a single individual would not be able to earn any incremental returns based on contracting costs.

To hone my definition of entity, it is useful to analyze a long-term, multi-person arrangement that intuition demands must fall outside the scope of such definition: the purchase of a residence with traditional mortgage financing. Thus, suppose that *Homeowner* lives in Texas, and that *Bank* loans *Homeowner* the funds to purchase a house in Texas. *Bank* receives a mortgage on the house. *Homeowner* is employed by *Employer*, and *Bank* is aware of such employment at the time it makes the loan. Indeed, even though the house is sufficient collateral to secure its loan, *Bank's* willingness to extend the loan is really based on its perception of *Homeowner*'s employment prospects.

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[154] Reg. § 301.7701-1(a)(2).

[155] Id.

[156] Reg. § 301.7701-1(a)(1). Indeed, the check-the-box regulations exempt single-member limited liability companies from entity tax treatment. Reg. § 301.7701-3(a). In addition, § 761(a) elections allow certain state law partnerships to be treated not as partnerships but as aggregates of their members.

[157] Reg. § 301.7701-3(a). Of course, entity classification does not mean that such entities invariably pay the current corporate income tax. Most of them do not. See IRC §§ 1361 et seq.

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Before considering the three possible entities within this fact pattern, I note that this fact pattern poses an exceptional circumstance in which the absence of a juridical person may not, without more, negate the existence of an entity. The reason is that the only relevant assets in the fact pattern, the house and *Homeowner*'s human capital, are partitioned from creditors, the former by virtue of the location of the residence in Texas[158] and the latter by virtue of the Thirteenth Amendment. So what are the three possible entities?

The first and smallest is a *Bank-Homeowner* entity formed to purchase a house and to share the economic fruits of such house. That is, *Bank* and *Homeowner* both contribute funds that are used to purchase an asset that can be viewed as an investment asset.[159] *Homeowner*, as the manager of the asset, rents it to a financially capable tenant, namely *Homeowner* herself. Of course, no cash actually changes hands. Nevertheless, *Homeowner* turns a portion of the hypothetical rental payment over to *Bank* to pay interest and principal on the loan and pockets the remainder of the hypothetical rental payment herself, that is, earns imputed income. And, of course, *Homeowner* is entitled to any appreciation (and generally to any depreciation) in the asset. Thus, in tax argot, *Bank* and *Homeowner* arguably "carry on a trade, business, financial operation, or venture and divide the profits therefrom."[160] On the other hand, this "venture" might appear to involve "mere co-ownership of property that is maintained, kept in repair, and rented or leased."[161]

Fortunately, I need not dwell any further on the first possible *Bank-Homeowner* entity, since such entity clearly focuses on an incomplete picture of the relationship between *Homeowner* and *Bank*. That is, *Bank*'s loan is not merely secured by the house, but by *Homeowner* herself. Thus, *Bank* has an interest not merely in the house, but in *Homeowner*'s human capital (and, to the extent she has any, *Homeowner*'s other assets). That suggests a second possible entity, still made up solely of *Bank* and *Homeowner*, but now including among its assets not merely the house but also *Homeowner*'s human capital. As above, *Bank* and *Homeowner* both contribute assets to their joint undertaking; *Homeowner* manages such assets, turns a portion of the earnings produced by the assets over to *Bank*, and pockets the remainder herself. In this case, *Bank* has actually invested in something

[158] Tex. Prop. Code Ann. § 41.001 (Vernon Supp. 2003), § 41.002 (Vernon 2000).

[159] Current law treats a house used as a residence solely as a personal consumption asset, rather than partially as an investment asset. Since this treatment is patently ludicrous, I do not follow it here.

[160] Reg. § 301.7701-1(a)(2).

[161] Id.

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that current tax law recognizes to be a trade or business: *Homeowner*'s trade or business of being an employee.[162]

Before analyzing this second possible *Bank-Homeowner* entity, I want to dispose of the third possible entity arising out of the mortgage lending relationship. That entity is the broadest of all. For if it is really the case that *Bank* is sharing not so much in the fruits of the investment asset (*Homeowner*'s house), but much more in the fruits of *Homeowner*'s labor, then *Bank* is indirectly "participating in" the fruits of *Employer*'s economic activity. Thus, an entity called *Bank-Homeowner-Employer*, or more simply just *Employer*, but now not only with *Homeowner*, but also with *Bank*, as a participant, suggests itself. But this seems silly. Why? I think the best reason is that the theory of the firm posits that individuals (and other entities) that form an entity join together willingly and knowingly to conduct their joint economic activity. In the instant case, *Bank* (at least arguably) willingly and knowingly embraces *Employer*,[163] but *Employer* does not willingly and knowingly return *Bank*'s embrace. That is, *Employer* (not invariably but) typically neither knows nor cares whether *Homeowner* is a homeowner, and if so whether and with whom *Homeowner* has arranged mortgage financing. In such case, a theory-of-the-firm type thread that would tie *Bank* to *Employer* is simply too tenuous.

Thus, out of the three possible entities created by the mortgage lending relationship, only one remains standing: the *Bank-Homeowner* "venture" that includes within its purview both *Homeowner*'s house and her human capital. The proper question must be: Does this venture really provide its participants with the sorts of benefits that one commonly associates with the theory of the firm? Well, sort of. Both *Bank* and *Homeowner* benefit from the fact of entity form (here, as noted, the peculiar legal status of houses owned by Texas residents). *Homeowner*, for example, can undertake long-term projects to improve the house without any fear that creditors will take the house before such projects are completed; *Bank* benefits from such projects since they enhance the value of its collateral. In addition, *Homeowner* and *Bank* both benefit from the considerable flexibility that the arrangement affords to *Homeowner* (as manager) to maximize the value of the venture's assets. Thus, *Homeowner* typically can change employment if she chooses; she typically can deploy excess assets as she sees fit, for example, holding assets that produce a

[162] For the proposition that being an employee is a trade or business, see, e.g., Primuth v. Commissioner, 54 T.C. 374, 377 (1970).

[163] Even this characterization is a bit of a stretch. Typically, what *Bank* cares about is not *Employer*'s identity, but the fact that *Homeowner* has an employer. Thus, a change in *Homeowner*'s place of employment is not generally a trigger that accelerates a mortgage loan.

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high rate of return rather than using such assets to accelerate the payoff of *Bank*'s loan; and she typically can change the value of the collateral, for example, by making improvements to the house, or conversely by falling behind on necessary maintenance.

Nevertheless, despite some superficial resemblance to an entity, I still maintain that it would be silly to treat *Bank-Homeowner* as an entity. One way to reach the more sensible result is to place a size threshold on entities, to say that any "arrangement" involving less than a certain number of participants is not an entity for entity income tax purposes. While such a threshold may seem arbitrary, it can be grounded in a principled way. Subsection A discusses such threshold. In the instant case, so long as the threshold is greater than two (which it will be), *Bank-Homeowner* would not be an entity.

A second way to (largely) reach the desired result is to place a limit—at one—on the number of entities that can be deemed to use any asset.[164] Such limit may seem arbitrary, but it is quite logical: At any moment in time, a given asset can have only one true master. Moreover, this limit will be necessary if the sovereign wants to avoid the possibility that multiple levels of entity income tax can be imposed on the returns produced by a single asset. Subsection B discusses this issue. In the instant case, the upshot would be that either *Employer* or *Bank-Homeowner*, but not both, would be deemed to use *Homeowner's* human capital. Thus, one, but not both, would be subjected to entity income tax on the income generated by such human capital.

A. *Small Entities*

The theory of the firm posits the existence of certain types of benefits that can be achieved only if an economic activity is conducted in entity form.[165] Some of these—economies of scale, division of labor, and contracting efficiencies—cannot accrue to a single taxpayer conducting an economic activity on her own. That is why I stated that single-taxpayer economic activity, even when housed within a formal juridical person, should not constitute an entity for entity income tax purposes. I now elaborate that conclusion.

Consider again the entrepreneur with the great idea who, for reasons of her own, does not join forces with a venture capitalist, a manager, and various and sundry laborers. She admittedly is condemned to conducting her business on a small scale and with some degree of inefficiency. Should this be fatal to entity classification? Note that

[164] This second way would not necessarily remove the *Bank-Homeowner* entity from the reach of the entity income tax, but would greatly limit the income tax burden potentially faced by such entity.

[165] See Section II.C.2.

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her venture does appear to reap some offsetting benefits. In particular, once she has committed her various inputs to her venture, she can generally deploy them as she sees fit, irrespective of the occurrence of unexpected circumstances.[166] Moreover, her project will never be plagued by agency costs, she will never need to expend resources monitoring her inputs, and she will never need to negotiate about the division of the income generated by the venture. While these benefits are real, and may be significant, and may even be of the same general type as those made possible by an entity organizational form, they in fact have nothing to do with such form; indeed, they are benefits that a Coasian firm could not achieve. In contrast, the detriments suffered by her venture are precisely the type of detriments that a Coasian firm could avoid. That is, the very raison d'etre of a Coasian firm is to efficiently enable optimal inputs for a venture to come together. Thus, I stand by my conclusion.[167]

Still, little would be gained in terms of administrative ease if the sovereign could exclude nothing more complicated than single-taxpayer economic activity from the entity income tax net. Fortunately, it can. As noted, the transaction cost benefits provided by using entity organizational form do not actually begin to accrue until an economic activity requires more than three participants, and such benefits only become significant at some (much) larger number of participants.[168] Thus, a principled case can be made for excluding from the entity income tax any economic activity that involves sufficiently few participants, since such activity, although it might generate transaction cost

[166] This is a slight overstatement. While the entrepreneur will be able to flexibly deploy the assets, she generally will not be able to partition them from her creditors, absent taking the further step of placing them in a formal legal entity. Thus, if the unexpected circumstance involves a creditor, the venture's economic activity could be disrupted.

[167] As frequently noted, it is not my intention in this Article to modify any individual income tax rules; entity taxation alone is my focus. In particular, it is not my intention to impose tax on any individual's imputed income. This intention reinforces my conclusion that the entrepreneur's venture should not be subject to entity income tax. For one way to characterize her business activity is as follows: First, her venture manufactures some output; then, her venture distributes such output to the entrepreneur; and finally, the entrepreneur disposes of such output as she sees fit. If the entrepreneur consumed all of the output of her venture, no taxable income of any sort would result, since all of her economic income would be unrecognized imputed income. This result should not change simply because the entrepreneur does not consume all of the venture's output. In that case, the entrepreneur has merely converted potential imputed income into actual taxable income. Robustness demands that such conversion be treated as being for the entrepreneur's own account. Thus, the gain generated by such conversion should appear only on her individual income tax return.

[168] See Section II.C.2.

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savings, cannot generate sufficient savings to justify imposing the tax.[169]

Whether the sovereign ultimately concludes that transaction cost savings become sufficiently significant to justify entity classification at 51 participants, or at 501, it is important to remember that "participants" does not mean equity owners.[170] And it is also important to note that, as with similar bright line rules, administrative problems will arise. On the one hand, it would be relatively easy to count the equity-type participants of a smallish business.[171] And it would be relatively easy to count the lenders.[172] And it would be relatively easy to count the lessors and licensors of assets. And it would be relatively easy to count the employees. But, on the other hand, with so many categories of participants, it could well be difficult to keep track of the shifting number of participants through time. Thus, the metaphysical question will arise: Is a business an entity only at those moments in time that it has more than 50 participants, or is it an entity during an entire taxable year if at some point in time during such year it has had more than 50 participants, or is it an entity during an entire taxable year if during such year it has had more than 50 participants, or . . . ?[173]

B. *Large Entities*

Most economic projects begin with an idea. In the good old days, the individual with the idea presented it to an entity (typically her employer), and the entity decided whether or not to pursue it. If it did, it generally sought the inputs for the project among its own assets. And of course it controlled the distribution of the returns from the project. In modern times, this pattern is breaking down. It is now fairly common for an entrepreneur to coordinate a project outside of the framework of an old established entity (even if the entrepreneur

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169 Thus, the proposed entity income tax accomplishes something that the current income tax does not: It exempts "small business" from its reach for a principled reason.

170 Thus, this measure differs from certain optically "similar" measures found in the Code. See, e.g., IRC § 1361(b)(1)(A) (a corporation with more than 75 shareholders may not be an S corporation); Reg. § 1.7704-1(h)(1)(ii) (a partnership is a publicly traded partnership only if it has more than 100 partners).

171 This is because, unlike under current law, it would not be necessary to have special rules to identify owners of disguised equity. The reason is that such owners obviously would be participants. Cf. IRC § 1361(c)(5); Reg. §§ 1.1361-1(*l*)(4)(ii)(B), -1(*l*)(4)(iii)(C).

172 Smallish businesses, in general, would not have loans that are large enough to warrant loan participations.

173 A sovereign facing such implementation issues might choose to avoid them by employing a proxy in their stead. For example, joint economic activity might be deemed to constitute an entity if, and only if, the annual revenue from such activity exceeds some threshold.

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nominally works for such an entity).[174] Thus, the entrepreneur locates and secures the necessary inputs (not necessarily at the entity that employs her), coordinates and directs such inputs as required to complete the project, distributes the project's proceeds, and then returns those inputs that are capable of being redeployed to their owners. The project's structure thus has all the trappings of an entity, perhaps partially "owned" by one or more established entities, perhaps not.

Whether or not this description is an even remotely accurate reflection of reality, it begs the important question of the extent to which the entity definition should be atomized. That is, should every economic project requiring (for example) more than 50 participants be treated as a separate entity?[175] Or should the notion of entity allow the aggregation of projects, perhaps to the extent that such projects are housed within a single multi-project juridical person?[176] Two conceptual issues are at stake. First, there is the potential for multiplication of entity income tax if the chosen entity definition is the most atomized one, unless the law provides rules that prevent such multiplication. Second, there is at least some potential for the disappearance of entity income tax if the chosen entity definition is a broad one, due to the possibility that "large" entities will offset the taxable income produced by profitable projects with the losses produced by unprofitable projects.[177] This potential is probably not great, given that the definition of entity taxable income disallows the deduction of most compensation and many other payments and accruals that are deductible under current law. But the potential exists nonetheless. Finally, there is also an administrative issue at stake: To the extent the entity income tax allowed too little aggregation of projects, the number of entity income tax returns would increase "exponentially"; to the extent it allowed too much aggregation, the complexity of any given entity income tax return would increase exponentially. The former choice could lead the sovereign to be drowned in a blizzard of paper; the latter choice could render the sovereign incapable of accurately auditing the returns it receives.

Potential multiplication of entity income taxes is a problem with which the current corporate income tax regime is familiar. Three general approaches are used to combat it. First, except in the case of corporate equity owners, current law does not recognize the participa-

[174] See, e.g., G. Mitu Gulati, William A. Klein & Eric M. Zolt, Connected Contracts, 47 UCLA L. Rev. 887, 894-98, 940-41 (2000).

[175] If so, the law would need to define what constitutes a discrete economic project.

[176] Since the notion of participation is broader than that of equity ownership, the sovereign might want to expand the current rules for consolidation.

[177] I assume, as under current law, that the entity income tax would not be generally refundable.

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tion concept. Thus, when one corporation makes a payment to another and the payment is not attributable to the receiving corporation's ownership of equity in the paying corporation, the paying corporation is allowed a deduction. This deduction has the effect of moving income from the paying corporation's income tax return to the receiving corporation's income tax return. Thus, there is no multiplication of corporate income tax on such income. Second, when one corporation makes a payment to another and the payment is attributable to the receiving corporation's ownership of equity in the paying corporation, the receiving corporation is allowed a partial or complete deduction with respect to such payment.[178] This deduction prevents (most of the) income that already was included on the paying corporation's income tax return from appearing on a second corporate income tax return. So once again, there is no (significant) multiplication of corporate income tax on such income. Third, if one corporation owns a sufficient share of the equity of another corporation, such corporations essentially are taxed as if they were a single corporation.[179] In particular, any payment made by one to the other that is attributable to the receiving corporation's ownership of equity in the paying corporation is ignored on a "consolidated" tax return. So again, there is no multiplication of corporate income tax on such income.

An entity income tax can adopt this same arsenal of anti-tax multiplication techniques. But should it? To make matters concrete, consider a project that will require some capital and some labor to complete. Some capital providers form *Entity* by making a capital contribution of $200. *Entity* uses $140 of this capital to purchase raw materials from nonparticipants and the remaining $60 to hire employees and consultants. *Entity* then manufactures a product that it sells to nonparticipants for $240. Finally, *Entity* liquidates. Table 13 illustrates *Entity*'s tax return under the simplified assumption that there is absolutely no entity deduction for payments to participants who provide human capital.

TABLE 13

ENTITY'S (CONSOLIDATED) TAX RETURN

Gross receipts	$240	Wages	$ 60
Raw materials	(140)	Interest and dividends	40
Taxable income	$100	Allocations to participants	$100

[178] See IRC § 243.

[179] IRC § 1501 et seq.

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Suppose, now, that the consultants, for whatever reason, are incorporated separately. Thus, they could be viewed as an entity, henceforth, *Consulting*, in their own right. Assume that the relationship between *Consulting* and *New Entity* (that is, *Entity* less *Consulting*) continues to be one of participation. That is, *Consulting* provides to *New Entity* one or more of its assets (the human capital of its consultants) for *New Entity* to use and receives a suitably deferred payment. Under the assumption that *Consulting* engages in no activity other than providing consulting services to *New Entity*, and moreover that the consideration it receives from *New Entity* is $30, Table 14 illustrates the entity income tax effect of treating *Consulting* as a separate entity.

TABLE 14
SEPARATE RETURNS

	New Entity	*Consulting*
Gross receipts	$240	$30
Raw materials	(140)	0
Taxable income	$100	$30
Wages	$ 30	$30
Fee to *Consulting*	30	0
Interest and dividends	40	0
Allocations to participants	$100	$30

Thus, when *Entity* is "atomized" into two fully taxable entities, *New Entity* and *Consulting*, system-wide entity taxable income would increase from $100 to $130. Is there a theoretical justification for this increase? The argument would have to be that both *New Entity* and *Consulting* earn theory-of-the-firm type incremental returns and that the aggregate of such incremental returns is approximately 30% greater than the incremental returns that otherwise would have been earned by *Entity* alone. While the first part of the argument is plausible, the second part is not.

For consider how the given project would look in a world without entities. In such world, the project's participants cannot realize any theory-of-the-firm type efficiencies. As a result, they will earn a lower aggregate return than shown in Table 13 and 14. Without loss of generality, such lower return can be modeled by assuming that the product they manufacture would be of lower quality and that it accordingly would be sold for a lower price, say $220. In that case it is easy to determine that the aggregate benefit participants realize as a result of

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the formation of *Entity* is $20. Now consider the pair *New Entity* and *Consulting*. This duo manufactures the same basic product as *Entity* from exactly the same inputs (raw materials and participant assets) as *Entity*. Moreover, its product must be of exactly the same quality as that manufactured by *Entity*, since it too is able to raise the price of such product from $220 to $240. But that means that the duo has generated exactly the same amount of aggregate incremental theory-of-the-firm type benefit as did *Entity*.

It is, of course, the case that *Entity* and the pair *New Entity* and *Consulting* produce exactly the same aggregate amount of theory-of-the-firm type benefit because I have chosen an ultimate selling price for their product that forces this result. To the extent, however, that this choice throws my conclusion into doubt, it should be because it is unlikely that the pair in fact could sell their product for as high a price as *Entity*, and not because it is likely that they could sell their product for a higher price. That is, *Entity* would have greater flexibility than *New Entity* to deploy the various assets used in its project, because it would have greater control over one such asset, the consultants. Thus, if anything, *Entity* should be able to achieve more theory-of-the-firm type benefits than *New Entity*.[180]

The question remains: How should the entity income tax regime avoid the imposition of untoward multiple levels of entity income tax? In accordance with my intuition that the incremental returns from entity organizational form primarily are earned in the trenches, at the point where the assets actually are deployed and where the ability to command and control them is implicated most directly, I would advise a sovereign to tax *New Entity*, rather than *Consulting*, on the income ultimately allocable to the consultants. Thus, my entity income tax would contain a "participations-received deduction" pursuant to which an entity would be able to deduct from its entity taxable income the entire amount of any payment received from another entity, so long as such payment was attributable to the receiving entity's participation in the paying entity.

I noted at the outset of this Subsection that, in addition to avoiding an untoward multiplication of entity income tax, the sovereign might want to prevent an untoward diminution of entity income tax through the mechanism of aggregating multiple projects in a single entity. The question, at heart, reduces to whether the entity income tax should allow the losses from one project to offset the income from another.

[180] This same argument will not hold if *Consulting* is not a captive of *New Entity*. In that case, *Consulting* would be able to generate separate theory-of-the-firm type efficiencies. For example, if it had a large pool of consultants, it could provide *New Entity* with those best suited to *New Entity*'s needs. Thus, the quality of *New Entity*'s product could be enhanced, allowing it to charge a higher price.

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Table 15 illustrates this possibility: *Project 1* produces a taxable loss of $20; *Project 2* produces taxable income of $60. Thus, if *Projects 1* and *2* were each treated as separate stand-alone entities, and if tax losses were nonrefundable, total entity taxable income would be $60. On the other hand, if *Projects 1* and *2* were combined in a single entity, total entity taxable income would be $40.

TABLE 15
CONSOLIDATION OF LOSSES

	Project 1	*Project 2*	*Combined*
Gross receipts	$ 80	$160	$240
Raw materials	(100)	(100)	(200)
Entity taxable income	($ 20)	$ 60	$ 40

Under current law, projects may be combined for purposes of computing corporate taxable income whenever the projects from their inception are conducted within a single entity.[181] On the other hand, current law goes to great lengths to prevent projects from being combined for purposes of computing corporate taxable income when the projects originate in separate entities.[182] Unfortunately, no great unifying principle seems to underlie either of these results.

In the entity income tax context, the theory probably better supports a prohibition on the aggregation of projects. The reason is that any project conducted by an entity is able to reap the benefits that result from being conducted in entity organizational form. In particular, this will be true even if the project, in the aggregate, loses money for its participants. That is, but for the benefits of entity organizational form, the project presumably would have lost even more money for its participants. In such a case, the sovereign's assumption that an entity's benefits from the use of an entity organizational form are proportional to its entity taxable income cannot be correct. And so, in such a case, the sovereign could discard it.

But I frankly see little benefit from doing so. First, allowing entities to consolidate losing projects will have far less impact under the entity income tax than it has under the current corporate income tax. Under

[181] This rule has some possibly unintended consequences. Thus, it favors established entities over start-up entities when it comes to conducting high-risk projects (since the former, but not the latter, will have taxable income that can be offset by any losses produced by such projects).

[182] See, e.g., IRC § 269 (authorizing disallowance of deductions, credits, and similar benefits in certain tax-motivated acquisitions); § 382 (limiting the carryover of net operating losses and certain built-in losses following an ownership change); Reg. § 1.1502-21(c) (prohibiting the losses of certain consolidated group members from offsetting the income of other members).

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current law, it is quite easy for an economically highly profitable corporation to parley wages, rents, royalties, interest payments, and the like into a tax loss. But under the entity income tax, all such payments are largely or wholly nondeductible participation payments. Thus, in order for an entity to have a tax loss for entity income tax purposes, it must perform really, really poorly. This is not to say that it cannot happen. But it is hardly something the sovereign should lose much sleep over.

Moreover, there are two strong pragmatic arguments and a weak theoretical argument that also point to allowing a considerable degree of project aggregation within a single entity. The theoretical argument is that one of the theory-of-the-firm-type benefits derived by a participant who joins an entity is diversification: She participates in the returns created by multiple assets rather than simply in the return created by her own. This, for example, largely explains why transactional attorneys and litigation attorneys so often band together. Sure, there is a certain synergy created by serving all the different legal needs of a single client. But there is also a benefit borne of the fact that transactional work is cyclical while litigation is not. Thus, in exchange for giving away some income in boom times, the transactional attorney is assured of some income during busts. More importantly, she is able to reap certain ancillary cost savings. For example, the presence of the litigator's steady cash flow will allow her (indirectly) to borrow or to enter into a long-term premises lease on more favorable terms than she otherwise might. Such benefit can be attributed to the entity organizational form.

The first pragmatic argument for allowing project aggregation is that it obviates the need to define an atomic "project." The real world simply does not break down cleanly into little bite-sized chunks. And even if it did, the entity income tax law would need to devise a myriad of rules to handle the allocation of costs, especially overhead, that are not clearly associated with any one project. Of course, the current tax law already has some such rules.[183] But adding more freight to cost allocation rules strikes me as a highly dubious thing to do.[184]

The second pragmatic argument for allowing project aggregation, at least to a point, already has been noted. In the absence of significant

[183] In general, a taxpayer must allocate costs that relate to multiple activities among such activities. To the extent that such activities include the acquisition or construction of capital assets, the costs allocated to such activities are capitalized. IRC § 263A(a); see also Commissioner v. Idaho Power Co., 418 U.S. 1, 10-14 (1974).

[184] An ancillary issue that the tax law in an atomized world would need to confront is how to handle projects that do not have a stand-alone profit motive (at least not from a zero income baseline), and thus will never show positive taxable income. The paradigm is securities litigation. Is this a separate project? Is it just overhead?

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aggregation, once taxpayers have identified their myriad atomic entities, they would need to file an entity income tax return for each such entity. The effect would be a huge number of tax returns, each involving relatively small amounts of income. In time, no doubt, a sovereign would develop the capability to efficiently handle all such returns, and would develop guidelines for determining which returns were the most fruitful candidates for audit, and so on. But in the meantime, . . .

C. *Entity Risk Management*

1. *Pure Gambles*

In addition to conducting what might be termed real economic activity, entities also engage in risk management. Thus, for example, entities frequently enter into financial transactions designed to protect themselves from unfavorable business outcomes. These transactions all have the same basic form: With some probability the entity makes a net payment to a contractual counterparty, and with some probability the contractual counterparty makes a net payment to the entity.[185] Thus, these transactions are (not necessarily fair) gambles. The question for the entity income tax is whether or not the contractual counterparty should be treated as a participant in the entity.

For ease of exposition, suppose, contrary to the discussion in Subsection V.A., that economic activity conducted by two participants constitutes an entity. Thus, *X* and *Y* form an entity; each contributes $150, which the entity uses to buy raw materials and fashion a product; the entity sells such product, with equal probability, for either $350 or $450; and the entity then liquidates, distributing either $175 or $225 to each participant. Under the rules set forth for computing entity taxable income, the entity would have taxable income of either $50 or $150, and the participants would have aggregate returns on their investments in like amounts.

Now suppose, after the formation of the entity, that *X* decides that the returns she will receive from her investment are too volatile for her taste. Rather than receiving, with equal probability, a return of either $25 or $75, she would prefer to receive a smaller expected but fixed return of $45. She communicates her desires to *Y*, who turns out to be accommodating. *X* and *Y* thus agree that, after the liquidation of the entity, *Y* will make a payment of $20 to *X* in the low income state of the world, and *X* will make a payment of $30 to *Y* in the high income state of the world. The net effect of such payments is that *X*

[185] I ignore the explicit investment component that is present in some of these transactions. See Reg. § 1.446-3(c)(1)(i) (treating nonperiodic payments under notional principal contracts as loans).

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will end up with $45 in either state, while *Y* will end up with $5 or $105, respectively.

What has happened? *X* and *Y* have entered into a gamble, entirely outside the confines of their entity. To be sure, their gamble has pay-offs that are dependent on the financial results achieved by the entity (it is a so-called "derivative" gamble). But this author and his reader could enter into a similar gamble with pay-offs dependent on the financial results of the entity. No one would seriously argue that such a gamble, between two individuals who are utterly unknown to the entity, should have any effect on entity taxable income. But if that is so, then it would be equally improper to allow the gamble between *X* and *Y* to affect entity taxable income, simply because they are, fortuitously, entity participants. And, indeed, as illustrated in Table 16, nothing in the structure of my entity income tax would allow their gamble to affect entity taxable income.

TABLE 16
PARTICIPANT HEDGE

	State 1	*State 2*
Gross receipts	$350	$450
Raw materials	(300)	(300)
Entity taxable income	$ 50	$150
X's entity participation	$ 25	$ 75
X's gamble	20	(30)
Y's entity participation	25	75
Y's gamble	(20)	30
Individual taxable income	$ 50	$150

Of course, nothing requires *X* and *Y* to conduct their gamble wholly outside of the confines of their entity. Instead, they could incorporate it into the terms of their participation in such entity. Thus, upon liquidation, *X* would be entitled to a distribution of $45, irrespective of the entity's gross receipts, and *Y* would be entitled to all remaining liquidation proceeds, that is, either $5 or $105. This amendment to the terms of *X*'s and *Y*'s participation does not affect the entity's underlying real economic activity. Nor does it change the aggregate amount the entity distributes to its participants. All it changes is the way the participants share the aggregate amount. Thus, it would be strange indeed if the amendment affected the entity's taxable income.[186] And

[186] It would be strange, that is, except to practitioners used to the current corporate income tax. Under such tax, the "fixed" payment to *X* almost surely would be characterized as a payment with respect to a debt instrument, and so would be deductible in calculating corporate taxable income. IRC § 163(a).

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as illustrated in Table 17, it would not do so. The reason is that the only change from the prior fact pattern is the relative size of *X*'s and *Y*'s distributions. And these would not enter into the entity income calculation (Rule 3).

TABLE 17
MODIFIED TERMS OF PARTICIPATION

	State 1	*State 2*
Gross receipts	$350	$450
Raw materials	(300)	(300)
Entity taxable income	$ 50	$150
X's entity participation	$ 45	$ 45
Y's entity participation	5	105
Individual taxable income	$ 50	$150

Finally, instead of amending the terms of their participation in the entity, *X* and *Y* could run their gamble through the entity. For example, *Y* could enter into a contract with the entity pursuant to which *Y*, immediately prior to the liquidation of the entity, would make a payment of $40 to the entity in the low income state of the world or receive a payment of $60 from the entity in the high income state of the world. In light of this contract, the entity in either state of the world will have $390 available at the time of its liquidation, and so would distribute $195 (for a net return of $45) to each of *X* and *Y*. Since this transaction is fundamentally identical to the two that have preceded it, it should produce the same amount of entity taxable income. As illustrated in Tables 18 and 19, however, this result would obtain only if the preliquidation payments are treated as involving a participant.

TABLE 18
ENTITY HEDGE WITH NONPARTICIPANT

	State 1	*State 2*
Gross receipts	$350	$450
Hedge	40	(60)
Raw materials	(300)	(300)
Entity taxable income	$ 90	$ 90
X's entity participation	$ 45	$ 45
Y's entity participation	45	45
Y's hedge	(40)	60
Individual taxable income	$ 50	$150

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TABLE 19
ENTITY HEDGE WITH PARTICIPANT

	State 1	*State 2*
Gross receipts	$350	$450
Raw materials	(300)	(300)
Entity taxable income	$ 50	$150
X's entity participation	$ 45	$ 45
Y's participation (equity)	45	45
Y's participation (hedge)	(40)	60
Individual taxable income	$ 50	$150

Before proceeding, it is worthwhile to note that nothing in the foregoing analysis hinged upon the fact that the individual providing the hedge, *Y*, is already a participant in the entity. That is, suppose *Y* is uninterested in helping to avert *X*'s risk. Instead, *X* finds an individual, *Z*, who is willing to help. If *X* and *Z* enter into their gamble outside the entity, there should be, and indeed would be, no change in the entity's income tax results. Thus, a robust tax regime requires that there be no change when *X* and *Z* route their hedge through the entity, whether by having the entity issue a formal financial instrument to *Z* (pretty clearly turning *Z* into a participant) or by having the entity simply enter into a hedging contract with *Z* (perhaps less clearly turning *Z* into a participant).

The theory of the firm would appear to support treating *Z* as a participant. That is, the entity appears to control exactly the same assets, and hence to reap exactly the same efficiencies, whether *Z* is waiting on the sidelines or not. Thus, *Z*'s presence can do nothing more than redistribute the wealth generated by the entity's economic activity; it can neither create nor destroy any efficiencies. But if that is true, then Z's presence should have no effect on entity taxable income. Since the only way to ensure this is to deem *Z* to be a participant, *Z* must be deemed to be a participant.

Moreover, a more nuanced story also supports treating *Z* as a participant. According to this story, the entity does not control exactly the same assets when *Z* is on the sidelines as it otherwise does. It additionally has a call on a certain amount of *Z*'s capital, and this might enable it to more efficiently engage in certain transactions (from borrowing money to hiring employees to entering into long-term supply agreements). But this story would not change *Z*'s tax treatment. Rather, it would merely illustrate that *Z* is quite explicitly a participant: She has made an asset (her credit, or her willingness to contribute capital under certain circumstances) available to the entity

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for the entity to use as it sees fit, in exchange for a future (in this case probabilistic) payment.

Note that the foregoing analysis can be repeated, with the same conclusion, if the gamble is risk-increasing rather than risk-reducing. Thus, one can imagine an entity assuming the risk of some individual, possibly (although not necessarily) with the effect of increasing its aggregate level of risk.[187] For example, suppose that *X* and *Y*'s entity enters into a contract with *Z* pursuant to which the entity will pay $40 to *Z* in the low income state of the world and will receive $60 form *Z* in the high income state of the world. As illustrated in Tables 20 and 21, this contract affects the entity's taxable income calculation if, and only if, *Z* is treated as a nonparticipant in the entity.

TABLE 20
RISK-INCREASING GAMBLE WITH NONPARTICIPANT

	State 1	*State 2*
Gross receipts	$350	$450
Hedge	(40)	60
Raw materials	(300)	(300)
Entity taxable income	$ 10	$210
X's entity participation	$ 5	$105
Y's entity participation	5	105
Z's hedge	40	(60)
Individual taxable income	$ 50	$150

TABLE 21
RISK-INCREASING GAMBLE WITH PARTICIPANT

	State 1	*State 2*
Gross receipts	$350	$450
Raw materials	(300)	(300)
Entity taxable income	$ 50	$150
X's entity participation	$ 5	$105
Y's participation (equity)	5	105
Z's participation (hedge)	40	(60)
Individual taxable income	$ 50	$150

[187] Section IV (discussing guarantees). An entity need not bear incremental risk as a result of assuming the risk of others, due to the effects of the law of large numbers. The calculation in Table 31 demonstrates that if the entity earns no profit on its aggregate interaction with those it "insures," that is, it pays out to such insureds exactly the amount of their premiums and the after-tax earnings on such premiums, then there is no relevant tax difference between treating the insureds as participants or nonparticipants.

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Since the underlying economic activity of the entity has not changed, the contract with *Z* should not affect the entity's income calculation, and so *Z* must be treated as a participant. Alternatively, to the extent that the underlying economic activity of the entity has changed (by virtue of being influenced by the opportunities either created or lost due to its access to *Z*'s capital in certain states of the world and its obligation to *Z* in other states of the world) it has changed because *Z* has made an asset (her capital) available to the entity in exchange for a future (probabilistic) payment, in other words, because *Z* is a participant. Thus, either to ensure a robust entity income tax result, or because the theory of the firm forces the conclusion, *Z* must be treated as a participant. And this is true even though *Z*'s participation has a negative expected return.[188]

2. *Impure Gambles: Hedging Inputs or Outputs*

So far, I have limited my discussion to purely financial gambles: transactions that arguably have no effect on the economic activity of an entity, but merely affect how the participants in such entity share the entity's returns. For these gambles, it is a relatively easy matter to conclude that they should not affect the entity income tax law's calculation of entity taxable income. But many gambles do directly involve the economic activity of an entity. Thus, suppose that *X* and *Y* each contribute $150 to form an entity; the entity purchases $100 of raw materials and begins to fashion an output; the entity then purchases a second raw material which costs, at the time it is needed, either $200 or $100 with equal probability; the entity then sells its output for the invariant amount of $350; and the entity finally liquidates, distributing either $175 or $225 to each of *X* and *Y*. This fact pattern, which is illustrated in Table 22, produces entity income tax results that replicate those of the fact pattern discussed above: Absent hedging activity, the entity generates, with equal probability, $50 or $150 of entity taxable income.

[188] It follows that if one entity engages in hedging activity with another, each entity is a participant in the other. This is not at all problematic for the entity income tax: Under the usual operating rules, each would be denied a deduction for any payment made to the other. And by virtue either of the operating rules or of the participations-received deduction, each would be able to exclude from income any payment received from the other.

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TABLE 22
UNHEDGED ENTITY

	State 1	*State 2*
Gross receipts	$350	$350
Raw materials	(300)	(200)
Entity taxable income	$ 50	$150
X's entity participation	$ 25	$ 75
Y's entity participation	25	75
Individual taxable income	$ 50	$150

Suppose *X* and *Y* want to diminish the volatility of their returns. Since the volatility follows directly from the price of the second raw material, the entity could protect itself by entering into a forward contract to purchase that raw material. For example, the entity might find an individual, *Z*, who is willing, in either state of the world, to provide the raw material for the fixed price of $160. If the entity enters into the forward contract, at the time the second raw material is required, it will be able to choose between two economically equivalent courses of action. First, it can "cash settle" the forward contract and purchase the raw material in the spot market for its market price. Second, it can take delivery of the raw material from *Z*. Since these choices are economically equivalent, a robust entity income tax regime must treat them alike.

Consider first the case where the entity cash settles its forward contract. If, at such time, the fair market value of the raw material is $200, the contract would have a value of $40, since the entity is entitled to pay $160 for something that is worth $200. Accordingly, the entity would receive $40 from *Z*. On the other hand, if, at such time, the fair market value of the raw material is $100, the contract would have a value of -$60, since the entity is obligated to pay $160 for something that is only worth $100. Accordingly, the entity would pay $60 to *Z*. Note that, ex post, the entity and *Z* will have engaged in a purely financial gamble. I already have concluded that such gambles should not affect the quantity of an entity's taxable income. Thus, in order for the entity income tax regime to be robust, the cash settlement of a forward contract to hedge the price volatility of an input should not affect entity taxable income either. As illustrated in Tables 23 and 24, this result obtains only if *Z* is treated as a participant.

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TABLE 23
CASH SETTLEMENT OF NONPARTICIPANT HEDGE

	State 1	*State 2*
Gross receipts	$350	$350
Cash settlement payment	40	(60)
Raw materials	(300)	(200)
Entity taxable income	$ 90	$ 90
X and *Y* taxable income	$ 90	$ 90
Z taxable income	(40)	60
Aggregate individual income	$ 50	$150

TABLE 24
CASH SETTLEMENT OF PARTICIPANT HEDGE

	State 1	*State 2*
Gross receipts	$350	$350
Raw materials	(300)	(200)
Entity taxable income	$ 50	$150
X and *Y* taxable income	$ 90	$ 90
Z taxable income	(40)	60
Aggregate individual income	$ 50	$150

Now consider the entity's second choice: taking delivery of the raw material from *Z*. As this choice is essentially a perfect substitute for cash settlement, it should produce the same income tax result as cash settlement. Table 25 illustrates the tax results obtained when *Z* is treated as a nonparticipant, under the further assumption that *Z* is "naked." That is, *Z* purchases the raw material in the spot market at its then market price immediately prior to delivering it to the entity. Quite clearly, these tax results differ from those under cash settlement.

TABLE 25
DELIVERY FROM NAKED NONPARTICIPANT

	State 1	*State 2*
Gross receipts	$350	$350
Raw materials	(260)	(260)
Entity taxable income	$ 90	$ 90
X and *Y* taxable income	$ 90	$ 90
Z taxable income	(40)	60
Aggregate individual income	$ 50	$150

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Table 26 illustrates the tax results obtained under the alternative treatment of *Z* as a participant from the moment the forward contract is executed, again under the further assumption that *Z* is naked. Such alternative treatment would sweep *Z*'s gain or loss on the forward contract into entity solution. Mechanically, *Z* would receive a cash payment of $160 from the entity, and either add $40 to it, or subtract $60 from it, before buying the raw material and transferring it to the entity. As in the case of any transfer of an asset from a participant, the entity would receive a fair market value basis in the raw material, hence either $200 or $100.[189] Thus, the proper income tax results are produced.

TABLE 26
DELIVERY FROM NAKED PARTICIPANT

	State 1	*State 2*
Gross receipts	$350	$350
Raw materials	(300)	(200)
Entity taxable income	$ 50	$150
X and *Y* taxable income	$ 90	$ 90
Z taxable income	(40)	60
Aggregate individual income	$ 50	$150

Suppose, now, that *Z* is not naked. Thus, at the time of entering the forward contract, *Z* has ownership of a sufficient quantity of the raw material to meet the entity's needs. In that case, one might be tempted to integrate *Z*'s long position in the raw material and *Z*'s treatment as a participant in the entity from the moment the forward contract is executed. This integration would lead to the conclusion that the raw material "enters" entity solution at the moment the forward contract is executed. Table 27 illustrates the entity income tax results that would follow from this conclusion, under the further assumption that the fair market value of the raw material is $150 at the time the forward contract is executed. Note that both the entity and the participants now show identical amounts of taxable income in the two states of the world. This is hardly a surprise, since the single cause of income variation, the market price of the second raw material, no longer affects either the entity or the participant.

[189] See Section IV.A.1.

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TABLE 27
DELIVERY FROM COVERED PARTICIPANT (ASSET DEEMED TRANSFERRED)

	State 1	*State 2*
Gross receipts	$350	$350
Raw materials	(250)	(250)
Entity taxable income	$100	$100
X and *Y* taxable income	$ 90	$ 90
Z taxable income	10	10
Aggregate individual income	$100	$100

Sadly, this most rational of tax results must be rejected. The reason is that *Z* will not necessarily deliver to the entity the raw material she has on hand at the time she enters into the forward contract. That is, as illustrated in Table 28, she may cash settle the forward contract, or purchase raw material for delivery in the spot market. In other words, nothing prevents *Z* from acting as if she were naked.[190] Thus, until such time as the entity actually takes ownership or control of the raw material, it cannot be treated for entity income tax purposes as if it has ownership or control of anything more than *Z*'s promise to deliver the raw material. And this is not illogical; after all, it does not.

TABLE 28
DELIVERY FROM COVERED PARTICIPANT (ASSET NOT DEEMED TRANSFERRED)

	State 1	*State 2*
Gross receipts	$350	$350
Raw materials	(300)	(200)
Entity taxable income	$ 50	$150
X and *Y* taxable income	$ 90	$ 90
Z taxable income	(40)	60
Z's unrealized income	[50]	[(50)]
Aggregate individual income	$ 50	$150

Finally, note that all of the same issues discussed above can be played out, with perfect symmetry, in the case of an entity that enters a hedge to protect itself against the change in the price of an output (or any other asset that it owns). Thus, the counterparty to any such hedge must be treated as a participant in the entity, whether such counterparty ultimately cash settles her hedge or takes delivery of the

[190] Under current law, the seller of fungible property is entitled, for purposes of basis recovery, to specifically identify which property she is selling. Reg. § 1.1012-1(c).

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entity's output (or asset). Furthermore, to ensure identical amounts of entity income in the latter case as in the former, it will be necessary to mark the output (or asset) to market at the time it leaves entity solution.

VI. Special Taxpayers

A. *Tax-Exempt Organizations*

1. *Treatment of Participations in Taxable Entities*

Under current law, tax-exempt organizations[191] investing in corporate or partnership debt instruments are able to reap returns that are largely unburdened by any sort of income tax, since a corporation or partnership generally receives a deduction for its interest payments or accruals to a tax-exempt organization[192] and a tax-exempt organization generally pays no income tax on the interest it receives.[193] On the other hand, tax-exempt organizations investing in corporate equity reap returns that are fully, albeit indirectly, burdened by the corporate income tax. And tax-exempt organizations investing in partnership equity reap returns that are somewhat less than fully, but directly, burdened by the corporate income tax.[194] Thus, tax-exempt organizations generally prefer debt instruments to equity instruments, but have no reason to prefer corporate debt instruments to partnership debt instruments or vice versa. In addition, tax-exempt organizations have a reason to prefer partnership equity instruments to corporate equity instruments, although possible taxes saved with respect to the former may be more than offset by the costs related to the need to file a tax return.[195]

Under the entity income tax, tax-exempt organizations would face a uniform income tax burden with respect to all of their investments in

[191] Under current law, foreign investors owning participation interests in U.S. entities are taxed very much like tax-exempt organizations. Thus, much of the discussion in this Subsection would apply to foreign investors as well. I defer to a sequel a closer examination of international aspects of the entity income tax.

[192] But see IRC § 163(j). Other interest disallowance rules can limit the deduction as well.

[193] Exceptions arise if the tax-exempt organization owns a sufficient portion of the equity of the corporation, IRC § 512(b)(13); Reg. § 1.512(b)-1(l), or if the debt instruments are themselves debt-financed, IRC § 514; Reg. § 1.514.

[194] A partnership's allocation of operating income to a tax-exempt organization generally is unrelated business taxable income, or UBTI, subject to income tax in the tax-exempt organization's hands at corporate income tax rates. IRC § 511; Reg. § 1.512(c)-1. On the other hand, a partnership's allocation of income that is not operating income to a tax-exempt organization generally is not UBTI, and thus generally is not subject to income tax in the tax-exempt organization's hands.

[195] In practice, many tax-exempt organizations uniformly prefer corporate equity investments to partnership equity investments due to their aversion to filing income tax returns.

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entities. Specifically, all of their income would be taxed indirectly and exactly once. Thus, tax-exempt organizations would be able to base their entity investment choices solely on the nontax characteristics of the instruments offered by such entities. And that is unambiguously a good thing. But the fact that it is a good thing does not mean that tax-exempt organizations would appreciate it. That would depend on whether the aggregate income tax they (indirectly) would pay with respect to all of their entity investments-all debt and equity instruments in all corporations and partnerships-would be more or less than the aggregate income tax they (indirectly and directly) currently pay.

As discussed below,[196] perhaps the most significant change that would accompany the entity income tax would be a precipitous drop in corporate income tax rates, reflecting the fact that the entity income tax base would be augmented by the inclusion of all of the currently deductible forms of corporate participation as well as by all partnership income. Thus, although tax-exempt organizations would pay more tax (at a low rate rather than zero) with respect to corporate and partnership debt investments, they would pay less tax (at a low rate rather than at a high rate) with respect to corporate and partnership equity investments. It is an empirical question whether the net effect of this tax increase and this tax decrease would benefit or harm tax-exempt organizations. My sense, however, is that even if the net effect were harm, the magnitude of such harm would not be so great that any compensating special tax relief would be warranted.

2. *Treatment of Tax-Exempt Organizations as Partially Taxable Entities*

Under current law, tax-exempt organizations are generally not subject to income tax with respect to their operations.[197] While this result is appropriate under the current corporate income tax—such tax is imposed on income directly paid to or indirectly allocated to a corporation's equity owners, and a tax-exempt organization has no equity owners—it would not be appropriate under the entity income tax. The reason should be obvious. The entity income tax would not be limited to income paid or allocated by an entity to its equity owners. Rather, it would burden income paid or allocated by an entity to any entity participant. Tax-exempt organizations are entities and they do have participants: employees, lenders, lessors, and so forth. Moreover, it is reasonable to assume that such participants incrementally benefit from their tax-exempt organization's entity organizational

[196] See Section VII.

[197] I ignore UBTI, since it is not relevant to this discussion.

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form. That is, a tax-exempt organization has all the same ability as a taxable entity to control and flexibly deploy multiple assets. Thus, at least when a tax-exempt organization earns income from an identifiable economic activity—for example, a hospital, a university, or a television station—such income is augmented because of the tax-exempt organization's use of entity organizational form. It follows that the tax-exempt organization's payments to its participants would be similarly augmented.

Of course, many tax-exempt organizations do not earn income from any identifiable economic activity, unless one considers fundraising and fund-disseminating to be an economic activity.[198] These tax-exempt organizations view their mission to be solely one of wealth redistribution: They collect wealth from donors and bestow it on donees. So far, I have treated redistributive activity, albeit the kind engaged in by participants in taxable entities, as having no entity income tax consequences. My reason has been that redistribution among participants does not affect the underlying real economic activity of an entity, and so should have no effect on a tax that attempts to measure certain incremental benefits that such participants, in the aggregate, are able to derive from that underlying real economic activity. One might think that a similar argument should absolve the redistributive activity of a tax-exempt organization from the entity income tax.

To see if it does, consider the tax treatment of a tax-exempt organization that engages solely in redistributive activity. That is, it collects donations, pays a portion of such collections to various participants, invests the remainder, collects returns on such investments, and periodically distributes funds to worthwhile donees. Under Rule 3, the entity would receive a partial cost recovery deduction for its payments to its participants. And under Rule 1, as modified by the participations-received deduction, it would be able to exclude from its income the returns it earns on its investments, at least if such investments are in the form of interests in other entities.[199] Thus, this "purely" redistributive tax-exempt organization would appear to have no (positive) entity taxable income. But this appearance depends critically on an unstated assumption.

That is, the tax-exempt organization would have an absence of positive entity taxable income only if its donors were treated as participants, since it is such treatment that would allow the tax-exempt organization to exclude their donations from its taxable income (Rule

[198] An entity that engages in such "economic activity" ought to be able to realize theory-of-the-firm type benefits in the same way as would an entity engaged in more traditional economic activity. That is, it will reap efficiencies from its ability to control and flexibly deploy its assets, and so forth.

[199] See Section V.B.

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2). But can a donor really be described as a participant? What is the participation of an individual who makes a disinterested contribution to a tax-exempt organization in the hope that the tax-exempt organization will redistribute such contribution wisely? By definition, the donor receives nothing from the tax-exempt organization in return for her contribution.[200] Nor does she have any continuing interest in the tax-exempt organization after her contribution is made. Thus, for example, if the tax-exempt organization chooses to squander her contribution on lavish executive compensation, she has no recourse (beyond withholding future contributions that she otherwise might have made). In light of this, the better view would seem to be to treat donors as nonparticipants in the tax-exempt organizations to which they make contributions.

Similarly, the recipients of a tax-exempt organization's charitable largesse cannot really be described as participants either. They contribute no assets to the tax-exempt organization and hence can earn no "return." Indeed, an investment analogy would fail, if for no other reason, because the donees can never have an entitlement to any particular receipt from the tax-exempt organization.[201] Thus, the better view would be to treat donees as nonparticipants.

If neither the donors nor the donees of a redistributive tax-exempt organization are treated as participants, then, absent a blanket income tax exemption, it would be possible, even probable, for the tax-exempt organization to be subject to the entity income tax. For example, suppose in a taxable year that a tax-exempt organization receives $500 of donations, distributes $300 to various donees, pays $100 to various employees, and invests the remaining $100. The $500 of donations would be includible in taxable income; the $300 of distributions would be deductible from taxable income (Rule 1). Thus, entity taxable income would be $200.[202]

Of this amount, $100 is the current participation of the employees in the tax-exempt organization. What is the remaining $100? It is the

[200] There can be no quid pro quo for a contribution. Thus, for example, a donor's charitable contribution deduction is limited to the amount by which the donor's contribution exceeds the value of any goods or services received in exchange. Reg. § 1.170A-1(h)(2). Note that, as is standard, I do not treat the intangible benefits of charitable giving as constituting a cognizable return. See Hernandez v. Commissioner, 490 U.S. 680 (1989) (exploring the distinction between intangible benefits that do not preclude deductibility and tangible benefits that do preclude deductibility).

[201] For the vast majority of tax-exempt organizations (including those public charities often meant when referring generically to "tax-exempt organizations"), the statutory language of the provisions granting the tax exemption require this. See, e.g., IRC § 501(c)(3), (4), (6), (7), (9), (10), (11), (13), (19), (26); Reg. § 1.501(c)(3)-1(c)(2).

[202] I ignore the partial cost recovery deduction applicable to certain payments to participants.

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potential future participation of the employees in the tax-exempt organization. That is, the entity income tax, in the same manner as the current corporate income tax, tentatively allocates any amount that has not been definitively paid or allocated to a nonparticipant to participants. And it thus imposes tax on such amounts. Of course, in the event that this amount is in fact paid to nonparticipants in a subsequent year, the "accelerated" income inclusion would be reversed.

But such reversal is unlikely: As a rule, tax-exempt organizations allow donations to accumulate, thus establishing or increasing their endowments. A decision to tax such accumulations surely would be controversial. But that does not mean it would be bad. It would encourage tax-exempt organizations to distribute contributed funds more rapidly: a change that surely comports with the expectations of at least some donors.[203] And by the same token, it would discourage tax-exempt organizations from excessively accumulating funds: a change that would make it more difficult for their managers to entrench themselves. These strike me as quite salutary effects.

B. *Financial Intermediaries*

1. *Banks*

Among other things, the entity income tax would eliminate the corporate interest expense deduction. One effect of this might be to raise the cost of financial intermediation: to increase the spread between lending and borrowing rates in the economy. Such an increase would be undesirable because it would slow the flow of capital from those who have it to those who need it, with the result that relatively more capital would be trapped in inefficient uses. Would cataclysm ensue forthwith?

As a baseline, I assume that the capital flows under current law are acceptable. Corporate financial intermediaries—and all banks are classified as corporations[204]—deduct from taxable income the interest they pay, irrespective of the identity of the lender, and include in taxable income the interest they receive, irrespective of the identity of the

[203] See, e.g., Stephanie Strom, Foundations Roiled By Measure to Spur Increase in Charity, N.Y. Times, May 19, 2003, at A1 ("The House is considering a bill that could force the nation's foundations to give away more of their money to charity each year. . . . The bill has created a furor in the philanthropic world, with foundations warning that they could be forced to squander their assets and spend themselves out of existence. Its supporters, however, say it will actually rein in wasteful spending—on salaries and overhead—as it gives charities needed help in a time of withering government budgets and growing economic pain.")

[204] Reg. § 301.7701-2(b)(5).

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borrower.[205] To the extent that a lender to the financial intermediary is itself a corporation, the lender has a taxable income inclusion for interest received that exactly offsets the intermediary's deduction for interest paid. And to the extent that a borrower from the financial intermediary is itself a corporation, the borrower has a deduction for interest paid that exactly offsets the intermediary's inclusion of interest received. Thus, in each case, there is no net taxable income in the corporate sector.

The entity income tax would replicate this result for the entire entity sector, albeit through an alternative mechanism. That is, the entity income tax would deny a deduction for interest paid by an entity borrower, since the interest represents the lending entity's participation in the borrower. The lending entity, however, would exclude any interest it receives from the borrowing entity from its gross income, by virtue of the participations-received deduction. As under current law, there would be no net taxable income in the entity sector.

Consider now the effect of disallowing the entity interest expense deduction on interactions between entities and individuals. There are two types of such interactions. First, the lender can be an entity and the borrower an individual. Under both current law and the entity income tax, the same result would obtain: There would be taxable income in the entity sector.[206] Second, the lender can be an individual (for example, a depositor at the local bank) and the borrower an entity. This is where current law and the entity income tax would diverge. Under current law, the entity deducts interest paid to an individual. Under the entity income tax, such interest payments would be nondeductible participation. This, then, is the sole basis for the potential cataclysm: A financial intermediary subject to the entity income tax would fall victim to the very same broadening of the tax base as any other entity. That is, such financial intermediary would have more taxable income than a corporate financial intermediary has under the current corporate income tax.

But there would be a compensating factor: The entity income tax would permit tax to be imposed at a dramatically lowered tax rate. Thus, the additional amount of entity income tax that a financial intermediary would pay with respect to amounts borrowed from individuals would not be anywhere near as great as it would be if Congress simply repealed the current corporate interest expense deduction but otherwise left tax rates unchanged. Furthermore, and for the same

[205] IRC §§ 163(a), 61(a)(4). The modifications allowed under § 582 do not affect the correctness of this statement.

[206] A borrower would not be a participant in the lending entity. Thus, the interest payments from such borrower would be gross income of the entity (Rule 1).

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reason, a financial intermediary actually would pay less entity income tax with respect to its equity than it does under current law. Whether the net effect of the increased tax with respect to debt capital and the decreased tax with respect to equity capital would be a tax increase or a tax decrease is an empirical question. But I suspect there would be no cataclysm.

To illustrate, suppose that *Bank* accepts deposits of $950 from individuals and promises to pay interest at the rate of 2% on such deposits. In addition, *Bank* raises $50 of equity capital in order to comply with regulatory and rating agency capitalization requirements. *Bank* then lends its $1,000 to various individuals to enable such individuals to purchase residences. *Bank* charges interest at the rate of 6% on its loans. Finally, suppose that *Bank*'s lending operations require the services of various employees, and that they earn wages of $25 per year. As set forth in Table 29, under current law, *Bank* has taxable income of $16. Thus, assuming a 35% corporate income tax rate, *Bank* pays income taxes of $5.60. In contrast, under the entity income tax, *Bank* would have taxable income of $60, since neither the interest nor the wages it pays would be deductible. Thus, if the entity income tax rate were 9.33%, *Bank* would pay exactly the same $5.60 of income tax as under current law. Of course, I chose the 9.33% tax rate precisely because it produces equivalence. A lower tax rate actually would leave *Bank* with relatively more after-tax cash under the entity income tax; a higher tax rate would leave *Bank* with relatively less after-tax cash.[207] But in either case, I see no cataclysm.

TABLE 29
BANK

	Current law	*Entity tax*
Interest income	$60	$60
Interest expense	(19)	0
Wages	(25)	0
Taxable income	$16	$60
Taxes at 35%	$ 5.60	–
Taxes at 9.33%	–	$ 5.60

2. *Insurance Companies*

Under current law, insurance companies invariably are taxed as corporations.[208] Their taxable income includes premiums received (as

[207] A rough calculation in Section VII.D. estimates that the tax rate under the entity income tax would be no higher than 10.4%.

[208] Reg. § 301.7701-2(b)(4).

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well as other items, such as investment income earned) and is reduced by claims paid (as well as other items, such as employee wages).[209] Thus, the excess of premiums received over claims paid,[210] which can be viewed as a redistribution of wealth from insureds to other insurance company participants, is subject to the current corporate income tax. This tax treatment, of course, mirrors that currently accorded to another form of wealth redistribution. Thus, if an individual enters into a risk-shifting transaction with a corporation, the corporation currently includes in its taxable income any gain from such transaction and deducts from its taxable income any loss from such transaction.[211] But this tax treatment ultimately undermines a sovereign's ability to collect corporate income tax, since it allows corporations intent on tax reduction to systematically shift taxable income out of corporate solution.[212]

A desire not to let the entity income tax fall prey to such nonrobustness led me, in Section V.C. above, to determine that any individual who enters into a hedge, a gamble, or a similar purely financial transaction with an entity must be treated for entity income tax purposes as a participant in such entity. And this determination applied whether the individual assumed some risk of the entity, or whether the entity assumed some risk of the individual. Is it a necessary sequel to this determination to treat each individual who purchases insurance from an insurance company as a participant in the insurance company? After all, each such individual enters into a purely financial transaction with the insurance company pursuant to which she pays an expected net fee to the insurance company in exchange for having the insurance company assume some of her risk. On the other hand, each such individual also looks very much like a plain vanilla customer of the insurance company. And in keeping with such appearance, nonparticipant tax treatment arguably would be the more natural one. How is a sovereign to decide?

Suppose a hypothetical insurance company, *IC*, is formed with an initial contribution of $50 of equity capital (this being the amount required by regulators and desired by rating agencies). Suppose *IC* col-

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[209] IRC § 832.

[210] Due to the ability of an insurance company to invest premiums and use a portion of its investment earnings to help pay claims, this amount in fact may be a deficit when measured in terms of nominal currency. For any profitable insurance company, however, premium receipts will exceed the discounted value of expected claims payments.

[211] Reg. § 1.446-3.

[212] The strategy is as follows. First, the corporation pays a deductible net fee to a noncorporate third person—for example, a hedge fund taxed as a partnership—that is willing to assume some of its risk. Then, the corporation takes advantage of the reduced volatility of its cash flows (occasioned by its risk reduction) to increase its leverage. See generally Little Boxes, note 2.

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lects premiums totaling $950 from various individuals and promises in exchange to pay such individuals certain benefits upon the occurrence of various low-probability events. *IC* knows, based on the law of large numbers, that it will be required to pay approximately $1,000 in claims. For ease of exposition, suppose all claims are paid exactly one year after the premiums are received. Thus, pending the payment of claims, *IC* has some amount—its equity capital and its after-tax premium receipts—to invest. Suppose *IC* invests in various fully taxable investments that yield 20%. Finally, suppose that at the end of one year, *IC* indeed pays exactly $1,000 of claims to its insureds.

If the insureds are deemed to be participants in *IC*, *IC* would have no taxable income during its first year of operation. That is, neither the equity capital nor the premiums received would be gross income, since they each are received from participants (Rule 2). Thus, *IC* would have $1,0000 to invest and would earn $200 on such investment. This means that *IC* would have $200 of entity taxable income during its second year of operation. That is, in Year 2, *IC* earns $200 of fully taxable investment income (Rule 1). In addition, it pays claims that would not be deductible since they are paid to participants (Rule 3). Assuming, for purposes of illustration, a 10% entity income tax rate, *IC* would pay $20 of tax in Year 2, and thus would have $180 to return to its equity investors. Table 30 illustrates this result.

TABLE 30
INSURANCE COMPANY

	Insureds are participants	*Insureds are nonparticipants*
Equity capital	$ 50.00	$ 50.00
Premiums received	950.00	950.00
Year 1 taxable income	$0.00	$950.00
Year 1 taxes at 10%	0.00	(95.00)
Available capital to invest	$1,000.00	$ 905.00
Investment income (20%)	$ 200.00	$ 181.00
Claims paid	(1,000.00)	(1,000.00)
Year 2 taxable income	$ 200.00	$ (819.00)
Year 2 taxes at 10%	(20.00)	81.90
Return to equity	$ 180.00	$ 167.90

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If, however, the insureds were treated as nonparticipants, *IC* would have $950 of net taxable income during its first year. That is, the $950 of premiums received would be taxable gross receipts (Rule 1). And *IC* would have a loss of $819 during its second year. That is, assuming again a 10% entity income tax rate, *IC* would pay $95 of Year 1 tax, and thus would have only $905 available for investment. Assuming that it still invested at the same 20% pretax rate of return, *IC* would thus earn $181 of fully taxable Year 2 investment income (Rule 1). And, of course, *IC* would pay $1,000 of fully deductible claims (Rule 1). Netting these amounts yields the $819 loss. Assuming *IC* is allowed to carry back its Year 2 loss to offset its Year 1 taxable income, *IC* would receive a tax refund of $81.90 in Year 2. Thus, it would have $167.90 to return to its equity investors.

Why does the treatment of insureds as participants or nonparticipants matter here, when the treatment of Wal-Mart's guarantee recipients (who are conceptually identical to insureds) as participants or nonparticipants did not matter in Section IV?[213] The reason is simple. I assumed in Section IV that Wal-Mart "priced" its guarantees in such a way that it made no profit on them. That is, Wal-Mart returned 100% of the amounts deemed paid for the guarantees and 100% of the after-tax investment income earned on such amounts to the purchasers of the guarantees. Why would Wal-Mart do this? The short answer is: It would not, if it actually sold the guarantees separately. But since it does not sell the guarantees separately, the tax law must divine a price for them. One possible price, and one which is particularly easy to calculate, is the price that produces no profit.

IC, however, explicitly prices its insurance to make a profit. But it need not do so. Thus, suppose that *IC* returns to its insureds the entirety of their premiums and the after-tax investment income earned by investing such premiums: a total of $1,121 in claims payments and/or premium refunds.[214] As illustrated in Table 31, *IC*'s equity owners would earn a uniform $59 after taxes, irrespective of whether the insureds were deemed to be participants or nonparticipants.

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[213] See note 98.

[214] The insureds pay premiums of $950. *IC* earns an 18% after-tax return by investing such premiums, or $171. Thus, *IC* can pay claims and/or refund premiums in an amount totaling $1,121.

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TABLE 31
"MUTUAL" INSURANCE COMPANY

	Insureds are participants	*Insured are nonparticipants*
Equity capital	$ 50	$ 50
Premiums received	950	950
Year 1 taxable income	$ 0	$ 950
Year 1 taxes at 10%	0	(95)
Available capital to invest	$1,000	$ 905
Investment income (20%)	$ 200	$ 181
Claims paid	(1,121)	(1,121)
Year 2 taxable income	$ 200	$ (940)
Year 2 taxes at 10%	(20)	94
Return to equity	$ 59	$ 59

And the sovereign would garner equivalent entity income taxes in either case. That is, if the insureds were deemed to be participants in *IC*, it would receive a payment of $20 in the second year. And if the insureds were deemed to be nonparticipants in *IC*, it would receive a payment of $95 in the first year, which it could invest at the 20% (pretax) rate of return, thereby producing $19 of Year 2 revenue. Thus, it would have $114, from which it would pay the Year 2 tax refund of $94. When the dust settled, it would again be left with $20 at the end of the second year.

Returning then to the original query: Is the systematic redistribution of wealth from insureds to other participants in the insurance company context the type of redistribution that should have no entity income tax effect? I do not think so. The better view, it seems to me, and the one that comports most closely with reality, is one that would treat the insureds as wearing two hats: They are customers who purchase a risk-shifting service from the insurance company, and they are investors who participate in the insurance company. Thus, returning to the insurance company illustrated in Table 30, the insureds as customers would be treated as paying $102.50 to *IC* for *IC*'s risk-shifting service. And the insureds as investors would be treated as transferring $847.50 to *IC* which *IC* would invest at its pretax 20% rate and then return, less taxes, to them. Table 32 illustrates this bifurcated treatment of the insureds.

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TABLE 32
INSURANCE COMPANY (BIFURCATED TREATMENT OF INSUREDS)

Equity capital	$ 50.00
Premiums (investment)	847.50
Premiums (service fee)	102.50
Year 1 taxable income	$ 102.50
Year 1 taxes at 10%	(10.30)
Available capital to invest	$ 989.70
Investment income (20%)	197.90
Claims paid (investment)	(1,000.00)
Year 2 taxable income	$ 197.90
Year 2 taxes at 10%	(19.80)
Return to equity	$ 167.80

3. *Finance Companies and More on Leases*

Section IV.A.2 set forth, in elaborate detail, the proper entity income tax treatment of temporally-limited interests in nonhuman capital assets. Thus, an entity that leases such an asset would be allowed no deduction for the rent it pays (since the rent is a payment to a participant), but would be allowed a deduction for the statutory depreciation of the asset based on its fair market value at the time it enters entity solution (since such depreciation reduces the amount of return earned by the participant). Perhaps the greatest benefit of this tax treatment is that it would create tax parity from an entity's perspective between leases and fee ownership of nonhuman capital assets.

Just as an entity can gain control of an asset by means of a lease, so too can it transfer control of an asset by means of a lease. Thus, suppose that a finance company, *FC*, leases an asset with a fair market value of $300 from *Owner* for a one-year period, and in exchange makes a single payment of $100 to *Owner*. Suppose *FC* then finds *User*, who would like to use the asset during the one-year period. *FC* subleases the asset to *User* (an entity), and in exchange receives a single payment of $110. Suppose that *User*, by virtue of its use of the asset, generates incremental gross receipts of $130. Finally, suppose that at the simultaneous termination of the sublease and the lease, the asset has a fair market value of $250 (that is, the asset has suffered $50 of economic depreciation over the course of the one-year period).

All in all, this lease-in, sublease-out transaction is a profitable one for *FC*. But should it be derivatively profitable for the sovereign as well? One could argue that it should not be. After all, *FC* does not

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make any direct use of the asset itself. Thus, how can the income earned by *FC* possibly reflect the sort of theory-of-the-firm type benefits that flow from the ability to control and flexibly deploy the asset? On the other hand, one could also argue that the ability to control and flexibly deploy an asset encompasses the ability to find the highest and best use for such asset, and such highest and best use need not be by the entity itself. Thus, perhaps *FC*'s profit should be in the entity income tax base.

Table 33 illustrates the entity income tax treatment of this transaction. *User* would have taxable gross receipts of $130 (Rule 1), would receive no deduction for rent paid to its participant, *FC*, but would receive a deduction of $50 for the depreciation of the subleased asset.[215] Hence, it would have taxable income of $80. This taxable income accrues to the benefit of its participants: The lessor *FC* participates to the extent of $60 (the rent paid to *FC* less the depreciation on the asset); the equity owners of *User* participate to the extent of the $20 of net cash generated. *FC*, in turn, would have $110 of taxable gross receipts (Rule 1), would receive no deduction for rent paid to its participant, *Owner*, but would receive a deduction of $50 for the depreciation of the leased asset. In addition, as a participant in *User*, *FC* would be entitled to a participations-received deduction in the amount $60 that reflects its participation in *User*. Thus, *FC* would have no net entity taxable income.

TABLE 33
LEASE-IN, SUBLEASE-OUT

	FC-1	*User-1*
Gross receipts	$110	$130
Rent paid	(100)	(110)
Net cash generated	$ 10	$ 20
Gross receipts	$110	$130
Depreciation	(50)	(50)
Part. rec'd deduction	(60)	0
Taxable income	$ 0	$ 80
Lessor participation	$ 50	$ 60
Equity participation	10	20

[215] Statutory depreciation based on the asset's fair market value when it enters entity solution and limited by the asset's fair market value when it leaves entity solution is equivalent, in the aggregate, to economic depreciation. See Jeff Strnad, Tax Depreciation and Risk, 52 SMU L. Rev. 547 (1999).

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This result, which is nothing more than an illustration of the consolidation rule, is clearly the proper one. That is, the entity sector generates a total return of $80 as a result of the asset's entry into entity solution: The asset generates incremental entity returns of $130 but loses $50 in value while in entity solution. Correspondingly, the individual sector generates a total return of $80 as a result of the asset's entry into entity solution: *Owner* receives $50, *FC*'s equity owners receive $10, and *User*'s equity owners receive $20. And, in accordance with the idea that the greatest part of the theory-of-the-firm type entity benefits are realized by the entity that actually uses an asset, the entire $80 of entity taxable income would appear on *User*'s tax return.

4. *Mutual Funds, Investment Funds, and Similar Vehicles*

Many individuals participate in financial markets by purchasing shares of mutual funds rather than direct participations (debt, equity, or other) in corporations conducting active businesses. The great advantage of mutual funds, of course, is that they allow investors with relatively little capital to achieve significant levels of diversification. Current law does not discourage mutual fund investing by burdening mutual funds with incremental corporate income tax. For although a mutual fund generally is taxed as a corporation,[216] it is required to distribute essentially all of its investment income annually as a dividend[217] and it receives a dividends-paid deduction when it does so.[218] Moreover, since mutual funds generally are prohibited from earning income other than investment income,[219] the net effect is that the funds are tax-transparent.

Individuals with significant amounts of capital to invest can choose from a wider array of investment vehicles than just mutual funds. Thus, they may purchase interests in venture capital funds, leveraged buy-out funds, commodities funds, hedge funds, and so on. All of these funds invariably are structured as tax partnerships. Accordingly, under current law, they also pay no entity-level income tax on the income they generate.

Under the entity income tax, a mutual fund or other type of investment fund would be a taxable entity. But that does not mean that it would pay much tax. The reason is that it receives inflows from only two sources. The first source is investors, and since investors are participants in the fund, those receipts would appear to be tax-free (Rule 2). The second source is investment income. To the extent that such

216 IRC §§ 851(a), 852(b).
217 IRC § 852(a)(1).
218 IRC § 852(b)(2)(D), (3)(A).
219 IRC § 851(b)(2).

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income is earned from participations in other entities, it too would be tax-free by virtue of the participations-received deduction. Thus, at the end of the day, albeit by a different mechanism than under current law, mutual funds and investment funds would appear to be largely free from the reach of the entity income tax.

But this analysis is incomplete. It is not the case that such funds simply receive capital from investors, invest such capital, collect returns from the investments, and distribute the returns to investors. Rather, the funds more or less actively manage the capital at their disposal and charge investors a fee, generally based on a percentage of invested capital and a percentage of realized return, for such management services. And this fee is not simply a redistribution of participant wealth from one class of participants (investors) to another (fund managers and employees). Rather, it is a fee for a service. Thus, it is analogous to the fee paid by insureds to their insurance company for its risk-shifting service. That fee would be subject to entity income taxation. And a fund management fee should be likewise. Thus, to the extent that a fund investor directly or indirectly pays a management fee to a fund, the investor should be treated as a nonparticipant in the fund, with the result that the management fee would be taxable gross income to the fund (Rule 1).

A final investment vehicle currently granted favorable entity-level income tax treatment is the real estate investment trust (REIT). A REIT is essentially a mutual fund that invests in real estate rather than in financial instruments. As with other mutual funds, current law does not discourage REIT formation by burdening REITs with incremental corporate income tax. In particular, although a REIT generally is taxed as a corporation,[220] it is required to distribute essentially all of its net real property income annually as a dividend[221] and it receives a dividends-paid deduction when it does so.[222] Since REITs generally are prohibited from earning income other than real property income,[223] the net effect is that they are tax-transparent.

Under the entity income tax, REITs would be entities and so would be fully subject to tax. Unlike other types of investment funds, they generally would not be able to exclude their income from taxation, since such income generally would not reflect participation in another entity. Thus, absent a special dispensation from the sovereign—one that I am not prepared to grant—such trusts, and hence their underlying real estate, would be taxed more heavily than they currently are.

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220 IRC §§ 856(a), 857(b).

221 IRC § 857(a)(1).

222 IRC § 857(b)(2)(B), (3)(A).

223 IRC § 856(c)(2).

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VII. Tax Rates

My proposed entity income tax defines entity taxable income in a way that differs substantially from the way income is defined under most alternative tax regimes. In order to illustrate the extent of such difference, and its impact on entity income tax rates, I examine how a hypothetical entity would fare under various entity income tax regimes. Thus, suppose three individuals *X*, *Y*, and *Z* form an entity *E*. (For purposes of illustration, I ignore the fact that, per the discussion in Section V, *E* would likely not be an entity for purposes of the entity income tax since it would lack the requisite number of participants.) *X* is a manager who will run the entity; *Y* is an entrepreneur who owns an asset that is essential to the entity (for simplicity, assume the asset is intellectual property that is neither depreciable nor amortizable); *Z* is an investor who has $100 of cash to invest in the entity. Suppose that *E*'s proposed economic activity requires, in addition to the services and property to be provided by *X*, *Y*, and *Z*, raw materials that can be purchased in the spot market for $100 and labor that can be purchased from *W* for an expected wage of $10.50.

Once *E* has secured its various inputs, its economic activity will generate gross receipts in the amounts of $132, $162, or $192, each with equal likelihood (and unrelated to the effort, or lack thereof, of *W* or *X*). In addition, *E*'s economic activity will generate unrealized appreciation (goodwill) of -$20, $10, or $40, respectively, in the three states of the world. Given these returns, *X*, *Y*, and *Z* must determine how they will share the "income" generated by *E*. After much negotiation, the agreed-upon scheme allocates an expected wage of $26 to *X*, an expected royalty of $14 to *Y*, and an expected investment return of $21.50 to *Z*. If *Z* divides her $100 investment in *E* into $50 of debt and $50 of equity, her return may be subdivided further. Thus, suppose she is allocated expected interest of $5.50 and expected dividends of $16. Table 34 illustrates the ultimate allocation scheme.

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TABLE 34

	State 1	*State 2*	*State 3*	*Expected inflows*
Gross receipts	$132.00	$162.00	$192.00	$162.00
Appreciation	(20.00)	10.00	40.00	10.00
	$112.00	$172.00	$232.00	$172.00
Outflows				
Raw materials	$100.00	$100.00	$100.00	$100.00
W - wages	9.50	10.50	11.50	10.50
X - wages	20.00	26.00	32.00	26.00
Y - royalties	7.00	14.00	21.00	14.00
Z - interest	5.00	5.50	6.00	5.50
Z - equity	(29.50)	16.00	61.50	16.00
	$112.00	$172.00	$232.00	$172.00

A. *Income Definitions Based on Current Tax Law*

If an entity income tax were added to this ideal world, *E* would be required to share its returns with the sovereign. For purposes of illustration, suppose that the sovereign decides to extract an expected tax of $4. Such outflow would reduce the returns available to *E*'s participants. Thus, the participants must renegotiate their shares of *E*'s returns. It is conceivable that the sovereign's levy is so great that *E*'s business would cease to be viable; that is, *E*'s participants would be able to generate greater returns by deploying their assets in other ventures. I assume, however, that the sovereign's levy of $4 has no such devastating effect on *E*. Thus, following some wailing and gnashing of teeth, *E*'s participants agree on an alternative division of *E*'s spoils: *W* agrees to an expected wage of $10, *X* to an expected wage of $25, *Y* to an expected royalty of $13, and *Z* to an expected interest payment of $5 and an expected dividend of $15. As illustrated in Table 35, all such expectations could be accommodated in a world with a 36% income tax imposed on positive taxable income as defined by the current corporate income tax regime: gross receipts less deductions for raw materials, wages, royalties, and interest.

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TABLE 35
CURRENT CORPORATE INCOME TAX BASE

	State 1	*State 2*	*State 3*	*Expected inflows*
Gross receipts	$132.00	$162.00	$192.00	$162.00
Appreciation	(20.00)	10.00	40.00	10.00
	$112.00	$172.00	$232.00	$172.00
Outflows				
Raw materials	$100.00	$100.00	$100.00	$100.00
W – wages	9.00	10.00	11.00	10.00
X – wages	19.00	25.00	31.00	25.00
Y - royalties	6.00	13.00	20.00	13.00
Z - interest	4.50	5.00	5.50	5.00
Z – equity	(26.50)	15.78	55.73	15.00
	$112.00	$168.78	$223.23	$168.00
Taxes				
Taxable income	($ 6.50)	$ 9.00	$ 24.50	–
Tax at 36%	0.00	3.22	8.77	$ 4.00

Current law contains a second definition of entity taxable income, albeit one that does not lead to a direct imposition of income tax on the affected entities. Thus, if *E* were a tax partnership, then any or all of *W*, *X*, *Y*, and *Z* conceivably could be partners, with the result that some portion of the returns allocable to them would not be deductible in computing partnership taxable income.[224] For example, suppose that *E*'s partnership agreement confers the partner designation only on *X* and *Z*. The effect of this designation is to convert amounts treated under the corporate income tax regime as deductible wages paid to *X* into nondeductible allocations of partnership income to *X*. Necessarily, such treatment broadens the tax base (here, quite dramatically). As illustrated in Table 36 (and assuming the participants in *E* make no further adjustments to their shares of *E*'s returns), an income tax imposed at the rate of 12% on partnership taxable income yields the sovereign's desired $4 of expected tax revenue.

[224] IRC § 703(a).

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TABLE 36
CURRENT PARTNERSHIP INCOME TAX BASE

	State 1	*State 2*	*State 3*	*Expected inflows*
Gross receipts	$132.00	$162.00	$192.00	$162.00
Appreciation	(20.00)	10.00	40.00	10.00
	$112.00	$172.00	$232.00	$172.00
Outflows				
Raw materials	$100.00	$100.00	$100.00	$100.00
W – wage	9.00	10.00	11.00	10.00
X – allocation	19.00	25.00	31.00	25.00
Y – royalties	6.00	13.00	20.00	13.00
Z – interest	4.50	5.00	5.50	5.00
Z – allocation	(27.97)	15.00	57.97	15.00
	$110.53	$168.00	$225.47	$168.00
Taxes				
Taxable income	$ 12.50	$ 34.00	$ 55.50	–
Tax at 12%	1.47	4.00	6.53	$4.00

B. Entity Income Definitions From the Academic Literature

The academic tax literature contains a number of alternative entity income tax regimes. Perhaps the most widely discussed of these is the Comprehensive Business Income Tax (CBIT).[225] The salient feature of CBIT is that it treats entity debt and equity alike, denying any entity deductions for either. Thus, in particular, it neuters the ability of *E*'s participants to shrink the entity income tax base by playing characterization games with *Z*'s capital interests.[226] Inevitably, the disallowance of interest expense deductions would broaden the entity income tax base relative to that under the current corporate income tax. As illustrated in Table 37 (and assuming the participants in *E* make no further adjustments to their shares of *E*'s returns), an income tax imposed at the rate of 27% on the CBIT tax base would yield the sovereign's desired $4 of expected tax revenue.

[225] Treasury Integration Study, note 4, at 39-60.

[226] It does not affect the ability of *E*'s participants to play other games, such as those available when various participants provide *E* not only with liquid capital, but also with tangible or intangible assets and/or human capital.

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TABLE 37
CBIT TAX BASE

	State 1	State 2	State 3	Expected inflows
Gross receipts	$132.00	$162.00	$192.00	$162.00
Appreciation	(20.00)	10.00	40.00	10.00
	$112.00	$172.00	$232.00	$172.00
Outflows				
Raw materials	$100.00	$100.00	$100.00	$100.00
W – wages	9.00	10.00	11.00	10.00
X – wages	19.00	25.00	31.00	25.00
Y – royalties	6.00	13.00	20.00	13.00
Z – interest	4.50	5.00	5.50	5.00
Z – allocation	(26.50)	15.18	72.69	15.00
	$112.00	$168.18	$240.19	$168.00
Taxes				
Taxable income	($2.00)	$14.00	$30.00	–
Tax at 27%	0.00	3.82	8.19	$4.00

Another entity income tax scheme is the market value tax proposed by Joseph Bankman and Michael Knoll.[227] This tax has as its tax base the change in the market value of an entity's equity (and, if desired, debt) over the course of the taxable year. Thus, the market value tax regime is essentially a mark-to-market tax regime and possesses all the benefits and limitations of such regimes.[228] In the instant case, it would result in the inclusion of *E*'s unrealized appreciation in the income tax base. As illustrated in Table 38 (and assuming the participants in *E* make no further adjustments to their shares of *E*'s returns), an income tax imposed at the rate of 14% on the market value tax base would yield the sovereign's desired $4 of expected tax revenue.

227 Joseph Bankman, A Market-Value Based Corporate Income Tax, 68 Tax Notes 1347 (Sept. 11, 1995); Michael S. Knoll, An Accretion Corporate Income Tax, 49 Stan. L. Rev. 1 (1996).

228 Herwig J. Schlunk, The Cashless Corporate Tax, 55 Tax L. Rev. 1, 10-15 (2001) (discussing such benefits and limitations).

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TABLE 38
MARKET VALUE TAX BASE

	State 1	*State 2*	*State 3*	*Expected inflows*
Gross receipts	$132.00	$162.00	$192.00	$162.00
Appreciation	(20.00)	10.00	40.00	10.00
	$112.00	$172.00	$232.00	$172.00
Outflows				
Raw materials	$100.00	$100.00	$100.00	$100.00
W – wages	9.00	10.00	11.00	10.00
X – wages	19.00	25.00	31.00	25.00
Y – royalties	6.00	13.00	20.00	13.00
Z – interest	4.50	5.00	5.50	5.00
Z – equity	(26.50)	16.27	55.23	15.00
	$112.00	$169.27	$222.73	$168.00
Taxes				
Taxable income	($26.50)	$19.00	$64.50	–
Tax at 14%	0.00	2.73	9.27	$4.00

Finally, consider my proposed entity income tax. Under that regime, *W*, *X*, *Y*, and *Z* all would be participants in *E*. Hence, as a first cut, payments or allocations to them would not be deductible when determining *E*'s taxable income. But as set forth in Section IV, not allowing any deductions would result in an overstatement of certain participants' participation in *E*. In particular, borrowing from the illustrations in Section IV, one-fourth of the wage of a rank-and-file worker like *W* should be deductible and one-sixth of the wage of an executive like *X* should be deductible. In addition, *E* should be entitled to a cost recovery deduction for amortization of *Y*'s intellectual property. Assuming that property has a fair market value of $50 and would be subject to a 15-year straight-line amortization scheme,[229] *E* would be entitled to an annual deduction of $3.33. Under these predicates (and assuming the participants in *E* make no further adjustments to their shares of *E*'s returns), Table 39 illustrates that a tax imposed at the rate of 7.7% on the entity income tax base would yield the sovereign's desired $4 of expected tax revenue.

[229] See IRC § 197(a).

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TABLE 39
ENTITY INCOME TAX BASE

	State 1	*State 2*	*State 3*	*Expected inflows*
Gross receipts	$132.00	$162.00	$192.00	$162.00
Appreciation	(20.00)	10.00	40.00	10.00
	$112.00	$172.00	$232.00	$172.00
Outflows				
Raw materials	$100.00	$100.00	$100.00	$100.00
W – wages	9.00	10.00	11.00	10.00
X – wages	19.00	25.00	31.00	25.00
Y – royalties	6.00	13.00	20.00	13.00
Z – interest	4.50	5.00	5.50	5.00
Z – equity	(28.29)	15.00	58.29	15.00
	$110.21	$168.00	$225.79	$168.00
Taxes				
Gross income	$132.00	$162.00	$192.00	
Raw materials	(100.00)	(100.00)	(100.00)	
Wages (25%)	(2.25)	(2.50)	(2.75)	
Wages (16.7%)	(3.17)	(4.17)	(5.17)	
Royalty (1/15)	(3.33)	(3.33)	(3.33)	
Income	$ 23.25	$ 52.00	$ 80.75	-
Tax at 7.7%	1.79	4.00	6.21	$4.00

C. *Entity Taxes Not Imposed on "Income"*

Of course, nothing precludes a sovereign from departing from entity "income" taxes in its search for an efficient way to burden the entity sector.[230] Thus, a sovereign instead could impose a lump sum entity "head" tax of $4, collected from *E* in every state of the world. Or, if it could identify states of the world, it might refine the lump sum head tax to be $2 in the low income state of the world, $4 in the middle income state of the world, and $6 in the high income state of the world. Or it could impose a gross receipts tax at a rate of approximately 2.5%.

Alternatively, nothing precludes a sovereign from embarking on more comprehensive tax reform, combining an overhaul of the entity income tax system with an overhaul of the individual tax system. One such possible overhaul is the so-called X-Tax proposed by David

[230] The hallmarks of an income tax are that it is a tax imposed on realized net gain. See, e.g., Reg. § 1.901-2(b) (defining when a foreign tax is an "income tax"). The "realized" part of the definition is quite loose: Increases or decreases in the fair market values of property can constitute realization. Reg. § 1.901-2(b)(2). The net part of the definition requires that gross receipts are reduced to reflect significant costs of producing such receipts. Reg. § 1.901-2(b)(4).

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Bradford.[231] The X-Tax comes in two flavors: a basic X-Tax and an alternative X-Tax. The flavors differ in mechanics, but not in ultimate effect. Each imposes a consumption tax on entities, broadly defined to include all businesses (whether corporations, partnerships, or proprietorships). And each supplements the tax on entities with a tax (or possibly a credit) on wages.[232]

The entity tax base of the basic X-Tax would include all receipts and allow a deduction for all payments made to other businesses and for all payments made to workers (however classified).[233] For *E*, this definition would produce the same tax base as CBIT.[234] This congruity is accidental, however, since it is partly an artifact of using a one-period model (which creates an identity between the implicit depreciation-type cost recovery regime of CBIT and the consumption-tax immediate-expensing regime of the X-Tax) and partly an artifact of focusing on one particular entity (under the X-Tax, *Y*'s business of licensing her intellectual property would be a second entity). As illustrated in Table 40, a basic X-Tax imposed at a 15% rate on *E* and *Y* would yield the sovereign's desired $4 of expected tax revenue from the entity sector. But such a tax rate would not produce revenue neutrality when all taxes were taken into account, since the X-Tax would eliminate any second level of tax—that is, an individual income tax—on *E*'s participants' receipts of interest, dividends, or after-entity-tax royalties.

TABLE 40
BASIC X-TAX

	State 1	*State 2*	*State 3*	*Expected*
Entity's income	($2.00)	$14.00	$30.00	14.00
Y's income	6.00	13.00	20.00	$13.00
Taxes				
Taxable income	$4.00	$27.00	$50.00	–
Tax at 15%	0.59	4.00	7.41	$4.00

[231] David F. Bradford, What are Consumption Taxes and Who Pays Them?, 39 Tax Notes 383 (Apr. 18, 1988) (discussing the basic tax and several alternatives).

[232] Id. at 384, 387-88.

[233] Id. at 384.

[234] See Table 37.

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TABLE 41
ALTERNATIVE X-TAX

	State 1	*State 2*	*State 3*	*Expected*
Entity's income	$26.00	$49.00	$72.00	$49.00
Y's income	6.00	13.00	20.00	$13.00
Taxes				
Taxable income	$32.00	$62.00	$92.00	–
Tax at 6.5%	2.06	4.00	5.94	$4.00

The alternative X-Tax would have an entity tax base that includes all receipts and allows a deduction only for payments made to other businesses.[235] Thus, wages would be part of its entity tax base. As illustrated in Table 41, an alternative X-Tax imposed at a 6.5% rate on *E* and *Y* would yield the sovereign's desired $4 of expected tax revenue from the entity sector. But as above, such a tax rate would not produce revenue neutrality when all taxes were taken into account, since the X-Tax would eliminate any second level of tax—that is, an individual income tax—on *E*'s participants' receipts of interest, dividends, or after-entity-tax royalties, and, in this case, also would eliminate any incremental individual income tax on wages (replacing such tax with a partial credit).

Of course, it is not necessary for Bradford's individual tax regime changes to accompany his proposed entity tax regime changes. Thus, viewed solely as an incremental tax on entities, the alternative X-Tax would produce a tax base that is identical to the tax base under a subtraction method value-added tax. Thus, a VAT imposed at a 6.5% rate is yet another entity tax alternative for a sovereign to consider.

Finally, it is worth noting that the alternative X-Tax and a subtraction-method VAT would have tax bases that are quite similar to my proposed entity income tax. The chief differences are that the entity income tax (1) would incorporate income-tax-type cost recovery for depreciable and amortizable assets, (2) would allow partial cost recovery for labor, and (3) would exempt from tax any economic activity conducted by an economic unit that is too "small" to be classified as an entity. Despite these differences, it would not be entirely incorrect to call my proposed entity income tax a subtraction-method income VAT. What conclusion should be drawn from this? None, I think, since the congruity is unsurprising. After all, my entity income tax was designed to measure and tax a kind of "value added," the incremental economic return made possible by taking advantage of entity organizational form. This is not exactly the same value added that is

[235] Id. at 387-89.

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measured by a VAT. But given the need to use a proxy to measure it, it is not surprising to find that the best such proxy is a VAT.

D. A Rough Estimate

The foregoing illustrations based on a single entity give the flavor for the type of rate reduction that might be accomplished by replacing the current corporate income tax with my proposed entity income tax. I now generate a more accurate estimate, based on real numbers. Thus, in 1998, IRS statistics show corporate income tax collections of $182 billion on net corporate taxable income of $838 billion, for an effective corporate income tax rate of 21.7%.[236]

The first required adjustment is that such reported taxable income included $20 billion of dividends,[237] all of which must be excluded under the participations-received deduction. The second required adjustment is for human capital. Thus, corporations deducted $1,614 billion of salaries and wages, $357 billion of compensation of officers, $195 billion for employee benefit programs, and $72 billion for pensions.[238] Assuming that a 20% deduction for human capital expenditures would obtain under the entity tax (an ad hoc "average" of the deductions I divined in Section IV for executives and rank-and-file workers), the net effect of disallowing a deduction for all but this amount of human capital expenditure would result in an add-back of $1,790 billion.

Interest, rents, and royalties require more subtle handling. The entity income tax would affect these items in two ways. First, none of the interest and only part of the rents and royalties (the part corresponding to cost recovery) would be deductible, since these items represent participations in the entities paying them. Second, however, the portion of these items received from other corporations would be excludible under the participations-received deduction. To take the former first, corporations paid $967 billion of interest and $308 billion of rent for business property, for an aggregate deduction of $1,275 billion that would be almost entirely disallowed.[239] In addition, corporations received $1,228 billion of interest and $202 billion of rents and royalties.[240] Unfortunately, the statistics do not break out the portion of these receipts that are from other corporations. Logically, however, such amount cannot be greater than $967 billion in the case of interest and $202 billion in the case of royalties. If so, the very most

236 IRS, Statistics of Income 1998: Corporation Income Tax Returns 82 tbl. 1 (2001).

237 Id. at 95 tbl. 3.

238 Id. at 96 tbl. 3.

239 Id.

240 Id. at 95 tbl. 3.

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that would need to be excluded from entity taxable receipts would be $1,169 billion. Using this very conservative figure, the net effect would be to add merely $106 billion, reduced by a cost recovery allowance, to the entity income tax base. Arbitrarily setting the cost recovery allowance at 33%, $71 billion would be added to the tax base.

In addition, the entity income tax would include in its tax base income generated by tax partnerships. For 1998, IRS statistics show partnership business income of $89 billion and partnership net real property income of $27 billion.[241] Partnerships also earned a considerable amount of portfolio income, but I ignore that under the assumption that most such income would be excludible from the entity income tax base under the participations-received deduction. Adding returns to human capital yields additional partnership income of $138 billion, composed of $143 billion of salaries and wages, $18 billion of guaranteed payments to partners, $8 billion for employee benefit programs, and $3 billion for pensions,[242] less an amortization deduction that I again set at 20%.

In addition, partnerships paid $73 billion of interest and $28 billion of rent for business property, for an aggregate deduction of $101 billion that largely would be disallowed under the entity tax.[243] They also received $51 billion of interest (which I already excluded as portfolio income), $27 billion of rents, and $4 billion of royalties.[244] Under the unrealistically conservative assumption that all of the rental income and all of the royalty income was received from other partnerships, I exclude $31 billion from my estimate. Thus, there would be an additional net amount of $70 billion of income.

Of course, it is within the realm of possibility that some partners in partnerships are corporations, and therefore that some fraction of reported partnership income already has been reflected in the corporate income results discussed above. The absolutely unrealistically most conservative amount of such income is all of it, except for the piece attributable to human capital. Thus, in keeping with conservatism, I subtract out $186 billion of partnership income. Finally, I also ignore all income generated by tax-exempt organizations. Nevertheless, even with my very conservative assumptions, entity income in 1998 would have been at least $2,817 billion, as illustrated by Table 42. Thus, an effective entity tax rate of only 6.5% (and quite possibly less) would have yielded the same $182 billion of entity tax revenue as the corporate income tax in fact produced.

[241] IRS, Statistics of Income 1999: Partnership Returns 75 tbl. 1 (2000).

[242] Id.

[243] Id.

[244] Id.

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TABLE 42
ENTITY INCOME, 1998

	Corporations	
Net income reported	$ 838	
Dividends	(20)	
Wages (net)	1,790	
Capital (net)	71	conservative
	Partnerships	
Net income reported	$ 116	
Wages (net)	138	
Capital (net)	70	conservative
Allocated to entities	(186)	conservative
	Tax-Exempts	
Net income	0	conservative
	$2,817	

Assuming that nominal tax rates would fall in the same proportion as effective tax rates, the entity income tax would have a nominal tax rate of 10.4%.[245] But nominal rates under the entity tax would likely fall disproportionately further than effective tax rates. The reason is that, under the entity income tax, gains from tax planning would be greatly reduced.[246] Thus, under current corporate income tax rates, an entity will pay up to $54 in real resources to engage in a transaction that produces a wholly artificial taxable loss of $100, provided that the corporation has complete confidence that the loss cannot be disallowed.[247] Of course, it is not generally possible to have such complete confidence, so the corporation would need to engage in a more complicated calculation, with probabilistic assessments of victory, loss, settlement opportunities, penalties, litigation costs, and the like. But at the end of the day, it would arrive at an amount of real resources, greater than zero and less than $54, that it would be willing to expend for the artificial taxable loss.

On the other hand, under the entity income tax, the nominal tax rate of 10.4% would reduce to at most $11.61 the amount that the

[245] The ratio of 6.5 to 10.4 is the same as the ratio of 21.7 to 35.

[246] Opportunities would be greatly reduced as well. Thus, tax shelters based on capital structure—attempts to deduct returns to equity-like participants—would be eviscerated. The benefits to be reaped from eliminating these kinds of tax shelters already are taken into account in the text, since deductions for interest expense and the like have been disallowed. The remaining types of tax shelters are those based not on capital structure, but on other infirmities in the Code. These are the infamous circles of cash: A dollar travels in a circle, with absolutely no economic consequences, but produces, as a result of its travels, a wholly fictitious net deduction.

[247] Since the $54 paid would be deductible, the total taxable loss from the transaction is $154, which produces a tax savings at a 35% nominal tax rate of $54.

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entity could pay to generate an absolutely certain artificial taxable loss of $100.[248] Thus, many (or even most) tax shelters that are profitable from a corporation's vantage under current law would cease to be profitable under the entity income tax, and so would disappear. When the taxes resulting from the disappearance of such tax shelters are taken into account, it seems clear that the nominal tax rate necessary to achieve entity income tax revenue neutrality would fall still further under the entity income tax.

VIII. Conclusion

This Article began with a search for a theoretical underpinning that could explain the structure of the current corporate income tax regime, and found such underpinning lacking. It proposed an alternative underpinning for a "corporate" income tax based on the theory of the firm. The basic idea is that every firm generates incremental economic returns that would not be achieved but for its organizational structure as a firm. Thus, a sovereign could rationally choose to confiscate a portion of such returns, since it has made such returns possible (by enacting legislation that recognizes firms, etc.). (Whether or not a sovereign should confiscate a portion of such returns is a different matter entirely.) If it chooses to do so, the resulting "corporate" tax would not be a corporate tax at all, but a tax on all entities.

The Article then showed how such an entity income tax might be structured. My strategy was to model the entity income tax on the current corporate income tax, which nominally burdens all (but only) corporate equity participants. Thus, the entity income tax nominally burdens all (but only) those taxpayers who plausibly benefit from conducting their economic activity in entity organizational form. I labeled such beneficiaries "participants," and demonstrated that this group includes not only equity owners within the parlance of current tax law, but debt owners, lessors and licensors, and, most significantly, almost all employees. I then imposed a nominal entity income tax burden on participants by generally denying all entity deductions for payments or allocations made to participants. This proved to be a complicated task, since it was not always obvious how to disaggregate a payment or allocation to a participant into a participation component and a "return of capital" component.

After having defined entity income, I embarked on the related task of finding a robust definition of "entity." That is, a good entity in-

[248] Under the generous but not inevitably correct assumption that the $11.61 paid would be deductible, the total taxable loss from the transaction would be $111.61, which would produce a tax savings at a 10.4% nominal tax rate of $11.61.

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come tax must be robust, and robustness is a function of two factors: It must be absolutely clear which economic actors are entities and it further must be absolutely clear how the income of such entities is to be calculated. The real trick here was to prevent income that should or reasonably could be considered to be entity income from being swept out of the entity income tax base. Current tax law permits a host of mechanisms that do just that, ranging from the trivial (debt instruments, nonqualified options) to the sublime (swaps, hedges). The entity income tax neutered trivial mechanisms by designating those who employ them as participants. It neutered sublime mechanisms by also designating those who employ them as participants. That is, any individual who engages in a risk-shifting transaction with an entity would be a participant in the entity, with the result that all of the income paid or allocated to her would be in the entity income tax base. It follows that what matters to the entity income tax is only and exactly the set of assets actually controlled, operated, and managed by an entity, and the income such assets produce. Once the income is produced, the manner in which it is shared by various taxpayers, that is, by participants, has no further effect on the entity's taxable income. Thus, under the entity income tax, capital structure, in the very broadest sense of the term, would be entity income tax irrelevant.

Finally, the Article compared my proposed entity income tax to various other entity tax schemes. In general, my tax bears a relatively strong family resemblance to the entity portion of the alternative X-Tax (although not to the X-Tax scheme in general) and thus also to a subtraction-method income VAT. But there are also considerable differences, for example in deciding who should be subject to tax (that is, on the question of what is an entity). These differences are not surprising: They result directly from the theory-of-the-firm based foundation of my proposed entity income tax. Still, despite the differences, anyone who takes tax reform seriously is likely to consider each of these taxes to be a relatively good substitute for each other.

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