SHOULD TAX LAW MIND MINORITY AND MONITOR MAJORITY: THE CASE OF UNDISTRIBUTED DIVIDENDS AND THE ABILITY-TO-PAY PRINCIPLE

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This paper analyzes the tax problem of undistributed dividends through the agency problem lens. Or actually, vice versa. It utilizes both corporate governance tools and tax rationales to address the taxation of undistributed dividends in closely held corporations. The joint discussion of both fields is uncommon and has, thus far, been employed mainly to explain the problem of two-tier taxation or problems occurring in large corporations. Not only is the cumulative discussion of both corporate governance and taxation uncommon, but the conclusion that these legal fields are coherent is even rarer.

The paper argues that taxing all shareholders – both minority and majority – on undistributed dividends deviates from the ability-to-pay principle and thus is inequitable. More specifically, the paper examines how the ability-to-pay principle can justify the taxation of undistributed dividends in closely held corporations where conflicts between minority shareholders and majority shareholders may arise. It discusses both the taxation of undistributed earnings at the shareholder level and at the corporate level, and restricts itself to the agency problem of dividend deprivation, or non-distribution.

The division between ownership and control in closely held corporations, when minority shareholders are exploited, undermines the justification of taxing minority shareholders on undistributed-deemed dividends. Thus, it is argued that the above question is linked to the agency problem, and the power to control dividend payments. Namely, it is claimed that whenever an agency problem occurs the ability-to-pay principle should be understood in terms of the ability to control dividend payments. As a re-

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sult, to achieve equitable taxation, deemed dividend distribution rules should not be applied to minority shareholders.

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I. INTRODUCTION

Assume, a hypothetical but very plausible scenario, that you have invested a substantial fortune and effort in a small corporation. So far you and the other controlling shareholders managed to run the corporation in harmony. Though recently, due to an acute disagreement with them, they try to unwind your holdings. They do it elegantly (after consulting the matter with their lawyer). They do not threaten you or send legal letters. Nothing is being done explicitly. But since the current controlling shareholders, who serve also as directors, are aware that you are in a financial stress, (remember – you invested substantially in the corporation) they made a decision not to distribute dividends. Now, you face a dual financial problem. First, you get no cash from your corporation; second, according to the law you may be forced to pay tax on the undistributed dividends. You could cry out loud: "it's not fair" and you could sue them and litigate for ages relying on corporate rules. This paper would like to demonstrate that the remedy is not limited to corporate governance but also to taxation – tax law could and should assist you too as a minority shareholder. If you are interested to know how taxation could and should assist minority shareholders in such a state, you are welcome to read the paper. This paper addresses this quandary via the analysis of tax rational, agency costs theory, and interpretation of the "ability-to-pay principle."[1]

The paper analyzes the tax problem of undistributed dividends through the agency problem lens. Or actually, vice versa. It utilizes both corporate governance tools and tax rationales to address the taxation of undistributed dividends in closely held corporations. The joint discussion of both fields is uncommon and has thus far been employed mainly to explain the problem of two-tier taxation or problems occurring in large corporations.[2] In that respect, the focus of attention (if any) was given so far to widely held corporations and not necessarily to closely held corporations.[3]

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1. This principle is the most popular justification principle for taxation nowadays (see the discussion below in Chapter II.) and the premise of this paper is the superiority of this principle.

2. *See* discussion *infra* note 89, Chapter III. (A); *see e.g.*, Michael A. Behrens, *Citizens United, Tax Policy, and Corporate Governance*, 12 FLA. TAX REV. 589, 591 (2012) (discussing the Citizens United v. Federal Election Commission, 130 S. Ct. 876, 917 (2010) verdict, which by facilitating tax motivated corporate-political speech would increase corporate governance conflicts).

3. *See* Douglas K. Moll, *Shareholder Oppression & Dividend Policy in the Close Corporation*, 60 WASH. & LEE L. REV. 841, 842 (2003).

The core concept of the ability-to-pay principle is that tax should be levied in accordance with peoples' economic well-being. This paper examines how the ability-to-pay principle could validate the taxation of undistributed dividends (or as referred to – de jure dividends) in closely held corporations. It argues that this question is linked to the agency problem and the power to control dividend payments. In other words, it is claimed that the ability-to-pay principle should be understood in terms of the ability to control dividend payments whenever an agency problem occurs. In restricting the analysis to majority/minority problems in closely held corporations, the paper analyzes the problem of dividend deprivation, or non-distribution, which is an acute problem for minority shareholders.

In addressing the aforesaid, the paper differentiates between *de facto* dividends and *de jure* dividends (defined in Chapter III. (B) below), centering the discussion only on the latter. De facto dividend refers to the classical case of taxing dividends when distributed; the tax unit is the receiver of the distribution (usually, the shareholder).[4] De jure dividend means taxation of dividends which are deemed to be distributed and is common to various tax systems.[5] These dividends are realized though not distributed. De jure dividends are grouped into two subcategories: de jure "dividends" which are taxed at the corporate level (*i.e.*, the tax unit is the corporations in jurisdictions applying two-tier taxation).[6] The paper refers to taxing accumulated earnings at the corporate level as de jure dividends since tax law usually treats these earnings as dividends that should have been distributed to shareholders, but were accumulated at the corporate level, and de jure dividends which are taxed at the individual level.

In the first subcategory of de jure dividends where tax law sanctions corporations for not distributing earnings (*e.g.*, accumulated earnings provisions) (discussed in Chapter III. (C) below), one does not face a special problem in applying the ability-to-pay principle. Moreover, tax law and corporate law go hand in hand since agents have incentives to reduce their tax burden.[7] Naturally, in a closely held corporation, corporate tax has more

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4. *See* Moll, *supra* note 3, at 877.

5. *See* I.R.C. § 316 (defining dividend as a distribution of property by a corporation to its shareholders). All references to the Internal Revenue Code in this paper are to the most recently published editions unless otherwise indicated.

6. *See id.*In addition, this paper accepts the practice of both entity and integrated tax. The profound, long-lasting discussion, whether a tax system should employ either entity tax and/or integrated tax is beyond the scope of this paper.

7. Hideki Kanda & Saul Levmore, *Taxes, Agency Costs and the Price of Incorporation*, 77 VA. L. REV. 211, 226-27 (1991).

impact on shareholders than in large corporations.[8] The larger the concentration of ownership of shareholders in the corporation, the higher is their incentive to avoid this tax sanction.

With regard to the second subcategory – de jure dividend at the shareholders' level (*as applied to*, Controlled Foreign Corporations and S Corporations) (discussed in Chapter III. (D) below) – it is claimed here that this fiction – taxing undistributed earnings as if they were distributed as dividends – cannot be upheld and justified according to the ability-to-pay principle when an agency problem occurs. The key feature behind this argument rests with minority's powerlessness and lack of control. When minority shareholders have no control, especially over their wealth, the ability-to-pay principle cannot justify taxing them on de jure dividends. Thus, whenever an agency problem arises, the ability-to-pay principle should be understood in terms of the ability to control the distribution of dividends.

Without this understanding of the ability-to-pay principle, minority shareholders are not only deprived of dividends but forced to pay tax on these dividends – taxation that might put them under unwarranted financial stress.

The paper also shows that, by applying this designation to the ability-to-pay principle, tax law may alleviate or at least not augment the dividend deprivation problem.[9] This paper is structured as a trilateral pyramid having two layers: the basis and the vertex. The basis is built on three blocks. Each of the first three chapters represents a different block: Chapter I delineates agency conflicts raised in closely held corporations; Chapter II discusses the ability-to-pay principle, a common principle used in tax systems to accomplish fairness. And Chapter III discusses the phenomenon identified as de jure dividends where tax systems tax undistributed income as if they were distributed. All three chapters merge in the pyramid's vertex, discussed in Chapter IV. Chapter IV introduces a core feature in the discussion – the power to control – and progressively combines all of the aforementioned chapters into one chapter endeavoring to answer the aforesaid question. The last chapter briefly summarizes the conclusion and recommendations.

8. Daniel J. Morrissey, *Another Look at the Law of Dividends*, 54 U. KAN. L. REV. 449, 475-77 (2006).

9. For a more extensive discussion on the ability of tax law to mitigate the agency problem, see LIMOR RIZA, THE IMPACT OF CORPORATE TAXATION ON THE PRINCIPAL AGENT PROBLEM 171-81 (Peter Lang, 2003) and *infra* note 124.

II. AGENCY PROBLEMS

A. *Foreword*

This subchapter constructs the first pyramid's basis. It adumbrates the agency problem and focuses on the minority-majority problem, and mainly on the problem of depriving dividends of minority in closely held corporations.

As the informed reader will already know, principal-agent problems are a ubiquitous problem in economic transactions.[10] The core of the agency problem is the separation of ownership and control.[11] The agency problem within corporations comprises three categories of conflicts: the conflict between managers and shareholders, the conflict between minority and majority shareholders, and the conflict between the corporation itself and third parties.[12] The discussion in this paper is limited to the conflict between minority and majority.[13]

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10. *See* Kenneth J. Arrow, *The Economics of Agency*, *in* PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 37, 37 (John W. Pratt & Richard J. Zeckhauser eds., Harvard Business School Press 1985) (noting that "[t]he agency relationship is a pervasive fact of economic life"); *see also* Eric A. Posner, *Agency Models in Law and Economics*, *in* CHICAGO LECTURES IN LAW AND ECONOMICS 225, 233 (Eric A. Posner ed., Foundation Press 2000). Agency problems emerge due to both asymmetric information and conflict of interest among parties. *See generally, e.g.*, John W. Pratt & Richard J. Zeckhauser, *Principals and Agents: An Overview*, *in* PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 1, 3 (John W. Pratt & Richard J. Zeckhauser eds., 1985). Asymmetric information in this context indicates that the agent is better informed than the principal. *Id.* Where there is a conflict of interests, the agent, depending on his possible payoffs, may be induced to act opportunistically and pursue his own interests at the expense of the principal. *Id.* Clearly when the interests of the informed agent are not aligned with the principal's interests, and there is an information asymmetry, the former has both incentives and a certain capacity to conceal valuable information. *Id.* Poor information may lead the principal to make poor and inefficient decisions. *Id.* Monitoring the agent can reduce this problem, but monitoring is costly and, therefore, occasionally impractical. *Id.* For an introduction to this literature, see for example, AMIR BARNEA, ROBERT A. HAUGEN, AND LEMMA W. SENBET, AGENCY PROBLEMS AND FINANCIAL CONTRACTING 1 (Prentice-Hall, Inc. 1985).

11. *See* Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737, 740 (1997).

12. *See* John Armour, Henry Hansmann & Reinier Kraakman, *Agency Problems and Legal Strategies*, *in* THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 35, 36 (Reinier Kraakman et al. eds., Oxford 2d ed. 2009) [hereinafter *Agency Problems*]. The first conflict arises when managers (agents) advance their own interests instead of shareholders' (principals) interests. *Id.* The second agency problem arises within the shareholders where majority shareholders (referred to as agents) seek to expropriate minority shareholders (principals). *Id.* The last category of agency costs arises between the firm (jointly referring to shareholders and managers) and third parties contracted with the firm (such as creditors, employees, suppliers and customers). *Id.* Here, the conflict arises when shareholders, via the firm, have the opportunity to exploit third parties (principals). *Id.*

13. Since the paper is not concerned with the side effects of this conflict, the efficiency arguments on which this discussion is based are largely founded upon Pareto effi-

Traditional law and economic discussions suggest two principle methods to solve agency conflicts.[14] First, it offers incentive mechanisms, such as performance-based compensation, to induce agents to follow principal's interests.[15] Second, it utilizes controlling and constraining mechanisms.[16] However, since the discrepancy between minority and majority interests is multiform, not too many specific mechanisms have evolved to protect minority shareholders, and the ones which have developed, are not always adequate. For example, mandatory dividends, briefly discussed below, may solve the agency conflict of withholding dividend distribution but they intervene with directors' discretionary and business latitude. The solution offered in this paper does not suffer from this kind of externality. Not only does it not carry any negative by-product but it simultaneously promotes equitable treatment.

B. *The Distinctive Features of Minority-Majority Conflicts*

The minority-majority conflict prevails mainly in closely held corporations.[17] For the purpose of the paper, a "closely held corporation" is defined as a corporation that contains the following accumulated features: first, a corporation is held by relatively few shareholders; second, its shares cannot be freely traded on

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ciency. Pareto efficiency means that one person is better off without causing the other person's situation to be worse off. *See, e.g.*, OECD, GLOSSARY OF STATISTICAL TERMS, *Pareto Efficiency* (Mar. 10, 2003), http://stats.oecd.org/glossary/detail.asp?ID=3275. Armour, Hansmann and Kraakman measure welfare on Kaldor-Hicks efficiency criteria with some distribution elements. *See* John Armour, Henry Hansmann & Reinier Kraakman, *What is Corporate Law*, *in* THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 1, 28 (Reinier Kraakman et al. eds. Oxford 2d ed. 2009) [hereinafter *Corporate Law*].

14. *See, e.g.*, Posner, *supra* note 10, at 225-26.

15. *Id.* at 226.

16. *Id.* at 225-26.

17. *See* 12B WILLIAM MEADE FLETCHER, FLETCHER CYCLOPEDIA OF THE LAW OF CORPORATIONS § 5820.10 (2012). In large corporations it may carry other forms such as block-holders. *See id.* § 5845. Though, corporate governance structures in continental European countries differ markedly from the stock ownership pattern in the United States and Great Britain. Klaus J. Hopt, Professor, Max Planck Inst. for Foreign Private & Private Int'l Law, Modern Company Law Problems: A European Perspective, Keynote Speech at Company Law Reform in OECD Countries: A Comparative Outlook of Current Trends 4 (Dec. 8, 2000). Frequently, ownership is highly concentrated in continent corporations. *See id.* Due to this difference, the conflict between minority and majority is typical in the former countries, whereas the conflict between managers and shareholders is more acute in the latter countries. *See id.*; *but see* Rafael La Porta, Flórencio Lopez-de-Silanes, Andrei Shleifer & Robert Vishny, *Investor Protection and Corporate Valuation*, 57 J. FIN. 1147, 1160-61 (2002) (revealing that empirical research seems to indicate that the conflict between minority and majority is also significant in Anglo-Saxon countries).

the open market;[18] and third, its managers are the largest residual claimants.[19]

A controlling shareholder who has the power to exploit the minority usually holds the management position.[20] Consequently, the discussion on majority-minority conflict bears some similarities to the manager-shareholders conflict, where majority shareholders perform as managers. For example, self-dealing by a manager resembles the discussion of self-dealing of a majority shareholder; the former misbehaves at the cost of all shareholders and the latter at the expense of the minority. However, the focus here on depriving dividends is unique to the discrepancy between minority and majority interests.

Majority shareholders may misuse their control and exploit minority shareholders.[21] They have developed various techniques to oppress minority shareholders in their jointly held corporation, where the lack of an active market for closely-held corporation shares facilitates majority shareholders to self-serving behavior.[22]

A useful technique to suppress minority shareholders, which is fundamental for the ensuing discussion, is to deprive them of liquidated funds.[23] Majority shareholders have the ability to ei-

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18. *See* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 228-30 (1991) (similar (and analogous) to partnerships and contrary to public corporations). For a look at trade restrictions on shares, see *Agency Problems*, *supra* note 12, at 41.

19. *See* EASTERBROOK & FISCHEL, *supra* note 18, at 228. For another definition of closely-held corporations, see also Sandra K. Miller, *Minority Shareholder Oppression in the Private Company in the European Community: A Comparative Analysis of the German, United Kingdom, and French "Close Corporation Problem"*, 30 CORNELL INT'L L.J. 381, 383 (1997).

20. *See, e.g.*, Simon Johnson, Rafael La Porta, Flórencio Lopez-de-Silanes & Andrei Shleifer, *Tunneling*, 90 AMER. ECON. REV. 22, 23-25 (2001) [hereinafter *Tunneling*].

21. *See* ALAN R. PALMITER, CORPORATIONS: EXAMPLES & EXPLANATIONS 571, 571 (7th ed. 2012). The two broad ways are through forceouts and/or freezeouts. *Id.* Forceouts and freezeouts are coined in the literature as "squeezeouts." *See id.* Through "forceouts," majority shareholders manipulatively restructure the corporation, resulting in minority shareholders losing their interest in the corporation. *See id.* Through "freezeouts," majority shareholders suppress minority shareholders and compel them to sell their shares on adverse terms. *See id.* at 572. Depriving dividends fall into this latter category. *See id.* Johnson et al. use the term "tunneling" instead of "squeezeouts" to describe the exploitation problem of minority shareholders. *See Tunneling*, *supra* note 20, at 22. This terminology, however, refers to a more limited expropriation; it describes only the transfer of assets from the corporation (usually publicly-held) to the hands of majority shareholders. *See id.* The term "tunneling" usually refers to shareholder exploitation in publicly-held corporations, however, its form of exploitation is valid also for closely-held corporations. *See id.*

22. *See* FLETCHER, *supra* note 17, § 5820.10.

23. The summary in this subsection is based mainly on WILLIAM H. PAINTER, PAINTER ON CLOSE CORPORATIONS: CORPORATE, SECURITIES, AND TAX ASPECTS (3d ed. 1999). For a comparative analysis of problems arising in closely-held corporations in Eu-

ther end minority's salaries and/or their dividends.[24] It is commonly accepted that, in highly concentrated corporations, shareholders run the corporation and function as officers.[25] As the largest residual claimants, majority shareholders can stop minority-shareholders' employment. Consequently, minority-shareholders are left unemployed without employment-related income. Furthermore, majority shareholders can go one step further and decide to reduce or cease dividend distribution to all shareholders. As a result, a minority shareholder, who once used to enjoy a salary and dividend income, may lose both sources of income due to majority coercion. Whilst depriving a minority of salary and dividends, majority shareholders can provide themselves with larger and even exorbitant salaries. Naturally, this can easily be concealed with agile reasoning. For example, majority shareholders who act as managers can disguise their intention to exploit the minority and claim that the decision to withhold dividend distribution is due to a high tax rate.[26] This specific agency conflict is as aforesaid the focus of the paper.

In an ideal world, dividend policy has no effect on shareholders' wealth.[27] Since we do not live in a prototypical world – dividend policy does matter. There are various agency models of dividends.[28] These theories in general endeavor to explain how dividends can discipline controlling shareholders.[29] The basic thought is that dividend distributions prevent inside shareholders from using free cash flows for private benefits of control or for unproductive projects.[30] In this agency perspective, dividends are

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ropean countries, see Miller, *supra* note 19, at 382. Courts have developed three mechanisms to evaluate oppression. Moll, *supra* note 3, at 853. The first mechanism measures if majority's conduct was "burdensome, harsh and wrongful" and if they conducted their performance unfairly. *Id.* The second mechanism emphasizes the breach of fiduciary duties. *Id.* The third mechanism, which seems widespread, examines if majority's behavior harms minority's reasonable expectations; oppressive in this aspect means that if minority had known majority would have acted in this manner, they would have not entered the joined venture. *Id.* at 853-54.

24. *See* EASTERBROOK & FISCHEL, *supra* note 18, at 233.

25. *Id.* at 228-29, 233.

26. *See, e.g.*, Behrens, *supra* note 2, at 590-91.

27. According to the Modigliani and Miller theorem the value of the firm is independent of the form of finance – equity or debt. *See* RICHARD A. BREALEY, STEWART C. MYERS & FRANKLIN ALLEN, PRINCIPLES OF CORPORATE FINANCE – GLOBAL EDITION 446 (10th ed. McGraw-Hill). This theorem is naturally based on some prerequisites, such as no taxes and agency costs – conditions which do not apply in the real world. *See id.*

28. *See* Rafael La Porta, Flórencio Lopez-de-Silanes, Andrei Shleifer & Robert W. Vishny, *Agency Problems and Dividend Policies Around the World*, 55 J. FIN. 1, 7 (2000) [hereinafter *Dividend Policies*].

29. *See Corporate Law*, *supra* note 13, at 5-6.

30. *See* Lucian A. Bebchuk, Reinier Kraakman & George Triantis, *Stock Pyramids, Cross-Ownership, and Dual Class Equity: The Mechanisms and Agency Costs of Separat-*

better than accumulated earnings.[31] Moreover, if no retained earnings are available when the corporation requires cash to run its business, managers are forced to raise funds in the open market. When there is an enduring commitment to distribute dividends, corporations lose their option to fund new projects from accumulated earnings and are forced to address the open market for raising capital. The open market is an effective mechanism to supervise managers.[32] Easterbrook draws the analogy from interests and debt to dividends and equity.[33] Other scholars center their model on the power of shareholders towards managers.[34] In cases where shareholders can vote for the dismissal of managers or for the firm's liquidation, managers are induced to distribute dividends.[35]

Some existing legal mechanisms based on labor, contract and corporate law could mitigate this problem.[36] However, vari-

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ing Control from Cash-Flow Rights, in CONCENTRATED CORPORATE OWNERSHIP 295, 309-10 (Randall K. Morck ed., 2000) (leverage might serve as a commitment device for CMS controllers who wish to refrain from exploiting their opportunities to take private benefits. Thus, debt financing can limit controller latitude to invest in negative net-present-value projects by forcing firms to distribute free cash to investors).

31. *See Dividend Policies*, *supra* note 28, at 6-7.

32. *See Agency Problems*, *supra* note 12, at 40-42.

33. *See* Frank H. Easterbrook, *Two Agency-Cost Explanations of Dividends*, 74 AM. ECON. REV. 650, 653, 656 (1984).

34. *See id.* at 650.

35. *See e.g.*, references stated in Shleifer & Vishny, *supra* note 11, at 765. In the paper *Dividend Policies*, *supra* note28, the authors empirically examine two agency models: The "outcome model" (dividend distribution as an outcome of legal protection of minority) and "substitute model" (dividends as a substitute for legal protection of shareholders, where the quality of legal system is not good and dividend policy signals investors of the firm's attributes). They examine in which jurisdictions high dividend distributions are plausible. *But see* Brian R. Cheffins, *Dividends as a Substitute for Corporate Law: The Separation of Ownership and Control in The United Kingdom*, 63 WASH. & LEE L. REV. 1273, 1274-1338 (2006). Cheffins presents a somewhat different approach concerning the "law matter" thesis; in brief, the law matter thesis is that due to poor corporate regulation and weak protection to stockholders, widely held corporations will not be prevailed in the market. *See id.* at 1278-79. The author claims that the economic law matter thesis did not prove itself in the United Kingdom. *See id.* at 1275, 1332. This paper suggests that a plausible reason is due to the dividend policy of publicly quoted firms. *E.g.*, *id.* at 1275, 1309, 1332. Empirical evidence shows that UK widely held corporations tended to pay dividend to shareholders and wished not to depart from past practices (probably to keep shareholders "quiet"). *See id.* at 1308. This practice induced investors to purchase shares in widely held corporations. *See id.* at 1302.

36. For example, a minority shareholder may enter into an employment and compensation agreement with a corporation. This employment agreement may to some extent protect the shareholder-employee from arbitrary and unjustified dismissal. The employment agreement may be valid for a long, however, reasonable duration. For more protective mechanisms, which could be specified in an employment contract see, for example, PAINTER, *supra* note 23, at 4:6. Some other mechanisms such as obligatory dividend distribution (which are proportional to the corporation's profits), high voting and quorum requisites, EASTERBROOK & FISCHEL, *supra* note 18, at 233, shall additionally alleviate the majority's "oppressive" behavior. Naturally, there are other oppressive techniques, for

ous mechanisms do not always assist if we take into consideration the inception of this minority-majority problem. Regardless of the thesis explaining the goal of corporate law,[37] two common features exist with respect to minority-majority conflict. One feature focuses on the time a corporation was conceived and the other on the imbalance of hierarchical power between the parties – features that are unique to minority-majority agency problem (contrary to other agency costs). First, the conflict arises in many instances ex post, not ex ante. Thus, parties do not anticipate this problem. For example, on many occasions shareholders establish a closely held corporation as a united group.[38] The conflict between shareholders evolves later after the corporation has been founded. Therefore, during the inception and the formulation of the article of incorporation shareholders have not yet been identified as either minority or majority. Second, even if they had anticipated this problem, minority shareholders would have been in no position to negotiate their rights.[39] The two above mentioned features insinuate that not too many non-compulsory legal mechanisms could moderate this agency problem. Thus, it supports to some extent mandatory rules with regard to minority-majority conflicts.[40] Some jurisdictions, therefore, apply manda-

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example, by issuing additional shares. *See id.; see also* Rafael La Porta, Flórencio Lopez-de-Silanes, Andrei Shleifer & Robert W. Vishny, *Law and Finance*, 106 J. POL. ECON. 1113, 1114 (1998) [hereinafter *Law and Finance*] (it is not sufficient to protect minority by law (for example, by granting voting rights, pro rata dividends etc.) but in general with regard to widely held corporations the legal system should be properly enforced).

37. *See* James E. Vallee, *Beyond Reproach: Management Entrenchment Through the Texas Business Combination Law*, 30 TEX. TECH L. REV. 1283, 1288 (1999). Is it only a contractual frame to firms, or is it designed solely to solve the agency problem?

38. *See* Tara J. Wortman, *Unlocking Lock-in: Limited Liability Companies and the Key to Underutilization of Close Corporation Statutes*, 70 N.Y.U. L. REV. 1362, 1367-68 (1995).

39. Easterbrook and Fischel note that "[a]ll the terms in corporate governance are contractual in the sense that they are fully priced in transactions among the interested parties." EASTERBROOK & FISCHEL, *supra* note 18, at 17. This sentence is valid when one considers two competing firms. In this situation, the terms carry a contractual character towards the competing parties. The terms, however, lose their contractual character when the competing parties are minority and majority. *Id.* They further write that:

> [t]hey are thereafter tested for desirable properties; the firms that pick the wrong terms will fail in competition with other firms competing for capital. It is unimportant that they may not be 'negotiated'; the pricing and testing mechanisms are all that matter, as long as there are no effects on third parties. This should come as no shock to anyone familiar with the Coase Theorem.

Id.

40. As mentioned,"[t]he mandatory dividend right may be a legal substitute for the weakness of other protections of minority shareholders." *See Law and Finance, supra* note 36, at 1128.

tory dividends.[41]Although mandatory rule discussion vindicates a distinct discussion, which is beyond the scope of this paper,[42] the paper offers an indirect mandatory approach to mitigate the dividend deprivation problem. Here tax law has an implied compulsory but positive effect on the agency problem, as elaborated below in Chapter IV.

It should be noted that despite an array of rights granted to minority shareholders,[43] it is plausible to claim that corporate law has made little progress in addressing the minority problem.[44] Thus, one may claim that if jurisdictions struggle unsuccessfully with minority-majority conflicts by exercising traditional tools, they should seek mechanisms that are more creative. If corporate law does not provide minority shareholders with sufficient protection, some further external protection should be welcome. One should keep this claim in mind throughout the paper.

The agency problem is re-addressed in Chapter IV. and, as aforementioned, focuses only on the problem of depriving dividends of minority.

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41. *Law and Finance*, *supra* note 36, at 1132. Mandatory dividends are a remedy measure applied in French civil law countries. *See id.* Those dividends assist in protecting shareholders with few legal rights. *See id.*

42. Lucian Arye Bebchuk, *The Debate on Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395, 1412 (1989) (claiming that even if one decides to adopt a nonmandatory rule, which the parties wish to change, one has to keep in mind that the "opting-out process is unlikely to be perfect and to realize all its potential gains."); *see also* Lucian Arye Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 HARV. L. REV. 1820, 1848-59 (1989) (claiming further that one should differentiate between two stages of time: time of forming the corporation and the midstream. The question of option out may also vary between those stages. Some value-decreasing amendments may be proposed in midstream (by managers or by a dominant shareholder in a public corporation). Although this amendment is value-decreasing it might be accepted. Thus he concludes that mandatory rules have an important role in midstream.).

43. *See Agency Problems*, *supra* note 12, at 37-44; Luca Enriques, Henry Hansmann & Reinier Kraakman, *The Basic Governance Structure: The Interests of Shareholders as a Class*, *in* THE ANATOMY OF CORPORATE LAW 55, 55 (2d ed. 2009).

44. *See, e.g.*, MODEL BUS. CORP. ACT § 6.23 (2002). In the section entitled "Share Dividends," section 6.23 states the following:

> (a) Unless the articles of incorporation provide otherwise, shares may be issued pro rata and without consideration to the corporation's shareholders or to the shareholders of one or more classes or series. An issuance of shares under this subsection is a share dividend. (b) Shares of one class or series may not be issued as a share dividend in respect of shares of another class or series unless (1) the articles of incorporation so authorize, (2) a majority of the votes entitled to be cast by the class or series to be issued approve the issue, or (3) there are no outstanding shares of the class or series to be issued.

Id.

III. PRINCIPLES OF TAX LAW AND THE ABILITY-TO-PAY PRINCIPLE

The ability-to-pay principle is at the heart of the paper and concisely means that tax should be levied in accordance with peoples' economic well-being. This discussion is relevant for establishing in our analysis its second pyramid's basis.[45] Though, a reader who is familiar with this tax discourse may pass over this Chapter. But before going any further with the analysis, it is necessary to recognize the basic premises of tax law – both its goals and principles. This discussion sets the basic premises for understanding the ability-to-pay principle.

The fundamental undisputed aim of tax law is revenue collection.[46] This is not to suggest that tax law has not been used to promote other social and economic goals, as tax laws have long been used to further regulatory objectives and to redistribute sources.[47] Some authors would argue that social and economic goals are inevitably inherent in tax systems, since governments are interested in redistribution.[48] Thus, it is widely accepted that tax law is not restricted to the revenue hoarding goal but also strives for wealth redistribution.[49]

Not only are the additional goals of tax law controversial,[50] but so are its principles.[51] The notion of what is the proper tax

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45. *See supra* note 9 and accompanying text.

46. *See* Robert E. Cushman, *Social and Economic Control Through Federal Taxation*, 18 MINN. L. REV. 759, 762–64 (1934) (recognizing, in 1934, that Congress had used the federal tax code to achieve social and economic goals). Various theories – such as economics and philosophy – have continuously examined if tax should be levied and what is a proper tax. *See, e.g.*, Herbert Hovenkamp, *The First Great Law & Economics Movement*, 42 STAN. L. REV. 993, 1002-10 (1990) (discussing various arguments made by economic theorists in the late nineteenth century regarding progressive taxation). Needless to say, the tax purposes presented at the outset of this chapter are not utterly acknowledged by scholars; for example, economists that support free-market economics (such as the Chicago School) oppose governmental interferences in the markets. *See* JOSEPH E. STIGLITZ, ECONOMICS OF THE PUBLIC SECTOR 5-6, 55-56 (W.W. Norton & Company, 2010). Libertarians such as Nozick, who favors individual freedom including the freedom on his private property and the minimal state, reject any coerced distribution of property. *See* Thomas C. Grey, *Property and Need: The Welfare State and Theories of Distributive Justice*, 28 STAN. L. REV. 877, 881-87 (1976).

47. *See* Reuven S. Avi-Yonah, *The Three Goals of Taxation*, 60 TAX L. REV. 1, 11 (2006).

48. *See* Cushman, *supra* note 46; MYRON S. SCHOLES ET AL., TAXES & BUSINESS STRATEGY: A PLANNING APPROACH 19–21 (4th ed., Prentice Hall 2009).

49. *See, e.g.*, HENRY CALVERT SIMONS, PERSONAL INCOME TAXATION 41 (1938) ("Income taxation is broadly an instrument of economic control, a means of mitigating economic inequality."); John G, Head, *Tax-Fairness Principles: A Conceptual, Historical, and Practical Review*, *in* FAIRNESS IN TAXATION 3, 19-20 (Allan M. Maslove ed. 1993) (holding theories related to the optimal tax approach such as Rawls, based social welfare not only on the total welfare of the society but also used a parameter based on each individual's utility); *see also* GEOFFREY MORSE & DAVID WILLIAMS, PRINCIPLES OF TAX LAW 4 (2004).

50. *See* Avi-Yonah, *supra* note 47, at 3.

has been echoed through the ages.[52] Adam Smith already noted in the eighteenth century four principles necessary for constructing a proper tax: a proper tax is an equal, certain and efficient tax, which also takes into account the convenience of taxpayers.[53] These principles are commonly accepted today.[54] Occasionally additional principles such as the neutrality principle are supplemented to Adam Smith's definition.[55]

One of the basic tax principles, which is not controversial per se, is the equity principle.[56] Despite far-reaching agreement that tax should be equal, scholars have long disputed the concept of equity – what is equity and how can it be reached.[57] Two prevailing and basic principles have been developed to accomplish this goal:[58] First, the benefit principle, and second, the ability-to-pay principle.[59] The benefit principle means that taxation shall be levied on individuals according to the benefits they receive from the government in public goods.[60] It follows the concept of market powers in which public services, like other products, have a price.[61] The second principle is the ability-to-pay principle.[62] Ac-

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51. *See* Patrick B. Crawford, *Analyzing Fairness Principles in Tax Policy: A Pragmatic Approach*, 76 DENV. U. L. REV. 155, 185 (1998) (discussing different methods for analyzing fairness in taxation).

52. Avi-Yonah, *supra* note 47, at 11.

53. ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 825-28 (R.H. Campbell & A.S. Skinner eds., 1979).

54. *See* Edward J. McCaffery, *A New Understanding of Tax*, 103 MICH. L. REV. 807, 829-55 (2005).

55. *See* RICHARD A. MUSGRAVE & PEGGY B. MUSGRAVE, PUBLIC FINANCE IN THEORY AND PRACTICE 235 (1980).

56. *See, e.g.*, LIAM MURPHY & THOMAS NAGEL, THE MYTH OF OWNERSHIP 12 (2002).

57. *See id.*

58. *See* Head, *supra* note 49, at 7; JOEL SLEMROD & JON BAKIJA, TAXING OURSELVES: A CITIZEN'S GUIDE TO THE DEBATE OVER TAXES 61–62 (4th ed. 2008). It should be noted that discussion on those principles focused mainly on personal income taxation and not on corporate taxation. *See generally* Head, *supra* note 49, at 7–10; SLEMROD & BAKIJA, *supra*, at 61.

59. Head, *supra* note 49, at 7–10; SLEMROD & BAKIJA, *supra* note 58, at 61–66.

60. SLEMROD & BAKIJA, *supra* note 58, at 62. On the benefit principle, see Joseph M. Dodge, *Theories of Tax Justice: Ruminations on the Benefit, Partnership, and Ability-to-Pay Principles*, 58 TAX L. REV. 399, 401-2 (2005). The benefit principle was developed from a contractarian principle to a quasi-exchange principle. *Id.* at 402–4. The contractarian principle deems a contract, between citizens and the government, where taxes are the costs citizens have to pay the government for enabling a civilized society. *Id.* at 402. The quasi-exchange principle means that people should pay taxes for the benefits they receive from the government. *Id.* at 403-4.

61. SLEMROD & BAKIJA, *supra* note 58, at 62. When an individual wishes to consume those public services, he is required to pay the price according to the benefit he gains from those services. *Id.* If the government wishes to tax, it should tax those who benefit from its services according to the level of benefit. *Id.* The government should not take into account other considerations such as redistribution of wealth. *Id.* at 63–64. Thus, libertarian views in favor of free property rights also support the benefit principle

cording to this principle, liability tax shall be imposed based on individual well-being.[63] In that perspective, tax liability based on this principle is unrelated to government expenditures.[64]

The basic thrust of this principle is that a well-off person has a higher ability to pay taxes than a poor person. Equity has two dimensions: Horizontal Equity – equal tax levied on people with the same economic ability – and Vertical Equity – different tax levied on people with different economic liability.[65]

Utilitarian views tried to conceptualize the ability-to-pay principle in at least two ways[66]: First, a wealthy person is able to pay higher taxes since his marginal utility from money diminishes.[67] Second, a wealthy individual can sacrifice a larger portion of his income, since he will be in a better position having more

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over the ability-to-pay principle. *Id.* at 64. Therefore, tax liabilities of individuals based on the benefit principle vary when governments adopt different expenditure policies. *See* Head, *supra* note 49, at 7–8. Two key criticisms are raised against the benefit principle. *See* SLEMROD & BAKIJA, *supra* note 58, at 62–64. First, it is claimed that this principle is impractical since it is difficult to assess benefits. *Id.* at 62. Second, the basic concept of the benefit principle does not take into account distributive justice, and thus is unjust. *Id.* at 63–64. Economists endeavored to alleviate this flaw in the model by evolving voting rules aimed at both reflecting a persons' will and achieving distributive goals. *See* Head, *supra* note 49, at 8–9. For example, the Swedish economist, Knut Wicksell, developed a voting rule of approximate/near unanimity. *Id.* at 9. This rule is designed to reflect as much as possible individuals' will to pay for public products according to their marginal willingness to pay. *Id.* Although, for the purpose of allocating resources, a voting rule based on majority-voting rule is preferable, and Wicksell's view is preferable to a constitutional aspect. *Id.* at 18. Some scholars have suggested a modified principle – named the "new benefit principle" – attempting to overcome the shortcomings of the benefit principle. Dodge, *supra* note 60, at 399. According to the new benefit principle, a person's benefit is his or her economic well-being. *Id.* For an expanded definition of the new benefit principle, see *id.* at 399–400, 406. For further discussion of the new benefit principle and its criticisms, see generally *id.* at 399–444.

62. SLEMROD & BAKIJA, *supra* note 58, at 62.

63. *Id.* at 64.

64. *See* Head, *supra* note 49, at 8. Income in this economic definition is the sum of consumption and increase of wealth (including savings) during a period of defined time. *See* HAROLD M. GROVES, TAX PHILOSOPHERS 80 (Donald J. Curran ed., 1974). Simons refined Haig's definition of income. *Id.* at 81; *see also* SIMONS, *supra* note 49 (for more on Simons' work). Haig said that "[i]ncome is the money value of the net accretion of one's economic power between two points of time." GROVES, *supra*. This formula does not differentiate with regard to individual income between the source of income and its recurrence. *Id.* at 81–82. This lack of differentiation supplemented to progressive tax enhances the equity principle. *See* SIMONS, *supra* note 49, at 41; Head, *supra* note 49, at 11–12.

65. *See, e.g.*, SLEMROD & BAKIJA, *supra* note 58, at 59, 87-89 (concerning vertical and horizontal equity). The main debate is on vertical equity and not on horizontal. *See id.* at 60; *see also* Head, *supra* note 49, at 1-12. *See generally* James R. Repetti, *Horizontal and Vertical Equity: The Musgrave/Kaplow Exchange*, 1 FLA. TAX REV. 607, 607-8 (1993) (discussing the Musgrave/Kaplow exchange regarding whether horizontal equity has an independent value (as Musgrave maintains) or is dependent on the vertical equity (as Kaplow claims)).

66. *See* Head, *supra* note 49, at 10.

67. *See* MURPHY & NAGEL, *supra* note 56, at 24.

money after making a tax payment than a poorer individual.[68] Nevertheless, the sacrifice principle faced some practical obstructions.[69]

This ability-to-pay principle is the most prevalent principle used in both scholarly discussion and practice.[70] Nevertheless, it does not clearly and comprehensively guide us on how to convert theory into practice.[71]

Mentioned above, the ubiquitous employment of the ability-to-pay on income, is "income" defined by the Haig-Simons formulation.[72] A precondition for the Haig-Simons formula is the ability to measure income.[73] Namely, income should be both quantifiable and objective.[74] Although most scholars advocate the ability-to-pay principle, one still faces the problem of its application.[75] Namely, the question is whether one should use an income base or a consumption base in order to comply with this principle.[76] The discussion on which base – consumption or income – is preferable is long-standing, and it was revived in the United States in 2005.[77] This discussion, however, is beyond the concern of this paper. The paper adopts income tax as the measurement for the ability-to-pay principle and accepts the general view that income should be comprehensively defined. To satisfy the ability-to-pay principle, income should comprise each person's entire accretion to his entire wealth[78]: money income, imputed income and value of the appreciation of assets.[79] In other words, income can be either constant or sporadic, anticipated or unanticipated, realized or unrealized.[80]

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68. *See id.*

69. *See* Head, *supra* note 49, at 10-11.

70. *See, e.g.*, MURPHY & NAGEL, *supra* note 56, at 20 (concerning the dominance of the ability-to-pay principle); *see also* Head, *supra* note 49, at 19.

71. *See* SLEMROD & BAKIJA, *supra* note 58, at 63.

72. *See* Dodge, *supra* note 60, at 459.

73. *See id.* at 461, n. 243.

74. SIMONS, *supra* note 49, at 42.

75. *See* Dodge, *supra* note 60, at 401, 449.

76. MUSGRAVE & MUSGRAVE, *supra* note 55, at 243.

77. Report of the President's Advisory Panel on Federal Tax Reform, Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System (November 2005), *available at* http://govinfo.library.unt.edu/taxreformpanel/final-report/index.html. President George W. Bush appointed in January 2005 an advisory panel to recommend a federal tax reform to simplify the Internal Revenue Code and to make it fairer and more attentive to economic growth. *See id.* (follow "Chapter One – Four" hyperlink). The advisory panel handed its proposals in November 2005. *Id.* The advisory panel has some consensus as to income tax issues but did not reach unanimously plan with regard to consumption tax. *Id.* Thus, it did not recommend any changes in that tax field. *Id.*

78. MUSGRAVE & MUSGRAVE, *supra* note 55, at 243-44, 344.

79. *Id.* at 243-44.

80. *Id.* at 344.

Following this understanding of income, below is a brief elaboration on what constitutes income. This elaboration is relevant to our discussion in Chapter IV., which combines the ability-to-pay principle and de jure dividends, which is considered as income. Income should be considered as net income and be taxed on a net basis.[81] Losses and expenses accrued in the course of business should be deducted from income.[82] Second, income should be measured in real and not nominal terms to rightly express the ability-to-pay principle.[83] Third, income should be considered as either realized or unrealized.[84] Unrealized income should be included in a taxpayer's income base.[85] An investor has the option either to realize his asset and receive cash flow in return, or to not realize it.[86] Unrealized income can be deemed as another investment alternative available to an investor,[87] and thus should be included in an individual's income tax base. Fourth, imputed income based on the opportunity costs approach should also be included in a taxpayer's income base.[88] An example of imputed income is the assigned rent, which a private self-owner could have received if he had let his residence.[89] Fifth, transfers, such as gifts, should be treated as income like any other earnings since they increase a person's ability to pay.[90] The same idea applies to irregular and unexpected income, both should be considered as income.[91]

If one looks at our tax laws, one can easily notice that they do not necessarily apply this wide concept of income.[92] Due to

81. *Id.* at 345. For an elaborated discussion on income, see also William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309, 318-25 (1972).

82. MUSGRAVE & MUSGRAVE, *supra* note 55, at 345.

83. *See id.*; *see also* I.R.C. § 61 (defining "gross income").

84. *See* MUSGRAVE & MUSGRAVE, *supra* note 55, at 345; *see also* I.R.C. § 61 (explaining further "gross income").

85. *See* SIMONS, *supra* note 49, at 158. Following the economic definition of income, capital gains on the theoretical level should be considered as income (and thus be taxed when accrued) but Simons, for example, was aware of the practical implications (such as, evaluation) involved in their taxation. *See id.*

86. *See* MUSGRAVE & MUSGRAVE, *supra* note 55, at 346.

87. On the realization criterion, see for example SIMONS, *supra* note 49, at 167.

88. "Imputed Income" is defined as "[t]he benefit one receives from the use of one's own property, the performance of one's services, or the consumption of self-produced goods and services." BLACK'S LAW DICTIONARY (9th ed. 2009).

89. Simons claimed that there is no economic difference between renters and home-owners and we should also tax "income in kind." SIMONS, *supra* note 49, at 112-13.

90. *See* R.A. Musgrave, *In Defense of an Income Concept*, 81 HARV. L. REV. 44, 47-48 (1967) (arguing that income classified as gains in net worth includes transfers, such as gifts; income may be unexpected, irregular or regular, accrued or realized).

91. *See id.*

92. *See, e.g.*, BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶3.1.1 at 1 (3d ed. 1999) (stating that the Haig-Simons defi-

practical reasons, there is a divergence between the economic definition of income and statutory definitions.[93] Although current tax laws deviate from the ability-to-pay principle, it is most important that this principle shall guide scholars, judges, practitioners, regulators, and other decision-makers.[94] Since the ability-to-pay principle reflects equity concepts, tax reforms or tax interpretation should be guided and comprehended in accordance with this principle.[95]

The aim of this paper is to examine if taxing either corporations or shareholders on accumulated undistributed income complies with the ability-to-pay principle and how we should understand the ability-to-pay principle when agency problems occur.

IV. ONE/TWO-TIER TAXATION AND TAXATION OF UNDISTRIBUTED INCOME

A. *The Debate over One/Two-Tier Taxation*

This subchapter is an explanatory chapter for the reader, who is unfamiliar with the concept of and the debate on one and two-tier taxation and undistributed earnings. This discussion is important because it explains the third and last block of the pyramid's basis, where a distinction between the taxation of undistributed earnings at the hand of corporations and individuals is made. The following subchapters shall clarify the terminology used in the paper.

Undistributed earnings, which are the central focus of this paper, can occur in both one and two-tier taxation systems.[96] In one-tier taxation, only individuals can be taxed on undistributed earnings.[97] In two-tier taxation, the undistributed earnings can be levied on either the corporation or its shareholders.[98] This discussion concentrates on this latter issue, though it should be emphasized that the paper does not question the justification for two-tier taxation and takes the practice of two-tier taxation as a

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nition of income, which encompasses consumption and savings, approaches income taxation from a different perspective than our current statutory scheme).

93. *See id.* at 2.

94. On the disparity between Haig-Simons and current statutory definition of income see *id.*

95. *See* MUSGRAVE & MUSGRAVE, *supra* note 55, at 364 ("though implementation is imperfect, it remains crucial that the specific issues of income definition, as they arise in practice, be measured against the yardstick of an income concept which provides a meaningful and consistent criterion of equity.").

96. *See* Kanda & Levmore, *supra* note 7, at 214-15.

97. *See id.*

98. *See* HOWARD E. ABRAMS & RICHARD L. DOERNBERG, FEDERAL CORPORATE TAXATION 303 (Foundation Press, 6th ed. 2008).

starting point. This subchapter puts forward some explanatory comments on one/two-tier taxation without questioning their validation. The next subchapters elaborate on the taxation of undistributed earnings.

Corporations can either be taxed separately from individual income or together with individual income.[99] In the first instance, income is taxed twice – first at the corporate level, and then, when distributed at the individual level.[100] This corporate dual taxation is one of the fundamental features of corporate taxation.[101] The focus here is on earnings, which were not distributed by corporations to shareholders. The antithesis of the entity tax is the full integration system, which applies only one-tier taxation.[102]

Integration systems are multi-faced. One application of the integration system is a reduction or total annulment of shareholder level taxation by credit or by excluding this income from gross income or by other imputation mechanism given to shareholders.[103] Another alternative is to eliminate corporate level taxation and apply a pass-through taxation system. Namely, the income passes through the corporation (or other entities) into individual-shareholder hands (or other interest-holders). The integration system is based on the presumption that all taxes should be borne by individuals.[104] Corporate income tax is integrated in

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99. *See id.*

100. *See id.*

101. *See id.* at 1.

102. For a more detailed discussion than the one presented here on corporate tax justification, see Charlotte Crane, *Corporate Taxation*, *in* ENCYCLOPEDIA OF LAW & ECONOMICS 165, 167-73 (Boudewijn Bouckaert & Gerit Defendant Geest, eds., 1999), *available at* http://encyclo.findlaw.com/6060book.pdf.

103. For example, the full imputation system (*Vollanrechnungsverfahren*) in Germany that was employed to cope with two-tier taxation was abolished. *See* Monatsbericht des Bundesministerium der Finanzen (20 Dezember 2004) (1. Januar 2005: Die letzte Stufe der Steuerreform 2000 wird wirksam) (Monthly Report of the German Federal Tax Minstry) (1 January 2005: The last stage of the 2000 tax reform be effective) p. 50. Instead, from 2002 this system was replaced by the "half-income system" (*Halbeinkünfteverfahren*). *Id.* The half-income system includes (and taxes) only half of the dividends in the shareholder's personal income tax base. *See* Monatsbericht des Bundesministerium der Finanzen (January 2005), *available at* http://www.bundesfinanzministerium.de/Content/DE/Monatsberichte/Publikationen_Migration_vor_2005/28869_0.pdf?__blob=publicationFile&v=6.
For other integration mechanisms, see MUSGRAVE & MUSGRAVE, *supra* note 55, at 408.

104. *See* MUSGRAVE & MUSGRAVE, *supra* note 55, at 399. For more references concerning the support of the integrated system, see Kanda & Levmore, *supra* note 7, at 226 n. 35 and Reuven S. Avi-Yonah, *Corporations, Society, and the State: A Defense of the Corporate Tax*, 90 VA. L. REV. 1193, 1197 (2004) (citing articles arguing for an integration system that abolishes the corporate income tax).

individual income tax base and eventually this tax is borne by individual-shareholders.[105]

The classical entity tax approach, on the other hand, rests on the belief that corporations are separate entities, and separate from their shareholders.[106] Following this belief, corporations should be subject to separate tax, *i.e.*, the entity tax. However, some scholars believe this two-tier taxation does not comply with the ability-to-pay principle because eventually, the economic burden of this two-tier taxation is borne by human beings[107] while others oppose two-tier taxation for other reasons.[108]

Contemporary scholars studied the question whether one should apply either entity tax or pass-through tax using an agency cost analysis.[109] They have focused on the connection between one and two-tier-taxation, and agency costs.[110] For example, Kanda and Levmore defend two-tier taxation as a means to reduce conflicts between an owner-manager and non-managing shareholders.[111] Snoe,[112] like Kanda and Levmore, endorses the

105. *See* Avi-Yonah, *supra* note 104, at 1201.

106. *See id.* at 1195.

107. *See* MUSGRAVE & MUSGRAVE, *supra* note 55, at 401. But Musgrave claims that entity tax may be used as a regulatory device to control corporate behavior. *Id.* On the recognition of a separate entity, see analysis of Avi-Yonah *infra* note 115. In addition, corporate tax may have other justifications. MUSGRAVE & MUSGRAVE, *supra* note 55, at 401. For instance, business organizations, including corporations, may use governmental services and thus, may be subject to a tax based on benefit grounds. *Id.* Avi-Yonah refers to this latter justification as the "artificial entity defenses of the corporate tax." *See* Avi-Yonah, *supra* note 104, at 1205-9.

108. *See*, Yariv Brauner, *The Non-Sense Tax: A Reply to New Corporate Income Tax Advocacy*, 2008 MICH. ST. L. REV. 591, 592 (2008) (arguing that corporate income taxation should be abolished); Anthony P. Polito, *Constructive Dividend Doctrine from an Integrationist Perspective*, 27 AKRON TAX J. 1, 1-9 (2011-2012) (arguing for the integration system, criticizing the "constructive dividend doctrine," and supporting the "Laissez-Faire" approach which "seeks to advance the Integrationist Norm by taxpayer self-help rather than by assuming the burden of an active integration program."). *Id.* at 8. Polito believes that "integrationism should be regarded as normative." *Id.* at 2. According to the author there are cases that the law should ignore the constructive dividend doctrine due to its distortion effects. *Id.*. *See* SIMONS, *supra* note 49, at 185-87 (opposing two-tier taxation and claiming that the main instrument of individuals to avoid income tax is through using corporations). Legal systems endeavor to combat this avoidance by various mechanisms such as the accumulated earnings penalty. *See* discussion *infra* Chapter III. (C) (describing accumulated earnings). Simons claims that no taxation on corporations can be effective unless a very drastic levy can properly respond to an individual's attempts to reduce their personal tax liability. *See id.* at 187. For these reasons, Simons prefers a single integrated tax, such as the tax on partnership, and not an entity tax. *See id.*

109. *See* 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, 2 (1993).

110. *See id.* at 36.

111. Kanda & Levmore, *supra* note 7. Kanda and Levmore concentrate on the tradeoff between "choice and control" or between timing of taxation and the burden of taxation. *See id.* at 215-16. Whenever investors have more latitude to control timing of taxation, like in corporations, they are exposed to additional tax burden. *See id.* at 221.

use of entity taxation as a means to reduce agency costs, but his study does not focus on the owner-manager but on the professional manager.[113]

A different approach to the justification of two-tier taxation was offered by Avi-Yonah, who has justified the concept of corporate taxation as a controlling mechanism for restraining excessive power held by contemporary corporations.[114] He claims that the normative concept of corporate income taxes has grown alongside the development of the corporate forms but those concepts ignored corporate changes.[115] He claims that corporations in our new world encompass wealth and power, and therefore, corporate tax should be justified on a regulatory basis.[116] Corporate tax may assist in controlling the massive power held by cor-

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Kanda and Levmore justify two-tier taxation on agency cost grounds. *See id.* at 229, 235; *see also* Hideki Kanda, *Taxes and the Structure of Japanese Firms: The Hidden Aspects of Income Taxation*, 74 WASH. U. L.Q. 393, 397 (1996) (restating the notion of defending two-tier taxation as a mechanism to reduce agency costs). Kanda and Levmore continue arguing that without corporate taxation, corporate managers could adjust "timing" of taxation to their personal needs, and they choose when to distribute gains according to their personal tax rate. *See* Kanda & Levmore, *supra* note 7, at 246. Two-tier taxation helps to minimize this conflict of interests by unifying shareholders' interests. *Id.* at 250. Since the corporation itself is subject to tax, the individual tax rate would not affect the corporate disposition decisions. *Id.* Nevertheless, it should be noted that although two-tier taxation solves the agency costs as to the corporation's disposition (concerning the in-firm decisions), it constructs a new agency problem concerning distribution decisions. *See id.* at 234. Yet, the authors believe that the later problem is not as severe as the former one. *Id.* at 236.

112. Snoe, *supra* note 109, at 2-28.

113. Snoe claims that in a pass-through tax system when earnings are not distributed, shareholders are obliged to find other means to comply with their tax liabilities, and managers are not obliged to and have no incentive to take into consideration tax issues. *Id.* at 14-15, 43. Entity tax reduces managers' power to control corporate assets and forces them to consider tax liability. *Id.* at 43; *See* Jennifer Arlen & Deborah M. Weiss, *A Political Theory of Corporate Taxation*, 105 YALE L.J. 325, 325-69 (1995) (explaining the existence of two-tier taxation on political grounds.) Although managers and shareholders have different attitudes towards tax policies, managers usually do not oppose any tax benefit that enhances shareholder profits. *Id.* However, since managers are apathetic towards shareholders tax benefit they do not lobby for a tax integration system. *Id.*

114. Avi-Yonah, *supra* note 104, at 1249. A counter argument to both Avi-Yonah's paper and Kanda & Levmore is presented by Brauner who supports the elimination of corporate income taxation. Brauner, *supra* note 107, at 635.

115. According to Avi-Yonah, corporations had four major development phases: the first stage was the recognition of a separate entity, which is entitled to sue and be sued; second, corporations changed their form from non-profit corporations towards for-profit business corporations; third, corporations transferred from closely-held corporations to publicly-held ones; and fourth, corporations had started to globally expand their business. Avi-Yonah, *supra* note 104, at 1231-32. Corporations were changed from local business corporations to global multi-national corporations doing business overseas. *Id.* at 1232. Avi-Yonah believes that the main flaw shared by all aforesaid approaches, including the entity tax, is that they did not succeed in describing corporations as they actually behave in reality. *Id.* at 1234.

116. *Id.* at 1244, 1249.

porate managers.[117] Avi-Yonah, thus, argues that corporate tax can discipline managers operating multinational corporations.[118]

Later, Bank[119] has endeavored to explain (and not necessarily to justify)[120] the existence of a separate corporate tax.[121] He believes that the development of capital lock-in[122] can explain this separate entity taxation.[123]

As mentioned above, the paper accepts the practice of both entity and integrated tax. The profound, long-lasting discussion, on whether a tax system should employ either entity tax and/or integrated tax is beyond the scope of the paper. Yet, as elaborated above, it is interesting to see that this discussion is one of the uncommon direct scholarly discussions where tax law and corporate governance issues converge.[124] The analysis here integrates

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117. *Id.* at 1244-45 (claiming that the common local non-tax regulations do not have an impact on multinational corporations which carry out their business abroad. Common regulatory power has local influence but not a global one. Tax laws, on the other hand, have the power to serve as a regulatory mechanism for national and international activities and organizations. Tax laws embracing the well-recognized residence principle subject those corporations to the local supervision).

118. Avi-Yonah, *supra* note 47, at 22-23.

119. *See* Steven A. Bank, *A Capital Lock-In Theory of the Corporate Income Tax*, 94 GEO. L.J. 889-947 (2006) [hereinafter *A Capital Lock-In*].

120. *See id.* at 947 (concluding that: "[t]his [the compromise] is not to suggest that this compromise is the best or only means of resolving the tension between these two competing concerns, but rather that it is the compromise that was struck and continues to be followed.").

121. *Id.* at 939.

122.

> Capital Lock-In includes the firm's control over the distribution of earnings that arise from the capital and that may be reinvested in the corporation as well. Capital lock-in also differs from the economic concept of a 'retained earnings trap' that is associated with double taxation. It exists because the legal power is in the hands of the board of directors and not because of the tax disincentive to distribute dividend.

Id. at 892.

123. Bank questions the rationalizations given thus far to the existence of separate corporate tax. *A Capital Lock-In, supra* note 119, at 890-91. As indicated by Bank, those former rationalizations are inadequate since they ignore the unique character of corporations, *i.e.*, the capital lock-in phenomenon. *Id.* at 891-92. His historical analysis illustrates that corporate tax is a compromise between a penalty on retained earnings and indefinite deferral of taxation. *Id.* at 894. Corporate tax tried to settle between two conflicting problems. *Id.* First, capital lock-in was utilized by managers to run businesses in the early twentieth century. *See id.* at 931. Taxing corporations similarly to partnerships would penalize corporations and endanger capital lock-in. *Id.* at 946. Second, if taxation were only imposed on distributed dividends, it is likely that corporations would have avoided distribution. *Id.* at 947. This avoidance could have reduced tax hoarding. *Id.* Bank infers that corporate taxation removes both threats – the threat of capital lock-in and tax deferral – and this compromise explains the continuation of corporate tax. *Id.*

124. Nevertheless, there are some other noteworthy writings combining both taxation and corporate governance. *See, e.g.*, Mihir A. Desai, Alexander Dyck & Luigi Zingales, *Theft and Taxes*, 84 J. FIN. ECON. 591, 591-601, 618 (2007) (examining corporate taxation through the lens of both outside shareholders and tax authorities, who both

these two fields, but in a different manner. First, this paper does not focus on the justification of two-tier taxation but on undistributed earnings. Second, it reaches the conclusion that the correct interpretation and an accurate application of a core principle of taxation - the ability-to-pay principle - follows the same line of mitigating agency problems. But before exploring this reasoning, it is necessary to explain the last block of the pyramid's basis, and that is what undistributed earnings refers to in the paper.

B. *Undistributed Income in Closely held Corporations: De Facto and De Jure Dividends*

This subchapter clarifies the notions of "de facto dividends" and "de jure dividends," and the subsequent subchapter focuses on the tax treatment of various de jure dividend provisions.

Legal systems use various mechanisms to tax dividends. Here, one should keep in mind that dividends in the corporate law field are not parallel to dividends in tax systems.[125] The latter contains both real and deemed dividends. One can indicate three main mechanisms for taxing dividends (either "real"/*de facto* or deemed/*de jure*): First, taxing dividends when distributed; the tax unit is the receiver of the distribution (usually, the shareholder).[126] Second, taxing de jure dividends at the corporate level (*i.e.*, the tax unit is the corporation) and finally, taxing de

share the same interests to reduce managerial diversion). The authors reach the conclusion that strong corporate tax enforcement can assist in corporate governance by reducing manager opportunities to attract private benefits. *Id.* at 618; *see also* Steven A. Bank, *Tax, Corporate Governance, and Norms*, 61 WASH. & LEE L. REV. 1159, 1159 (2004) [hereinafter *Corporate Governance*] (examining the power of tax law to influence corporate governance). He concludes that this power is limited to reinforce existing corporate governance norms. *Corporate Governance, supra,* at 1229. But when the federal tax code initiates new corporate governance norms their effective outcome is dubious. *Id.*; *Cf.* Ilya Beylin, *Tax Authority as Regulator and Equity Holder: How Shareholders' Control Rights Could Be Adapted to Serve the Tax Authority*, 84 ST. JOHN'S L. REV. 851, 851-54, 874-85 (2010) (exploring how shareholders and corporate governance can protect and promote tax authority interests. The author believes that shareholders and tax authority share some resemblance in the firm. If so he wonders why tax authorities are deprived of the same control rights granted to shareholders).

125. *See* DOUGLAS A. KAHN, JEFFREY H. KAHN, TERRENCE G. PERRIS & JEFFREY S. LEHMAN, CORPORATE INCOME TAXATION 10 (6th ed. 2009) ("In common parlance and for general corporate law purposes, most distributions from a corporation are referred to as a 'dividend.' However, for federal tax purposes, the word 'dividend' is a term of art that is specifically defined in the Code. The tax definition of a dividend is separate and independent of the characterization of a corporate distribution to shareholders for state corporate law purposes.").

126. *See* REGINALD MOMBRUN, GAIL LEVIN RICHMOND & FELICIA BRANCH, MASTERING CORPORATE TAX 82 (2009) ("If a shareholder receives a distribution of money or other property that is covered by E&P [earnings and profit], the shareholder reports gross income from dividends."); *see also* I.R.C. § 301(c)(1) (indicating that a distribution which qualifies as a dividend under I.R.C. § 316 is taxable to the recipient shareholder).

jure dividends at the individual level.[127] This paper refers to taxing accumulated earnings at the corporate level as de jure dividends since tax law treats these earnings as dividends that should have been distributed to shareholders, but were accumulated at the corporate level.

Dividends are a form of income.[128] The word income literally indicates "what comes in" or "what enters."[129]This literal definition fits in de facto income (or dividends) but does not fully describe de jure dividends, because the latter refers to earnings that do not exactly "come in".

It should be noted, that the definition of de jure dividends is not equivalent to "constructive" or "disguised" dividends.[130] The latter refers to instances where apparently a distribution is made to a shareholder in his capacity as such, and where the true essence of this distribution is unrelated to this capacity.[131] In addition, a real cash payment may be transferred to these shareholders.[132] De jure dividends, on the other hand, have nothing to do with artificial transactions and moreover do not involve a transfer of cash or other real economic properties.

In addition, the definition of "de jure dividends" is not equivalent to imputed income, though these two terms have common ground.[133] In both cases, there is not any transfer of cash. Nevertheless, imputed income is an estimated income based on opportunity costs.[134] De jure dividends do not involve any evaluation process since income has been matured. Thus contrary to imputed income, the scope of de jure dividend is known, but similar to imputed income; this dividend is not distributed to shareholders.[135]

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127. *See* discussion *infra* Chapter III. (C)-(D).

128. *See* I.R.C. § 61(a)(7) (including "Dividends" under the general definition of gross income).

129. *See* SIMONS, *supra* note 49, at 43 ("The noun 'income' denotes, broadly, that which comes in."). For discussion of the development of the income concept, see *id.* at 41-58.

130. For a discussion on "constructive dividends" see, for example, BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶8.05 (updated 2012).

131. Some scholars use a different terminology and distinguish between "true" dividend and "de facto" dividend. *See* Moll, *supra* note 3, at 877. For example, Moll treats true dividend as the equivalent of our "de facto" dividend, and defines "de facto" dividend as "a distribution of corporate profit to shareholders that a company disguises, often for tax reasons, as some other form of compensation or perquisite." *See id.*

132. 7 MERTENS LAW OF FED. INCOME TAX'N § 25E:30 (2002).

133. For an explanation on imputed income see David Elkins, *Tax Consequences of Shareholders' Rent-Free Use of Corporate Property*, 5 FIU L. REV. 41, 63 (2009).

134. *See id.* at 63.

135. *See id.*

De jure dividend is thus undistributed income exposed to tax either levied on the corporation or its shareholders.[136] Tax laws contain a myriad of provisions taxing de jure dividends; they are usually filled to the brim with words such as "deemed" and "as if."[137] The most celebrated de jure dividend provisions are discussed below from a tax perspective only. In the next subchapter, the paper thus discusses only the tax rationales of these provisions. Later, Chapter IV. questions to some extent these rationales keeping in mind the agency problem, and examines how this rationale could be understood and integrated into the ability-to-pay principle.

C. *De Jure Dividends at the Corporate Level*

In this subchapter and the following one, the paper briefly gives some concrete illustrations to de jure dividends taken from the federal tax systems; these examples, though, are common also in other jurisdictions. Subchapter C. presents an example for de jure dividends at the corporate level. In subchapter D., two other examples are adumbrated to illustrate de jure dividends at the individual level.

Taxing de jure dividends at the corporate level has the power to induce shareholder-managers to distribute dividends to escape this additional tax.[138] There are various common tax provisions which apply de jure dividends at the corporate level. In

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136. It should be noted that this paper does not query into the general question of taxing undistributed income. The reason behind the taxation of undistributed income in many instances is to comply with the equity principle. *See* Jeffrey L. Kwall, *The Uncertain Case Against the Double Taxation of Corporate Income*, 68 N.C. L. REV. 613, 627 (1990) (discussing the inequity that results from the taxation of distributed income compared to undistributed income under a corporate tax). In order to prevent tax avoidance, jurisdictions have developed various techniques to combat tax avoidance. On the American response to tax planning see for example JOSEPH ISENBERGH, INTERNATIONAL TAXATION 17 (2010), and REUVEN S. AVI-YONAH, INTERNATIONAL TAX AS INTERNATIONAL LAW 186-87 (2007). One technique is the taxation of undistributed income (see the discussion under Chapter III. (D) below and especially the text accompanying fn. 160).

137. For the use of the word "deemed" in the Internal Revenue code see I.R.C. § 78 ("[A]n amount equal to the taxes *deemed* to be paid." (*emphasis added*)).

138. But see Bank's argument when large corporations are at stake. According to him, the above argument may be true when a tax cut is temporary. Steven A. Bank, *Dividends and Tax Policy in the Long Run*, 2007 U. ILL. L. REV. 533, 533 (2007) [hereinafter *Dividends and Tax Policy*]. Bank challenges the prevailing old view that dividend tax rate cuts will lead to a rise in dividend distributions. *Id.* He emphasizes the temporary effect of the 2003 tax rate cut in the U.S.– contrary to a permanent tax cut. *Id.* at 536. The distribution effect shall differ between short and long run. *Id.* at 536-37. In the short run – the traditional view – tax rate cuts on dividends have the power to induce distributions but not necessarily in the long run, especially in large public companies. *Id.* at 537. As a consequence, it is "either futile or potentially counterproductive" to influence corporate governance via tax law. *Id.*

some tax jurisdictions, for instance, accumulated earnings are penalized.[139] In a tax system which taxes both entities and individuals (when the entity distributes funds), accumulated earnings are a simple tax planning means to escape and avoid this two-tier taxation.[140]

The federal income tax system in the United States is an example of such a jurisdiction.[141] It imposes a certain penalty, an additional tax, on undistributed income by an entity.[142] Tax law does not forbid accumulation *per se*, however, in some instances it fines this undistributed earnings.[143] Such an entity is exposed to additional tax.[144] This subsection focuses on the tax penalty and does not address its current rate.[145]

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139. *See infra* text accompanying notes 141-145.

140. *Dividends and Tax Policy*, *supra* note 138, at 537-39.

141. I.R.C. § 531.

142. I.R.C. §§ 531-37. For the history of undistributed profits tax in U.S. – see *Corporate Governance*, *supra* note 124, at 1187-206.

143. I.R.C. §§ 531-37.

144. I.R.C. § 531. Until 2003, an entity that endeavored to avoid double taxation was exposed to the maximum individual tax rate. H.R. 2, 108th Cong. § 302(e)(5) (2003) (enacted). The Jobs and Growth Tax Relief Reconciliation Act of 2003 sharply reduced the penalty tax to 15% as part of an inclusive tax reform that reduced tax on dividends. *Id.* §§ 1(a), 3(e)(5).
The initial aim of this reform was to eliminate double taxation. U.S. Dep't of the Treas., General Explanations of the Administration's Fiscal Year 2004 Revenue Proposals 4 (2003), *available at* http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2004.pdf [hereinafter Treas. General Explanations]. As a political compromise it eventually reduced tax on dividends to 15%. See, for example, Senator Kyl's speech concerning the Jobs And Growth Tax Relief Reconciliation Act of 2003, 149 Cong. Rec. S7186-87 (daily ed. June 2, 2003) (statement of Sen. Kyl), *available at* http://www.gpo.gov/fdsys/pkg/CREC-2003-06-02/pdf/CREC-2003-06-02-pt1-PgS7186-4.pdf.

> Our bill also significantly reduces the taxes individuals pay on dividends they receive from corporations. In order to change investment behavior-and we know that the ongoing economic troubles are almost exclusively related to a collapse in business investment, not to a problem of consumer demand-taxpayers must see a meaningful and permanent reduction in rates at the margins. The bill we pass today does that.
>
> Under current law, a corporation pays taxes on its earnings, usually at a rate of 35 percent, and its shareholders will pay ordinary income rates-currently, the top rate is 38.6 percent, on any dividends distributed by the corporation. President Bush said we should end this double taxation by eliminating entirely the tax on individuals. I fought hard for the original Senate bill that would have done this, and I still believe that is the best tax and economic policy. However, the conferees from the House were unwilling to agree. The compromise we settled on will reduce the individual tax rate for dividends to 15 percent-a significant improvement over current law. I will continue to work to eliminate the double tax on dividends.

And see also one argument in favor of abolishing the two tier taxation in corporations:

> The bias in the current system against paying dividends can result in a reduced pressure on corporate managers to make the most efficient use of retained earn-

There are various tax incentives for accumulating earnings, for example, when the individual tax rate is higher compared to the corporate income tax rate.[146] It is well-known that a straightforward tax planning measure, mainly in closely held corporations, is to establish a corporation whenever the individual tax rate exceeds the corporate tax rate.[147] In that case, the established corporation accumulates its earnings until the individual tax rate is lower than the corporate tax rate.[148] When the individual-shareholder is subject to a lower tax bracket, however, the corporation ceases to accumulate its earnings and distributes them to its shareholders.[149]

This prevailing tax planning induced the development of a specific anti-avoidance measure of imposing tax on accumulated earnings.[150] The general rule is thus to sanction accumulated earnings[151] in ". . .every corporation[152] . . . formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided or distributed."[153] Unreasonable accumulation[154] is determinative of the purpose to avoid income tax, as set out in the general provision.[155] For example, taxpayers are required to bring evi-

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> ings, because corporate investments funded by retained earnings may receive less scrutiny than investments funded by new, outside sources of capital.

Treas. General Explanations, *supra*, at 144. The dividend tax cut is still on the political agenda. Recently Senate Democrats announced they wish to set the top tax rate on dividends at 23.8%, which is almost 20 points lower than President Barack Obama's proposal in his budget. *See, e.g.*, Alan Fram, *Senate Dems 1-Year, $272b Tax-Cut Extension Raises Rates On Income, Capital Gains For Rich*, ASSOCIATED PRESS (July 16, 2012), http://finance.yahoo.com/news/senate-dems-ready-272b-tax-145753433.html.

145. That is, its current *low* rate. I.R.C. § 531.

146. *See, e.g.*, ABRAMS & DOERNBERG, *supra* note 98, para. 12.02. Other possible incentives to accumulate earnings include, inter alia, first the divergence between ordinary income and capital gains tax rate; and second, considerations of deferring tax payments. *Id.*

147. *Id.*

148. *Id.*

149. See Bank's claim that this outcome depends on the temporality of tax rate cut. *Dividends and Tax Policy*, *supra* note 138, at 536-37.

150. I.R.C. § 531.

151. I.R.C. § 535(a).

152. Excluding corporations specified in I.R.C. § 532(b).

153. I.R.C. § 532(a).

154. I.R.C. § 533(a).

155. I.R.C. sections 532-33 establish two distinct tests for applying the accumulated earnings penalty. The first is a subjective test and the second is an objective test. *E.g.*, ABRAMS & DOERNBERG, *supra* note 98, at 306. *See also* Israeli parallel sections §§ 76-77 of the Israeli Income Tax Ordinance. Income Tax Ordinance (5271-1961), *available at* http://www.financeisrael.mof.gov.il/FinanceIsrael/Docs/En/legislation/FiscalIssues/5721-

dence that the accumulation is connected with a corporation's business.[156] The need to accumulate earnings shall be considered reasonable if it is directly related with the corporation's bona fide business purposes.[157] Needless to say, minority exploitation is not an acceptable argument for establishing a bona fide business purpose.

To conclude this subchapter, the accumulated earning provisions are an example for taxing undistributed earnings at the corporate level, when tax law aims at preventing income tax reduction.[158]

D. *De Jure Dividends at the Individual Level*

De jure dividends exist, not only at the corporate level, but also at the individual level[159] – the latter is discussed in this subchapter. Tax law often taxes individuals for undistributed earnings even though this disregards corporations' separate entity. Sometimes this technique is activated or initiated by individual's request, for example, S Corporations and sometimes it is used as an anti tax planning, for example, Controlled Foreign Corporations [hereinafter: CFC],[160] discussed hereby. Although in some jurisdictions, as elaborated here, minority shareholders are taxed on de jure dividends;[161] it is claimed in Chapter IV. that exposing minority shareholders to de jure dividend taxes does not comply with the ability-to-pay principle.

De jure dividends at the individual level can occur in cross border transactions. Taxpayers occasionally prefer using corporations located in tax offshores to reduce their tax liabilities.[162] They prefer performing their activities not within their resident country but through a foreign corporation situated in a foreign country, where activities are exposed to lower tax liabilities.[163] The advantages to domestic taxpayers of using CFCs vary from one jurisdiction to the next.[164] The scope of these tax advantages

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1961_Income_Tax_Ordinance_%5BNew_Version%5D.pdf [hereinafter: Israeli Income Tax Ordinance].

156. *See* Treas. Reg. § 1.533-1 (as amended in 1963).

157. *See* Treas. Reg. § 1.537-1 (1998) (example of consideration of accumulated earnings if related with the corporation's bona fide business purposes).

158. *Id.*

159. *See* BITTKER & EUSTICE, *supra* note 130, at ¶ 15.61[1] (CFC rules or as referred to as "subpart F rules").

160. *Id.*

161. *Id.* ¶ 15.61[2].

162. HUGH J. AULT & BRIAN J. ARNOLD, COMPARATIVE INCOME TAXATION – A STRUCTURAL ANALYSIS 476 (3d ed. 2010).

163. *Id.*

164. *See id.* at 477 (comparative analysis of CFC rules).

depend on the international tax systems applied both in their resident state and in the host state.[165] The use of this international structure sometimes grants them only tax deferral benefits and other times it provides them with full tax exemption benefits.[166] The main rationale underlying CFC rules is that they are aimed at reducing tax benefits by utilizing an international corporate formation.[167] An international tax plan that avoids tax in the domestic country, while reaping a low tax in the foreign country, is the center focus of CFC rules.[168] These rules attempt to reduce tax advantages to taxpayers, who have a significant economic interest in that foreign corporation.[169] Therefore, CFC rules were developed to prevent domestic taxpayers from avoiding local tax.[170] The main technique to thwart this tax avoidance is by taxing domestic/resident shareholders on the undistributed earnings of their foreign corporation *as if* they were distributed pro rata.[171]

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165. *Id.*

166. *Id.*

167. *See* JOEL D. KUNTZ & ROBERT J. PERONI, U.S. INTERNATIONAL TAXATION ¶ B3.01 (2012).

168. *See id.*

169. *See, e.g.*, I.R.C. § 951(b) (imposing tax on U.S. shareholders who have "10 percent or more of the total combined voting power of all classes of stock entitled to vote" of a foreign corporation).

170. *See* KUNTZ & PERONI, *supra* 167, at ¶¶ B3.02-B3.03; *e.g.*, I.R.C. §§ 951-965 (comprising the rules for controlled foreign corporations); *see also, e.g.*, Income Tax Ordinance, 99-104 (A.G. Publications 12th ed. 2003) (English translation of § 75B) (Isr.), *and* Income and Corporation Taxes Act, 1988 § 747 (Eng.).

171. *See* KUNTZ & PERONI, *supra* 167, at ¶ B3.03; *e.g.*, I.R.C. §§ 951, 957, 958. The other polar alternative is where the domestic country taxes the foreign corporation itself. *See, e.g.*, Limor Riza, *Does the 'Foreign Vocation Company' Undermine Tax Principles?*, 7 IDC L. REV. 249, 250-52, 277-90 (2007) (in Hebrew). However, this alternative interferes to some extent with the authority of the foreign country to tax this corporation and may impose double taxation. *Cf.* BITTKER & EUSTICE, *supra* note 130, at ¶ 15.61[1] (observing CFC rules avoid interfering with international rationales by focusing the tax on U.S. shareholders). Therefore, this option violates common international tax systems *See*Riza, *supra,* at 287-90. To some extent a Passive Foreign Investment Company ("PFIC") is similar to a CFC, however it is easier to be qualified as a PFIC than CFC because it does not require a minimum percentage U.S. shareholder ownership. *See, e.g.*, I.R.C. § 1297 (defining a PFIC on the percentage of passive income and assets rather than the total value of stock owned by shareholders). Nevertheless, the tax treatment under PFIC regime differs from CFC if the U.S. shareholder did not elect to treat the PFIC as a qualified electing fund. *See, e.g.*, I.R.C. § 1291(c) (imposing interest on the value of the deferral). The tax incentive to encourage distribution and to prevent tax deferral is to impose on U.S. shareholders in PFIC the top marginal rates when income is realized. *See* BITTKER & EUSTICE, *supra* note 130, at ¶ 15.44[3]. This tool is not suggested as a general mechanism in this paper since it may interfere with the traditional goals of tax law.

In the United States, for example, every U.S. shareholder of a CFC, defined above, shall pay tax on the corporations' undistributed earnings according to his pro rata share.[172]

The CFC is relevant to the discussion because not only does the CFC tax undistributed income by shareholders to prevent tax avoidance but it usually also refers to small corporations. For example, the American CFC is a corporation owned by not more than ten American shareholders.[173] In other words, the CFC rules apply only to foreign corporations of concentrated ownership by American shareholders.[174] These rules impose tax on – as termed in the paper – de jure dividends at the shareholders level.[175]

Another example of de jure dividends at the individual level occurs in S Corporations.[176] Law systems levy tax on "tax units."[177] There are various tax units, however, two "units" are well recognized in tax jurisdictions: the individual and the corporation.[178] Both individuals and corporations are in general required to pay tax on their income.[179] The corporation is considered a separate tax entity.[180] But even in jurisdictions, which apply two-tier taxation, some pass-through rules were introduced, mainly to minimize tax considerations in planning one's economic activities. One example is the S corporation employed in the United States.[181]

The S corporation is a hybrid corporation allowing its shareholder to enjoy both nontax and tax benefits: namely, the benefits of a corporation from a corporate law perspective and the tax benefits of individuals from a tax law perspective.[182] It is founded

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172. I.R.C. § 951(a). Not all distributions by CFC are qualified as "dividends" and therefore eligible for the reduced capital gains tax rates under § 1(h)(1). *See* BITTKER & EUSTICE, *supra* note 130, at ¶15.61[3] n. 498. For detailed discussion on how this distribution is being treated and taxed, see Notice 2004-70, 2004-44 I.R.B. 724.

173. I.R.C. § 951(b).

174. *See* I.R.C. § 951(a)(1), (b).

175. *See* I.R.C. § 951(a)(2)(B).

176. *See* I.R.C. § 1368.

177. *See generally* SLEMROD & BAKIJA, *supra* note 58, at 47: (mentioning that Haig-Simons formula refer to individuals not to corporations), For a discussion of the problem of taxing either families or individuals, see *id.* at 91-95. For a discussion on who eventually bears the tax burden, see *id.* at 74-87

178. *See generally* I.R.C. §§ 1-12; SLEMROD & BAKIJA, *supra* note 58, at 47.

179. *See generally* I.R.C. §§ 1, 11.

180. See the above discussion on one and two-tier taxation. Crane, *supra* note 102, at 167-173.

181. RICHARD D. BLAU, BRUCE N. LEMONS & THOMAS P. TOHMAN, S CORPORATIONS FEDERAL TAXATION § 1:2 (2012); *See, e.g.*, I.R.C. § 1366.

182. This paper will not discuss the Limited Liability Company (LLC). For the purpose of the current paper, it is sufficient to mention that it can bear some similarities to

on the partnership model, *i.e.*, treats the corporation as a partnership.[183] The main tax advantages of using an S corporation are eliminating the two-tier taxation and usually the application of lower tax rates on income.[184] The S corporation is not taxed as a C corporation at the corporate level but rather only at the shareholder level when dividends are distributed.[185] Most income of S corporations is not taxed at all at the entity level.[186] The shareholders of the S corporation pay income tax on the income derived by the corporation according to their pro rata shares.[187] The income that passes through the corporation to the shareholder shall retain its character and thus, be treated "as if such item were realized directly from the source from which it had been realized by the corporation."[188] Not every corporation is eligible to be recognized as an S corporation for tax purposes.[189]For this discussion, it is important to remember that an S corporation is a corporation with a restricted number of shareholders,[190] and although it has the characteristics of a corporation, it is subject topass-through taxation.[191]

Contrary to the examples given in subchapters C. and D., the formal rationale underlying S Corporation provisions is not to combat tax planning but to allow business activities without the interference of tax law.[192] Nonetheless, S Corporations provide another example of taxing individuals on undistributed earnings.

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the taxation of the S Corporation (though the members of LLC enjoy more flexibility under Subchapter K of the Internal Revenue Code than shareholders of the S Corporations). *See, e.g.*, ABRAMS & DOERNBERG, *supra* note 98, at 59-60.

183. ABRAMS & DOERNBERG, *supra* note 98, at 318-19, 324.

184. *Id.*

185. BLAU, LEMONS & TOHMAN, *supra* note 181; *see, e.g.*, I.R.C. § 1366.

186. I.R.C. § 1363(a).

187. I.R.C. §§ 1366, 1377.

188. I.R.C. § 1366(b); *see generally* Income Tax Ordinance, 1961, KT 5721, 78 (Isr.) (describing "S Corporation" in section 64A1).

189. *See generally* I.R.C. § 1361.

190. I.R.C. § 1361(b)(1)(A). Subsection (1361(b)(1)(A)) was amended in 2004 by American Jobs Creation Act of 2004 (sec. 232) increasing the threshold of shareholders from 75 to 100. American Jobs Creation Act of 2004, Pub. L. No.108-357, § 232(a), 118 Stat 1418 (2004). In addition, the reason for allowing only one class of stock is to facilitate tax calculations. *See* BITTKER & EUSTICE, *supra* note 130, at ¶6.02[3]. Since even undistributed income is taxed at the individual level, it would have been difficult to weigh each type of stock for tax purposes. *Id.*

191. *See* I.R.C. § 1366; Snoe, *supra* note 109, at 22-23.

192. *See* BITTKER & EUSTICE, *supra* note 130, at ¶6.01 (describing the history and purpose of S Corporations).

V. THE CONTROL THEORY AND THE ABILITY-TO-PAY PRINCIPLE

A. *Foreword*

The discussion thus far introduced three various topics – two topics related to taxation and one topic related to corporate governance. Chapter I. viewed the agency problem, mainly the minority-majority problem emphasizing the acute problem minority shareholders may face in closely held corporations when they are deprived of dividends. Chapter II. turned the attention to a fundamental principle in taxation – the ability-to-pay principle. Economists and philosophers have long discussed the question of how to allocate the tax burden within society.[193] This principle suggests that in order to achieve an equitable tax, tax burdens should be levied according to peoples' economic capacity.[194] Chapter III. elaborated on the phenomena of using de jure dividends. It discussed the reasoning behind taxing de jure dividends and indicated that de jure dividend provisions are commonly used in tax systems.[195] This paper emphasized the two categories of de jure dividends: taxation at the corporate level and at the shareholder level.

Summing up, this current chapter links up the former three chapters: Chapter I. outlining the agency costs; Chapter II. adumbrating the prevailing principle for taxing income – ability-to-pay principle; and Chapter III. addressing the de jure dividend concept. The following paragraphs endeavor to reply to the question presented in our introduction. The response to this question is based on all of three chapters discussed above, which are gradually brought together below.

B. *Control Tests*

Shareholders in closely held corporations commonly enjoy a wide variety of rights.[196] In small corporations, shareholders usually manage the corporations.[197] Without agency costs, control and ownership merge in small corporations, where shareholders

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193. *See* Daniel Shaviro, *Beyond the Pro-Consumption Tax Consensus*, 60 STAN. L. REV. 745, 745-46 (2007).

194. *See* Dodge, *supra* note 60, at 401.

195. *See, e.g.*, I.R.C. § 531 (imposing an additional tax on undistributed income by an entity).

196. *See* Snoe, *supra* note 109, at 3 (noting, for example, that investors are often the managers in closely-held corporations).

197. *Id.*

occupy both positions.[198] Control and ownership grant various privileges including, *inter alia*: rights to receive dividends, to vote on dividend distribution, to receive net assets upon dissolution, to vote on dissolution proposals, to vote on other internal affairs, to vote on reorganization, to elect and dismiss directors and to amend bylaws.[199] This list is incomplete but illustrative.

One can classify those privileges into different categories. For example, one can differentiate between the privileges associated with day-to-day activities, and others, which are related to more fundamental, strategic decisions. This classification is based on the traditional division of powers between the board of directors and shareholders' assemblies correspondingly. The second alternative means of *taxonomy* is based on whom the rights relate to – do the rights relate directly to shareholders or to the corporation.[200] A third alternative is similar in some respect to the former but has a different core-focus. Here, classification is according to economic wealth. Are these rights associated directly with economic wealth (such as the right to dividends) or do they contain indirect economic wealth (such as the right to appoint a manager, which does not affect directly dividend distribution, but eventually has an indirect effect on shareholder's wealth). These divisions are not inclusive; one may think of other characteristics on which to differentiate between shareholders' rights in closely held corporations.

The paper employs the third categorization. The "direct economic wealth" category contains two rights: the right to receive dividends and the residual claim right to receive corporate net assets upon liquidation.[201]

The right here is broadly defined – it does not include only the right to receive the asset but also the directly related right to

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198. *See id.* at 3-8 (describing how agency costs define and divide the investors from the managers in terms of perspectives, goals, and decisions).

199. For a general discussion on ownership and control see for example BREALEY, MYERS & ALLEN, *supra* note 27, at 374-75. For the rights of shareholders in public corporations see for example PAUL MILGROM & JOHN ROBERTS, ECONOMICS, ORGANIZATION & MANAGEMENT 314-15 (1992).

200. *See* Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy*, 119 HARV. L. REV. 1641, 1642 (2006) (describing current shifting trends in controlling shareholders vs. corporate governance).

201. Shareholders have another right related to the sale of their shares. On the general right to transfer stocks see, for example MARK S. RHODES, TRANSFER OF STOCK § 4:1 (7th ed. 2012). This paper does not consider this as an additional right, since first it is a mechanism to recover their investment and second this right may be restricted in a closely-held corporations. *Id.* In addition, the "right" to sell shares is also associated with the termination concept – when shareholders sell their shares, they terminate their ownership, and when they receive net assets upon dissolution, the corporation terminates his activities. *See id.*

take part in the decision to distribute assets.[202] The "indirect economic wealth" category is defined as a complementary category to that of "direct economic wealth." All rights granted to shareholders that do not fall into the direct economic wealth category belong to the latter one. As aforementioned, shareholders can possess only two forms of direct economic wealth: dividends and assets allocated upon dissolution.[203] Shareholders cannot enjoy those two economic benefits concurrently.[204] Shareholders can receive dividends throughout the lifetime of the corporation.[205] On the other hand, shareholders may receive the net assets only upon dissolution, *i.e.*, upon the termination of the corporation. In other words, shareholders cannot possess those two economic benefits simultaneously.

Control takes many forms; the discussion here focuses on control related to the execution of direct and indirect economic wealth. Control based on the economic wealth idea may be widely or narrowly defined. The narrow control test includes only rights associated with direct economic wealth rights. The broad test contains both direct and indirect economic rights. As seen above, tax provisions usually adopt the broad definition of control. For example, a shareholder in the American CFC rules is defined as a person who owns directly or even indirectly at least ten percent of the foreign corporation total voting power.[206] As the paper shall clarify below the ability-to-pay principle can only justify taxation of shareholders on de jure dividends if shareholders possess at least control according to the narrow test.

C. *Ownership and Control in Closely held Corporation: Majority Enjoys Ownership and Control, Minority Remains with Ownership*

In closely held corporations where shareholders have parallel interests, control and ownership are both enjoyed by shareholders.[207] Without an agency problem in closely held corpora-

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202. To some extent this distinction is similar to one made concerning "controlling-minority structure" corporations. In these corporations there is a clear but *legal* separation between control and cash flow rights. *See* Bebchuk, Kraakman & Triantis, *supra* note 30, at 295-96.

203. *See* BREALEY, MYERS & ALLEN, *supra* note 27, at 374.

204. The two sources of economic wealth show they cannot occur at the same time. Thus, shareholders cannot be taxed simultaneously on those two benefits. Even if one accepts the comprehensive definition of income, it would be difficult to include during the lifetime of the corporation net assets in the shareholder tax base, not because it is unrealized income but because it may never be realized by a specific shareholder.

205. I.R.C. § 316.

206. I.R.C. § 958; *see supra* text accompanying note173.

207. Moll, *supra* note 3, at 847.

tions, control and ownership are merged into one.[208] However, recall the discussion in Chapter I., where conflicts of interests between minority and majority shareholders arise, control and ownership depart. Minority shareholders usually lose their entire control bundle of rights and are legally left only with ownership.[209] As aforesaid, there are various ways to exploit the minority.[210] In most cases, exploitation means a loss of control.[211] Exploited minority shareholders stay the official owners of the corporation but have no power to control its activities.[212] Agency conflicts leave the minority with only ownership, not with control.[213] The question that arises – should this ownership be translated into income or economic wealth? Does it have an economic value that should be taxed based on the ability-to-pay principle? Or put it differently – is it equitable to tax minority shareholders in this scenario?

D. *De Jure Dividends and Minority-Majority Conflicts*

Before addressing this question, let us put aside the control test and examine the provisions stated above in Chapter III. together with Chapter II. discussing the agency problem. The author wishes to examine the relationship between the agency problem and the taxation of de jure dividends. Recall, the term de jure dividend refers to tax levied on dividends which were not actually distributed to shareholders.

Here, there are two options. These two possibilities are relevant only in tax jurisdictions that apply two-tier taxation; taxation at both the corporate and individual level.[214] The first option is where tax law sanctions corporations for not distributing dividends (*e.g.*, accumulated earnings provisions).[215] The second option is where it taxes individuals on these undistributed dividends (*e.g.*, CFC and S Corporations).[216]

In the first alternative, the paper discussed the set of sections dealing with accumulated earnings.[217] One of the advantages of tax law is attributable to its importance in the decision-making process and in that respect, it is an efficient

208. *Id.*
209. *Id.* at 848.
210. *Id.*; *see* the discussion under Chapter I. (B).
211. Moll, *supra* note 3, at 847-49.
212. *Id.*
213. *Id.*
214. *See* the discussion under Chapter III. (A).
215. I.R.C. § 531. *See supra* note 142 and accompanying text.
216. *See* discussion *supra* Chapter III. (D).
217. I.R.C. §§ 531-37.

regulatory mechanism.[218] Tax considerations are fundamental to individuals and entities in making business decisions, and they generally react rather promptly to tax reforms.[219] Tax law is a fundamental consideration taken by taxpayers – especially businesspersons – before and in the course of their activities.[220] Thus, it is plausible to assume that the additional tax imposed on corporations for their accumulation shall induce entities to distribute their earnings.[221] Namely, corporations are induced to distribute dividends to all shareholders; otherwise, they are exposed to additional tax.[222] The accumulated earnings provision taxes corporations on undistributed earnings.[223] This can serve as a tool to minimize the conflict between minority and majority shareholders. Since agents are value maximizers and are part of their corporation, they are induced to reduce the corporation's tax burden. And since eventually corporate tax is borne by individuals (though, not necessarily shareholders), in a highly concentrated corporation a tax imposed on corporations has a larger effect on shareholders than in a corporation with dispersed ownership. As long as the majority shareholders' holdings in the corporation are substantial, they are motivated to escape this extra taxation levied on their corporation.[224] Thus, tax law and corporate law go hand in hand since agents have incentives to reduce their tax burden.

The second alternative does not bring us to the same conclusion if tax law provisions are poorly designed. On the contrary, it may lead to adverse effects on the minority. Let us recall the discussion, outlined at the outset of this section. From the corporate law perspective, this taxation is the most problematic since it may tax minority shareholders for undistributed earnings.[225] If a

218. *But see* David A. Weisbach & Jacob Nussim, *The Integration of Tax and Spending Programs*, 113 YALE L.J. 955, 957 (2004) (arguing that the effectiveness of the tax system as a regulatory mechanism should be based on institutional design, and not on tax policy).

219. *See Corporate Governance, supra* note 124, at 1161-63.

220. *See, e.g.*, SCHOLES ET AL., , *supra* note 48, at 1-13.

221. *But see Dividends and Tax Policy, supra* note 138, at 536-37.

222. I.R.C. § 531.

223. *Id.*

224. It has been seen that sections 531-37 encourage corporations to distribute dividends to their shareholders. I.R.C. §§ 531-37. This distribution may mitigate one of the most acute conflicts between minority and majority. The advantage of this set of sections and their regulations to the minority-majority conflict is not limited, however, to alleviate this conflict only. It is interesting to see that the use of the general rule and its exceptions of accumulation may moderate other conflicts between minority and majority shareholders – other than the conflict caused by preventing dividends to minority. For a more elaborate discussion, see Riza, *supra* note 9, at 190-200.

225. *See* MURPHY & NAGEL, *supra* note 56, at 12.

system obliges exploited minority shareholders to pay tax on undistributed dividends, it both enhances the agency problem and as this paper claims, departs from tax principles. A minority shareholder, who is deprived of dividends and is forced to pay tax on these dividends, is subject to unwarranted financial stress.[226] This result is intolerable and does not coexist with tax principles.

E. *Introducing the Ability-to-Pay Principle into the Discussion*

At this stage of the discussion – after highlighting the relationship between the agency problem and taxation on de jure dividends – we should refer to the ability-to-pay principle discussed in Chapter II.

Income tax by definition taxes income; however, as seen above, defining the income base is not always an easy task and each tax system characterizes an income tax base differently. Some systems require a source to that income, others do not,[227] and yet the common feature based on the ability-to-pay principle in all systems is enrichment.[228] Income is not taxed if it does not enrich a person, either it has or does not have a source.[229] A simple example is where a person actually receives a liquidated income such as a salary (ignoring the source non/compulsory requirement). If a person receives a salary, he shall usually pay tax on it, because the income enhanced his well-being, and thus his ability to pay.[230] The ability-to-pay principle is the leading principle which justifies the equitable tax levy.[231] But if the person did not receive that income, is it justifiable to tax him on that income? Adumbrated above, the ability-to-pay principle justifies a broad definition of income. The idea of taxing income that was not distributed is also based on the ability-to-pay principle.[232] This principle can be comprehensively interpreted as endowment taxation – taxing the individual on their "human capital" and on

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226. *See id.* at 24.

227. The general rule set by section 61(a) is that source is irrelevant for defining income: ". . . gross income means all income from whatever source derived." I.R.C. § 61(a). And see the landmark case, *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 429-30 (1955), stating that "[b]ut Congress applied no limitations as to the source of taxable receipts, nor restrictive labels as to their nature."

228. For the discussion on income, see Chapter II.

229. *See* I.R.C. § 61(a).

230. *See* MURPHY & NAGEL, *supra* note 56, at 24.

231. SAMPAT MUKHERJEE, MODERN ECONOMIC THEORY 828 (2005); *see supra* notes 59-69 and accompanying text.

232. *See infra* notes 59-69 and accompanying text.

their ability to earn.[233] In other words, according to this concept, we tax people on their potential earnings and not only on their actual earnings.[234]

The broad definition of income includes unrealized income and imputed income.[235] However, undistributed income differs from both unrealized and imputed income.[236] Undistributed earnings are not unrealized income; they are earnings, which were realized but not distributed.[237] Therefore, they do not involve any estimation difficulty,[238] which is relevant to realization. De jure dividends, though not distributed, are deemed to have been distributed (as illustrated above in our discussion).[239] This fiction of distribution is usually based on the assumption that the "deemed" receiver of that income has the power to control this income, or otherwise this income does not belong to him, and it is irrational and inequitable to tax him.[240] If he has some control over that income, tax law sometimes deems that this income has already been distributed.[241] Without the taxpayer having control over his income, it is undoubtedly inequitable to tax this income. This problem is related to the phenomenon in tax law known as

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233. *See* Daniel Shaviro, *Endowment and Inequality*, in TAX JUSTICE – THE ONGOING DEBATE 123-144(Joseph J. Thorndike & Dennis J. Ventry Jr. eds., 2002).

234. *See* MURPHY & NAGEL, *supra* note 56, at 20.

235. *See* HENRY C. SIMONS, PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY 50, 60-62 (2d ed. 1950); BITTKER & LOKKEN, *supra* note 92, at ¶ 3.1.1 (observing "the Haig-Simons definition of income is the most widely accepted").

236. *Compare* BITTKER & EUSTICE, *supra* note 130, at ¶ 1.02 (describing undistributed corporate income), *with* BITTKER & LOKKEN, *supra* note 92, at ¶¶ 5.2, 5.3 (describing realization and imputed income respectively).

237. *See, e.g.*, I.R.C. §§ 531-537, 541-547 (establishing rules on undistributed income of various corporations).

238. *Cf.* Deborah H. Schenk, *A Positive Account of the Realization Rule*, 57 TAX. L. REV. 355, 365 (2004) (noting that one theory that supporting the realization rule is based on the practical periodical evaluation problem); SIMONS, *supra* note 49, at 56.

239. *See, e.g.*, I.R.C. §§ 531, 535 (including "accumulated" earnings that are "beyond the reasonable need of the business").

240. *See, e.g.*, Treas. Reg. § 1.451-2(a) (not a constructive income "if the taxpayer's control of its receipt is subject to substantial limitations or restrictions"); BITTKER & LOKKEN, *supra* note 92, at ¶ 105.3.3 (describing development of constructive receipt doctrine).

241. *See, e.g.*, Treas. Reg. §§ 1.451-2(a) (including income "constructively received"); Treas. Reg. § 1.451-1(a) (stating that "[g]ains, profits, and income are to be included in gross income for the taxable year in which they are actually or constructively received by the taxpayer").

"phantom income" or "paper income."[242] It occurs when income is taxed; although, it is not supported by cash flow.[243]

F. *Reintroducing Control to the Discussion*

The control test shall be reintroduced to the discussion on the ability-to-pay principle. It is argued that the power to control is the cornerstone in understanding the ability-to-pay principle with regard to de jure dividends. The ability-to-pay principle as seen above does not require cash receipts in order to include income in the tax base.[244] Distribution of income is not a prerequisite for the application of the ability-to-pay principle. Thus, following the ability-to-pay principle, de jure dividends – which were discussed in the paper – can be taxed. We still, however, have to pose the following question: does the ability-to-pay principle always justify taxation of de jure dividends? To respond to this question, it is necessary to distinguish between taxation on the corporate level and the shareholder level.

The application of the ability-to-pay principle does not require a special inquiry regarding the jure dividend at the corporate level. The baseline in this paper was the acceptance of entity tax. If one recognizes the separate entity of corporations and its tax rate, then literally, corporations are able to pay tax on income (dividends) they have chosen to accumulate rather than distribute. Whenever corporations accumulate earnings in order to avoid tax, tax laws impose tax on this undistributed income. Tax laws, in a way, equalize the tax treatment between corporations (and their shareholders), who distribute earnings, and corporations (and their shareholders), who maintain those earnings.[245] Thus, corporations that are deemed to be separate entities have to bear this tax. In this respect, imposing tax on de jure dividends at the corporate level meets the ability-to-pay principle. As illustrated below, this taxation – taxing de jure dividends at the corporate level – is even justified, not only on the ability-to-pay

242. *See, e.g.*, Deborah H. Schenk, *supra* note 238, at 377-78 n. 102 (noting that "[w]hile economists may view paper profits as income, people do not" and neither do courts).

243. *See, e.g.*, Treas. Reg. §§ 1.451-2(a), 1.451-1(a).

244. *See* MURPHY & NAGEL, *supra* note 56, at 20.

245. *See, e.g.*, I.R.C. §§ 482, 531, 541. There is a certain paradox here. Anti-avoidance tax provisions, in this context, are usually designed to prevent shareholders from exploiting the corporate entity to reduce their tax liability. *See* BITTKER & EUSTICE, *supra* note 130, at ¶ 1.02. Although two-tier taxation can be justified on the grounds that corporations are separate entities, the anti-avoidance provisions pierce the corporate veil. *See id.* The paper will not elaborate here on this paradox since it deserves a separate discussion.

principle but also as a mechanism to mitigate the agency problems in closely held corporations.[246]

However, taxing de jure dividends at the shareholder level is not straightforward according to the ability-to-pay principle. When we concentrate on de jure dividends in closely held corporations, we need to differentiate between two scenarios: first, when there are no agency costs, and second, when there is a conflict between minority and majority. In the first scenario, when generally all shareholders share both ownership and control, shareholders can be justly taxed on the undistributed earnings. The deemed distribution is usually required by tax laws to avoid tax exemption or deferral by shareholder-managers in small corporations, who both run and own the corporation.[247] Shareholders, in these corporations, have the option to decide if they wish to distribute accumulated earnings as dividends or not.[248] Imagine a button that shareholders can press and receive dividends from the corporation. Shareholders have the power to control this button and to decide whether they press the button or not. However, when shareholders have conflicting interests and where minority shareholders are oppressed, not all shareholders have the power to access and use this button. All shareholders have the legal right to receive dividends when the button is pressed, no matter by whom, but minority shareholders cannot reach that button. The imaginary button illustrates the division between ownership and control in closely held corporations when minority shareholders are exploited. If a tax provision levies shareholders on de jure dividends, shareholders have to pay tax, although, they did not receive any cash flow. If shareholders were financially well-off, they would not face any financial difficulty. But minority shareholders repressed by majority shareholders, who might lose other sources of income due to this coercion, may face grave financial stress. This category of tax provisions may even aggravate the agency problem.

It is claimed here that taxing all shareholders with regard to de jure dividends, without excluding exploited minority share-

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246. This discussion could serve as an additional justification for two-tier taxation from an agency perspective, see Kanda & Levmore, *supra* 7, at 226-39, and Snoe, *supra* 109, at 28-42, but the justification here is based and analyzed on the ability to pay principle.

247. *See* 14A WILLIAM MEADE FLETCHER, FLETCHER CYCLOPEDIA OF THE LAW OF CORPORATIONS § 7033.30 (2012).

248. *See id.*; *see, e.g.*, MODEL BUS. CORP. ACT §§ 1.40(6), 6.40, 8.01-02. Each corporation has to have a board of direction (§ 8.01(a)); in the U.S. the board of directors is authorized to declare dividends (under § 6.40) (§ 1.40(6) defining dividend as distribution);. 3 JAMES D. COX & THOMAS LEE HAZEN, TREATISE ON THE LAW OF CORPORATIONS § 14:3 (3d ed. 2012) (observing agreements with minority shareholders on declaring dividends).

holders, undermines the ability-to-pay principle. The ability-to-pay principle requires that individuals should be taxed according to their well-being. Minority shareholders who lost control over their wealth cannot be exposed to a tax on de jure dividends (even if they are not in any financial distress). Even if minority shareholders still possess the legal entitlement to dividends, as long as they have no control of the dividend distribution, they should not be taxed on this undistributed income. Minority shareholders, who do not have direct control on their dividend distributions, cannot be deemed to possess the wealth derived from these dividends. The narrow test for control should be applied in all tax provisions imposing de jure dividend on shareholders.[249] The direct economic wealth right is a precondition to tax shareholders on undistributed income. Thus, the ability-to-pay principle concerning de jure dividends should be regarded in terms of the **ability to control dividend payments in closely held corporations.**

As emphasized, the power to control income is a vital feature in the paper. It is interesting to see that rewriting this feature into the ability-to-pay principle assists in mitigating the agency problem. This feature amalgamates both tax and corporate disciplines and aligns the analysis of those fields. It was shown that there is a certain symbiotic relationship between corporate law and tax law with regard to de jure dividends. On the corporate level, corporations may be induced to distribute dividends to escape additional tax since people are responsive to tax. This induced distribution can assist minority shareholders in mitigating their problem. On the shareholder level, excluding the minority from the tax burden may perhaps not alleviate their problem but at least not worsen it. It is possible to promote corporate law objectives – assisting the minority to receive dividends or to at least not exacerbate their position. Here, poorly designed tax provisions, allowing the taxing of exploited minority shareholders on de jure dividends should be revised. Such provisions are neither

249. This paper focuses on agency problems occurring between minority and majority in closely-held corporations. In general, the same outcome concerning the control requirement shall apply to partnerships – where partners are taxed also on de jure income (as part of the pass-through system). However the main difference between partners and shareholders is the default rule concerning winding up. *See, e.g.*, 1 COX & HAZEN, *supra* note 248, at § 1:7[7]; 4 *id.* at § 26:7. Partners can leave the partnership at will. *See* UNIF. PARTNERSHIP ACT § 37 (1914). Dissolution of a partnership is easier and quicker than a corporate dissolution and thus, partners have more direct control on their wealth than (minority) shareholders. *See, e.g.*, 1 COX & HAZEN, *supra* note 248, at § 1:7[7].

aligned with the ability-to-pay principle nor with corporate ideas. Thus, legislators should modify these sorts of provisions.[250]

VI. CONCLUSION

By studying the incident of undistributed dividends, the paper shows that the apt interpretation of tax terms follows corporate governance rationales. The paper reaches this outcome by examining if taxation of de jure dividends both at the corporate and shareholder level falls in line with the ability-to-pay principle. By introducing the agency problem – and more specifically, the depriving of dividends to minority shareholders in closely held corporations – the paper argues that taxing all shareholders on undistributed dividends deviates from the ability-to-pay principle and thus is unjust. This conclusion is reached by focusing on the power to control. When agency conflicts occur, ownership by itself does not represent the economic power. Control is a necessary ingredient to generate the economic power and wealth. Control in tax law should be defined, at least, in accordance with the test identified in the paper as the narrow control test. The paper suggests that de jure dividend provisions taxing shareholders should not apply on all shareholders but only on majority shareholders who possess control over dividend distribution decisions. Using this understanding, this paper reaches a different conclusion with regard to de jure dividends at the corporate level. It is noted that taxation of undistributed dividends does not interfere with the ability-to-pay principle. Moreover, the paper discusses its power to mitigate the agency problem and studies the relationship between tax law and corporate governance with respect to the agency problem. If the ability-to-pay principle, when agency problems occur, is understood in terms of the ability to control dividend payments, the indirect outcome is that income tax law has the ability to "mind" minority and "monitor" majority.

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250. The paper does not elaborate on the practical issues involved with this proposal. It can only be suggested that in order to minimize costs incurred by the tax authorities and as a result of shareholders being better informed about their exploitation, shareholders should bear the burden of proving that they are exploited. If shareholders succeed at proving that majority shareholders are exploiting them, they should be exempt from the tax imposed on undistributed dividends.