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ARTICLES

TAX AUTHORITY AS REGULATOR AND EQUITY HOLDER: HOW SHAREHOLDERS' CONTROL RIGHTS COULD BE ADAPTED TO SERVE THE TAX AUTHORITY

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INTRODUCTION

There has been some hullabaloo about governments worldwide taking equity stakes in troubled banks[1] and car companies.[2] The surprised and at times outraged tone of the hullabaloo reveals a broadly shared and incorrect belief that governments do not already have equity stakes in enterprise. Governments, including our own, regularly take equity stakes in distressed corporations.[3] In fact, governments have a substantial

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[1] For an explanation of the benefits to government involvement in bank restructuring, see AUGUSTIN LANDIER & KENICHI UEDA, INT'L MONETARY FUND, THE ECONOMICS OF BANK RESTRUCTURING: UNDERSTANDING THE OPTIONS 9 (June 4, 2009), *available at* http://www.imf.org/external/pubs/ft/spn/2009/spn0912.pdf.

[2] *See* Conor Clarke, *What Socialism Looks Like*, THE ATLANTIC (June 3, 2009), http://correspondents.theatlantic.com/conor_clarke/2009/06/what_socialism_looks_like.php (responding to some of the hullabaloo with a pie chart that compares publicly to privately managed assets in the United States, without accounting for the government's equity position explained in this Article).

[3] Governments, including the U.S. government, have taken equity stakes in distressed firms for decades. For instance, the Public Benefits Guarantee Corporation ("PBGC") interjects itself between insolvent employers and their pensioners, partly meeting defined benefit obligations to the pensioners and in exchange becoming a claimant in the employer's bankruptcy. As a claimant, the PBGC receives assets of the bankrupt entity or an interest therein. On occasion, the interest is that of a shareholder. *See, e.g.*, *U.S. Sees Profit on Airline Loan Guarantee Program*, USA TODAY (Nov. 30, 2006), http://www.usatoday.com/travel/news/2006-01-30-loan-profits_x.htm (discussing the PBGC's equity stakes in the reorganized U.S. Airways and United airlines). The government has also occupied an exclusive

equity stake in each corporation, distressed or not, via the tax authority's claim on a fraction of corporate income. Some degree of government ownership and control of enterprise is an inevitable consequence of a functional income tax.[4] This observation not only challenges popular notions that recent direct investments by the government in public corporations[5]

ownership and control role in the resolution of failed banks. The present statutory scheme under which the Federal Deposit Insurance Corporation ("FDIC") may liquidate or operate failed banks has been in place for over thirty years. *See* 12 U.S.C. § 1821 (2006).

[4] In 1945, Evsey D. Domar and Richard A. Musgrave explained that "[b]y imposing an income tax on the investor, Congress appoints the Treasury as his partner who will always share in his gains, but whose share in his losses will depend upon the investor's ability to offset losses against other income." Evsey D. Domar & Richard A. Musgrave, *Income Taxation and Risk Taking*, 23 TAXES 60, 60 (1945). The insight that "the income tax grants the tax authority economic rights in firms comparable to those enjoyed by shareholders" has been developed at length by public finance and corporate finance literature investigating the effect the tax authority's interest has on firms' risk preferences. For example, in 1985, Richard C. Green and Eli Talmor elaborated a model showing the conflicting incentives progressive tax rates created for and against risk taking. *See* Richard C. Green & Eli Talmor, *The Structure and Incentive Effects of Corporate Tax Liabilities*, 40 J. FIN. 1095, 1095–96 (1985). Legal scholars working in the tax field have recognized the similarity between shareholders' and the tax authority's economic rights. *See* Louis Kaplow, *Taxation and Risk Taking: A General Equilibrium Perspective*, 47 NAT'L TAX. J. 789, 797 n.5 (1994); Herwig J. Schlunk, *The Cashless Corporate Tax*, 55 TAX L. REV. 1, 1 (2001). Working from that insight in 2000, Herwig J. Schlunk developed a proposal to replace the corporate income tax with a " 'cashless corporate tax' (CCT)." *Id.* The proposal expressly sought to do away with subsidies accomplished through the Internal Revenue Code (the "Tax Code") in the form of favorable tax rates for certain forms of enterprise, which it divided into three categories: (1) those intended by Congress, (2) those representing administrative compromises, and (3) those unintended. *See id.* at 5, 7. The resulting uniform tax rate would be operationalized through virtual nonvoting shares in the taxpayer-corporation. *See id.* at 33–36. The proposal assumed a world without agency costs, where firms were run to maximize true economic income to shareholders. *Id.* at 2 n.1. By tying shareholders' returns to the tax authority's returns, the CCT would end shareholders' efforts to reduce tax liability as any such reduction would proportionately reduce their own returns. Whereas the CCT proposal advocates replacement of the tax authority's economic rights with those of shareholders, this Article instead considers whether it would be worthwhile to add shareholders' control rights to the tax authority's economic rights.

[5] For example, the government has taken equity positions and/or made loans to General Motors, Chrysler, AIG, Bank of America, and Citigroup. *See* DEP'T OF THE TREASURY, TARP TRANSACTIONS REP. 1, 14–17 (2009), *available at* http://www.financialstability.gov/docs/transaction-reports/transactionsreport_08042009.pdf (last visited Nov. 6, 2010) (summarizing cumulative government investments under the Troubled Asset Relief Program and redemptions by the investees for the period ending July 31, 2009).

represent adventurous departures from the status quo[6] but also prompts a puzzle: If the government's economic interest resembles that of a shareholder, why is it denied the control rights shareholders typically enjoy?

The traditional taxonomy of participants in a firm's capital structure divides them between debtholders and shareholders.[7] The former sit atop the capital structure, removed by bankruptcy priority and contractually fixed interest payments from the risks and returns the latter face below.[8] Differences between debtholders' and shareholders' economic interests lead to conflicts over business strategy. Control rights paired to debtholders' and shareholders' economic interests are designed to resolve these potential conflicts without hindering productive efforts of the firm. The primary puzzle prompting this Article is how—in the absence of control rights traditionally afforded to shareholders—the tax authority protects its interests.[9]

The tax authority stands in two distinct positions vis-à-vis each firm.[10] First, the tax authority promotes the government's

[6] *See, e.g.*, Hugh Hewitt, *Just Say No to Government Motors and Obamacars*, WASH. EXAM'R (June 1, 2009), http://www.washingtonexaminer.com/opinion/columns/Hugh-Hewitt/Just-say-no-to-Government-Motors-and-Obamacars-46615602.html ("The very idea of a socialized American car company ought to cause millions of Americans to reject the idea of doing their car shopping at those venues.").

[7] Financial engineers have irradiated these basic categories to produce a bewildering menagerie of interests, which have been studied at length in financial and legal literature. *See generally* THE CREDIT DERIVATIVES HANDBOOK: GLOBAL PERSPECTIVES, INNOVATIONS, AND MARKET DRIVERS (Greg N. Gregoriou & Paul Ali eds., 2008) (discussing contemporary strains of credit derivatives); Edward D. Kleinbard, *Equity Derivative Products: Financial Innovation's Newest Challenge to the Tax System*, 69 TEX. L. REV. 1319, 1322–27 (1991) (discussing the evolution of equity derivatives).

[8] *See* O'Hare v. Comm'r, 641 F.2d 83, 86–87 (2d Cir. 1981) (explaining that the taxpayer should be treated as a creditor rather than as an equityholder in a venture because the taxpayer was not exposed to the risk of the venture); Comm'r v. O.P.P. Holding Corp., 76 F.2d 11, 12 (2d Cir. 1935) ("The shareholder is an adventurer in the corporate business; he takes the risk, and profits from success. The creditor, in compensation for not sharing the profits, is to be paid independently of the risk of success, and gets a right to dip into the capital when the payment date arrives.").

[9] *See* Kaplow, *supra* note 4 ("By owning nonvoting shares through taxation—in the past, shares approaching or exceeding 50 percent—rather than directly, the government is subject to the other shareholders diverting proceeds to themselves at the expense of the silent partner—*i.e.*, through tax avoidance and evasion.").

[10] Revenue raising and regulation may not be distinct ends but rather distinct means. The government may use revenues to finance its regulatory agenda or may forego revenue through favorable tax rates that encourage taxpayers to pursue its regulatory agenda. If a sufficient amount of congressional intelligence is assumed,

interest as regulator. It does so by imposing relatively lower rates on congressionally favored forms of enterprise. Second, the tax authority serves a revenue raising function, which is accomplished through a right to share in firms' revenues.[11] That right to share in firms' revenues is similar to that possessed by the firms' shareholders. Specifically, both share in the residual of a firm's earnings after expenses have been paid.[12] But while the economic rights of shareholders and the tax authority show profound similarities, the control rights afforded to the latter take a drastically different form from those afforded to the former. Unlike a shareholder, the tax authority cannot vote for representatives on the board of directors, cannot threaten management with a transfer of its interest to those more able to impose discipline, and cannot align management's interests with its own by sharing a portion of tax receipts with them. Thus, it lacks three basic tools shareholders use to focus management on the interests of equity: corporate democracy, the market for control, and the market for management.[13] Moreover, directors and officers do not owe the tax authority fiduciary duties that protect other interest holders from their disfavor. Having identified that shareholders and the tax authority have similar economic interests in a firm, but that the latter lacks control rights possessed by the former, Part II considers three questions.

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then the contours of the Tax Code will reflect legislative judgment as to which projects are more effectively delegated to private actors.

[11] Though this Article focuses its discussion on corporations, its reasoning generally applies to other business entities. If the tax authority's control rights in corporations were in excess of those in businesses taxed as pass-through entities, incorporators would face higher incentives to avoid subchapter C. The deadweight loss to tax avoidance prompted by corporate taxation has been extensively addressed. *See*, *e.g.*, Jane G. Gravelle & Laurence J. Kotlikoff, *The Incidence and Efficiency Costs of Corporate Taxation When Corporate and Noncorporate Firms Produce the Same Good*, 97 J. POL. ECON. 749, 749 (1989); Jeffrey K. MacKie-Mason & Roger H. Gordon, *How Much Do Taxes Discourage Incorporation?*, 52 J. FIN. 477, 477–78 (1997). But few, if any, of the control rights typically possessed by shareholders could not also be adapted in favor of the tax authority in pass-through contexts.

[12] *See* Green & Talmor, *supra* note 4, at 1096; Schlunk, *supra* note 4.

[13] *See* Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675, 677 (2007) (critiquing theories of managerial discipline through shareholder democracy); Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 112 (1965) (developing the disciplinary effect of the mergers and acquisitions market on management); Stephen A. Ross, *The Economic Theory of Agency: The Principal's Problem*, 63 AM. ECON. REV. 134, 134 (1973) (developing the disciplinary effect of compensation structure on management).

First, does the tax authority need distinct control rights? If taxes served solely the goal of generating revenues, the tax authority could simply be granted nonvoting common shares in every corporation and rely on assertive shareholders to safeguard its interest.[14] As is, however, taxes are designed to do more than raise revenues—they are also used to encourage congressionally favored behavior.[15] In other words, the tax authority as interest holder does not only care about how much the taxpayer earns but also about how the taxpayer earns it. As a result, the interests of shareholders and the tax authority are not always aligned, as the latter operates under statutory directives that balance raising revenue with encouraging congressionally favored enterprise. If it were not allowed distinct control rights, the tax authority could not steer firm strategy when private and public policy diverged.

Second, if the tax authority requires distinct control rights, why not grant it the same rights as those possessed by shareholders? Part II proposes a series of alternative designs to the contemporary tax system that adapt safeguards afforded to common shareholders to serve the tax authority. The practical and theoretical consequences of adopting these alternatives are discussed. While both a market of control and a market for management could be implemented to benefit the tax authority, neither could, without more, simultaneously accommodate the tax authority's regulatory and financial goals. For example, if the tax authority were allowed to auction off its tax receipts or reward management when firms pay more in taxes, tax revenues would improve, but the incentives imposed by differential tax rates to pursue congressionally favored behaviors would weaken. The same would be true if fiduciary duties were owed to the tax authority.

The third question is, given that the tax authority lacks the legal protections provided to shareholders, how is its distinct economic interest in the firm safeguarded? The control rights of the tax authority take the form of a mandatory dividend calculated based on the source of income as well as its amount. This substitute is not surprising. Firms in jurisdictions where

[14] *See* Schlunk, *supra* note 4, at 1–2.

[15] *See* Edward D. Kleinbard, Chief of Staff, Joint Comm. on Taxation, Address Before the Chicago-Kent College of Law Federal Tax Institute: Rethinking Tax Expenditures (May 1, 2008), *in* STAFF OF JOINT COMM. ON TAXATION, 110TH CONG., A RECONSIDERATION OF TAX EXPENDITURE ANALYSIS 9 (Comm. Print 2008).

shareholders' control rights are otherwise weak are required to pay mandatory dividends to ensure earnings are distributed to shareholders rather than misappropriated by their fiduciaries. The novel feature is the variation in effective tax rates, which seeks joint maximization of the competing goals of revenue and regulation. Part III explains how in addition to being an effective substitute for traditional control rights, the design of the mandatory dividend provides lawmakers with a series of levers that may be used to set risk policy across private enterprise.[16] Because the tax authority shares in the income from a period but does not fully share in the loss, the tax system poses a disincentive to risk seeking. The strength of that disincentive can be affected through changes in the tax rate or the ability of taxpayers to carryover losses between years.

I. CORPORATE FINANCE IN A NUTSHELL[17]

Every corporation begins its life as a legal abstraction—a certificate of incorporation issued from the office of a secretary of state.[18] Before becoming self-sufficient through operations that produce enough cash to cover its expenses, a corporation survives on money raised from investors.[19] Corporate finance studies the choices firms face when financing their operations and the consequences of those choices.[20] Firms offer instruments that

[16] *See generally* Green & Talmor, *supra* note 4, at 1103–06 (explaining how a progressive tax reduces risk taking by a solvent firm).

[17] Those familiar with basic issues in corporate finance are encouraged to skip Part I.

[18] The office issuing corporate charters and the procedure to receive them vary by state. For example, in Delaware, charters are issued by the Secretary of State and require the filing of a certificate of incorporation setting forth the name of the new corporation, its address and the address of its incorporator(s), its scope of business, and the number and par value of its authorized shares. DEL. CODE ANN. tit. 8, §§ 101–03 (2010).

[19] Firms with sufficient cash flows to cover their costs may also turn to outside financing, for example, to expand or redeem incumbent investors.

[20] *See* Eugene F. Fama, *The Effects of a Firm's Investment and Financing Decisions on the Welfare of Its Security Holders*, 68 AM. ECON. REV. 272, 272–74 (1978) (discussing assumptions under which the capital structure of a firm does not affect its value).

provide their purchasers claims to the firm's assets.[21] Investors purchase these instruments on the primary market, with the purchase price going to the firm.[22]

Each instrument establishes a contract between its issuer and holder, which provides certain rights to the holder in consideration for the capital received by the issuer. At the core of the bundle of rights provided for by an instrument are economic rights or those rights that define the holder's share of the earnings of a firm and its assets in liquidation. For example, prototypical debtholders have rights to receive a fixed stream of payments and, in liquidation, be repaid in full before any payments are made to shareholders. Prototypical shareholders may receive dividends from retained earnings so long as sufficient cash remains to pay debts as they come due and, in liquidation, have rights to what assets remain after debtholders have been satisfied. The instruments that a firm issues to acquire capital comprise the firm's "capital structure."

In addition to conferring economic rights, instruments provide their holders with rights that safeguard those economic rights. These safeguards are referred to as control rights. Control rights are primarily concerned with ensuring that management does not follow policies that maximize returns to other interest holders at the instrument holder's expense. As this Part will explain in more detail, the business decisions that provide optimal returns to the investor depend on the investor's position in the firm's capital structure.

A firm's management team decides between business projects.[23] Projects have a range of returns. These ranges may be described by their mean or by their volatility. Volatility of returns is frequently referred to as risk.[24] Projects may have

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[21] Some interests, such as those in a general partnership, also impose obligations.

[22] The proceeds received by the firm are purchase price less transaction costs. How instruments are marketed is the province of securities laws. After being sold on the primary market, instruments may be traded on the secondary market, though the gain or loss realized through such trades does not directly inure to the firm.

[23] Part I.B discusses the separation of decisionmaking power between shareholders, directors, and officers in more detail. For now, the individuals who make the decisions as to which projects to pursue are referred to as the management team.

[24] Risk may be decomposed into firm specific and systematic risk. *See generally* HARRY M. MARKOWITZ, PORTFOLIO SELECTION: EFFICIENT DIVERSIFICATION OF INVESTMENTS 102–15 (Blackwell 1991) (1959) (explaining how portfolio

lower or higher mean returns than other projects. Projects may also be riskier or less risky than other projects. A firm's management team must decide between projects that have varying risk and return profiles. In general, debtholders will prefer lower risk projects and shareholders will prefer higher return projects.[25] The preferences may be understood by returning to the prototypical claimholders introduced above. Once the firm has sufficient assets to meet debtholders' claims, debtholders would prefer for the firm to reduce risk no matter what such reduction would cost in terms of returns.[26] Shareholders, on the other hand, may sacrifice low risk returns when such returns would not provide the firm with sufficient assets to meet debtholders' claims. Thus, if either debtholders or shareholders had exclusive control over selecting a firm's projects, the firm would end up making inefficient tradeoffs between risk and return.[27]

A firm engaged in financing is an impartial creature.[28] It cares only to raise the most capital, without caring from whom it

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diversification reduces performance volatility). The former may be reduced through diversification of investments across firms. Diversification imposes administrative costs, as even the most passive index has to be rebalanced at the expense of brokerage fees. Moreover, diversification greatly reduces firm specific risks but does not wholly eliminate them. While in the abstract, it may be more correct to discuss the conflicts of interest between stakeholders as to nondiversifiable risk—as other risk could be neutralized through diversification—except where the distinction should be emphasized, this Article will leave risk unqualified, and arguably be simpler and truer to reality, where diversification is neither free nor perfect.

[25] *See* Clifford W. Smith, Jr. & Jerold B. Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. FIN. ECON. 117, 118–19 (1979) (explaining conflicts of interest between debtholders and shareholders as to dividend payments, claim dilution, asset substitution, and underinvestment).

[26] Management may either act to further the interests of other claimholders at the expense of shareholders or to further its own interests at the expense of shareholders. The latter threat may be ameliorated by the participation of debtholders in the capital structure. There is evidence for the proposition that management tends to pursue suboptimal strategies that reduce diversifiable risk at the expense of revenue. *See* Yakov Amihud & Baruch Lev, *Does Corporate Ownership Structure Affect Its Strategy Towards Diversification?*, 20 STRATEGIC MGMT. J. 1063, 1064 (1999) (reviewing studies before concluding that management tends to prefer suboptimal levels of risk reduction); Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323, 324 (1986) (explaining how reduction of retained earnings through debt financing may increase managerial discipline).

[27] *See* Fama, *supra* note 20, at 282.

[28] *See* Franklin Allen & Douglas Gale, *Optimal Security Design*, 1 REV. FIN. STUD. 229, 229–30 (1988) ("An important question concerns how . . . securities should be optimally designed; in other words, how should the payoffs to a security be

raises capital. When a firm seeks to raise capital, it is in the firm's interest to commit to a corporate policy of pursuing projects with maximum risk adjusted returns. As discussed above, instruments provide their holders claims on the issuing firm's assets. A firm's assets, in turn, consist of the sum of proceeds from financing and net returns. Thus aggregate claims to a firm's assets become more valuable as a firm's net returns increase, so a firm that can promise higher risk adjusted returns faces a lower cost of capital.[29] To decrease cost of capital, control rights accompanying instruments have been designed to avoid the troubling possibility that a firm will forego a business plan that maximizes aggregate returns because its management is dominated by one group or another. The remainder of this Part reviews the economic rights and safeguards enjoyed by prototypical debtholders and equityholders.[30]

A. *The Economic and Control Rights of Typical Debtholders*

A debt instrument entitles its holder to recover the principal, or the purchase price of the instrument, by the maturity date of the instrument.[31] In addition to the principal, the issuing firm will pay the holder interest on the principal to compensate the holder for the time value of the principal as well as risk.[32] Thus a

allocated across states of nature in order to maximize the amount the issuer receives?"); Arnoud W. A. Boot & Anjan V. Thakor, *Security Design*, 48 J. FIN. 1349, 1369 (1993) ("The perspective in our theory of security design is that a firm will partition its total asset cash flows into different claims because this maximizes its expected revenue.").

[29] *See* Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 396 (1983) (explaining that stakeholders in a firm only receive voting rights "to the extent those rights are beneficial to the whole enterprise").

[30] The next Part reviews the economic and control rights of the tax authority. It is important to note that while a firm will raise more capital on net if it accompanies the instruments it issues with control rights designed to increase after-tax risk adjusted returns, the firm does not similarly benefit from control rights that maximize pretax returns.

[31] *See* Fin Hay Realty Co. v. United States, 398 F.2d 694, 696 (3d Cir. 1968) (discussing the tax consequences of treating an instrument as either debt or equity and providing a multifactor balancing test—which includes "the relative position of the obligees as to other creditors regarding the payment of interest and principal" and the "contingency [of] the obligation to repay"—to evaluate whether the instrument should be treated as debt or equity for tax purposes).

[32] A debtholder's risk exposure may be decomposed into interest rate risk, counterparty default risk, reinvestment risk, call risk, prepayment risk, and purchasing power risk. For an explanation of the risks faced by a debtholder, see KENNETH R. KAPNER & JOHN F. MARSHALL, THE SWAPS HANDBOOK 56–69 (1992).

debtholder's economic rights are usually limited to a return of principal and interest.[33] So long as a firm's expected earnings are sufficient to satisfy its principal and interest obligations, its debtholders will be unwilling to revise business strategy in a way that increases the likelihood that they will not recover their principal and interest—no matter how much additional profit the firm may be expected to make as a result of such revisions.

Safeguards attending debtholders' interests are designed to protect the fixed returns they are due, without excessively interfering with the aggregate interests of the firm. First, debtholders may enjoy security interests in the firm's assets. These security interests provide collateral in case the firm's income is insufficient to satisfy principal[34] or interest obligations.[35] So long as the value of the collateral remains above the amount due on the loan, the creditor does not incur the debtor's default risk.[36]

Second, debt contracts frequently include covenants. Some covenants require the firm to meet or maintain accounting ratios or other performance targets.[37] Other covenants prohibit the firm from selling its operating assets, incurring additional debt, or otherwise materially changing its business or financial

[33] Interest payments need not be fixed. For example, the interest due on a bond may vary with the London Interbank Offered Rate ("LIBOR"), which is the rate that banks offer when making loans to other banks. *See What's in a Number? Donald MacKenzie on the Importance of Libor*, LONDON REV. BOOKS, Sept. 25, 2008, at 11. Whether an instrument will be treated as debt by the tax authority, however, does partly turn on the determinant of interest payments. *See Fin Hay Realty Co.*, 398 F.2d at 697.

[34] *See* 11 U.S.C. § 506(a)(1) (2006) (providing secured status to lienholders and those holding setoff rights); *id.* § 725 (providing for the distribution of property subject to a lien to the lienholder before any other distribution of the estate's property takes place).

[35] *See id.* § 506(b) (providing for limited satisfaction of postpetition interest from the security interest).

[36] The law of secured transactions is concerned with how and when security interests in collateral are established. *See* U.C.C. § 9-109 (2010) (discussing subject matter of Article 9 of the Uniform Commercial Code); *see also* Ronald J. Mann, *Strategy and Force in the Liquidation of Secured Debt*, 96 MICH. L. REV. 159, 220 (1997) (reporting empirical findings on debtor's recourse to their rights to liquidate collateral).

[37] *See, e.g.*, Freeland v. Iridium World Commc'ns, Ltd., 545 F. Supp. 2d 59, 65–66 (D.D.C. 2008) (tripping of performance based covenants put Iridium World Communications into default).

structure.[38] If the debtor breaches a covenant, the creditor usually has the right to accelerate repayment.[39] Covenants provide both flexibility and deterrence for the benefit of creditors.[40] Performance based covenants provide creditors with early warning that the debtor is approaching an area where shareholders cease to bear the downside.[41] When covenants are tripped, the threat of acceleration allows the creditor to renegotiate the instrument's terms ex post rather than having to attempt to provide for all contingencies ex ante.[42] Covenants that prevent substantial changes in the firm's operations such as mergers, spin-offs, and entry into new lines of business help ensure that the risk profile of a firm is not radically altered post-issuance. Otherwise, a workaday issuer could transform into a tech startup with proceeds from creditors who had purchased the debt at an interest rate calibrated for the more sober business. In short, covenants are designed to safeguard debtholders from management without involving them in management.

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[38] *See* William W. Bratton, *Bond Covenants and Creditor Protection: Economics and Law, Theory and Practice, Substance and Process*, 7 EUR. BUS. ORG. L. REV. 39, 49–62 (2006) (providing an overview of commonly used debt covenants).

[39] As an alternative to accelerating the principal, tripping a covenant may increase the interest rate. *See* Vipal Monga, *Return of the Covenants*, THE DEAL, Feb. 23, 2009, at 4:21 ("Covenants can take many forms, but they are essentially restrictive clauses in loan agreements that force borrowers to meet specific benchmarks or keep them from incurring debt beyond a set level.").

[40] *See* Harry DeAngelo et al., *Asset Liquidity, Debt Covenants, and Managerial Discretion in Financial Distress: The Collapse of L.A. Gear*, 64 J. FIN. ECON. 3, 5 (2002) (describing the use of debt covenants in a case study of the financial distress of L.A. Gear and concluding that "debt covenants sometimes constrain managerial discretion more effectively than does the pressure to meet cash interest obligations").

[41] *See, e.g.*, VFB LLC v. Campbell Soup Co., 482 F.3d 624, 628 (3d Cir. 2007) (providing an example of an earnings based covenant). *See generally* Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209 (2006).

[42] *See* HILARY ROSENBERG, THE VULTURE INVESTORS 17–18 (Wiley 2000) (describing the ability of distressed investors to use the Bankruptcy Code's voting rules to achieve control positions—known as "negative control"—in debtors); Alex Raskolnikov, *The Cost of Norms: Tax Effects of Tacit Understandings*, 74 U. CHI. L. REV. 601, 654–55 (2007) (observing that lenders frequently renegotiate strict covenants); Michael R. Roberts & Amir Sufi, Control Rights and Capital Structure: An Empirical Investigation 23 (Aug. 11, 2008) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=962131 (providing empirical evidence showing that creditors use covenant violation to reduce firms' debt load).

Third and fourth, debtholders benefit from the right to transfer their instruments to other investors and from fiduciary rights.[43] Neither right is unique to debtholders and both will be discussed at length in the following Subpart on shareholders.[44]

B. The Economic and Control Rights of Typical Shareholders

Common shares entitle their holders to the "residual" of a firm or those assets that remain after all other interest holders have been satisfied. The residual is composed of the sum of the firm's proceeds from equity issuances and net income.[45] The residual is reduced to the extent it is distributed.[46] A firm's net income is the difference between its gross income and expenses. Gross income includes, for example, revenues a firm receives from selling its inventory or interest it is paid on bonds it holds. Expenses include, for example, the costs of acquiring the inventory sold, rent for the store space, and wages paid to employees. From the perspective of shareholders, expenses also include interest and taxes due, as these reduce the net income available to shareholders. It is important to note that current

[43] *See VFB*, 482 F.3d at 635–36 (discussing directors' duty of loyalty to creditors where a company is insolvent).

[44] For reasons that will be explained in Part II.B.3, debtholders only benefit from fiduciary rights when the firm enters the zone of insolvency.

[45] A well known formulation by Robert Haig and Henry Simons defines net income as the algebraic sum of: "(1) the market value of rights exercised in consumption [by the taxpayer] and (2) the change in the value of the [taxpayer's] store of property rights between the beginning and end of the period in question." *See* Robert M. Haig, *The Concept of Income—Economic and Legal Aspects*, *in* THE FEDERAL INCOME TAX 1, 7 (Robert M. Haig ed., 1921); HENRY C. SIMONS, PERSONAL INCOME TAXATION 50 (photo reprint 1980) (1938). This definition is inadequate because not all value is protected by legal rights, and moreover, as every lawyer knows, the exact scope of legal rights is difficult to determine precisely. *See, e.g.*, Chris William Sanchirico, *Progressivity and Potential Income: Measuring the Effect of Changing Work Patterns on Income Tax Progressivity*, 108 COLUM. L. REV. 1551, 1551 (2008) (explaining that changes in the composition of off-market labor supply during the 1990s were sufficient to countervail progressive amendments of the Tax Code); *see also* Raskolnikov, *supra* note 42, at 602 (2007) (explaining how norms are relied on in structuring transactions to reduce tax liability).

[46] For example, if a firm is initially capitalized through an equity issuance of $50, operates for a year incurring a net loss of $30, makes net income of $50 in the second year, and breaks even in the third year, declaring dividends of $40, the residual of the firm will be $50 at the outset of year one, $20 at the end of year one, $70 at the end of year two, and $30 at the end of year three.

retained earnings do not fully measure a common shareholder's economic interest in the firm, as shares also entitle their holders to future net income.

Financial statements help investors track and compare financial positions of firms.[47] To assist comparison, accountants have developed rules for when income and expenses are recognized and how they are measured.[48] For example, generally accepted accounting principles ("GAAP") govern[49] how firms report their condition in financial statements disclosed pursuant to the Securities Act of 1933[50] and the Exchange Act of 1934.[51] Financial statements do not fully reflect the value of shareholders' equity because they only reflect past and present net income.

When a firm has insufficient cash to pay its expenses, the firm becomes insolvent and the interests of common shareholders become extinguished.[52] Because shareholders receive as little if

[47] *See* David I. Walker, *Financial Accounting and Corporate Behavior*, 64 WASH. & LEE L. REV. 927, 974 (2007) ("The primary aim of financial accounting is to provide relevant, reliable, consistent and comparable financial information to the capital markets in order to ensure efficient allocation of resources.").

[48] *See* Financial Accounting Standards Board, Facts About FASB, http://www.fasb.org/jsp/FASB/Page/SectionPage&cid=1176154526495 (last visited Nov. 6, 2010) ("Such standards are important to the efficient functioning of the economy because decisions about the allocation of resources rely heavily on credible, concise, and understandable financial information.").

[49] *See* 15 U.S.C. § 77s(a) (2006); *id.* § 78m(b)(1); *see also The Roles of the SEC and the FASB in Establishing GAAP: Testimony Before the Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises of the H. Comm. on Financial Services*, 107th Cong. (2002) (statement of Robert K. Herdman, Chief Accountant, U.S. Securities & Exchange Comm.), *available at* http://www.sec.gov/news/testimony/051402tsrkh.htm (last visited Nov. 6, 2010).

[50] *See* 15 U.S.C. § 77s(a).

[51] *See id.* § 78m(b)(1).

[52] It is useful to distinguish financial from economic insolvency. *See* BARRY E. ADLER ET AL., CASES, PROBLEMS, AND MATERIALS ON BANKRUPTCY 26–27 (4th ed. 2007); Gregor Andrade & Steven N. Kaplan, *How Costly Is Financial (Not Economic) Distress? Evidence from Highly Leveraged Transactions That Became Distressed*, 53 J. FIN. 1443, 1444–45 (1998) (discussing measurement difficulty in distinguishing financial from economic distress). Financial insolvency describes a firm that meets distress solely because claims become due sooner than cash becomes available to meet them; in other words, a firm that is distressed because of the timing rather than the amount of its cash flow. *Id.* at 1445. Economic insolvency describes a firm that is distressed because its revenues will not cover its costs. *Id.* at 1444–45. When a firm faces financial, rather than economic, insolvency, its shareholders may retain an interest in the residual. *Compare* 11 U.S.C. §§ 701–84 (2006) (codifying chapter 7 of the Bankruptcy Code, which provides for economic insolvency), *with id.* §§ 1101–

the firm has not a cent as they do if the firm has exactly enough to satisfy all debtholders, they may be overly willing to risk bad making it worse—whereas debtholders are too willing to satisfy themselves with good instead of better. Collateral, covenants, and the other safeguards discussed in the preceeding Subpart[53] limit these shareholder inclinations but do not affirmatively prescribe firm strategy. While they ensure that debtholders' fixed returns are not unreasonably endangered for the benefit of shareholders, they allow the firm to pursue shareholders' interest, which generally consists of maximizing the residual. This Subpart discusses safeguards that ensure that management does pursue their interests. These safeguards include the right to vote, the right to be informed, the right to transfer shares, as well as fiduciaries' duties to the shareholders.

1. Shareholder Democracy

Governance in corporations takes the form of a constitutional, representative democracy.[54] Incorporation requires the filing of a certificate of incorporation, or analogous charter document, with an officer of a state. The certificate of incorporation may specify features of corporate governance, such as the number of initial directors, the percentage of outstanding shares required for a quorum at a meeting of shareholders or directors, and whether a supermajority is required for shareholder or director actions.[55] The certificate of incorporation may also delegate the determination of these features to the corporate bylaws, which differ from the certificate in several

174 (codifying chapter 11 of the Bankruptcy Code, which provides for reorganization from financial insolvency).

[53] *See supra* Part I.A.

[54] Voting rights attending share ownership have evolved over the course of the twentieth century from statutorily imposed egalitarianism, which required each share to confer one and only one vote on its holder, to the current system, which allows firms to issue classes of shares with distinct voting power. *See* LOUIS LOSS & JOEL SELIGMAN, 4 SECURITIES REGULATION 1831–49 (3d ed. 2000) (discussing the evolution of restrictions on shareholder disenfranchisement); *see also* David L. Ratner, *The Government of Business Corporations: Critical Reflections on the Rule of 'One Share, One Vote*,*'* 56 CORNELL L. REV. 1, 8 (1970) ("By the end of the nineteenth century, then, statutory restrictions on the rule of one vote per share in business corporations had virtually disappeared, and it is now unusual to find a statutory reference to any formula other than one vote per share.").

[55] The bylaws may also impose other restrictions. *See, e.g.*, Brown v. Jacobs, 29 F.2d 202, 202 (4th Cir. 1928) (enforcing restriction on executive compensation).

important respects.[56] First, the bylaws are a contract between shareholders, whereas the certificate is a contract with the state. Second, the bylaws may be amended by the board of directors, whereas the certificate can only be amended with shareholder approval. Though governance features may vary across corporations, and some corporations may fix features of governance permanently or subject only to amendment by shareholder supermajority, the separation of ownership and control is ubiquitous.[57] Shareholders do not themselves ordinarily manage operations.[58] In fact, they do not even manage those who manage operations. Instead, officers of the company make business decisions, and directors reward or terminate officers based presumably in part on the results of those decisions. Excepting requirements for shareholder approval of certain extraordinary actions such as mergers, liquidations, and sales of substantially all of the corporation's assets,[59] shareholders influence the acts of the corporation only indirectly, through electing directors to represent their interests.[60]

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[56] *See* Carr v. City of St. Louis, 9 Mo. 191, 191 (1845) ("It is a well settled principle of law, that the by-laws of a corporation must not be repugnant to its charter; the charter creates an artificial being, defines its powers, designates the purposes of its institution, and points out its mode of action. It is the fundamental law of the corporation, and is as a constitution to the body acting under and by it.").

[57] *See* Baird & Rasmussen, *supra* note 41, at 1213–14 ("Shareholders, as residual claimants, serve as good proxies for all investors when the business is flush. They bear both the costs and benefits of the enterprise, but they do not actually control the day-to-day affairs of the business, ceding decision making over all but a handful of matters to directors and officers."). Close corporations pose the exception to this general rule, allowing shareholders to manage the business of the corporation instead of the board of directors. *See, e.g.*, DEL. CODE ANN. tit. 8, § 351 (2010).

[58] *See, e.g.*, Trethewey v. Green River Gorge, Inc., 136 P.2d 999, 1010 (Wash. 1943) ("The power of management of the corporate affairs and the power to contract so as to bind the corporation is vested primarily in the board of directors and not in the stockholders; the principal rights of the latter, in ordinary business or trading corporations, are to attend and vote at corporate meetings, to pass and amend by-laws, to elect directors, to participate in dividends and profits, and to receive their proportionate shares of the corporate property or its proceeds upon dissolution and winding up of the corporation after payment of its debts.").

[59] *See, e.g.*, DEL. CODE ANN. tit. 8, §§ 253, 271, 275 (2010) (setting forth shareholder approval requirements to carry out a merger, asset sale, and liquidation of a Delaware corporation, respectively).

[60] *See id.* § 141(a) ("The business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation."); Abercrombie v. Davies, 123 A.2d 893, 898 (Del. Ch. 1956) (holding that Delaware corporate law "does not permit actions or agreements by stockholders which would take all power from the board to handle matters of substantial management policy"),

The power of shareholder democracy to discipline management weakens as share ownership becomes more diffuse. As the shareholder's proportionate ownership of the company shrinks, both the cost to the shareholder of allowing ineffective management and the voting power of the shareholder to prevent it diminish. Various bodies of law reinforce shareholder democracy in broadly held corporations. Proxy rules promulgated by the Securities and Exchange Commission ("SEC") under the Exchange Act of 1934 (the "Exchange Act") restrict manipulation of shareholder voting by, for example, preventing the bundling of several proposals to force shareholders to approve the bad with the good.[61] Securities exchanges and other markets qualifying as Self Regulating Organizations ("SROs") under the Exchange Act impose restrictions on listed issuers. These restrictions prop up shareholder democracy by, for example, requiring shareholder approval of additional equity compensation to management so as to prevent dilution of shareholder interests. Tax law also plays a role in encouraging shareholder democracy. For example, section 280G of the Internal Revenue Code (the "Tax Code") imposes an excise tax on certain severance payments to management in excess of a statutory threshold unless the payment is unanimously approved by shareholders.[62]

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rev'd on other grounds, 130 A.2d 338 (Del. 1957); Joseph Greenspon's Sons Iron & Steel Co. v. Pecos Valley Gas Co., 156 A. 350, 351–52 (Del. Super. Ct. 1931) (holding that control of the company is vested in a company's board of directors, which delegates its powers to officers); Cahall v. Lofland, 114 A. 224, 229 (Del. Ch. 1921) (holding that duties of directors "relate to supervision, direction and control, the details of the business being delegated to inferior officers, agents and employees"), *aff'd*, 118 A.1 (Del. 1922). For a proposal to expand policy decisions subject to shareholder democracy, responses to that proposal and its defense, see Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005); Stephen M. Bainbridge, Response, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735 (2006); Leo E. Strine, Jr., Response, *Toward a True Corporate Republic: A Traditionalist Response to Bebchuk's Solution for Improving Corporate America*, 119 HARV. L. REV. 1759 (2006); Lucian A. Bebchuk, Reply, *Letting Shareholders Set the Rules*, 119 HARV. L. REV. 1784 (2006).

[61] *See* 15 U.S.C. §§ 78a–*ll* (2006) (codifying the Exchange Act); 17 C.F.R. § 240.14a-4(a)(3), (b)(1) (2010); *see also* Koppel v. 4987 Corp., 167 F.3d 125, 134–35 (2d Cir. 1999).

[62] While corporate law allows the attachment of voting rights to instruments other than common shares, in practice voting is restricted to shareholders. *See* Easterbrook & Fischel, *supra* note 29, at 399 ("Almost all shares have one vote, and only shares possess votes."). Frank Easterbrook and Daniel Fischel have explained this practice as a reflection of the shareholders' incentives as residual claimants:

2. Disclosure

Enfranchisement without more does not guarantee responsible governance. For democratic feedback to steer management in the right direction, shareholders must be able to assess managerial performance. Shareholders' rights to be informed of firm performance serve as an essential complement to voting rights. These rights have many sources. State law generally provides "inspection rights," which require corporations to make available firm financial information at shareholder request.[63] A firm that has registered with the SEC either because it publicly issued securities or because its securities are held sufficiently broadly must comply with additional Exchange Act disclosure requirements, which include periodic reporting of the firm's financial position, risks the firm faces in running its business, and performance relative to close competitors.[64] In addition, the proxy statement of a registered firm must include details on directors' and officers' compensation, ostensibly to inform shareholders how much they are paying for the firm's

> The firm should invest in new products, plants, etc., until the gains and costs are identical at the margin. Yet all of the actors, expect the shareholders, lack the appropriate incentives. Those with fixed claims on the income stream may receive only a tiny benefit (in increased security) from the undertaking of a new project. The shareholders receive most of the marginal gains and incur most of the marginal costs. They therefore have the right incentives to exercise discretion.

Id. at 403. Whether shareholders truly are sole residual claimants will be addressed in Part II, below.

[63] The right of inspection has both common law and statutory sources. *See* DEL. CODE ANN. tit. 8, § 220 (2010) (granting inspection rights to shareholders of Delaware corporations); 5A WILLIAM MEADE FLETCHER ET AL., FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 2239 (West rev. vol. 2004) ("The right of the shareholder at common law extends to all the books, papers, records, federal reports, and other data of the corporation respecting assets, liabilities, contracts, operations and practices, including correspondence between the controlling officers relating to the internal affairs of the corporation."); *id.* (discussing statutory right, which in "a majority of . . . jurisdictions . . . extends to books and records of account, minutes and record of shareholders"). The business judgment rule, which is discussed subsequently, does not protect directors who fail to disclose information to the shareholders that is necessary to the latter's "informed choice on a matter of fundamental corporate importance." *In re* Anderson, Clayton S'holders' Litig., 519 A.2d 669, 675 (Del. Ch. 1986). In some states, the certificate of incorporation may confer upon debt holders the same rights enjoyed by shareholders, including inspection rights. *See, e.g.*, DEL. CODE ANN. tit. 8, § 221 (2010).

[64] *See* JAMES D. COX ET AL., SECURITIES REGULATION 545–78 (6th ed. 2009).

performance.[65] The rules of specific exchanges further expand shareholder access to information. For example, Rule 15c2-11 of the Exchange Act requires broker-dealers to provide financial information on unlisted issuers of securities they mediate,[66] thus ensuring that even a nonregistered firm's financials will be available by a route other than state corporate law.[67]

3. Fiduciary Duties

In addition to the private deterrence imposed by shareholder democracy, directors and management are subject to civil liability as shareholders' fiduciaries.[68] There are two qualities to fear in a caretaker—evil and stupidity—either one of which may precipitate abusive decisions. Fiduciary duties on their face offer protection against both evil and stupidity on the part of directors and management. Though the formulation varies across states, management and directors are generally obligated to "perform [their] duties . . . in good faith and with that degree of care which an ordinarily prudent person in a like position would use under similar circumstances" and to do so in a manner reasonably believed to be in the best interest of the corporation.[69] Evil violates the obligation to act in good faith and in a manner reasonably believed to be in the best interest of the corporation.

[65] *See* SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833, 856 (2d Cir. 1968) (approving rescission of options granted to management where material facts were not disclosed).

[66] 17 C.F.R. § 240.15c2-11(a) (2010).

[67] Presumably if a purchaser acquires an instrument directly from the issuer without intermediation, the purchaser can request desired information from the issuer as part of the same transaction.

[68] Like debt covenants, fiduciary duties prevent mismanagement rather than ensure managerial excellence. To borrow an analogy from horse racing, both fiduciary duties and debt covenants form rails. They prevent the horses from wandering into the center of the track to graze on the lush grass—but they do not ensure that the horses give their all to the race. This similarity should not obscure the many distinctions between debt covenants and fiduciary duties. Debt covenants and fiduciary duties differ in origin, specificity, and obligated parties. The former are based in private law, take the form of rules, and obligate the firm vis-à-vis the creditor. The latter are based in public law, take the form of standards, and obligate directors and officers to the firm.

[69] N.Y. BUS. CORP. LAW § 717(a) (McKinney 2010) (specifying duties of directors); *see* 3A WILLIAM MEADE FLETCHER ET AL., FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 1029 (perm. ed., rev. vol. 2002) (introducing duty of care and distinguishing it from duty of loyalty); MODEL BUS. CORP. ACT § 8.30 (2002) (requiring each director to act "in good faith" and "in a manner the director reasonably believes to be in the best interests of the corporation").

Stupidity would violate the statutory obligation of due care but for the court-created business judgment rule, which excuses decisions that yield poor results provided they are preceded with adequate procedure.[70]

Several justifications have been offered for declawing the obligation of due care, among them the dangers of judging business decisions in hindsight and the ability of shareholders who are dissatisfied with the quality of management to leave the firm.[71] The first explanation fails to explain courts' unembarrassed assessment of business decisions on their economic merits in other contexts. In the tax context, for example, the economic substance doctrine discussed in Part II.F asks whether a transaction poses "a reasonable possibility of [pretax] profit" when determining whether its form would be respected or whether the form would be disregarded and less favorable tax treatment accorded.[72] As another example, in the antitrust context, courts ask whether a decision not to deal with a competitor was precipitated by anticompetitive motives or legitimate business purpose.[73] A justification of the business judgment rule as judicious modesty fails to account for the selective practice of such modesty. The second explanation is also, without more, unsatisfying. It applies equally to the duty of good faith: if a shareholder dislikes a self-dealing manager, the shareholder is as free to sell as if she dislikes a foolish one. Considering fiduciary duties as a complement to shareholder democracy, however, helps explain why courts have trimmed the duty of due care but not the duty of good faith. A fiduciary who intentionally seeks to benefit himself at the expense of the firm is

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[70] *See* Brehm v. Eisner, 746 A.2d 244, 264 (Del. 2000) (limiting judicial analysis of due care to the procedure by which a decision was made rather than the substance of the decision).

[71] *See* Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1198 (1981) (discussing the business judgment rule as embodying a "policy of judicial restraint"); Hillary A. Sale, *Delaware's Good Faith*, 89 CORNELL L. REV. 456, 473 (2004); Jonathan R. Macey & Maureen O'Hara, *The Corporate Governance of Banks*, FED. RES. BD., N.Y. ECON. POL'Y REV., Apr. 2003, at 93 ("Courts have long recognized the risks associated with judging directors' decisions retrospectively . . . [and] responded by developing what is known as the Business Judgment Rule.").

[72] *See supra* Part II.F.

[73] *See* Aspen Skiing Co. v. Aspen Highlands Skiing Corp., 472 U.S. 585, 608–09 (1985) (requiring inquiry into whether decision not to cooperate with a rival was efficient when assessing whether such decision was anti-competitive).

likelier to manipulate the disclosure process upon which departure and deterrence through shareholder democracy are predicated. A fool fiduciary is likelier to leave footprints revealing his stumbles, especially after being forced down a procedural path.[74]

In a typical corporation and most of the time, fiduciary duties protect solely the shareholders. There are, however, exceptions in which fiduciaries are duty-bound to multiple stakeholders simultaneously. For example, officers and directors of a bank insured by the Federal Deposit Insurance Corporation ("FDIC") owe a duty of care to the bank, which the FDIC may enforce.[75] Outside the banking industry, fiduciary duties expand to protect debtholders when a firm nears the zone of insolvency.[76] Moreover, shareholders themselves do not necessarily have the same interests or even rights, as some may be investing for the long term and others for the short term, or they may simply be holding distinct classes of shares with distinct voting or transfer rights.

4. Market for Control

While dispersed shareholders may be too light a rider to spur management to excellence, and fiduciary duties do nothing to restrict management from shabby decisions, management in a broadly held corporation may not be safe to remain in a state of perfectly unproductive repose.[77] When management does less

[74] It is also worth noting that the deterrence effect of shareholder democracy diminishes during the fiduciary's final term. Being fired becomes less of a threat to an officer who plans to retire anyway. The duty of good faith helps guard against otherwise rational self-dealing by officers in their last term, as it forces disgorgement of any gains achieved thereby. This second reason for the selective reduction of fiduciary duties is not as satisfying as the first because it does not consider that a fiduciary may allow his laziness to triumph in the final term as easily as his venality.

[75] 12 U.S.C. § 1821(k) (2006); Atherton v. Fed. Deposit Ins. Corp., 519 U.S. 213, 216 (1997); Francis v. United Jersey Bank, 432 A.2d 814, 824–25 (N.J. 1981).

[76] While mismanagement in a firm with substantial residual hurts only the shareholders, as the residual evaporates, debtholders become exposed to additional losses. Thus while the occasions when debtholders formally enjoy fiduciary rights may be rare, positively, debtholders may enjoy such rights much of the time when they would matter.

[77] *See* Manne, *supra* note 13 (offering seminal formulation of the market for corporate control); Randall Morck et al., *Characteristics of Targets of Hostile and Friendly Takeovers*, *in* CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES 101 (Alan J. Auerbach ed., 1988).

than it can with a firm's assets, it faces the threat that the share price becomes sufficiently depressed to make it worthwhile for a concentrated owner to emerge. A third party with sufficient cash and certainty in the potential of the firm may buy a sufficient number of the shares from their dispersed holders to gain effective voting control over the board of directors, elect its own representatives to it, and have them install harder working management that better takes advantage of the firm's capacity.[78] The purchase price offered to the dispersed shareholders may reflect a "control premium," which shares the benefit of anticipated improvements in the firm's performance with incumbent shareholders. The more incumbent management mismanages the firm, the cheaper it becomes for a third party to offer a substantial premium to purchase control of the firm.[79] This corrective force is dubbed the "market for control" and rests on shareholders' right to transfer their shares. Without that right, the threat of a concentrated owner emerging to clean house would not be credible.[80]

5. Market for Management

Like the market for control, the market for management does not refer to a distinct shareholder right but rather to a force that derives from a legal right and encourages managerial excellence. The predicate right to the market for control is the shareholder's vote, especially as it applies to executive compensation. As mentioned above, layers of state, federal, agency, and SRO law enhance shareholder power as voters on issues of executive compensation.[81] Well-designed executive compensation packages align the interests of management with the interests of shareholders. For instance, by granting officers

[78] *See* Manne, *supra* note 13, at 112–14.

[79] The extent to which the market for control disciplines management has been the subject of academic debate. *See, e.g.*, F. M. Scherer, *Corporate Takeovers: The Efficiency Argument*, 2 J. ECON. PERSP. 1, 69, 80 (1988) ("In theory, tender offer takeovers provide a significant corrective against managerial departures from profit maximization. Careful scrutiny of the available evidence[, however,] leads to a more skeptical assessment.").

[80] *See* DEL. CODE ANN. tit. 8, § 202(d) (2010) (enumerating per se reasonable purposes for restrictions on the transfer of securities); ANGELA SCHNEEMAN, THE LAW OF CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS 286, 288–91 (3d ed. 2002) (discussing permissible restrictions on the alienability of stock).

[81] *See supra* Part I.B.1.

stock in the corporation, the shareholders can ensure that management will benefit when they do.[82]

Where the market for control takes place between shareholders, the market for management is between candidate-officers. The better a candidate believes she would be at the job, the more she expects to gain from stock based compensation. Thus, were the firm to run an auction for the executive office holding the amount of equity compensation constant and allowing candidates to submit bids reporting the minimum cash compensation they would be willing to work for, the best candidate[83] would take the lowest amount of cash compensation. To the extent that contests among candidates for executive positions follow this procedure, not only is the quality of the candidates maximized, but the amount of cash expended by the firm is minimized. This is the ex ante benefit of the market for management. The firm continues to benefit from the market ex post as the executive's well-being is tied to that of shareholders through the equity component of her compensation.

[82] Such grants are not without downsides. First, they dilute the nonofficer shareholders, who now must share the residual with the officers. When equity grants substitute for cash compensation, the dilution is offset by the savings the firm realizes on executives' salaries. Second, awarding an executive a large block of stock may discourage the executive from bold but efficient strategies because the block may represent a very large portion of the executive's net wealth. To offset this deterrent to productive risk taking, firms may award executives out of the money options, which only acquire value when the firm surprises investors' expectations. Finally, equity compensation may increase incentives for management to engage in earnings management. Michael C. Jensen & Kevin J. Murphy, *Remuneration: Where We've Been, How We Got to Here, What Are the Problems, and How To Fix Them* 47 (European Corporate Governance Inst., Finance Working Paper No. 44, 2004), *available at* http://ssrn.com/abstract=561305; *see also* Daniel B. Bergstresser & Thomas Philippon, *CEO Incentives and Earnings Management: Evidence from the 1990s*, 80 J. FIN. ECON. 511, 521–24 (2006) (showing evidence that earnings management increases with equity compensation).

[83] This assumes that candidates could judge their own quality and have equal opportunity costs. If they cannot judge their quality, the hired officer may suffer from the winner's curse, and the company may suffer from an arrogant fool. *See* J. B. Heaton, *Managerial Optimism and Corporate Finance*, 31 FIN. MGMT. 33, 33–35 (2002) (summarizing literature on optimism and exploring its implications for managerial decisionmaking). If candidates do not share the same alternatives, then a lower cash bid may be motivated by the absence of anything better rather than from an ability to more effectively exploit firm resources.

II. THE TAX AUTHORITY AS EQUITY HOLDER

The economic interest the tax authority has in a firm is similar but not identical to that of the shareholder.[84] To understand the extent of overlap between shareholders' and the tax authority's interests, it bears taking a look at the role and principles of tax accounting. Whereas accounting serves merely to inform shareholders of the firm's financial position, accounting wholly determines how much the tax authority receives. A firm's tax liability is calculated by applying a progressive schedule of rates to its positive taxable income and then subtracting certain credits.[85] Taxable income is arrived at by reducing the firm's gross income by various expenses, such as interest payments to debtholders.[86] At this level of generality, taxable income represents a quantity indistinct from net income under GAAP.

Tax and GAAP measures of gross income and expenses, however, do differ.[87] Whereas GAAP seek to assess a firm's financial position, tax accounting also serves regulatory goals, which occasionally conflict with accurate reporting of income.[88] For example, interest payments from municipal bonds are not included in taxable income. This is not an oversight by tax accountants. Rather, the omission is designed to allow the federal government to subsidize local governments without having to go through the additional steps of raising tax revenues at the federal level and then redistributing them to the local level.[89] As an example of another difference, revenues and expenses are generally recognized by tax accounting closer to the time at which they resolve into cash inflows and outflows. This

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[84] *See* Schlunk, *supra* note 4, at 1–2.

[85] *See* STEPHEN A. LIND ET AL., FUNDAMENTALS OF CORPORATE TAXATION 14–23 (7th ed. 2008) (describing the process of calculating a corporation's tax liability, including any under the alternative minimum tax).

[86] *Id.* at 132–34 (explaining the distinct tax treatment of equity and debt and discussing some of the factors used to determine whether an instrument is equity or debt).

[87] *See* David I. Walker, *Financial Accounting and Corporate Behavior*, 64 WASH. & LEE L. REV. 927, 971–1008 (2007) (discussing implications of conforming tax to GAAP accounting); *see also* Robert Willens, *Defining and Dealing with a Deferred Tax Asset*, 27 TAX MGMT. WEEKLY REP. 1224 (2008).

[88] *See* Thor Power Tool Co. v. Comm'r, 439 U.S. 522, 542 (1979) (discussing difference in purpose of tax and GAAP accounting).

[89] *See* Kevin M. Yamamoto, *A Proposal for the Elimination of the Exclusion for State Bond Interest*, 50 FLA. L. REV. 145, 150–52 (1998) (criticizing the subsidy as inefficient and inequitable and proposing an alternative means for subsidizing state spending on public goods).

difference in timing avoids potential liquidity costs that could be imposed on firms if they had to service tax liability based on gains in the value of assets difficult to convert to cash.[90] The difference in timing also extends the lag between accounting and reality.[91] While GAAP itself does not perfectly assess a firm's net income, these departures from GAAP further distort its measure.[92]

The differences in measurement between tax accounting and whatever measure shareholders use to gauge their own well-being qua shareholders is the practical justification for this Article because it is these differences that necessitate granting the tax authority its own control rights.[93] To the extent that maximizing the residual available to common shareholders also maximizes taxable income, assertive shareholders incidentally safeguard the tax authority's interest.[94]

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[90] *See* Wolfgang Schön, *The David R. Tillinghast Lecture: The Odd Couple: A Common Future for Financial and Tax Accounting?*, 58 TAX L. REV. 111, 133–39 (2005) (discussing liquidity impact of tax accounting as a motivation for the disparities between tax and GAAP accounting).

[91] *See, e.g.*, Black & Decker Corp. v. United States, 436 F.3d 431, 437 (4th Cir. 2006) (discussing a transaction that accelerated the recognition of contingent liabilities despite the general "prohibition against claiming a deduction in a given tax year for an estimate of liabilities that have not become fixed by the end of that year").

[92] Acknowledging that these differences should not obscure pervasive similarities between GAAP and tax accounting, just as failures of GAAP to provide omniscient accounts of firms do not rebut its utility.

[93] Michelle Hanlon and Terry Shevlin defend the nonconformity of tax and GAAP accounting based on similar observations. *See* Michelle Hanlon & Terry Shevlin, *Book-Tax Conformity for Corporate Income: An Introduction to the Issues*, *in* 19 TAX POLICY AND THE ECONOMY 101, 103–04 (James Poterba ed., 2005). If a single measure is adopted for calculating book and tax income, then either the regulatory goals of the tax system will be compromised or the informational content of financial statements will be limited to that provided by tax accounting. Hanlon and Shevlin review evidence of the relative informational paucity of tax accounting, arguing that book tax conformity will either blunt the regulatory force of the Tax Code or blind investors. *Id.* at 127 nn.1, 5, 7.

[94] Shareholders are further incented to pursue the interests of the tax authority through the tax authority's priority in bankruptcy. While the tax authority receives only a percentage of net income while the firm is solvent, a bankrupt firm must pay the tax authority in full before a shareholder receives a penny. 11 U.S.C. § 1129(b)(2)(B) (2006) (requiring that unsecured creditors are paid in full before junior creditors receive distributions pursuant to a chapter 11 plan); *id.* § 507(a) (granting, second, priority unsecured status—or administrative priority—to tax liability incurred post petition and, eighth priority unsecured status to tax liability incurred in the three years ending with the date of petition); *see in re* Hillsborough Holdings Corp., 116 F.3d 1391, 1396 (11th Cir. 1997) (holding that tax liability for income earned post-petition are afforded administrative priority,

Assertive shareholders pose a threat to the tax authority's interests when an activity that maximizes pretax income does not maximize after-tax income.[95] To understand why, it is sufficient to note that tax operates in reverse of tort. Whereas tort forces internalization of negative externalities, tax forces the externalization of positive internalities. Within a tax system, those engaging in productive economic activity internalize only a portion—after-tax income—of the market value of their output—pretax income. The balance is transferred to the state for the public wealth. When externalities are not internalized, social welfare may be lost as private actors maximize private gain. Just as, absent nuisance law, a factory may pollute though its profits do not exceed the environmental costs, absent control rights for the tax authority, shareholders may sacrifice tax receipts for increases in their after-tax income.

The choice of behaviors that increase after-tax income at the expense of pretax income is not necessarily troubling.[96] Tax accounting has regulatory goals besides measuring income, and many of these include encouraging (or discouraging) behaviors favored (or disfavored) by Congress, which again are assumed to be those with relatively higher positive (or negative) externalities. Examples include the favorable treatment of income from investment and patent production,[97] mortgage and tuition interest deductions,[98] and unfavorable treatment of income and loss—-ordinary income, capital loss—on disposition of land that was once wetland.[99] Like other statutes, however, the Tax Code is drafted by people who cannot predict all

whereas tax on income earned prepetition and taxes for the three taxable years preceding petition are afforded seventh—now eighth—priority).

[95] *See* Schlunk, *supra* note 4, at 7.

[96] *See* Stanley S. Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures*, 83 HARV. L. REV. 705, 711–13 (1970) (criticizing use of Tax Code to implement social programs as nontransparent).

[97] *See* David A. Weisbach, *The Taxation of Carried Interest in Private Equity*, 94 VA. L. REV. 715, 743–44 n.70 (2008).

[98] *See* JAMES J. FREELAND ET AL., FUNDAMENTALS OF FEDERAL INCOME TAXATION 500–03 (15th ed. 2009) (discussing deductibility of qualified residence interest, interest from home equity indebtedness, and interest on qualified educational loans as well as general nondeductibility of personal expenses).

[99] I.R.C. § 1257(a)–(b) (2006) (providing that gain from the disposition of such land will be treated as ordinary gain and thus subject to higher tax rates, while loss from the disposition of such land will be treated as capital loss and thus offsets income that would be taxed at lower tax rates).

instances in which it will be applied. As a result, favorable rates may be inadvertently granted.[100] If a corporation responds to a change in a tax rate, it does so to maximize its private income. If before an increase in an effective tax rate, the corporation pursued Project A and afterwards it chose to pursue Project B, that indicates that the tax rate reduced the relative private income from Project A. From a normative perspective, if the increase in positive externality from the firm's pursuit of Project B is not worth the decrease in private income, then the tax rate is socially inefficient.[101] From an engineering perspective—a perspective that seeks to implement congressional will whatever it may be—a response to the differential tax rate is only undesirable if it was unintended by Congress. Either view requires the control rights granted to the tax authority to be sufficiently flexible to distinguish between exploitative and desirable responses to tax incentives. Facially pro-tax authority designs that maximize pretax income may be inadvisable if they sufficiently reduce intended incentives.[102] On the other hand, designs that allow private interest holders to structure the firm's affairs exclusively to reduce tax liability will result in social costs as firms sacrifice pretax for after-tax income.[103]

Acknowledging this inherent tension, the rest of this Part compares control rights typically enjoyed by common shareholders with those protecting the tax authority. The contrast hopes to be productive by bringing alternative designs

[100] For example, a poorly drafted tax credit meant to incent a shift from gasoline to alternative fuels allows companies whose production process already relies on alternative fuels to qualify for the credit by *adding* fossil fuels. *See* Bob Ivry & Christopher Donville, *Black Liquor Tax Boondoggle May Net Billions for Papermakers*, BLOOMBERG (Apr. 17, 2009), www.bloomberg.com/apps/news?pid=newsarchive&sid=abDjfGgdumh4.

[101] *See* STAFF OF J. COMM. ON TAXATION, 110TH CONG., A RECONSIDERATION OF TAX EXPENDITURE ANALYSIS 53 (Comm. Print 2008) (explaining the efficiency concept).

[102] *See* David A. Weisbach, *Ten Truths About Tax Shelters*, 55 TAX L. REV. 215, 224 (2002) ("[I]f Congress intends to subsidize or penalize a particular activity through the tax system, changes in *behavior* because of the tax may be desirable.").

[103] *See id.* ("Anytime anyone alters his behavior because of taxes we have the same problem—the changed behavior imposes costs on others that the person does not take into account."). The costs to the tax authority of administering the safeguard and to the taxpayer of complying with it should be included when evaluating the desirability of adding the safeguard. *See* Edgar K. Browning, *The Marginal Cost of Public Funds*, 84 J. POL. ECON. 283, 294–95 (1976) (explaining why the costs of administering and complying with a tax have to be included in the assessment of its desirability).

into relief. This Part starts by observing that the tax authority does not participate in shareholder democracy and is not protected by the markets for control or management. It provides counterfactual designs of the tax authority's control rights that would allow it to vote and benefit from the markets for control and management. It then discusses why extending these protections to the tax authority may be inadvisable. Next, it explains how the primary substitute for these absent control rights that is granted to the tax authority—the mandatory dividend—balances the tax authority's competing interests as revenue raiser and regulator. This Part concludes with a comparison of the disclosure rights and judicial doctrines protecting shareholders and the tax authority. When proposing alternative designs, the Article seeks to understand whether revenue raising and regulatory goals can be preserved while making the tax system more efficient through reducing the exploitation of unintended subsidies.[104]

A. Shareholder Democracy

A basic difference between shareholders and the tax authority is that only the former participate in firm governance. This need not be the case.[105] Before considering alternatives, a basic constraint on the efficacy of allowing the tax authority board representation should be considered. Representative democracy has a winner take all property that leaves government exclusively to the representatives of the majority. Where two well-defined factions participate in an election, the majority will win and need not make concessions to the minority. On first pass, injection of the tax authority into corporate governance will

[104] Tax policy has goals besides efficiency—including equity. Concerns of equity will be ignored by this Article, in part because it concerns the treatment of corporations rather than people.

[105] Like any change contemplated in this Article, this one may be impractical politically due to, for example, cultural antipathy to government participation in the affairs of corporations. Political barriers to revising the protections currently afforded to the tax authority will not be discussed. Expansions of control rights may also be objected to as subversions of the constitutional division of power between state and federal government, which allocates regulation of corporations to states. *But see* Marcel Kahan & Edward Rock, *Symbiotic Federalism and the Structure of Corporate Law*, 58 VAND. L. REV. 1573, 1585 n.29 (2005) ("There is no plausible constitutional argument that Congress would not have the power, under the Commerce Clause, to preempt state corporate law with a national corporate law.").

either accomplish nothing or disenfranchise shareholders.[106] If shareholders are allowed a majority of board seats, the directors appointed by the tax authority act as little more than observers.[107] If, on the other hand, the tax authority is allowed to control a majority of the board, shareholders are denied their primary safeguard, thus discouraging investment. But grace and devils both dwell in implementation details. For example, rather than voting in the general election for directors, the tax authority could be allowed to appoint a representative to the board with veto power over any resolution that sought to exploit an unintended rate differential. Generally, this tax director would not take part in the actions of a board. To the extent, however, that a board action exploited what was, in the tax director's judgment, an unintentional rate differential, she would be able to veto such action or condition its validity on consent to the less favorable treatment.[108]

[106] This is a grossly oversimplified model of board behavior. For more nuanced treatment, see generally JAY W. LORSCH & ELIZABETH MACIVER, PAWNS OR POTENTATES: THE REALITY OF AMERICA'S CORPORATE BOARDS (1989); Gerald F. Davis & Henrich R. Greve, *Corporate Elite Networks and Governance Changes in the 1980s*, 103 AM. J. SOC. 1 (1997); Mark S. Mizruchi, *Who Controls Whom? An Examination of the Relation Between Management and Boards of Directors in Large American Corporations*, 8 ACAD. MGMT. REV. 426 (1983).

[107] Granting the tax authority observers on boards may result in certain benefits. To the extent tax observers did not push forthright deliberation outside the boardroom, they could inform subsequent assessments of board actions. As Part II.F discusses in more detail, anti-avoidance doctrines may disqualify taxpayers from favorable tax treatment where their actions were motivated by tax minimization. The inquiry into motive, however, suffers from limited information and hindsight bias. A competent attorney can sterilize the minutes and agreements that document a business decision to ensure they do not evidence improper motives. Without dependable memorialization of the decisionmaking process, a court may judge the motives for a decision by its results. A business decision that failed to pan out but generated tax savings may be attacked as impermissible tax avoidance. Tax observers can provide courts with a disinterested first hand account of the deliberative process behind business decisions, increasing accuracy and potentially enabling broader application of anti-avoidance doctrines.

[108] As an optional complement to the veto power, the representative's accession to board actions could insulate their results from ex post challenges by the IRS. The desirability of this alternative could be assessed based on the usual tradeoffs between judges and umpires. Judicial adjudication, being based on the categories established by sources of law including precedent, has the benefits of consistency and the costs of over and underinclusiveness. The accumulation of precedent tends to produce less uncertainty generally, but in any one case, subjects the regulated party to uncertainty for a longer period of time as disposition of the party's rights will generally follow its business decision and may even last beyond the original determination by the agency, district court or even court of appeals as judicial

Extending representation in corporate governance to the tax authority would have to overcome a significant practical hurdle. There are over 1.2 million corporations in the United States.[109] Finding one qualified tax director for each of them may demand more qualified appointees than are plausibly available, even if appointees serve on multiple boards.[110] Nor would tax directors be able to substitute for regular directors provided that their decisionmaking role was limited to situations where the board's act would exploit an unintended rate differential.[111] That said, these practical concerns could be addressed by deploying the right selectively. For example, a tax director could be appointed to the board of each of the Fortune 500 companies. In addition

review takes its course. In our present system—firms may reference the law the Treasury or judges will apply when auditing or adjudicating a challenge to the audit when designing business strategy. On the other hand, the present system exposes firms to risk of audit and adverse judicial determination well after a board adopts a business strategy. *See, e.g.*, Hoosier Energy Rural Elec. Coop., Inc. v. John Hancock Life Ins. Co., 588 F. Supp. 2d 919, 928 (S.D. Ind. 2008) (rejecting the trial court's conclusion that a contract was unenforceable because it accomplished tax avoidance), *aff'd on other grounds*, 582 F.3d 721 (7th Cir. 2009). An umpire based system lacks the consistency and ex ante predictability of accumulating predent but compensates with finality, as it insulates business decisions approved by tax directors from further scrutiny. An umpire based system also has the benefit that the authority evaluating a decision is located in the same place and time as the decision makers, so that the legal assessment is made with no more and (assuming communications are not made informally) no less information than that available to those who had to make the decision.

[109] *See* UNITED STATES GOVERNMENT ACCOUNTABILITY OFFICE, TAX ADMINISTRATION: COMPARISON OF THE REPORTED TAX LIABILITIES OF FOREIGN- AND U.S.-CONTROLLED CORPORATIONS, 1998–2005 23, 28 (2008) (reporting survey of corporate tax liability between 1998 and 2005, including the number of U.S. corporate filers).

[110] Moving beyond corporations, partnerships, limited liability companies, and other businesses may also engage in exploitation of unintended rate differentials. If the tax authority's control rights were to be implemented through participation as a partner, member, or analog, the demand for eligible directors would be even greater.

[111] Potentially, the involvement of tax directors could decrease the Treasury's demand for personnel to detect tax evasion and respond to effective tax avoidance. Moreover, their involvement could decrease the burden on courts that review transactions after challenge by the IRS. A tax director's consent or objection to board action could be granted presumptive validity. Acknowledging these potential savings, it remains difficult to imagine how a system of tax directors could be implemented that would ultimately result in savings of administrative resources—though such a system may improve other features of the tax regime.

and/or as an alternative, a thousand corporate taxpayers could be selected randomly and a tax director installed on each of their boards.[112]

Moving beyond more tangible resource constraints, it may be questioned whether an act that expressly installed government representatives in corporate governance would expose firm decisions to political influence to net social detriment. As discussed further below, safeguards of the tax authority's interest as currently implemented are designed to be passive. Differential tax rates align the self-interest of residual claimholders with policy goals, effectively subsidizing the cost of equity capital for favored projects. Rather than installing government appointees to choose firm policy, the present regime acts indirectly by supplying the parameters for decisions left to privately appointed directors and officers. The current regime, however, is not wholly passive, as the deterrents to tax evasion and avoidance ultimately rely on the involvement of courts. Where firms misreport tax attributes or exploit unintended rate differentials, government representatives do subsequently disqualify them from the favorable tax rates.[113] A system in which government representatives are exposed to the deliberations preceding board action and invalidate such actions at the time they are taken—rather than rely on a mix of imperfect evidence and hindsight to invalidate actions ex post—may intrude less and more accurately in private enterprise than the present system.[114] Whether the tax director concept is adopted or the status quo is maintained, officials selected through the political process effect the validity and tax treatment

[112] All credit for suggesting the use of random sampling to expand the tax director program is owed to David Weisbach, who suggested it. All discredit is due entirely to the author of this Article.

[113] *See, e.g.*, Long Term Capital Holdings v. United States, 330 F. Supp. 2d 122, 172 (D. Conn. 2004).

[114] *See supra* note 108.

of board actions.[115] The substantive difference between a tax director and a judge is not apparent and may be narrowed through design.[116]

B. Market for Control

The market for control does not distinctly benefit the tax authority. In fact, its present incarnation allocates assets to those who maximize their after-tax returns, thus preferring owners best able to minimize the tax authority's share.[117]

The market for control could be adapted to serve the revenue raising goals of the tax authority, but the current inalienability of tax receivables prevents such adaptation. Unlike a shareholder, the Treasury cannot sell its interest in a firm. Thus, parties who are better able to maximize the value of the tax receivables are prevented from acquiring them. If the Treasury could sell its rights in firms' tax receipts to parties who are better able to increase the value of those rights, co-ownership of the rights to such receipts and equity would reduce the externality and the resulting social costs imposed by tax.[118]

If shareholders had rights to a firm's tax liability in proportion to their ownership of the firm's equity, they would steer firms to maximize pretax income. Every dollar of additional pretax income would benefit such shareholders equally, whether it were distributed to them on account of their shares or their rights to tax receipts. Provided proportionate ownership of shares and tax receipts could be achieved, no shareholder would benefit from expenses incurred to reduce tax liability. Proportionate ownership could theoretically evolve from simply offering the receivables to the market. If the government were to auction its tax receivables to the highest bidder,

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[115] In the past, the SEC has signed consent decrees with corporations that violated federal securities laws, requiring the election of independent directors. *See* Chris R. Ottenweller, Comment, *Court-Appointed Directors: Ancillary Relief in Federal Securities Law Enforcement Actions*, 64 GEO. L.J. 737, 738 (1976).

[116] For example, the political independence of judges may partly be a function of life tenure. Tax directors could similarly be given life tenure, albeit the companies they are directors of may have to change over their lifetimes.

[117] *See* ZVI BODIE ET AL., INVESTMENTS 607–21 (2008) (explaining why share price reflects after-tax cash flows).

[118] *See* Richard A. Epstein, *Holdouts, Externalities, and the Single Owner: One More Salute to Ronald Coase*, 36 J.L. & ECON. 553, 561 (1993) ("[If] a single owner test yields a unique result, then [that result] should be followed by the legal system.").

assuming perfect information and no liquidity constraints, the receivables would be purchased by the entity able to turn the highest pretax profit.[119] In the absence of liquidity constraints, a single owner of both the common shares and tax receivables, who would be positioned to collect the full pretax returns from the business, would determine the highest bid. Of course, in the real world, liquidity would constrain potential bidders from collecting all of the shares and tax receivables of a firm. Moreover, information is scarce, so there may be few, if any, bidders able to valuate the pretax potential of a firm—though it is not clear that the tools to make those valuations are any different from the tools in use now to valuate firms' after-tax earnings.

For firms not yet incorporated, an easier alternative exists, which would not impose the administrative costs of organizing auctions on the government and be more accommodating to investors' liquidity constraints. Corporations could be taxed on their proceeds from their primary offerings of equity and then excused from paying corporate taxes.[120] The expected value of the excused taxes would be impounded in the purchase price as would the social welfare lost to tax avoidance.[121] By taxing the purchase price, the tax authority would be able to share in income undistorted by tax avoidance.[122]

An objection to implementing a market for receivables is that it negates the regulatory power of the Tax Code. As discussed

[119] Taxation on projected profits, even if the projection has the benefit of all available information, will result in overtaxing investors when the firm underperforms and undertaxing investors when the firm succeeds. *See* Alan J. Auerbach, *Retrospective Capital Gains Taxation*, 81 AM. ECON. REV. 167, 167 (1991).

[120] The present regime does not tax corporations on proceeds from offerings. *See* 25 U.S.C. § 1032 (2006).

[121] This assumes that share price reflects discounted after-tax dividends. *See* BODIE ET AL., *supra* note 117. The projected corporate tax liability would be impounded in the purchase price because the firm's after-tax retained earnings would no longer be reduced by taxes on its income. *See* MYRON S. SCHOLES ET AL., TAXES AND BUSINESS STRATEGY: A PLANNING APPROACH 130–37 (2009) (explaining that the market price of tax favored productive assets increases until prospective investors are indifferent between them and their non-favored alternative). In the absence of corporate taxes, corporations would face no incentive to structure their activities to reduce such taxes. Instead, corporations would pursue projects that maximized risk adjusted returns, allowing investors to internalize the deadweight loss of tax avoidance of the status quo.

[122] At the corporate level, this would effectively replace the income tax with a consumption tax. For a rigorous comparison of income to consumption taxation, see Joseph Bankman & David A. Weisbach, *The Superiority of an Ideal Consumption Tax over an Ideal Income Tax*, 58 STAN. L. REV. 1413 (2006).

above, maneuvers that maximize after-tax income at the expense of pretax income are not necessarily contrary to legislative intent. Preferential tax rates induce shifts to congressionally favored forms of enterprise.[123] Once the incentive to seek out preferential rates is removed, the power of the tax system to motivate legislatively preferred behavior is extinguished. That said, to the extent a tax regime overemphasizes the regulatory goals, introducing a partial market for tax receivables—for example, at a five percent rate on the proceeds—could be implemented to rebalance it. Some countries have done exactly this, imposing what is effectively a sales tax on proceeds from equity offerings.[124]

If the present system for delivering regulatory subsidies through the Tax Code was revised to separate them into credits, that system could then be adapted to decrease the efficiency loss to unintended subsidies.[125] Scholars and regulators have distinguished between favorable treatment justified by administrative concerns and favorable treatment that is predominantly regulatory.[126] If the administrative concerns were reflected in the calculation of taxable income, while regulatory goals were reflected solely in tax credits that were then subtracted from the product of the applicable rates and the taxable income calculated in the first stage, then privatization of tax liability owed based solely on taxable income would reduce the deadweight loss from adjustments to administrative subsidies. Firms would nevertheless remain subject to the regulatory incentives posed by the tax credits, as those would not be auctioned off.

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[123] Like other responses to regulation, these may be normatively desirable if the aggregate of pre-regulation private income and positive externalities is less than the aggregate of post-regulation private income and positive externalities.

[124] *See, e.g.*, PRICEWATERHOUSECOOPERS LLP, CORPORATE TAXES, WORLDWIDE SUMMARIES: 2004–2005, at 36 (2004) (Austria imposes a 1% tax on initial contributions of capital); *id.* at 295 (Greece imposes a 0.3% tax on sales of shares listed on the Athens Stock Exchange); *id.* at 483 (Luxembourg imposes a 1% tax on capital contributions); *id.* at 573 (the Netherlands impose a 0.55% tax on capital contributions).

[125] *See, e.g.*, STAFF OF J. COMM. ON TAXATION, 109TH CONG., OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES 42 (Comm. Print 2005) (proposing unification of tax subsidies for education through a credit).

[126] *See, e.g.*, STAFF OF J. COMM. ON TAXATION, 110TH CONG., A RECONSIDERATION OF TAX EXPENDITURE ANALYSIS 9–11 (Comm. Print 2008) (summarizing difference between tax subsidies and tax-induced structural distortions).

C. *Market for Management*

Like the market for control, the market for management as presently instituted does not protect the tax authority's interest where it departs from that of shareholders.[127] As explained above, the market for management provides three distinct benefits to shareholders.[128] First, it minimizes executive's cash compensation. Second, it selects for the most self-confident, and some argue competent, management.[129] Third, and most importantly, it makes managers and directors themselves equity-holders—thus aligning their interest with those of their

[127] A classic example where the market for management failed to the benefit of the U.S. Treasury is the well known case of *Kamin v. American Express Co.*, 86 Misc. 2d 809, 383 N.Y.S.2d 807 (Sup. Ct. N.Y. Cnty. 1976). Kamin, the plaintiff, had filed a derivative suit against the directors of American Express alleging that the directors had breached their fiduciary duties by approving a distribution of depreciated shares instead of selling the shares to realize the loss and thus decrease taxes at the corporate level. *Id.* at 811–12, 383 N.Y.S.2d at 810. The pleadings alleged that the choice to distribute was motivated by the parameters of managerial compensation contracts, which were tied to the earnings of American Express—earnings that would have been reduced had the shares been sold rather than distributed. *Id.* at 814, 383 N.Y.S.2d at 811. Because the compensation of a majority of the directors who approved the transaction was not dependent on whether the shares were sold or distributed, the court dismissed the suit. *Id.*, 383 N.Y.S.2d at 811–12. The court's analysis did not consider the predicate question of whether one set of residual claimants should be able to sue directors for failing to privilege them over another set of residual claimants. While *Kamin* is no more than a well-known anecdote, recent empirical research confirms a complex relationship between corporate governance and tax avoidance. *See* Shuping Chen et al., *Are Family Firms More Tax Aggressive Than Non-Family Firms?*, 95 J. FIN. ECON. 41, 41 (2010) (providing evidence that family firms engage in less tax management than broadly held firms and arguing that the difference is owed to the complementarity between tax avoidance and expropriation from outside shareholders); Mihir A. Desai & Dhammika Dharmapala, *Corporate Tax Avoidance and Firm Value*, 91 REV. ECON. STAT. 537, 537–38 (2009) (showing that the quality of corporate governance positively affects how much shareholders' value increases in after-tax income due to tax avoidance); Mihir A. Desai & Dhammika Dharmapala, *Corporate Tax Avoidance and High-Powered Incentives*, 79 J. FIN. ECON. 145, 146 (2006) [hereinafter *How-Powered Incentives*] (finding that increases in incentive compensation tend to reduce the level of tax sheltering); Mihir A. Desai et al., *Theft and Taxes*, 84 J. FIN. ECON. 591, 592 (2007); Omrane Guedhami & Jeffrey Pittman, *The Importance of IRS Monitoring to Debt Pricing in Private Firms*, 90 J. FIN. ECON. 38, 38 (2008) (arguing that expropriation from the tax authority is complementary to expropriation from debtholders based on evidence that IRS audits decrease yields on debt issued by private firms); *see also* Keith J. Crocker & Joel Slemrod, *Corporate Tax Evasion with Agency Costs*, 89 J. PUB. ECON. 1593, 1594–96 (2005) (proposing a model of firms' tax avoidance decision that accounts for the principal-agent relationship between the firm and those who make the decision).

[128] *See* Part I.B.5.

[129] *But see* Heaton, *supra* note 83.

principals. The first of these benefits does not fully redound to the tax authority's benefit. In calculating taxable income, the Tax Code deliberately ignores certain expenditures on executive compensation.[130] For example, under section 162(m), deductions for compensation to the chief executive officer and the next four highest paid employees of public companies are limited to $1 million.[131] As another example, under section 280G, certain severance payments deemed "golden parachutes" are nondeductible to public firms.[132] The second of these benefits accrues to the tax authority only to the extent that pretax income correlates with after-tax income. The third benefit, like the market for control, may actually run counter to the interests of the tax authority as it incents management to maximize after-tax income at the expense of tax receipts.

Legal revisions could expand the market for management to further the tax authority's interest. For example, executives in every company could be granted a percentage of the firm's tax receipts representing a fraction of their equity interest. If the fraction were one, any motivation to avoid taxes arising from their equity stakes would be neutralized by their interest in the tax receipts. Potentially, a fraction greater than one would be required to countervail the pressure exerted by other shareholders, who would continue to prefer any decrease in pretax income to achieve an increase in after-tax income.[133]

[130] *See* Brian J. Hall & Jeffrey B. Liebman, *The Taxation of Executive Compensation*, 14 TAX POL'Y & ECON. 1, 4–7 (2000).

[131] I.R.C. § 162(m) (West 2011); *see also* Gregg D. Polsky, *Controlling Executive Compensation Through the Tax Code*, 64 WASH. & LEE L. REV. 877, 884–86 (2007) (explaining the history and operation of § 162(m)).

[132] I.R.C. § 280G (2006 & Supp. II).

[133] Compensation contracts may condition pay on accounting metrics—such as "revenue," "revenue growth," "pretax profits," "EBIT/EBITDA," "return on assets," "return on operating income," "return on capital," and "cash flow"—and nonaccounting metrics—such as "quality assurance," "new business," "market share," and "customer satisfaction"—that are independent of a firm's tax expense. *See* LANCE A. BERGER & DOROTHY R. BERGER, THE COMPENSATION HANDBOOK: A STATE-OF-THE-ART GUIDE TO COMPENSATION STRATEGY AND DESIGN 334–35 (5th ed. 2008) (discussing use of accounting metrics in formula-value share plans that reward lower tier management with equity based on "the organization's earnings, revenues, cash flow, or other combination of measures that the market might be expected to consider in assigning value to the company or division"); KEN BERTSCH ET AL., U.S. EXECUTIVE PAY STRUCTURE AND METRICS 6–7 (2006) (providing an overview of accounting and nonaccounting based metrics); JAMES F. REDA & ASSOC., LLC, STUDY OF PERFORMANCE METRICS AMONG S&P 500 LARGE-CAP STOCK COMPANIES 12 (2009) (showing that metrics unrelated to tax liability appear in

A problem with granting management an interest in tax receipts is the same as the problem with granting all shareholders an interest in tax receipts. Specifically, as those directing the firm grow indifferent between uses of pretax income, the power of tax to incent legislatively desired behavior decreases. In fact, if management is granted too great an interest in tax receipts, disfavorable tax rates intended to deter exploitative behavior may result in a reverse effect, encouraging management to engage in conduct subject to high rates. That said, in a second best world where revenue is excessively compromised to regulatory goals, the implementation of such interests might result in an improvement. Moreover, assuming sufficiently high agency costs, this method may be preferable to the sale of tax receivables as it would more efficiently target the relevant decisionmakers.

As with the market for control, an alternative design could preserve the regulatory power of the Tax Code and further its revenue goals. If the Tax Code was redesigned so that its regulatory goals were achieved exclusively through tax credits, the market for management could be used to calibrate the balance towards either regulation or revenues.[134] In such a world, management compensation could be based on a combination of: (1) a fraction of tax credits earned by the firm, and (2) a fraction of the firm's taxable income, measured without application of tax credits. To stress either the regulatory or the revenue raising objectives, the former or latter fractions would be increased, respectively. To ensure that shareholders could not unwind the incentives to pursue objectives other than after-tax earnings, limitations—such as nondeductibility to the firm and high tax rates applicable to the executive—could be imposed on performance compensation. Such an approach, however, would

thirty and one hundred percent of contracts for S&P 500 companies); Christopher D. Ittner et al., *The Choice of Performance Measures in Annual Bonus Contracts*, 72 ACCT. REV. 231, 240 (1997) (observing that 12.8% of firms in a 312 firm sample selected based on availability of proxy statements via Lexis/Nexis based short term compensation on cash flow metrics). Directly rewarding management for increasing the firm's tax liability, however, may go beyond these accepted modes of compensation and implicate the duty of loyalty. If that were the case, changes in the tax regime to implement a market for management may have to be accompanied with provisions preempting state law liability for breach of the duty of loyalty.

[134] *See* Edward J. McCaffery & Jonathan Baron, *The Political Psychology of Redistribution*, 52 UCLA L. REV. 1745, 1763–64 (2005) (documenting behavioral preferences as between deductions and credits).

depend on being able to parse regulatory goals into credits. This problem is far from trivial but is simpler than the problem of actually jointly optimizing regulatory and revenue raising goals.[135]

D. Periodic Dividends

Shareholders of U.S. corporations do not have a right to receive a portion of a firm's retained earnings via a dividend at any time certain.[136] Instead, they receive distributions only when directors choose to declare them. Directors are under no obligation to declare dividends but are incented to declare them through shareholder democracy and the market for management. Presumably, if directors indefinitely delayed declaring dividends, shareholders could vote to terminate them. Additionally, to the extent director compensation includes stock, the board's own interest dictates eventual distribution. As discussed above, these two safeguards do not protect the tax authority.

Mandatory dividends require firms to periodically distribute a portion of their earnings to shareholders. Generally, mandatory dividends are found in jurisdictions where control rights are otherwise weak.[137] Shareholders in a firm that must distribute its earnings as dividends are protected from earnings being siphoned off for the benefit of other interest holders. The cost of mandatory dividends is the same as their benefit—they relieve directors of the choice of whether and when to distribute earnings. In the absence of mandatory dividends, earnings may be distributed or reinvested in the firm at the discretion of

[135] For examples of scholarship advocating a shift to credits in the context of personal taxation, see Lily L. Batchelder et al., *Efficiency and Tax Incentives: The Case for Refundable Tax Credits*, 59 STAN. L. REV. 23, 24–25 (2006); Daniel Shaviro, *The Minimum Wage, the Earned Income Tax Credit, and Optimal Subsidy Policy*, 64 U. CHI. L. REV. 405, 409–10 (1997).

[136] *See* United States v. Byrum, 408 U.S. 125, 140 (1972) ("Even where there are corporate earnings, the legal power to declare dividends is vested solely in the corporate board.").

[137] Examples of countries with mandatory dividends include Brazil, Chile, Columbia, Ecuador, Greece, and Uruguay. *See* Rafael La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113, 1132 (1998) (discussing results that suggest "that mandatory dividends are indeed a remedial legal protection for shareholders who have relatively few other legal rights").

directors.[138] Mandatory dividends allow reinvestment but vest discretion with shareholders who may not know the opportunities facing the firm as well as its directors. In jurisdictions where shareholder democracy and the market for management pose weak incentives for directors to look out for the interests of shareholders, divesting directors of discretion is less likely to injure shareholders. Where directors are fastidious guardians of shareholders' interests, the same will not be true. Thus adding mandatory dividends to an already robust package of control rights may do more harm than good.

A mandatory dividend is the primary control right enjoyed by the U.S. tax authority. As already observed, the Treasury does not participate in the election of directors, though law could be altered so it would; the Treasury cannot sell its tax receipts to those that could maximize their value, another legal artifact; and the Treasury does not incent directors or officers to maximize tax liability, again, a choice by those who write the law. Instead, the tax authority relies on firms periodically reporting their taxable income and remitting a share of it.[139] As discussed below, this system is critically sensitive to firms misreporting and manipulating earnings. To minimize misreporting, the tax authority benefits from extensive disclosure rights, well in excess of those enjoyed by shareholders.

The design of the mandatory dividend that benefits the tax authority differs from the basic design used to protect shareholders. The difference is that the percentage of earnings that must be distributed to the tax authority is based on how the firm earns its income. For example, tax credits for certain production processes deemed to be environmentally friendly effectively lower firms' tax rates whereas especially high tax rates imposed on dispositions of wetlands effectively raise firms' tax rates.[140] By basing the mandatory dividend on the character

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[138] *See* Jensen, *supra* note 26 (explaining management's incentives to retain earnings rather than subject itself to investor discipline by relying on external financing).

[139] Every corporation is required to annually report and pay its tax liability. I.R.C. § 6151(a) (2006) (requiring payment of tax at the time of filing a return); *id.* § 6072(b) (requiring every corporation to file a return on the fifteenth day of the third month following the end of its fiscal year).

[140] *See id.* §§ 45, 48 (favoring wind farms); *id.* § 1257(a)–(b) (disfavoring sales of wetlands).

of the production process, the tax authority balances revenue raising with regulatory goals without injecting itself into corporate governance.

E. Disclosure Rights

Disclosure rights are held by both the tax authority and shareholders,[141] albeit, to different extents. Disclosure due to the tax authority includes the filing of periodic tax returns[142] and where the tax authority chooses to audit a company, "[f]or the purpose of ascertaining the correctness of any return, making a return where none has been made[, or] determining the liability of any person for any internal revenue tax," the Treasury has rights to "examine any books, papers, records, or other data which may be relevant or material to such inquiry . . . [,] to summon . . . any officer or employee of such [company, and to] . . . take such testimony of the person concerned, under oath."[143] The rights to information enjoyed by the tax authority as auditor are broader than the rights granted to shareholders.[144] While the Treasury has access to all relevant "books, papers, records, or other data," which presumably includes all the financial records available to shareholders, the Treasury may also question company executives—a power shareholders do not enjoy.[145] Several explanations may be proposed for this difference. For example, allowing any shareholder to summon management to interrogation may paralyze the operations of the

[141] *See supra* Part I.B.2.

[142] *See id.* § 6001 (authorizing the Secretary of the Treasury "to make such returns, render such statements, or keep such records, as the Secretary deems sufficient to show whether or not such person is liable for tax under this title"); *id.* § 6011 (obligating taxpayers to provide information that may be requested in tax returns); *id.* § 6012(a) (requiring corporations to file tax returns).

[143] Treas. Reg. § 301.7602-1(a)–(b) (2007).

[144] It may be argued that when shareholders perform the equivalent of an audit by suing the firm for fraud under Rule 10b-5, discovery affords them comparable access to information. An audit, however, is not predicated on a showing of malfeasance that passes a motion to dismiss under Federal Rules of Civil Procedure ("FRCP") section 12(b)(6) and does not expose the IRS to potential liability under FRCP section 11.

[145] The Treasury is authorized to force shareholders to disclose certain suspect transactions and has used this authority to require disclosure of reportable transactions, listed transactions, and intermediary transactions. *See* Treas. Reg. § 1.6011-4(b)(1) (reportable transactions); *id.* § 1.6011-4(b)(2) ("listed transactions"); I.R.S. Notice 2001-16, 2001-1 C.B. 730; I.R.S. Notice 2008-111, 2008-51 I.R.B. 1299 (transactions with intermediaries to accomplish tax shelters).

firm.[146] Also, unlike the tax authority, shareholders may rely on corporate democracy, the market for control, and the market for management to incent a desirable level of disclosure indirectly. Because the tax authority does not have recourse for these alternate means of inducing directors and officers to look out for its interests, it must mandate desirable behaviors and rely on penalties to produce compliance.[147]

F. *Fiduciary Duties and Anti-Avoidance Doctrines*[148]

Another difference between shareholders and the tax authority is that the latter does not benefit from fiduciary duties. Under direction of directors and officers, firms spend money to reduce their tax liability and increase after-tax returns to shareholders, who typically, through share-based compensation, include directors and management.[149] A fiduciary diverting assets from shareholders to line her own pockets is in breach of the duty of loyalty.[150] There is no similar law that holds directors and officers liable for purposefully diverting the tax authority's

[146] *See* LOSS & SELIGMAN, *supra* note 53, at 2029–42 (describing the history of exclusion of shareholder proposals relating to a "company's ordinary business operations" from proxy statements under Rule 14a-8).

[147] *See* Anup Malani & Albert Choi, Are Non-Profit Firms Simply For-Profits in Disguise? Evidence from Executive Compensation in the Nursing Home Industry 1–2 (Sept. 26, 2004), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=617362 (providing evidence that because nonprofit firms cannot provide incentive compensation to executives, they rely on the threat of termination to induce managerial effort).

[148] Subsequent to the writing of this Article, anti-avoidance doctrines were codified in I.R.C. section 7701(o) (West 2011). Though the substance of the ensuing discussion is unaffected, the codification obviates much of the case law relied on.

[149] *See How-Powered Incentives*, *supra* note 127, at 145–46; Weisbach, *supra* note 100, at 225 ("A blanket statement that we should get rid of tax lawyers . . . clearly would be too broad . . . [but] we should not kid ourselves that tax planning generally is productive (or is even merely worthless)."); Lawrence H. Summers, U.S. Dep't of the Treasury, Tackling the Growth of Corporate Tax Shelters, Remarks to the Federal Bar Association (Feb. 28, 2000), http://www.ustreas.gov/press/releases/ls421.htm.

[150] *See* Willard *ex rel.* Moneta Bldg. Supply, Inc. v. Moneta Bldg. Supply, Inc., 515 S.E.2d 277, 287 (Va. 1999).

share of the residual to shareholders.[151] Whether this difference is justified and what the alternatives are is the subject of this Subpart.[152]

Presently, the tax authority is not left wholly unprotected from intentional manipulation of taxable income. A set of "anti-avoidance" doctrines work to prevent taxpayers from taking advantage of unintended rate differentials.[153] As explained above, certain activities are taxed at higher rates than others.[154] Some of these differences are the product of conscious decisions by Congress to subsidize behaviors—for example, wind farmers

[151] *See* Donald L. Korb, *Shelters, Schemes, and Abusive Transactions: Why Today's Thoughtful U.S. Tax Advisors Should Tell Their Clients to "Just Say No"*, *in* TAX PLANNING FOR DOMESTIC AND FOREIGN PARTNERSHIPS, LLCS, JOINT VENTURES & OTHER STRATEGIC ALLIANCES 2009, at 975, 979 (PLI Tax Law & Estate Planning, Course Handbook Series No. 19,889).

[152] David A. Weisbach provides a framework for assessing incremental anti-avoidance measures that compares their net benefit—including deadweight loss to the avoidance of the incremental measure—to their administrative cost. David A. Weisbach, *An Economic Analysis of Anti-Tax-Avoidance Doctrines*, 4 AM. L. & ECON. REV. 88, 88 (2002). It could be argued that extending fiduciary duties has low net benefits or high administrative costs. This argument poses what is essentially an empirical question. That said, it is hard to explain why the net benefit from extending fiduciary duties to the tax authority should be lower than the benefit of extending them to shareholders. Furthermore, once courts have developed a doctrine and had practice in its application, it seems unlikely that the administrative costs of claims brought by the tax authority would exceed the administrative costs of claims by private litigants. On first pass, it seems more appropriate to extend these doctrines to benefit the tax authority than install them to benefit shareholders in the first place. Conversely, if these doctrines are not efficient if applied to the tax authority, they should not exist at all.

[153] Though on its face the doctrine is as applicable to a taxpayer who takes advantage of purposeful tax subsidies, in practice, it is not applied where the tax preference is blatantly intentional. Tax avoidance doctrines do not threaten the cumquat farmer cum wind farmer who made the switch to harvest tax credits, though she may have sacrificed pretax income solely to reap the private benefit of the tax credits. Leaving extreme cases aside, judicial power to determine tax treatment through tax avoidance doctrines becomes less certain. Courts have discretion to construe statutes where there is ambiguity and to produce interstitial common law. Courts do not have discretion where a statute unambiguously governs the conduct in question. Application of anti-avoidance doctrine, therefore, has to be predicated on statutory uncertainty; in other words, as a threshold matter a court must find that the statute does not govern the taxpayer's conduct or that there is an ambiguity as to the appropriate taxation of the conduct. *See, e.g.*, Marvin A. Chirelstein, *Learned Hand's Contribution to the Law of Tax Avoidance*, 77 YALE L.J. 440, 472–73 (1968) (summarizing the evolution of Learned Hand's decisions in the area of tax avoidance, specifically, how they came to balance literal application of the Tax Code with the enforcement of the implicit legislative purpose of preventing tax avoidance).

[154] *See supra* Part II.D.

qualify for tax credits unavailable to cumquat farmers.[155] Other differences may be products of underspecification in the Tax Code.[156] Congresspersons cannot foresee every structure for earning or losing income. Statutory ambiguities threaten the tax authority, as equityholder, when they allow taxpayers to exploit unintended rate differentials.

Tax avoidance doctrines[157] generally disqualify taxpayers from favorable treatment where the taxpayer's conduct is directed to minimizing taxes.[158] More specifically, anti-avoidance doctrines consist of a two-part test that evaluates whether (1) "the taxpayer was motivated by no business purposes other than obtaining tax benefits" and (2) the transaction posed "a reasonable possibility of [pretax] profit."[159] The first component

[155] *See* I.R.C. §§ 45, 48 (West 2011) (providing tax credits for wind farms but not cumquat farms); *see also id.* § 38 (providing credits, for example, to oil recovery projects, renewable electricity projects, ethanol production, nuclear power projects, railroad track maintenance, employer provided childcare, orphan drugs, and mine rescue training); *id.* § 162(c) (disallowing deductions for payments that are illegal under the Foreign Corrupt Practices Act).

[156] *See* Weisbach, *supra* note 152, at 93–94 (explaining anti-avoidance doctrines as a substitute for underspecification).

[157] Tax avoidance doctrines are referred to by various names. *Compare* Black & Decker Corp. v. United States, 436 F.3d 431, 441 (4th Cir. 2006) (testing whether a transaction is a "sham" and describing the test as composed of a subjective prong, which asks whether the transaction had a nontax business purpose and an objective prong, which asks whether the transaction posed a reasonable possibility of profit and thus had nontax economic substance), *with* Long Term Capital Holdings v. United States, 330 F. Supp. 2d 122, 171 (D. Conn. 2004) (referring to "economic substance analysis" as containing an objective and subjective prong).

[158] *See* Gilbert v. Comm'r, 248 F.2d 399, 411 (2d Cir. 1957) (Hand, J., dissenting) ("Except in rare instances statutes are written in general terms and do not undertake to specify all the occasions that they are meant to cover; and their 'interpretation' demands the projection of their expressed purpose, upon occasions, not present in the minds of those who enacted them. The Income Tax Act imposes liabilities upon taxpayers based upon their financial transactions, and . . . [if] the taxpayer enters into a transaction that does not appreciably affect his beneficial interest except to reduce his tax, the law will disregard it . . . ."); Knetsch v. United States, 364 U.S. 361, 366 (1960) (adopting Learned Hand's dissent); *see also* Frank Lyon Co. v. United States, 435 U.S. 561, 583–84 (1978) (holding that a transaction will be respected if it is "compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached").

[159] Rice's Toyota World, Inc. v. Comm'r, 752 F.2d 89, 91 (4th Cir. 1985); *see Black & Decker*, 436 F.3d at 441 (explaining that the sham transaction doctrine asks the court to "find . . . [(1)] that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and [(2)] that the transaction has no economic substance because no reasonable possibility of a profit exists" (internal quotation marks omitted)); *see* STAFF OF J. COMM. ON TAXATION,

is subjective, inquiring into the taxpayer's motivations; the second component is objective, asking whether a taxpayer could reasonably expect a pretax profit from the transaction. Because direct evidence of mental state is hard to come by, courts have relied on the latter component when evaluating the former, reasoning that if a reasonable expectation of profits did not otherwise exist, the taxpayer was motivated by tax minimization.[160] As a result, though some courts formulate the test as conjunctive requiring both the subjective and objective components to be met and other courts phrase it as a multi-factor balancing test allowing one component to substitute for the other,[161] effectively, the objective component is frequently dispositive.[162]

The objective inquiry, which is sometimes referred to as the "economic substance" test, asks whether the transaction had a reasonable expectation of a pretax profit.[163] If the answer is yes, the transaction will be respected and the favorable tax treatment granted. A crucial question in applying the economic substance doctrine is how to define "profit." Courts almost exclusively adopt a naïve definition of profit, finding economic substance so long as the gross income from the transaction exceeds its direct costs.[164] A more robust definition adopted by the District Court of Connecticut in *Long Term Capital Holdings v. United States* includes opportunity cost when measuring profit.[165]

109TH CONG., OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES 14–17 (Comm. Print 2005).

[160] *See Black & Decker*, 436 F.3d at 443 (explaining that the "ultimate determination of whether an activity is engaged in for profit is to be made . . . by reference to [the] objective" component of the anti-avoidance test (internal citation and quotation marks omitted)).

[161] *See* Compaq Computer Corp. & Subsidiaries v. Comm'r, 277 F.3d 778, 781 (5th Cir. 2001) (noting that some courts require the absence of both subjective and objective non-tax motives whereas others consider each a non-essential factor).

[162] *See, e.g.*, *Black & Decker*, 436 F.3d at 443; Gilman v. Comm'r, 933 F.2d 143, 149 (2d Cir. 1991) (describing the objective inquiry as "the most important element").

[163] *See, e.g.*, *Gilman*, 933 F.2d at 147.

[164] *See* ACM P'ship v. Comm'r, 157 F.3d 231, 248–49 (3d Cir. 1998) (summarizing prior holdings that disqualified transactions as lacking economic substance, noting in each case that the transaction produced no more than a "pittance," if any, net income).

[165] 330 F. Supp. 2d 122, 182 (D. Conn. 2004) (including over $1.2 million in foregone profits as a cost of the transaction when evaluating its "reasonably expected . . . overall return" and stating "forfeiture of . . . potential profits is

The naïve definition goes further than courts usually do when determining whether a fiduciary satisfied her duty of care.[166] By inquiring into the substantive economic results of a transaction, courts exceed the strictly procedural examination used to test whether a fiduciary's decision falls within her business judgment.[167] That said, the naïve definition does not disqualify all those transactions that forego pretax profit to take advantage of unintentionally favorable tax rates. The approach taken in *Long Term Capital Holdings*, though limited to the facts of that case, comes closer to forcing the taxpayer to simulate the conduct of a single owner who was entitled to both the after-tax income and tax receipts generated by a business.[168]

Where a choice motivated by a favorable tax rate does not produce positive externalities, there is no economic justification for treating the taxpayer to the favorable tax rate.[169] Whether there is a legal justification is ultimately a matter of statutory application.[170] To the extent the applicable statutes—filtered through the relevant administrative actions—remain ambiguous, judges are free to develop methods of construction to achieve congressional intent. An ideal, though impracticable, canon of construction would be that Congress does not write the Tax Code to give taxpayers the choice between two different tax rates. When a legislative ambiguity poses such a choice, that ambiguity should be resolved by foreclosing the treatment that results in lower pretax profit. This ensures that tax does not incentivize private parties to forego social welfare. So, for example, if a taxpayer can consummate a transaction in one of two ways, one of which will cost one hundred thousand dollars in legal fees and

appropriately assessed against [the taxpayer] as a cost of the transaction that a prudent economic actor would have taken into account").

[166] The business judgment rule does not relax the duty of care if the fiduciary is shown to lack good faith. *See* Gantler v. Stephens, 965 A.2d 695, 705–06 (Del. 2009).

[167] As a result, the common law protects the tax authority both more and less than common shareholders. While managers and directors do not owe the Treasury a duty of loyalty, the substantive results of their business decisions may be challenged. *See supra* Part I.B.3.

[168] *Long Term Capital Holdings*, 330 F. Supp. 2d at 183 (noting that its inclusion of opportunity cost in the calculation of economic profit was appropriate "[u]nder the circumstances here").

[169] *See* Weisbach, *supra* note 102, at 224.

[170] *See* David P. Hariton, *Tax Benefits, Tax Administration, and Legislative Intent*, 53 TAX LAW. 579, 581 (2000) ("To analyze the efficacy of [policy motivated tax benefits], however, as well as to develop and administer them properly, one must know what Congress was trying to exempt and why.").

the other will cost twice that, the taxpayer should be subject to the tax rate applicable to the first alternative, whether or not that tax rate is the lower of the two. It is doubtful, however, that outside the rare cases such as *Long Term Capital Holdings*, in which the pretax rates on the alternatives were known, such a canon could be operationalized.

As an alternative to strengthening anti-avoidance doctrines, the duties of care and loyalty already imposed on fiduciaries could be extended so that they benefit the tax authority.[171] Courts could construe the Tax Code to provide for federal common law fiduciary duties.[172] When management sacrifices pretax profit to benefit shareholders—a constituency that because of the widespread use of share-based compensation usually includes management—management commits the economic offense of a disloyal agent. If the duty of loyalty to the tax authority were imposed on directors and officers, that duty would have to be tempered to ensure that congressionally intended avoidance would occur. Where a statute unambiguously prescribed favorable tax treatment, such prescription could be treated as a carveout from fiduciary obligations that authorizes sacrifice of pretax for after-tax profits. The current regime imposes ethical, civil, and even criminal penalties on tax attorneys who assist in forms of tax evasion. Whether adding civil liability for directors and officers for tax avoidance is desirable depends on the equity and efficiency considerations.[173] Efficiency concerns would require assessing whether deadweight loss would decrease or potentially increase as additional avoidance maneuvers were taken to avoid the new rule. Efficiency may also be affected by the administrative and

[171] While bold, this proposition is not radical. Directors and officers of FDIC insured banks, for example, are subject to a federal duty of care. 12 U.S.C. § 1821(k) (2006 & Supp. II); *see* Atherton v. FDIC, 519 U.S. 213, 216 (1997).

[172] *See* United States v. Kimbell Foods, Inc., 440 U.S. 715, 728 (1979) ("Whether to adopt state law or to fashion a nationwide federal rule is a matter of judicial policy 'dependent upon a variety of considerations always relevant to the nature of the specific governmental interests and to the effects upon them of applying state law.' ").

[173] *See, e.g.*, Daniel N. Shaviro, *Economic Substance, Corporate Tax Shelters, and the* Compaq *Case*, 88 TAX NOTES 221, 237 (2000) (using marginal efficiency of cost of funds to assess desirability of a change in the tax law).

error costs from applying the rule. The benefits, however, may be significant as officers ultimately have to approve if not initiate tax avoidance maneuvers.[174]

One objection to extending the benefit of fiduciary duties to the tax authority distinguishes between shareholders and government based on the latter's ability to write the tax law how it will.[175] Roughly, this argument is that the tax authority can unilaterally add to its control rights. This objection is not wholly satisfying because while theoretically Congress or the Treasury can always revise the Tax Code or Treasury Regulations, such revisions are not costless. They require time and consideration on the part of legislators—agency personnel. Furthermore, this argument (1) applies equally to anti-avoidance doctrines, which nevertheless exist and (2) does not address that shareholders are also free to change corporate bylaws. The ability to unilaterally change the control rights accompanying an economic stake in a firm does not distinguish shareholders from the tax authority. A second argument in the same vein observes that the tax authority can unilaterally change its economic rights by, for example, raising tax rates or disallowing deductions for interest. Such changes, however, affect all firms and not just those abusing the tax system. Accordingly, the government cannot simply increase its economic rights to make up for weak control rights if it does not want to further raise tax rates on compliant firms. That said, even if none of the differences between shareholders and the tax authority justify granting one but not the other the benefit of fiduciary duties, it does not necessarily follow that those benefits should be extended to the tax authority. Perhaps, instead, fiduciaries should be absolved of all duties.

III. THE RISK TAX

Part II described the differences between the control rights enjoyed by the typical shareholder and those enjoyed by the tax

[174] *See Corporate and Partnership Enforcement Issues Before the Subcomm. on Finance*, 109th Cong. 5 (2006) (statement of Eileen J. O'Connor, Assistant Att'y Gen., Tax Division) (explaining that "[s]ophisticated tax professionals promote [tax shelters to] key officers in . . . business entities").

[175] *But see* United States v. Winstar Corp., 518 U.S. 839, 910 (1995) (holding the United States liable for damages where legislation has the effect of breaching a contract executed among a federal agency and a private party).

authority. Mandatory periodic dividends ensure the tax authority its share of earnings without suspending the congressionally intended influence of differential tax rates and without injecting the tax authority into the governance of the firm. Disclosure obligations and anti-avoidance doctrines protect the tax authority from misrepresentation and manipulation, respectively, of the parameters that determine the amount of the dividend.

Having recognized that the mandatory dividend is a design choice rather than an inevitable feature of a tax regime, this Part considers its consequences, specifically, the purchase the mandatory dividend provides Congress on taxpayers' risk policies.[176] Implementation of a mandatory dividend in favor of the tax authority poses a series of subtle administrative questions as to whether and how negative taxable income in a period should be allowed to offset positive taxable income in another period. As discussed above, when a share is issued, the proceeds less transaction costs go to the firm.[177] The residual to which shareholders have claims consists of that capital, augmented by retained earnings, decreased by dividends paid. When expenses from a period exceed gross income, the residual available to shareholders is reduced by the net loss. Thus, in a period where income is negative, shareholders lose value.[178] This is not necessarily the case for the tax authority. The tax authority receives a share of taxable income so long as it is positive. Subject to a taxpayer's rights to "carryback" or "carryforward" its losses discussed below, negative taxable income does not affect the tax authority.[179]

If tax liability for a given year were calculated without any reference to income in other years, the tax authority would bear no downside: If a year's taxable income were positive, the tax

[176] These results are well known to the literature. *See* Mitchell A. Kane, *Risk and Redistribution in Open and Closed Economies*, 92 VA. L. REV. 867, 869 n.5 (2006) (reviewing literature).

[177] *See supra* note 22 and accompanying text.

[178] The loss is bounded by shareholders' initial investment in the firm, absent veil piercing. *See* Walkovszky v. Carlton, 18 N.Y.2d 414, 418–19, 223 N.E.2d 6, 8–9, 276 N.Y.S.2d 585, 588–89 (1966).

[179] *See* Evsey D. Domar & Richard A. Musgrave, *Proportional Income Taxation and Risk-Taking*, 58 Q. J. ECON. 388, 389 (1944) ("By imposing an income tax on the investor, the Treasury appoints itself as his partner, who will always share in his gains, but whose share in his losses will depend upon the investor's ability to offset losses against other income.").

authority would receive a share of that income; if a year's taxable income were negative, the tax authority—unlike a shareholder—would not lose a dime. As is, however, the tax authority does partially share in the downside. When a firm experiences negative taxable income, it may carry its losses back against taxable income from the two prior years by amending its returns from those years to deduct those losses.[180] Excess losses may be carried forward to offset taxable income in the following twenty years.

In the absence of carrybacks and carryforwards, firms would face incentives to reduce the volatility of their earnings.[181] Being unable to offset losses in one period against gains in another, firms with higher earnings volatility would pay more in taxes in the fat years and no less in the lean years. The incentives become apparent when comparing nominal after-tax returns of two hypothetical corporations subject to a 30% tax rate, shown in Table 3.a. Each corporation initially has $100 in capital. Corporation X chooses to pursue a higher volatility project, which produces a 10% pretax loss half of the time and a 40% pretax gain the other half. Corporation Y chooses a more conservative project, which produces a 10% pretax gain half the time and a 20% pretax gain the other half. Table 3.a summarizes the projects' returns.

Table 3.a: Pretax Rates of Return

	Low	**High**	**Expected**
Corp. X	-10.00%	40.00%	15.00%
Corp. Y	10.00%	20.00%	15.00%

Based on these assumed parameters, the corporations' pretax income, taxes, and after-tax income are shown in Tables 3.b, 3.c, and 3.d, respectively.

[180] *See* I.R.C. § 172 (West 2011). It is worth emphasizing that—to the extent that tax accounting tracks firm cash flows—refunds on account of carrybacks are likely to be made during times a firm is cash starved and thus in danger of being unable to satisfy its obligations as they come due. Thus, carrybacks serve to cushion firms against bankruptcy.

[181] *See* Domar & Musgrave, *supra* note 4 (explaining that the increase of tax rates in the absence of complete loss sharing would theoretically have uncertain results, but "practical evidence would indicate that the investor is likely to shift in the direction of less risk").

Table 3.b: Taxes Paid

	Low	High	Expected
Corp. X	$90.00	$140.00	$115.00
Corp. Y	$110.00	$120.00	$115.00

Table 3.b shows what is not unexpected. Two corporations equally capitalized and engaging in projects with the same average rate of return are expected to have the same income.

Table 3.c: Taxes Paid

	Low	High	Expected
Corp. X	$0.00	$12.00	$6.00
Corp. Y	$3.00	$6.00	$4.50

Table 3.c illustrates the asymmetry produced when the tax authority is insulated from any downside. Note that Corporation X is expected to pay higher taxes than Corporation Y because while the two have the same expected rate of return, Corporation X pays additional taxes in the high return scenario but its losses in the low return scenario do not affect its tax liability. The asymmetry is reflected in Table 3.c, which shows the corporations' after-tax position at the end of the first period, reflecting an additional $1.50 in after-tax wealth.

Table 3.d: After-tax Positions

	Low	High	Expected
Corp. X	$90.00	$128.00	$109.00
Corp. Y	$107.00	$114.00	$110.50

Obviously, the figures above are driven by the initial parameters—for example, initial capitalization, the rates of return, and the tax rate—but the observation that absent carryovers, taxpayers will prefer an income distribution with a smaller average loss in favor of one with a greater average loss, where the two distributions are otherwise equal, remains true across all initial parameters.[182]

[182] *See* Green & Talmor, *supra* note 4, at 1102 (proving that *ceteris paribus*, the least volatile stream of pretax income will produce the highest after-tax return in a progressive tax system). Though generally depressing equityholders' appetites for

Carryovers expose the tax authority to the downside because they allow the taxpayer to decrease its taxable income in those years in which it is positive by losses from other years. Thus, carryovers reduce incentives to avoid projects that pose higher average losses. If Corporation X could carryforward its losses, its $10 loss in the low return scenario would reduce taxable income in subsequent periods by $10. Assuming tax rates remained constant, the nominal after-tax value of the $10 deduction is $3—the product of the deduction and the tax rate. Thus, the after-tax wealth of Corporation X in the low scenario increases by $3 to $93, and its expected wealth increases by half that amount[183] to equal Corporation Y's expected wealth.

Carryforwards do not wholly neutralize the incentive to decrease earnings volatility once the time-value of money is accounted for.[184] Assuming a constant positive discount rate, it can be shown that the net present after-tax value decreases with the average pretax loss of an income distribution though its pretax mean remains constant. This can be illustrated by returning to the example of Corporations X and Y. Table 3.e reviews the returns to the two corporations in each of the scenarios for the first year, showing the pretax returns, taxes paid, and after-tax returns as the set of columns under YEAR 1. Assuming that the after-tax proceeds from the first year are reinvested, the columns under YEAR 2 show the pretax returns, taxes paid, and after-tax returns that would be received in year two given that those proceeds earn a 15% return.[185]

risk, if a firm is already insolvent, taxes may actually increase risk appetites. *See id.* at 1096.

[183] Half of $3.00—$1.50.

[184] It should be noted that the preceding paragraph spoke in terms of the deduction's nominal value.

[185] For example, the pretax figure in the low scenario for Corporation X reflects the results of investing $90 at a 15% rate of return.

Table 3.e: Effect of Discount Rate

	YEAR 1			YEAR 2		
	Pretax					
	Low	**High**	**Expected**	**Low**	**High**	**Expected**
Corp. X	$90.00	$140.00	$115.00	$103.50	$147.20	$125.35
Corp. Y	$110.00	$120.00	$115.00	$123.05	$131.10	$127.08
	Tax					
	Low	**High**	**Expected**	**Low**	**High**	**Expected**
Corp. X	$0.00	$12.00	$6.00	$1.05	$5.76	$3.41
Corp. Y	$3.00	$6.00	$4.50	$4.82	$5.13	$4.97
	After-tax					
	Low	**High**	**Expected**	**Low**	**High**	**Expected**
Corp. X	$90.00	$128.00	$109.00	$102.45	$141.44	$121.95
Corp. Y	$107.00	$114.00	$110.50	$118.24	$125.97	$122.10

Note that a 15% return in the year two produces a higher gain—$13.50[186]—on the $90 invested by Corporation X in the low return scenario than the amount Corporation X lost in the preceding year—$10.00—so the full carryforward is used up.[187] Notwithstanding the full deduction of the carryforward, Corporation X receives less in after-tax income than Corporation Y.[188] The intuition for this is that a $1 decrease in income is shared by shareholders and the tax authority so long as the resulting income is positive, but a $1 increase in loss is borne solely by shareholders until such time as the firm returns to

[186] Fifteen percent of $90 or $13.50.

[187] The assumption that returns in the second year are positive and sufficient to use up the full carryforward from the first year is conservative. If, for example, returns in the second year formed the same distribution as in the first, there would be a 50% likelihood that the $10 carryforward from the first year would go unused and an additional $9 carryforward is generated. As this paragraph explains, carryforwards constitute interest free loans from tax payers to the tax authority.

[188] Again, the figures are a function of initial assumptions. The $0.15 disparity between expected pre-tax earnings of corporations X and Y is equal to the cost of capital of Corporation's X expected deduction ($10.00 x .50 x 0.3 x 1.15 =) $1.725.

positive income. And at such time, the shareholders are not made whole for the time value of money that was used to cover the tax authority's share of the losses.[189]

To unpack the intuition, let us compare the consequence on after-tax income of the marginal dollar of costs when income is positive to the marginal dollar of costs when income is negative. In the first case, the marginal dollar of costs reduces after-tax income only by "1-t" of a dollar where "t" is the tax rate, because but for that loss, the corporation would have had a dollar more in pretax income but paid "t" of that dollar to the tax authority. In the second case, however, the marginal dollar of costs initially reduces after-tax income by the full dollar—assuming that the loss cannot be carried back against prior years' income. If and when a period arrives in which the corporation returns to positive income, that dollar of cost will be deducted from the period's gains. But for that deduction, the corporation would have paid tax on an additional dollar of income, or "t" of that dollar. Thus, eventually, the nominal after-tax loss attributable to the marginal dollar of costs becomes "1-t" of a dollar, whether the costs are incurred while the firm is in the black or the red. In real terms, however, the after-tax loss is greater when incurred while in the red because between incurring the full dollar in cost and being refunded "t" dollars, the taxpayer loses returns on those "t" dollars.

Thus, despite carryforwards, equity holders face a "risk tax," which leaves shareholders with higher after-tax income if the firm engages in the project with the minimum average loss given a set of projects with equal expected pretax income.[190] It is important to note that the risk tax is produced by a difference in treatment between a marginal dollar of cost that reduces positive income and a marginal dollar of cost that increases loss. It is for this reason that the risk tax affects taxpayers' attitudes towards

[189] This assumes: (1) that taxable income measures real economic income; (2) that carrybacks are insufficient to fully soak up the losses incurred; and (3) a constant tax rate.

[190] *See* Green & Talmor, *supra* note note 4, at 1108 ("The incentive effects of the government's tax option may be mitigated by the firm's ability to carry losses forward and back across periods. These opportunities fall short of a fully proportional tax for two reasons. First, the time-value of money implies taxes paid today are more valuable than rebates received tomorrow. Second, losses in future periods are uncertain, so if losses can only be carried back a finite number of years, there is always some probability that the taxes will never be refunded.").

average loss rather than volatility generally. Nevertheless, purely as shorthand, the effect will be referred to as a tax on risk or volatility.[191]

Unlike carryforwards, which require shareholders to wait until a period of positive income before they can share a period's losses with the tax authority, carrybacks force the tax authority to immediately participate in a net loss. Effectively, a regime that allows a firm to carryback its losses X years, delays the mandatory dividend X years. On first pass, this result may suggest that the insufficiency of carryforwards to compensate a taxpayer for losses is academic. As a practical matter, carrybacks are insufficient to make firms risk neutral for two reasons.[192] First, they only apply to established firms that have had income in their prior years. Thus, a firm choosing its original projects must look to carryforwards to refund startup costs from its initial years. Second, the carryback period is short: two years in the U.S. and zero years in many other countries.[193] Thus a firm with a long history of strong earnings that incurs net losses for several years may find itself unable to do anything with those losses except wait for the storm to pass. Even an established firm in choosing between projects, therefore, will take into account the possibility of a string of bad years that force it to rely on carryforwards.[194]

Having unpacked the effects of carryforwards and carrybacks on firms' appetites for risk, we can now describe the set of policy instruments that mandatory dividends provide. Just as Congress can change the minimum pretax return of projects a taxpayer will engage in by changing the tax rate, Congress can

[191] Again, it is worth remembering that some risk is diversifiable while some risk may be systemic. *See supra* note 24.

[192] *See* David A. Weisbach, *The (Non)Taxation of Risk*, 58 TAX. L. REV. 1, 34 (2004) (noting that "loss limitations often mean that losses cannot be fully deducted, which in turn means that losses effectively are taxed at a different rate than are gains").

[193] *See* PRICEWATERHOUSECOOPERS LLP, *supra* note 124 (summarizing tax regime in each covered country, and where a country provides for carrybacks, explaining their period and applicable limitations, if any). Countries that do not provide carrybacks include Australia, *id.* at 24, Austria, *id.* at 36, Belgium, *id.* at 69, China, *id.* at 158, Costa Rica, *id.* at 181, Croatia, *id.* at 189, Cyprus, *id.* at 196, Czech Republic, *id.* at 205, and Ecuador, *id.* at 227.

[194] *See* Roberta Romano, *A Guide to Takeovers: Theory, Evidence and Regulation*, 9 YALE J. REG. 119, 134 (1992) (noting that such tax benefits may encourage mergers, specifically, that a "merger effectively provides coinsurance by diversifying expected cash flows, so that deductions will not be wasted").

change the maximum average loss of a project a taxpayer will engage in by changing the carryover period.[195] To increase risk tolerance, Congress can extend the carryback period one year. To increase it a little less, Congress can instead extend the carryforward period a year or increase the carryback while decreasing the carryforward.[196] But playing with the carryover periods is not the sole means to influencing taxpayers' attitudes to risk. Congress can make losses more expensive by increasing the tax rate. This is evident by returning to where the intuition for the risk tax is presented. Note that the tax authority defers sharing in "t" cents of each dollar of loss. The greater the tax rate, the greater the loss the tax authority defers sharing in, and thus the more expensive the marginal dollar of loss for the shareholders. This means that an increase in U.S. tax rates has two countervailing effects. First, as has been amply discussed, given the global competition for capital, the increase will prompt U.S. corporations to choose projects with higher pretax returns to remain attractive to capital.[197] The shift will be at the expense of additional risk. Second, the increase in the tax rate increases the taxpayer's exposure to downside. This makes additional risk less attractive, thus dampening the first effect.[198] In all likelihood,

[195] *Cf.* Dale W. Jorgenson*, Capital Theory and Investment Behavior*, 53 AM. ECON. REV. 247, 248 (1963) (modeling and testing effects of changes in tax rates on the selection of projects by firms); Mervyn A. King, *Taxation and the Cost of Capital*, 41 REV. ECON. STUD. 21, 34 (1974).

[196] The American Recovery and Reinvestment Act of 2009 ("ARRA") extended the loss carryback period from two years to five years but did so only for small businesses. *See* American Recovery and Reinvestment Act of 2009, P.L. 111-5 § 1211(a) (Feb. 17, 2009). Whether the resulting transfer from taxpayers to unsuccessful small businesses and the additional incentives for risk taking are justifiable is a question for policymakers to consider. *See* Daniel Shaviro, *The 2008–09 Financial Crisis: Implications for Income Tax Reform* 12–16 (N.Y.U. Ctr. for Law, Econ. & Org., Working Paper No. 09-35, 2009), *available at* http://ssrn.com/abstract=1442089.

[197] *See* Weisbach, *supra* note 192, at 6–7 (explaining why it is relatively easy for even uninformed investors to adjust for changes in the tax regime by looking at after-tax returns). *See generally* Daniel Shaviro, *Some Observations Concerning Multi-Jurisdictional Tax Competition*, *in* REGULATORY COMPETITION AND ECONOMIC INTEGRATION: COMPARATIVE PERSPECTIVES (Daniel Esty & Damien Gerardin eds., Oxford 2001).

[198] In a progressive tax system, it is volatility of earnings as well as average loss that is taxed. *See* Green & Talmor, *supra* note 4, at 1096 ("It is shown that the firm's objective function assumes the form of its before-tax net present value less the value of a call option representing its tax liability. The convex 'shape' of this liability leads to risk-averse behavior."). Given two firms with identical average pretax earnings, more of the earnings of the one with higher volatility will be taxed at the higher

the second effect will outweigh the first.[199] If the net effect can be determined, the adjustment of the carryover period or the tax rate allows the government to dial risk taking across the economy.

CONCLUSION

There are at least two stages to legal evolution. First, an alternative to the status quo must be articulated. Second, the desirability of that alternative should be assessed. This Article began by observing that the tax authority's economic interest in corporations is fundamentally similar to that of shareholders, yet its control rights are extremely different. It used that observation to open up a space of design possibilities for revising how the tax authority is protected from corporate exploitation of unintended rate differentials. It accompanied the proposals with objections to them, consistently encountering the tradeoff between increasing revenues and decreasing desired behavioral shifts. Though this Article attempted to identify some of the consequences to its proposals, it did not attempt to net these consequences. Thus it offers no conclusions regarding the desirability of the proposals. Having broadened the design space of tax regimes, it leaves it to subsequent scholarship to assess whether any of the proposed designs are worth adopting.

What this Article does do, however, is show that there won't be easy answers. While it remains agnostic as to the right devices with which to balance regulatory and revenue raising goals, this Article means to leave no question that there is a tradeoff. Any proposal that claims to increase the tax base by reducing the incidence of regulated parties taking advantage of incentives should be scrutinized for its effect on compliance; and reciprocally, any proposal that claims to increase compliance should be scrutinized for its effect on revenues.

Finally, it is worth noting that the tradeoff between revenue and compliance itself may simply pose a question of means rather than ends. After all, government revenue is ultimately used to effect government policy. If that policy is effected directly—by the government raising money and then spending it

rates. While U.S. corporations face only limited rate progressivity, the earnings of U.S. limited liability companies, partnerships, and other entities that receive pass through tax treatment are effectively taxed at the rates facing their interestholders.

[199] *See* Domar & Musgrave, *supra* note 4.

on employees that produce the work it wants to done—that is simply a substitute for those goals being accomplished indirectly, by offering private parties incentives to do the desired work on their own. Viewed in the abstract, a government simply has policy goals, and how it goes about achieving those goals is a question of engineering.