Wolfgang Schön
Editor

MPI Studies on Intellectual Property, Competition and Tax Law 3

Tax and Corporate Governance

Max Planck Institute for Intellectual Property,
Competition and Tax Law

MPI Studies on Intellectual Property, Competition and Tax Law

Volume 3

Edited by

Josef Drexl
Reto M. Hilty
Wolfgang Schön
Joseph Straus

Wolfgang Schön
(Editor)

Tax and Corporate Governance

Professor Dr. Wolfgang Schön
Max Planck Institute for Intellectual
Property, Competition and Tax Law
Marstallplatz 1
80539 Munich
Germany
wolfgang.schoen@ip.mpg.de

ISBN 978-3-540-77275-0 e-ISBN 978-3-540-77276-7

DOI 10.1007/978-3-540-77276-7

Library of Congress Control Number: 2008922730

© 2008 Springer-Verlag Berlin Heidelberg

This work is subject to copyright. All rights are reserved, whether the whole or part of the material is concerned, specifically the rights of translation, reprinting, reuse of illustrations, recitation, broadcasting, reproduction on microfilm or in any other way, and storage in data banks. Duplication of this publication or parts thereof is permitted only under the provisions of the German Copyright Law of September 9, 1965, in its current version, and permission for use must always be obtained from Springer. Violations are liable to prosecution under the German Copyright Law.

The use of general descriptive names, registered names, trademarks, etc. in this publication does not imply, even in the absence of a specific statement, that such names are exempt from the relevant protective laws and regulations and therefore free for general use.

Production: le-tex Jelonek, Schmidt & Vöckler GbR, Leipzig
Cover-design: WMX Design GmbH, Heidelberg

Printed on acid-free paper

9 8 7 6 5 4 3 2 1

springer.com

Preface

The interaction of taxation and corporate governance is a classical topic and a start-up theme at the same time. Much has been written in the past on the influence of the tax framework on the choice of legal form for businesses and the structuring of company groups and their contractual obligations. But in recent years, many other features of this relationship between two different fields of law have emerged. First of all, tax authorities around the world have become aware of the potential influence of corporate governance rules on the tax strategy of an enterprise. "Tax in the Boardroom" is a keyword for a movement which tries to employ company law and securities law as a tool for governments to fight corporate tax avoidance. The concept of corporate social responsibility and its repercussions in the tax arena, the allocation of tax competences within a company, the requirement to disclose relevant tax information to investors or the necessity to establish a management system for tax risks have given rise to an emerging strand of literature both from an economic and a legal background.

This situation has led the Max Planck Institute for Intellectual Property, Competition and Tax Law (Department of Accounting and Taxation) in Munich to organize a conference on this topic – jointly with the International Network for Tax Research and the International Fiscal Association (German Branch) – in December 2006. This conference was meant to bring together leading academics and practitioners from different backgrounds (lawyers and economists, tax specialists, public accountants and corporate lawyers, business and government representatives, EC and OECD officials) in order to give a full and fair account of the interaction between tax and corporate governance. Two days of concentrated presentations and lively debate brought some light into this somehow "underresearched" topic.

This book contains the papers and proceedings of this conference. It starts with a general introduction into the political, economic and legal implications of the interaction between tax and corporate governance. It closely examines the influence of taxation on the life of a corporation and the influence of corporate governance on the tax behavior of companies. Moreover, it includes a chapter on the tools used in the fight against tax shelters in several jurisdictions, giving specific weight to the situation in the U.S. and the U.K.

The editor of this book is specifically indebted to Hugh Ault and Caroline Silberztein from the OECD for their invaluable help in the design of this conference. In addition, he owes gratitude to the members of the tax research group at the Max Planck Institute, in particular to Tobias Beuchert who was instrumental in the preparation both of the conference and of this volume. Moreover, his thanks go to the authors of this book's chapters who devoted a lot of time and thoughts to the interaction of "tax and corporate governance".

Munich, January 2008 *Wolfgang Schön*

Table of Contents

Preface V

List of Authors XI

Part 1: The Link between Taxation and Corporate Governance

The Link between Taxation and Corporate Governance 3
Dave Hartnett

Good Corporate Governance: The Tax Dimension 9
Jeffrey P. Owens

Tax and Corporate Governance: An Economic Approach 13
Mihir A. Desai and Dhammika Dharmapala

Tax and Corporate Governance: A Legal Approach 31
Wolfgang Schön

Report on the Discussion 63
Stefan Mayer

Part 2: The Influence of Tax on Corporate Behavior

Financial and Tax Accounting: Transparency and "Truth" 71
Judith Freedman

Taxation, Accounting and Transparency:
The Interaction of Financial and Tax Accounting 93
Martina Baumgärtel

Taxation, Accounting and Transparency:
The Missing Trinity of Corporate Life 101
Christian Nowotny

Tax and the Separation of Ownership and Control 111
Steven Bank and Brian R. Cheffins

Tax and the Separation of Ownership and Control –
Comment on the paper by Steven Bank and Brian R. Cheffins 163
Krister Andersson

Tax and the Separation of Ownership and Control –
Comment on the paper by Steven Bank and Brian R. Cheffins 171
Norbert Herzig

Report on the Discussion 177
Arne Friese

Part 3: The Influence of Corporate Governance on Tax Strategy and Compliance

Corporate Social Responsibility and Strategic Tax Behavior 183
Reuven S. Avi-Yonah

Corporate Social Responsibility and Strategic Tax Behavior –
Comment on the paper by Reuven S. Avi-Yonah 199
Pekka Timonen

Tax Risk Management and Board Responsibility 205
Bernd Erle

Report on the Discussion 221
Christian Kersting

Part 4: Tax Shelters, Business Behavior and Professional Responsibilities

Disclosure and Civil Penalty Rules in the U.S. Legal Response
to Corporate Tax Shelters 229
Daniel Shaviro

Disclosure and Civil Penalty Rules in the U.S. Legal Response
to Corporate Tax Shelters – Comment on the paper by Daniel Shaviro 257
Philip Baker

Tax Shelter Disclosure and Civil Penalty Rules –
Comment on the paper by Daniel Shaviro 261
Roman Seer

Opinion Standards for Tax Practitioners Under U.S. Department of the Treasury Circular 230 265

Michael J. Desmond

Opinion Standards for Tax Practitioners Under U.S. Department of the Treasury Circular 230 – Comment on the paper by Michael J. Desmond 277

Tobias Beuchert

Opinion Standards for Tax Practitioners Under U.S. Department of the Treasury Circular 230 – Comment on the paper by Michael J. Desmond 283

Paul Morton

Shelters, Schemes, and Abusive Transactions: Why Today's Thoughtful U.S. Tax Advisors Should Tell Their Clients to "Just Say No" 289

Donald L. Korb

Report on the Discussion 351

Simon Link

Part 5: Taxation and Corporate Governance – The State of the Art

Taxation and Corporate Governance – The State of the Art 357

Arne Friese, Simon Link and Stefan Mayer

List of Authors

Krister Andersson is Head of the Tax Policy Department, Confederation of Swedish Enterprise. Since 2005, he has been Chairman of the Fiscal Affairs Group of BUSINESSEUROPE (formerly the UNICE), Brussels. He is docent in Economics at Lund University, a board member of the Swedish National Tax Authority, the Swedish IFA branch and the Association of Swedish Industry Treasurers. He has worked for the IMF and has been Chief Economist of the Riksbank, the Swedish central bank, for a number of years.

Reuven S. Avi-Yonah is the Irwin I. Cohn Professor of Law and Director of the International Tax LL.M. Program at the University of Michigan Law School. Recent publications include International Tax as International Law: An Analysis of the International Tax Regime (Cambridge Univ. Press, 2007) and Comparative Fiscal Federalism: Comparing the U.S. Supreme Court and European Court of Justice Tax Jurisprudence (Kluwer, 2007, edited with M. Lang and J. Hines). He is a member of the Steering Group of the OECD International Network for Tax Research and Chair of the ABA Tax Section VAT Committee, an International Research Fellow of the Oxford University Centre for Business Taxation, and a Senior Fellow, Taxation Law and Policy Research Institute, Monash University.

Philip Baker is a Queen's Counsel practicing from Gray's Inn Tax Chambers in London. In addition, he is a visiting fellow at the Institute of Advanced Legal Studies at London University. He writes and lectures on issues of international tax law and European Community tax law.

Steven Bank is a Professor of Law and Vice Dean at the University of California, Los Angeles School of Law. His research frequently uses history and finance to explore the taxation of business entities in the United States and other countries. His recent books include War and Taxes (Urban Institute Press, 2007) and Business Tax Stories (Foundation Press, 2005). He is currently writing a history of U.S. and U.K. corporate income taxation during the twentieth century.

Martina Baumgärtel, Executive Vice President Allianz SE, heads the Allianz Group Center "Group Tax Policy and Products". Since she began working with Allianz in 1988 she has been primarily occupied with devising tax policy for the Allianz Group and the development of insurance and financial products from a tax viewpoint. Since 2002 she has as well been in charge of the tax department of Dresdner Bank. Ms. Baumgärtel has published widely on diverse issues of German and international tax law.

Tobias Beuchert studied law at the universities of Passau, Germany, and Nanjing, China. From 2005 through 2007, he was working as a doctoral researcher and Junior Research Fellow with a special focus on tax shelters at the Department of Accounting and Taxation of the Max Planck Institute for Intellectual Property, Competition and Tax Law in Munich. He is currently an LL.M. student at Harvard Law School.

Brian R. Cheffins is the S.J. Berwin Professor of Corporate Law at the Faculty of Law, University of Cambridge. Prof. Cheffins, before coming to Cambridge, taught at the University of British Columbia's Faculty of Law. He has held visiting appointments at Duke, Harvard, Oxford and Stanford and is a Fellow of the European Corporate Governance Institute. Prof. Cheffins is the author of Company Law: Theory, Structure and Operation (Oxford, 1997; co-winner, Society of Public Teachers of Law Prize for Outstanding Legal Scholarship), The Trajectory of (Corporate Law) Scholarship (Cambridge, 2004) and numerous articles on corporate law and corporate governance.

Mihir A. Desai is a Professor of Business Administration in the Finance and Entrepreneurial Management areas and the MBA Class of 1961 Fellow at Harvard Business School. Prof. Desai's research focuses on international corporate and public finance. He is a Faculty Research Fellow in the National Bureau of Economic Research's Public Economics and Corporate Finance Programs and is the co-director of the NBER's India program.

Michael J. Desmond is the Tax Legislative Counsel in the U.S. Treasury Department's Office of Tax Policy, responsible for providing the Assistant Secretary (Tax Policy) with legal advice and analysis on a broad range of issues relating to the domestic Federal tax law. Mr. Desmond has served as Tax Legislative Counsel since 2005. Prior to joining the Office of Tax Policy, Mr. Desmond was a partner at McKee Nelson LLP in Washington, D.C., where his practice focused on large case tax litigation and tax controversy matters.

Dhammika Dharmapala is Assistant Professor of Economics at the University of Connecticut. He received a PhD in Economics from the University of California at Berkeley, and is a Winner of the National Tax Association's Outstanding Doctoral Dissertation Award. He has previously served as a Postdoctoral Fellow at Harvard University and a Visiting Assistant Professor at the University of Michigan. His research focuses on the areas of public finance, taxation and the economic analysis of law.

Bernd Erle is member of the KPMG Europe LLP Board and Deputy Chairman of the Executive Board KPMG Deutsche Treuhand-Gesellschaft AG. Mr. Erle joined KPMG in 1987 in Frankfurt and was elected as Member of the Executive Board of KPMG in 1998. From 2002-2005 he served as Global Head of Tax. After several managerial functions in Leipzig, Chemnitz and Frankfurt he became Deputy Chairman of KPMG Germany in 2005 and is based in Berlin. As a qualified lawyer and

chartered accountant his fields of expertise include corporate law, national corporate tax and liquidation. Mr. Erle studied at the University of Bielefeld, which is also where he earned his PhD working as a research fellow to Prof. Hommelhoff from 1985-1987.

Judith Freedman has been KPMG Professor of Taxation Law in the Law Faculty, Oxford University since 2001. Previously, she worked in the corporate tax department of a leading London law firm and then lectured at the London School of Economics for many years, acting on various company law reform and taxation committees during this time. She is joint editor of The British Tax Review and is on the editorial boards of a number of other legal and tax journals. Prof. Freedman is Director of Legal Research and a Programme Director at the Oxford University Centre for Business Taxation and is a member of the Council and Executive of the Institute for Fiscal Studies (IFS) and of the IFS Tax Law Review Committee.

Arne Friese studied law in Trier and Munich, Germany, and London, U.K. From 2005 through 2007, he was working as a doctoral researcher and Junior Research Fellow with a special focus on European company tax law at the Department of Accounting and Taxation of the Max Planck Institute for Intellectual Property, Competition and Tax Law in Munich. He is currently working as a tax lawyer with Dissmann Orth Rechtsanwaltsgesellschaft Steuerberatungsgesellschaft GmbH, Munich, Germany.

Dave Hartnett, CB, is the Director General in HM Revenue & Customs responsible for tax co-ordination, tackling tax avoidance, the Large Business Service, international relations and for the Department's links with business of all sizes. And as a Commissioner he has a shared accountability with other Commissioners for tax administration in the U.K. He is one of the tax Commissioners who set up the Joint International Tax Shelter Information Centre – JITSIC – now in Washington and London, to facilitate exchange of information and risk assessment about tax avoidance. He led the development of disclosure rules in the U.K. and is now leading the study of tax intermediaries described in the Seoul Declaration.

Norbert Herzig is Professor of Business Administration in the area Taxation and Accounting of Cologne University since 1991. His research focuses on business taxation, group taxation and especially the relationship between international accounting and taxation. He is Vice President of the Schmalenbach-Gesellschaft für Betriebswirtschaft and a board member of the German IFA Branch.

Christian Kersting is Professor of Civil Law, German and International Business Law at the University of Düsseldorf School of Law. He is a graduate of Bonn University (J.S.D. 2000), Yale Law School (LL.M. 2002) and Munich University (Professorial Thesis 2006). From 2002 to 2007 he worked as a research fellow at the Department of Accounting and Taxation of the Max Planck Institute for Intellectual Property, Competition and Tax Law in Munich. His research interests include civil

law, corporate and business law, securities regulation, comparative law and tax law as well as antitrust law.

Donald L. Korb is the Chief Counsel of the U.S. Internal Revenue Service (IRS). The Chief Counsel is the chief law officer for the IRS and an assistant general counsel for the U.S. Department of the Treasury. The Chief Counsel supervises more than 1,500 attorneys who are assigned among the IRS National Office and the major operational divisions of the agency. Before assuming his current position, Mr. Korb was a partner in the taxation practice area of the Cleveland law firm of Thompson Hine. He has more than 32 years of experience in the practice of tax law both in public service and private practice.

Simon Link studied law and business administration at Ludwig-Maximilians-Universtät, Munich, Germany. From 2004 through 2006, he was working as a doctoral researcher and Junior Research Fellow at the Max Planck Institute for Intellectual Property, Competition and Tax Law in Munich. His research focused in particular on the application of tax treaties to companies subject to group taxation regimes. Since 2006 he is working as an associate lawyer for Hengeler Mueller in Munich.

Stefan Mayer studied law in Munich and London. He is currently working as a doctoral researcher and research assistant at the Department of Accounting and Taxation of the Max Planck Institute for Intellectual Property, Competition and Tax Law in Munich. His research focuses on European and corporate tax law.

Paul Morton is Head of Group Tax at Reed Elsevier Group plc. Previously he was head of tax for the global refining and marketing business of Royal Dutch Shell. He originally trained as a Tax Inspector in the U.K. Inland Revenue before becoming a Tax Manager at KPMG and serving in many roles at Shell. Mr. Morton was President of the Confédération Fiscale Européenne in 2006 having served on the Council and before that the Fiscal Committee for some years. The CFE is the umbrella body for tax professional bodies in Europe. He is a member of the Council of the U.K. Chartered Institute of Taxation and the Tax Law Review Committee of the Institute for Fiscal Studies. He also serves on industry tax committees.

Christian Nowotny is fulltime professor of civil and corporate law at the law department of the Vienna University of Economics and Business Administration (Wirtschaftsuniversität Wien). He is Vice President of the Austrian Financial Reporting and Auditing Committee and member of the Austrian Corporate Governance Board. Prof. Nowotny's research interests include corporate and business as well as capital markets law.

Jeffrey P. Owens is a public finance expert with a doctorate in Economics from Cambridge University in the United Kingdom. He is also a qualified accountant. He is the Director of the OECD's Centre for Tax Policy and Administration which is the focal point for the Organisation's work on taxation. Over the last ten years he has

built up the OECD's work on taxation so that it is now the leading organization in the international tax area. He has taught at Cambridge University, the American University in Paris, Bocconi University in Italy and Queen Mary's College in London. He is a member of numerous scientific committees and frequently contributes to international conferences and journals.

Wolfgang Schön is since 2002 a Director at the Max Planck Institute for Intellectual Property, Competition and Tax Law (Department of Accounting and Taxation) in Munich and Honorary Professor at Munich University. He is Chairman of the Scientific Council to the German Tax Law Association and a Member of the Permanent Scientific Committee of IFA as well as a Member of the Board of Trustees of the International Bureau of Fiscal Documentation. He was appointed Anton Philips Professor at Tilburg/NL University's Centre for Company Law for the Academic Year 2004/2005 and was invited to join the Global Law Faculty at NYU in 2006.

Roman Seer is a fulltime professor of tax and public law at the law faculty of the Ruhr University of Bochum (tax law chair). He is the President of the German Tax Law Association and a member of the board of the International Tax Law Association of Rhine-Ruhr Germany. He serves in numerous scientific committees and publishes books, articles and commentaries on different topics of German national tax law, comparative and European tax law. Furthermore he teaches as a guest professor at the St. Louis University/USA European and comparative tax law. Prof. Seer worked for some years as a PhD at the Tax Law Institute of the University of Cologne (law faculty) where he earned his habilitation.

Daniel Shaviro, the Wayne Perry Professor of Taxation at NYU Law School, is a graduate of Princeton University and Yale Law School. Before entering law teaching, he spent three years in private practice at Caplin & Drysdale, a leading tax specialty firm, and three years as Legislation Attorney at the Joint Congressional Committee on Taxation. His scholarly work examines tax policy, budget policy, and entitlements issues. Books he has published include Taxes, Spending, and the U.S. Government's March Towards Bankruptcy (2006), Who Should Pay for Medicare? (2004), Making Sense of Social Security Reform (2000), When Rules Change: An Economic and Political Analysis of Transition Relief and Retroactivity (2000), and Do Deficits Matter? (1997).

Pekka Timonen is Director General in Finnish Government Office and Head of Ownership Steering Department which has responsibility of state-owned companies and state shareholdings in Finland. He was a researcher and scholar at the University of Helsinki 1984-2001, Doctor of Laws 1997, Docent of Commercial Law at the University of Helsinki and Docent of Economics of Law at the University of Tampere. He is or has been board member of several listed and non-listed companies and is Finnish delegate in OECD Steering Group of Corporate Governance and OECD Working Group of Privatisation and Corporate Governance of State-Owned Assets.

Part 1:

The Link between Taxation and Corporate Governance

The Link between Taxation and Corporate Governance

Dave Hartnett

When thirty five national tax Commissioners from member countries of the OECD's Forum on Tax Administration met in September 2006, two things were on their minds:

– Organizational reforms to develop more effective tax administration, and
– Countering non-compliance in an international context.

And in relation to the second of these the Commissioners focused principally on:

– Improved use of risk management;
– Encouraging top management and audit committees of large enterprises to take a greater interest in, and personal responsibility for, tax strategies;
– Improving transfer pricing guidelines and ensuring their consistent application;
– Examining the role of tax intermediaries – law and accounting firms, financial institutions, *etc* – in relation to non-compliance and the promotion of unacceptable tax minimization arrangements; and
– Expanding the OECD's 2004 Corporate Governance guidelines to give greater attention to the linkage between tax and good governance.

Not surprisingly, these were also the themes discussed most when the Commissioners of the four countries which set up the Joint International Tax Shelter Information Centre (JITSIC) met in Canberra, Australia just recently. The Commissioners meeting there felt that JITSIC had been very effective in its first two years but an increased focus on risk management, better international exchange of information and further engagement with corporates to make tax a keystone of corporate responsibility statements were seen as essential steps to ensuring improved compliance.

So these two gatherings of tax administrators show the extent to which bringing tax within the scope of corporate responsibility has entered the international thinking of the heads of tax administrations.

A recent study in the United Kingdom of what business and HM Revenue & Customs – from hereon I'll call it HMRC – want from their relationship revealed a significant commonality of interest:

– Business wants a relationship based on mutual trust where there is an appreciation of commercial drivers, they want a recognition that tax is rarely the driver of large businesses' commercial decisions and that tax is managed responsibly. And business wants a tax administration where operational practices are delivered by appropriately trained and adequately supported staff within a culture that is conducive to providing certainty through swift resolution of issues;
– HMRC wants a relationship based on trust and transparency and a shared commitment to efficient and effective collection of the right tax at the right time.

> HMRC recognizes that allocating resource according to risk, with the result that issues are addressed and resolved quickly and efficiently, is not only cost effective but also forms the basis of building a better relationship.

And business and the U.K. tax administration agreed that they had a shared interest in:

- Creating greater certainty;
- An efficient risk based approach to dealing with tax matters;
- Speedy resolution of issues; and
- Clarity through effective consultation and dialogue.

These themes and outcomes are shared by business and tax administrations in many countries but delivering them requires real change on the part of business, their tax advisers and tax administrators.

Perhaps the greatest challenge of all is for tax administrators where cultural change to equip staff with the range of skills, competences and support necessary to understand business and to deal confidently with complex matters of relevance to business, combined with a skill in applying risk management techniques, are a high priority.

In the time remaining to me, my proposition for you is that by bringing tax within statements of corporate responsibility principles and by bringing those principles to life in the way tax issues are managed, business can convince tax administrators that a more trusting tax environment is possible, and high levels of suspicion occurring in tax administrations can be reduced.

The big issue for tax administrations is that aggressive and artificial tax shelters and schemes across the globe, promoted by advisers once more renowned for caution and the accuracy of their work than for breathtaking creativity in relation to tax, have at times reduced to nothing the tax paid by individuals and corporates who are often the persons best placed to pay the taxes governments expect of them. As a result, tax officials talk openly in relation to corporates and wealthy individuals of reputation, tax risk and responsible tax paying and these are also words now spoken by business executives as governments have responded to defend their tax bases.

Once a technical issue managed by specialists, tax is now something that engages business leaders because it raises complex issues and has become potentially damaging to personal and corporate reputations, and it carries more risk for business than ever before and tax is a major cost of doing business. But some business leaders argue that their companies now have to be sufficiently transparent so that stakeholders understand the annual accounts and can see where risks and issues lie. They see governments, and their tax collectors, as stakeholders in their companies with an undeniable right to full and fair disclosure just as shareholders can reasonably expect to understand the sustainability of the tax charge going forward. These business leaders argue that overly aggressive tax policies create a tension between a corporate's obligations to governments and shareholders and force corporates to assess the reputational impact of any dispute they have with a tax administration.

Some countries publish tax returns and other information about corporates in order to produce this kind of transparency. In the U.K. we work hard to ensure that

our media understands tax issues but of course without revealing any taxpayer specific information. And we work with key financial analysts to increase their understanding of tax. But more important than any of that, HMRC is working with corporates so that they understand how we perceive the tax risks they and the markets in which they operate pose.

Debate in the U.K. about the application of morality to tax has not been particularly helpful. More can be gained, I think, from considering the ethical stance of corporates, their advisers and tax administrations and their long-term self interest. But what has become clear in the U.K. is that a simple assertion that tax is about the application of black letter law is no longer sufficient. So with increasing numbers of investors taking an interest in the ethical and social policies of corporates in which they invest, and with statements of political donations, ethical considerations, environmental issues and social principles to be found in glossy annual reports and with remuneration policies constantly under scrutiny, there is widespread belief that tax can no longer be seen as a mere technical issue.

Government ministers in the U.K. have asserted that taxpayers should pay their fair share of taxes. Some people argue in reply that the only fair share can be what is required by law and that exploitation of schemes, loopholes and cross-border tax arrangements, for example, that work in law are all permissible in quantifying that fair share. But there is another approach – one that involves ultimate responsibility for a corporation's taxes lying with its board and being actively managed by that board through a policy that is well understood throughout the business, and published so that it is also understood by stakeholders and customers.

In broad terms, corporates recognize tax as a cost to business and that paying more tax than is strictly due may breach legal duties and obligations to shareholders. But an increasing number of corporates see real worth in a positive working relationship with tax administrations and they value a good reputation with governments, their customers, employees and the public at large. Perhaps more significantly, they have come to see that aggression in relation to tax can be damaging and they are passing up opportunities to get into shelters and schemes. Bringing tax firmly within the corporate responsibility agenda requires the involvement of boards of directors and getting boards fully involved requires action on the part of tax administrators. It means that tax leaders have to get to know business leaders better than they generally know them now and it needs tax administrations to invest in this relationship through their own board members – tax auditors and specialists cannot be expected to manage that relationship.

HMRC sees the corporate responsibility agenda as a lever for improving tax compliance. The introduction of rules requiring early disclosure of schemes and arrangements for tax avoidance, a determination to collect 100 pence in the pound where the technical analysis is clear, and the imposition of penalties on corporates where the law permits, have forced boards and audit committees in the U.K. to think about tax in a way they never have before.

Boards in the U.K. are beginning to realize that taxation disputes cost serious management time and serious money, and they involve serious reputational risk. Penalties for tax offences generate significant governance questions and in the U.K.

today governance groups and auditors have said that a penalty of £10m or more could lead a CEO or a CFO in a major corporation to lose their job. When the CFO of a major U.K. multi-national was told by Board members of HMRC that his group was regarded as a high risk in a high risk sector, he told his board of that "high/high" rating and they discussed it on many occasions. In the past they had considered their tax saving plans, both in the U.K. and internationally, as simple technical issues. This corporate is beginning to change its ways and has engaged with HMRC at the highest level to determine how best to reduce its risk rating.

What HMRC is looking for from corporates who embrace corporate responsibility is:

- Transparency,
- Disclosure,
- Dialogue,
- Alignment of tax with underlying business,
- Recognition of reputational risk, and
- Adherence to the spirit of the law, or if not to the spirit of the law, then to the policy rationale underpinning legislation.

In return, and provided corporates deliver these, we see the business as a lower risk and where the compliance track record is sound, we audit less often and then focus on bigger risks.

None of this heralds an end to tax planning as such, but aggressive schemes and arrangements which pose a challenge to Governments spending plans have no place in this context.

So how does a company embracing corporate responsibility in relation to tax manifest its commitment. Here are two examples taken from published corporate responsibility statements:

i "Our company operates according to certain key business values:
   - A commitment to complying with the spirit and the letter of all laws and regulations where ever we conduct our business…"

And record:

ii "Objective – minimizing the tax burden … in a manner consistent with commercial objectives, legal obligations and ethical standards.

   Tax planning is perfectly acceptable provided it is consistent with the laws of the jurisdiction concerned and has regard to the intention of the legislature as well as the strict letter of the law. Artificial transactions whose sole purpose is to reduce tax should not be undertaken, particularly those that have no economic effect other than tax saving …

   Tax planning should not be undertaken if the risks are such that the overall position, if the planning is ineffective, would be significantly worse than if the planning were not undertaken at all… Relationships with tax authorities must be considered."

So what do corporates think of all this? Two quotes from tax directors:

i "Corporate responsibility is part of the discussions of tax planning? I would have said no two or three years ago. Now I would say yes. And the way we define our responsibility is that we live by the spirit of the law rather than the letter of the law."

ii "If the government wants to introduce new legislation let them do it. We will not be pushed into changing our behavior by threats. Let the government legislate if they want to and let's see the fallout."

So a tax authority is ready to regard companies embracing corporate responsibility as fully compliant? Not just yet! Tax authorities need to remain vigilant. Trust and verify what corporate companies say about corporate responsibility. History has made tax administrators just a little cynical. First, what better way is there for corporates to argue against the need for regulation than by asserting that self regulation through corporate responsibility is working well. But for a growing number, corporate responsibility in relation to tax really means something.

Second, a senior official in an administration that is not HMRC, told me recently that in his personal opinion business leaders brought tax within corporate responsibility so that at the start of any litigation on a tax issue their first exhibit could be a published statement to the effect that they did not plan aggressively. If history has delivered numbers of administrators with that cynical view, building trust and transparency will be a really significant challenge.

If corporates have to change then I suggest that their advisers have to change more. It seems to me that the real issue here is that the tax profession itself has not taken an adequate grip on the invention and creativity of its tax planners. A question put to me last year by the CEO of an Italian company after I had spoken at a conference on tax avoidance – "why have my auditors and advisers never told me how concerned governments are about tax planning" – indicates that many advisers have a long way to travel. Why is it like that? – perhaps because the deeper the wedge between a corporate and a tax administration, the greater the fees to be earned by an adviser. In the U.K. companies embracing corporate responsibility in relation to tax are asking for much higher standards from their auditors and tax advisers and are ready to change advisers if they don't get those standards.

I want to close where I started out – with the challenge facing tax administrators. We too have to change if we want to leverage corporate responsibility to increase tax compliance, create greater transparency and disclosure, and promote dialogue. Corporates wants tax administrations that are:

- Tough on non-compliance,
- Consistent in their actions,
- Constantly producing good guidance on new initiatives and access to specialists who understand complex issues,
- With clarity of roles, responsibility and accountability,
- Providing more openness and ready to work in "real time" to resolve issues,
- Providing faster responses leading to faster settlement of issues, and
- Ready to share risk assessment.

Just one final thought – my department features in the U.K.'s corporate social responsibility index where it is placed higher than many major corporates. We are proud of that but not complacent.

Good Corporate Governance: The Tax Dimension

*Jeffrey P. Owens**

Increasingly, the OECD and its member governments have recognized the synergy between macroeconomic and structural policies in achieving fundamental policy goals. Corporate governance is one key element in improving economic efficiency and growth as well as enhancing investor confidence. Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders.

Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders and society at large. The presence of an effective corporate governance system, within an individual company and across an economy as a whole, helps to provide a degree of confidence that is necessary for the proper functioning of a market economy.

Corporate governance is only part of the larger economic context in which firms operate that includes, for example, macroeconomic policies and the degree of competition in product and factor markets. The corporate governance framework also depends on the legal, tax, regulatory, and institutional environment. In addition, factors such as business ethics and corporate awareness of the environmental and societal interests of the communities in which a company operates can also have an impact on its reputation and its long-term success.

The recent attention to corporate governance questions has raised some important issues concerning the interaction of corporate governance and taxation issues. Most of the corporate governance discussion has centered on the appropriate regulatory framework for establishing the principles of corporate governance. Thus consideration has been given to corporate law questions, regulatory and disclosure practice, principles of ethical conduct and the like. However, there has been relatively little attention paid until recently to the relation between corporate governance and tax rules. This means that tax and governance principles can sometimes be operating in an incoherent fashion.

These issues have recently been highlighted by a series of corporate scandals in the U.S. and Europe and by the aggressive promotion of tax shelters by some large accounting and law firms.

Tax and corporate governance issues can intersect in several different contexts. One set of issues is how to ensure that tax does not encourage behavior that is con-

---

* This article expresses the views of the author and does not necessarily represent the OECD or its members.

trary to the interest of the company and/or of its shareholders. Another set of issues is how to ensure transparency and quality of management decisions in the tax area. In particular, it is important to ensure that the board, shareholders and other stakeholders are aware of the stakes that are involved in the management of taxes. Both sets of issues are briefly discussed below.

1. Putting Tax on the Corporate Board's Agenda

Good corporate governance principles should extend to the corporation's attitude towards its tax liabilities. This is not a question of whether or not a corporation should seek to minimize its tax burden, but more an issue of the board's responsibility to assess the financial and reputation risks associated with any particular tax strategy.

Aggressive tax planning can create significant financial risks (adjustments and penalties). It can also create risks in terms of reputation (*e.g.* in cases of fraud as can be seen for the recent Enron case). It is a striking fact that while taxes often represent a very significant portion of a company's profits and potentially huge risks (tax adjustments may sometimes lead a company to bankruptcy), there is generally, in practice, limited involvement of the board and even more limited involvement of the shareholders in the management of a corporation tax strategy. A recent survey of business suggested that less than half of boards systematically carry out a formal strategic review of their tax strategies and yet many companies surveyed acknowledged that the risk of being challenged by the tax authorities on issues related to transfer pricing or tax havens or activities which are primarily directed to reduce tax was increasing.[1]

Some have argued that the board needs to formally endorse the tax strategy proposed by the tax directors; others that the CEO should sign the tax returns and yet others that tax returns should be publicly available. It is clear that governments are more and more convinced that encouraging responsible corporate tax behavior, combined with providing a better service to taxpayers, is the only effective long-term strategy to promote good compliance.

The duty of a company's auditors to review tax liabilities, tax assets and tax risks is also an issue which connects corporate governance and tax issues, including the extent to which auditors themselves should be permitted to give tax planning advice.

In some companies, tax managers and/or tax advisors are remunerated as a percentage of the decrease in the company's consolidated tax bill. One area that might be worth investigating is whether such remuneration policies can be compatible with good corporate governance and if so to what extent. For example, should they be specifically disclosed to the board and to the shareholders?

What is clear is that the recent spate of corporate scandals, the success of a number of tax administrations in challenging aggressive tax schemes and the general change in attitudes towards tax planning, will all combine to produce a greater awareness in the boardroom of the importance of tax issues.

---

[1] *See* Henderson's Global Investment Summary.

2. Ensuring that Tax Rules Do Not Encourage Behavior that is Contrary to the Interest of the Company and/or its Shareholders

In general, the effect of tax rules can be either to increase or lighten the after-tax cost of certain types of conduct, depending on the structure of the rules. The tax rules can thus have an implicit regulatory function which is similar in some respects to rules which are directly focused on corporate governance issues. This can happen in a number of different situations.

Some tax rules are aimed directly at corporate governance issues. For example, as a result of the OECD's work on the bribery of foreign officials all OECD countries tax systems deny a tax deduction for bribes and other illegal payments, thus increasing the cost of such payments. Similarly, in some cases deduction is denied for certain types of corporate expenditures such as so-called "greenmail" payments made in connection with corporate takeovers. In other cases, there is a limit on deductibility of executive compensation, again raising the after-tax costs of such payments.

Rather than making certain types of corporate conduct more expensive with the intention of restricting the conduct, some tax rules are aimed at encouraging certain corporate behavior. The most obvious example is the deduction for charitable contributions by corporations, which functions as a governmental subsidy for the private support of designated projects and activities. Favored tax treatment of certain kinds of employee benefits such as employer-provided health care, retirement benefits, child care, educational costs and the like are other examples.

In other cases, the impact of tax rules on corporate governance is more indirect. The tax rules for certain transactions, responding to tax principles and considerations, are often structured without taking their impact on corporate governance issues into account. Thus, for example, the tax treatment of employee stock options, determined simply by applying tax principles, can have an impact on the structure of executive compensation and, in turn, on executive behavior in ways which might be important from a corporate governance perspective. The granting of extensive stock option plans may, for example, encourage individual employees to behave in a manner which is contrary to the interest of the company and/or of its shareholders.

Another type of interaction is involved when certain forms of income are given preferential tax treatment. Some tax systems give preferred treatment to income in the form of capital gains on shares, as opposed to dividend distributions. In these circumstances, when problems of corporate performance arise, there might be an incentive for shareholders to avoid adequate monitoring of corporate management. The existence of a preferential tax rate might be one of the factors contributing to make it simpler and cheaper to just sell the shares at the preferential rate rather than trying to improve corporate conduct. The payoff for increased monitoring is an increased dividend stream which is more heavily taxed than the capital gain. Thus "flight and not fight" conduct might be encouraged indirectly by the tax rules at the expense of appropriate corporate governance practices by creating divergent interests between the shareholders (who might want to limit the immediate costs) and the company (in the longer term). There are several important academic studies which

look at the empirical effects of preferential capital gains taxation on shareholder propensity to sell rather than monitor.

Tax considerations may in some instances encourage management to make fiscal decisions on behalf of the shareholders that are contrary to the longer term interests of the company. Thus, for example, issues arise in the context of business reorganizations where the tax treatment of termination costs may in some instances encourage shareholders to decide in favor of plant closures, irrespective of the longer term interests of the company and other stakeholders.

There is a similar issue with respect to the impact of the general system of corporate-shareholder level taxation on corporate governance. In a so-called classical corporate tax system, where income is taxed both at the corporate and shareholder levels, there is pressure to retain the income at the corporate level rather than distribute it as dividends and thus incur a second layer of tax. This results in several pressures which are relevant to corporate governance questions. The company is freer to make investment decisions with respect to the retained funds which are not subject to direct market discipline. If the funds were first distributed to the shareholders, who would then have the ability to decide whether to reinvest in this company or another company, a more efficient allocation of funds might be achieved. The extra tax burden on distributions discourages distributions, encourages retentions and may, in the long run, make a corporation less accountable to its shareholders.

Tax and financial accounting and income reporting rules also raise corporate governance issues. Companies in some instances might try to inflate corporate profits for financial accounting purposes. If the financial accounting rules are also used to determine profits for tax purposes, with a resulting increased tax cost, the tax rules can act as a deterrent to profit manipulation. On the other hand, in some cases, the essentially conservative nature of financial accounting rules, aimed at the protection of creditors, may not be appropriate for determining the government's current share of the company's operating results. Thus it is important that the interaction between tax and financial accounting rules be examined in the context of any review of corporate governance.

3. Conclusion

There are many other interconnections of tax and governance issues but this brief list should be sufficient to make clear that any serious consideration of corporate governance must take into account the tax dimension.

Tax and Corporate Governance: An Economic Approach

*Mihir A. Desai and Dhammika Dharmapala**

How do the tax system and corporate governance arrangements interact? This chapter begins by reviewing an emerging literature that explores how agency problems create such interactions and provides evidence on their importance. This literature has neglected how taxation can interact with the various mechanisms that have arisen to ameliorate the corporate governance problem, such as concentrated ownership, accounting and information systems, high-powered incentives, financing choices, payout policy, and the market for corporate control. The remainder of the chapter outlines potentially fruitful areas for future research into how these mechanisms may respond to the tax system.

1. Introduction

When Adolf Berle and Gardiner Means launched the study of the agency problem – that managers appointed by shareholders may pursue their own interests – in the corporate setting, they were inspired by the role of taxes in diffusing ownership in the American economy.[1] This link between corporate governance and taxation has been neglected in subsequent decades as the study of these two important features of an economy became segregated. Corporate finance scholars have treated taxes only as market imperfections that influence capital structure and dividend policies, while public finance scholars have not incorporated the possibility of agency problems in their analyses. An emerging literature suggests that revisiting this link can generate new insights into the real effects of tax policies and the workings of corporate governance. This chapter reviews this incipient literature and suggests paths forward for understanding this link more deeply.

The rediscovery of this link has been spurred by two developments. First, rising concerns over the proliferation of corporate tax shelters has led to greater interest in

---

* The authors thank participants in the Symposium on Tax and Corporate Governance at the Max Planck Institute for Intellectual Property, Competition and Tax Law in Munich, and seminar participants at Harvard Law School and UCLA Law School, for helpful comments. Desai acknowledges the financial support of the Division of Research of Harvard Business School.

1 *See* DESAI/DHARMAPALA/FUNG, Taxation and the Evolution of Aggregate Corporate Ownership Concentration, in: AUERBACH/HINES/SLEMROD (eds.), Taxing Corporate Income in the 21st Century, 345-383 (2007) for a discussion of the Berle-Means argument (*cf.* BERLE/MEANS, The Modern Corporation and Private Property (1932)).

the mechanics and motivations for such transactions,[2] especially in the context of growing concerns about managerial malfeasance. As discussed below, initial explorations of these shelters suggest that a purely tax-driven motivation for these activities is not sufficient to account for many of their features. Second, the magnitude of corporate tax rates is sufficiently high relative to levels of ownership concentration that it is reasonable to characterize the state as the largest claimant on pretax corporate cash flows.

Before proceeding, it is useful to underscore the centrality of the agency problem to the intersection of corporate governance and taxation. There is great enthusiasm for labeling any issue (including, for example, tax shelters) as a corporate governance problem. Yet, tax shelters need not have any consequences for corporate governance. For example, a tax shelter undertaken by a corporation that is wholly owned and managed by an individual has no corporate governance implications. Such a transaction merely diverts resources from the state to shareholders. For there to be a meaningful intersection of taxation and corporate governance, it must be the case that ownership and management are separated, and that the incomplete nature of contracting and monitoring creates the scope for managerial opportunism.

This chapter proceeds by first outlining current research on the intersection of corporate governance and taxation. This research has emphasized that the tax system can mitigate or amplify the corporate governance problem. In addition, it has emphasized that the nature of corporate governance environment can influence the nature and consequences of the tax system. Section 2 begins by motivating these links; then, Section 3 reviews the growing evidence of their importance. The literature has neglected how taxation can interact with the various mechanisms that have arisen to ameliorate the corporate governance problem. Section 4 outlines the research opportunities that flow from systematically considering these mechanisms and how they might respond to taxation. Section 5 concludes.

2. How Taxation and Corporate Governance Interact

The basic intuition for how corporate governance and taxation interact is that tax avoidance demands complexity and obfuscation to prevent detection. These characteristics, in turn, can become a shield for managerial opportunism. This logic is perhaps best understood by example. Suppose that managers of a firm begin creating several special purpose entities (SPEs) in tax havens. These entities are rationalized as providing the means for reducing tax obligations. The details of the structures and transactions cannot be explicated fully or widely, explains management, due to the likelihood of detection by the tax system and the revocation of those benefits. Such structures and secrecy may also allow managers the ability to engage in various activities that may be harmful to shareholders. More specifically, such entities may facilitate earnings manipulation (by creating vehicles that can manufacture earnings

[2] For more on tax shelters, *see e.g.* BANKMAN, The Tax Shelter Problem, 57 National Tax Journal 925-36 (2004) and WEISBACH, Ten Truths about Tax Shelters, 55 Tax Law Review 215-253 (2002).

without enabling investors to understand their source), the concealment of obligations (by taking on debt that is not fully consolidated), or outright diversion (by allowing for insider transactions that are not reported widely). The secrecy laws of tax havens may well assist managers in obscuring these actions, all of which are rationalized as tax avoidance undertaken for the shareholders' benefit.

More formally, the technologies of tax avoidance and managerial diversion can be thought to be complementary. That is, undertaking tax avoidance can reduce the costs of managerial diversion or, alternatively, reduce the likelihood of detection. This complementarity is modeled by Desai, Dyck, and Zingales as creating an interaction between resources diverted by managers and the amount of tax savings created by shelters.[3] Another form of this complementarity is modeled by Desai and Dharmapala as creating an interaction between the ability to reduce taxable income and inflate book income in a setting of dual reporting.[4] This view can be thought of as, narrowly, an "agency perspective on tax avoidance" or, more broadly, as the "corporate governance view of taxation." These models yield several predictions that are elaborated on below.

Some Motivating Examples

Prior to discussing these predictions and the extant evidence, it is useful to provide some real-world illustrations of these interactions. Such examples are necessarily taken from court proceedings and thus reflect the experiences of firms caught in malfeasance. Nonetheless, the examples are illustrative of the broader phenomena, and they also point to the more widespread nature of these activities.

Initially attracted by the tax benefits of a shelter, Dynegy (an energy company) gave up plans to undertake the shelter when a journalist reported on the proliferation of such transactions. Their appetite for the shelter reappeared as investors began to question the quality of Dynegy's earnings. As a result of these pressures, managers began looking for devices to meet earnings and cash flow targets. Ultimately, they structured the tax shelter transaction so that it provided operating cash flows on Dynegy's financial statements. Indeed, the transaction size was determined by the amount of proceeds that would allow for a $300 million increase in operating cash flow and a 12 percent rise in net income. When the financial accounting treatment was in jeopardy, several Dynegy officials began maintaining two sets of documents in order to ensure that the transaction could close. Ultimately, several Dynegy employees admitted to federal fraud and conspiracy charges related to disguising a loan as operating cash flow, and one employee was convicted of those charges.[5]

This brief summary of the Dynegy example provides some intuition for how sheltering activities might give rise to opportunities for managers to pursue activities designed to mislead investors. First, a tax-oriented transaction became desirable

---

[3] DESAI/DYCK/ZINGALES, Theft and Taxes, 84 Journal of Financial Economics 591-623 (2007).

[4] DESAI/DHARMAPALA, Corporate Tax Avoidance and High Powered Incentives, 79 Journal of Financial Economics 145-179 (2006).

[5] *See* DESAI/DHARMAPALA, *id.*

when it morphed into a vehicle for misleading the capital markets. Second, features of the transaction designed to make it more opaque to the capital markets were justified on the basis of secrecy, supposedly necessitated by tax objectives. Finally, actions that served as the origins of the conspiracy to mislead the auditors were also justified on this same basis.

Earning manipulation was also central to Enron's extensive use of tax shelters. In summarizing various transactions, the Joint Committee on Taxation (JCT) concluded that Enron's management realized quickly that tax-motivated transactions could generate sizable financial accounting benefits. Accordingly, "Enron looked to its tax department to devise transactions that increased financial accounting income. In effect, the tax department was converted into an Enron business unit, complete with annual revenue targets. The tax department, in consultation with outside experts, then designed transactions to meet or approximate the technical requirements of tax provisions with the primary purpose of manufacturing financial statement income."[6]

One example of such a transaction was "Project Steele." As Enron had already guaranteed that it would not pay taxes well into the future through previous tax shelters, this transaction was motivated by the fact that it would create $133 million in pretax financial accounting income. Ironically, in order to generate favorable tax treatment, Enron admitted that its "purported principal business purpose for the transaction was to generate financial accounting income."[7] In addition to the fact that no current tax savings were generated, it is also useful to note that the very complex structure was extremely costly to undertake. Project fees were estimated at over $11 million. As such, shareholders did not benefit from material tax savings, were manipulated by managers with financial accounting goals, and paid considerable fees in the process.

How representative is such a transaction in depicting what motivates corporate tax shelters? The documents released through the JCT's investigations reveal that the purveyors of the transaction recognized the centrality of financial accounting benefits to corporate tax shelters. Bankers Trust, the advisor to Enron on this transaction, initially showed a variant on the final structure that did not provide financial accounting benefits. Internal documents reveal that Bankers Trust concluded "that it would not receive much, if any, interest for the tax benefits alone but if the transaction were redesigned to provide for financial accounting benefits, as well, then corporate clients would be extremely interested and would pay a substantial fee... other less expensive alternatives exist to generate equivalent tax benefits."[8]

These examples illustrate how central financial accounting motivations are to undertaking tax shelters. Desai and Dharmapala provide a more general stylized

---

[6] JOINT COMMITTEE ON TAXATION, Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations, vol. 1-3 (2003) (*see* http://www.access.gpo.gov/congress/joint/hjoint01cp108.html).

[7] JOINT COMMITTEE ON TAXATION, *id.*

[8] JOINT COMMITTEE ON TAXATION, *id.*

example of how earnings manipulation goals can be facilitated by tax shelters.[9] The wider theme here is that tax shelters may provide diversionary opportunities through obfuscation that is easily rationalized as tax avoidance, as in the Sibneft example provided by Desai, Dyck, and Zingales.[10] These interactions between avoidance decisions and managerial misbehavior are the critical grounding of the agency perspective on tax avoidance.

3. Empirical Evidence

The corporate governance view of taxation yields three distinct predictions that can be tested in various settings. First, characteristics of a tax system – such as the structure of rates and the nature of enforcement – will influence managerial actions and hence the extent of the agency problem. Second, the nature of the corporate governance environment – *e.g.* the protections afforded dispersed outside investors and the laws that regulate self-dealing – will influence the workings of the tax system. Third, tax avoidance need not represent a simple transfer of resources from the state to shareholders; rather, managers may capture a share of the benefits of tax avoidance. The first two of these predictions have been evaluated in the international setting (with particular emphasis on developing countries) while the third has been evaluated using U.S. data.

3.1. International Evidence

Desai, Dyck, and Zingales develop a model that yields a series of novel hypotheses about the interaction between the strength of corporate governance institutions and the tax system.[11] Their model predicts that increases in corporate tax rates should lead to larger revenue increases in countries with stronger corporate governance institutions. Managers or controlling shareholders of firms in countries with weaker governance find it easier to divert from shareholders, and so have a greater incentive to avoid corporate taxes; in effect, they act as residual claimants on the firms' cash flows. This hypothesis is tested using data on a panel of countries with differing corporate governance institutions. As predicted, corporate tax rate increases lead to increased revenues only in countries with strong corporate governance. For countries with weak corporate governance, the estimates suggest that revenues *decline* with higher tax rates, because of the interactions with the corporate governance system.

The model of Desai, Dyck, and Zingales also predicts that tax enforcement may benefit shareholders if the resulting decline in diversion by insiders is sufficiently large to offset the direct loss of shareholder value due to increased tax payments. This is tested using an episode from recent Russian history – the Putin administration's crackdown on tax evasion by corporations in 2000. They find that firms tar-

---

[9] DESAI/DHARMAPALA, Earnings Management and Corporate Tax Shelters, Harvard Business School Finance Working Paper 884812 (2006).

[10] *See* DESAI/DYCK/ZINGALES, *supra* note 3.

[11] DESAI/DYCK/ZINGALES, *supra* note 3.

geted by these enforcement efforts experienced an *increase* in market value, and that the voting premia for these firms (a proxy for private benefits of control) declined.[12] This test exploits heterogeneity across industries in firms' ability to evade taxes, and is robust to various alternative explanations. Indeed, it coincides with contemporaneous accounts of the crackdown which noted that tax avoiding companies "have begun closing offshore subsidiaries and consolidating their operations within Russia. To comply with the law, they have to declare higher profits and pay higher taxes. They must also show the true extent of their financial operations to outside shareholders, who are just as keen to have a share of the proceeds as the tax inspector."[13] This evidence is hard to reconcile with traditional views of tax avoidance.

3.2 Evidence on Tax Avoidance in the U.S.

While the international evidence discussed above may seem far removed from the developed country setting, an emerging literature has found significant interactions between taxation and corporate governance in the U.S. These empirical investigations are of course hampered by the difficulty of measuring tax avoidance. Building on research in the accounting literature, Desai and Dharmapala construct a proxy for tax avoidance activity based on so-called "book-tax gaps" – the difference between financial income, as reported by the firm to its shareholders and the SEC (using generally accepted accounting principles, GAAP) and the tax income it reports to the IRS.[14] However, because tax returns are confidential, the book-tax gap is not directly observable to most researchers or to investors. This problem can be addressed by estimating firms' taxable income using observable financial reporting data. In particular, Manzon and Plesko develop an approach that involves using a firm's reported tax expense in its financial statements, and grossing up this amount by the corporate tax rate in order to estimate its taxable income.[15] This estimated taxable income is then subtracted from the firms' reported pretax financial income in order to compute the estimated book-tax gap. While there are a number of important caveats to this approach,[16] it remains the only available procedure for measuring book-tax gaps, in the absence of direct observation of firms' tax returns. Moreover, this measure has the distinct advantage of being observable to investors.

However, book-tax gaps may be due to factors other than tax avoidance; in particular, they may reflect earnings management (*i.e.* the overreporting of financial income). In order to incorporate the effects of earnings management, Desai and Dharmapala implement a procedure that seeks to correct the book-tax gap for the

---

[12] DESAI/DYCK/ZINGALES, *id.*

[13] "Russia starts paying dividends: Shareholders are benefiting from improved corporate governance, says Andrew Jack", Financial Times, September 17, 2001, 32.

[14] DESAI/DHARMAPALA, *supra* note 4.

[15] MANZON/PLESKO, The Relation Between Financial and Tax Reporting Measures of Income, 55 Tax Law Review 175-214 (2002).

[16] Reviewed *e.g.* in HANLON, What Can We Infer about a Firm's Taxable Income from Its Financial Statements?, 56 National Tax Journal 831-863 (2003).

influence of earnings management.[17] In the accounting literature, a widely-used proxy for earnings management is the use of accruals – adjustments to realized cash flows made by managers in computing the firm's net income – as these provide a measure of the extent of managerial discretion in the reporting of the firm's income. The approach developed by Desai and Dharmapala isolates the component of the estimated book-tax gap that is not explained by accruals or abnormal accruals.

How good is the resulting proxy for firms' tax avoidance activity? Clearly, no such measure can be perfect, but Desai and Dharmapala provide a simple validation check that uses a sample of firms involved in litigation relating to aggressive tax sheltering activity.[18] The proxy for tax avoidance takes on larger values for a given firm in those years in which it is accused of aggressive tax sheltering. While the sample of firms involved in litigation is small, this provides some reassurance that the proxy is correlated with tax avoidance activity.

In order to test the implications of the agency model discussed above, this measure of tax avoidance can be related to the nature of managerial incentives and to market values to understand how markets value tax avoidance. Desai and Dharmapala present a simple model in which the impact of greater incentive-alignment between shareholders and managers has an ambiguous effect on the extent to which managers undertake tax avoidance activities. On the one hand, higher-powered incentives create a direct motivation to increase after-tax firm value, and hence to increase tax avoidance. On the other hand, higher-powered compensation schemes dissuade managers from acts of opportunism that may be complementary with tax sheltering. In turn, this induces managers to reduce tax avoidance activity as well. For example, consider a manager who can use a tax shelter to not only reduce tax obligations, but also to manipulate financial reporting to move earnings into the current period, and sell stock in the firm at temporarily higher prices. A compensation scheme based on stock options will reduce the incentive to engage in this type of earnings manipulation, and will also reduce the manager's benefits from using the tax shelter, possibly to such a degree as to offset its tax benefits.

Given this ambiguity, the effect of managerial incentives on tax avoidance is an empirical question. The results presented by Desai and Dharmapala indicate a negative relationship between their incentive compensation and tax avoidance measures.[19] This negative relationship contradicts the straightforward view of corporate tax avoidance as simply a means of reducing tax obligations, but is consistent with managerial opportunism being an important consideration and with the existence of

---

[17] DESAI/DHARMAPALA, *supra* note 4.

[18] DESAI/DHARMAPALA, Corporate Tax Avoidance and Firm Value, Working Paper (2006) (available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=689562). This sample of firms was first identified and studied by GRAHAM/TUCKER, Tax Shelters and Corporate Debt Policy, 81 Journal of Financial Economics 563-594 (2006). However, the number of firms involved in such litigation is small, and so their measure of tax sheltering activity is not suitable for a large-sample approach.

[19] DESAI/DHARMAPALA, *supra* note 4.

complementarities between tax avoidance and managerial opportunism. Moreover, this view is supported by further analysis that focuses on the differences in the governance characteristics of the firms in the sample.[20] The negative relationship is driven primarily by firms with relatively weaker governance environments, where managerial opportunism is likely to be a more important factor.

In a related paper, Desai and Dharmapala investigate the effects of their proxy for tax avoidance on firm valuation.[21] Given the theoretical framework sketched above, the central prediction is that firms' governance institutions should be an important determinant of how investors value managers' efforts to avoid corporate taxes. Specifically, tax avoidance should lead to larger increases in firm value at better-governed firms. This is not simply because of a tendency among managers of poorly-governed firms to waste or dissipate a larger share of any value-generating activity they may engage in, but also because complex and obfuscatory tax avoidance activities create a potential shield for managerial opportunism, and this factor will naturally loom larger at firms where governance institutions are weaker. Consistent with this prediction, they find that the impact of tax avoidance on firm value (as measured by Tobin's *q*) is significantly greater at better-governed firms. This result is robust to the use of a wide variety of controls and various extensions to the model. It also holds when a 1997 change in tax regulations (that apparently reduced the costs of tax avoidance for a subsample of firms) is used as a source of exogenous variation in tax avoidance activity.

3.3 Other Evidence

The emerging literature on the corporate governance view of taxation has begun to receive support more broadly from a variety of studies. These studies come in two varieties. First, several studies have also noted that market valuations of tax avoidance appear not to be consistent with the naïve view that tax avoidance is a transfer of value from the state to shareholders. For example, Hanlon and Slemrod study market reactions to news reports about tax sheltering activity by corporations.[22] They find a small negative reaction to news about tax sheltering. However, the reaction is more positive for better-governed firms, which is consistent with the theoretical framework developed by Desai and Dharmapala[23] and outlined above. Similarly, Desai and Hines study market reactions to corporate expatriations or inversions – transactions in which a U.S. parent corporation becomes the subsidiary

---

[20] Governance characteristics are measured using the index constructed by GOMPERS/ISHII/METRICK, Corporate Governance and Equity Prices, 118 Quarterly Journal of Economics 107-156 (2003) and by a measure of the extent of institutional ownership.

[21] DESAI/DHARMAPALA, *supra* note 18.

[22] HANLON/SLEMROD, What Does Tax Aggressiveness Signal? Evidence from Stock Price Reactions to News About Tax Aggressiveness, Working Paper (2007) (available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=975252). This sample includes a total of 108 events, and so (while somewhat broader than that constructed by GRAHAM/TUCKER, *supra* note 18) is quite small.

[23] *See* DESAI/DHARMAPALA, *supra* note 4.

of its former tax haven subsidiary through a share swap.[24] Although inversions are presumably motivated by tax savings (in particular, the avoidance of U.S. tax on foreign-source income and possibly also the avoidance of tax on U.S. income in certain circumstances), market reactions are not typically positive, as might be expected under the naïve view.

The second type of evidence relates to the role of the IRS as a meaningful monitor of managerial misbehavior. Erickson, Hanlon and Maydew analyze a sample of firms that were found by the SEC to have fraudulently overstated earnings.[25] They find that these firms paid a significant amount of taxes on these fraudulent earnings. This suggests that, at least for this sample of firms, the threat of IRS monitoring of their taxable income loomed larger than did investor monitoring of their financial statements. Similarly, Guedhami and Pittman find evidence that debt financing is cheaper when the probability of a face-to-face IRS audit is higher.[26] The role of IRS oversight on debt financing costs is also related to the ownership structure of firms and the presumed agency costs of those arrangements. Thus, managers and investors appear to appreciate the role of a tax enforcement agency as a monitor of managerial opportunism.

4. Mechanisms to Address the Agency Problem

The extant literature has emphasized the role of taxes in influencing the nature of managerial misbehavior. However, the role of taxes in shaping the various mechanisms that constitute the overall corporate governance environment has been neglected. To take one example, ownership patterns (such as concentrated ownership) can ameliorate one type of agency problem and give rise to another. The role of taxes in shaping ownership patterns can then have corporate governance implications. Similarly, corporate governance environments can lead to particular ownership structures (such as the pyramidal form) that can then modify the impact of tax policy. This section presents a somewhat speculative discussion of these links for five critical features of the corporate governance environment.[27]

---

[24] DESAI/HINES, Expectations and Expatriations: Tracing the Causes and Consequences of Corporate Inversions, 55 National Tax Journal 409-440 (2002).

[25] ERICKSON/HANLON/MAYDEW, How Much Will Firms Pay for Earnings That Do Not Exist? Evidence of Taxes Paid on Allegedly Fraudulent Earnings, 79 Accounting Review 387-408 (2004).

[26] GUEDHAMI/PITTMAN, The Importance of IRS Monitoring to Debt Pricing in Private Firms, Working Paper (2006).

[27] In the following, we limit our attention to the for-profit sector. It is worth briefly noting that the tax system is particularly important to governance of non-profit organizations. For example, tax returns for non-profits are made public and tax benefits can be contingent on operational decisions (levels of charitable activities) or financing decisions (payout decisions for foundations). For more on the governance of non-profits, *see* DESAI/YETMAN, Constraining Managers without Owners: Governance of the Not-for-Profit Enterprise, NBER Working Paper No. 11140 (2006).

4.1 Ownership Patterns

As discussed above, ownership patterns may change in response to problems created by the broader corporate governance environment. Indeed, in much of the world, the most common solution to the agency problem is for large shareholders to own controlling stakes in firms, thereby giving them both the incentive and opportunity to monitor managers. The prevalence of concentrated ownership around the world has been attributed to weak investor protection[28] or to political factors.[29] Of course, this solution entails its own costs, notably the emergence of a different type of agency problem, the potential expropriation of minority shareholders by the controller.

The American experience of dispersed ownership is anomalous by worldwide standards and the tax system may have played in a role in this situation. Indeed, Berle and Means motivated their original analysis of the agency problem by assessing the role of progressive taxes in shaping the diffusion of stock ownership in the U.S.[30] Berle and Means noted that highly progressive taxes enacted at the time of WWI gave incentives for a reallocation of stock ownership from the wealthy to a broader investor base. Desai, Dharmapala, and Fung revisit this intuition, and analyze it formally in the framework of the Miller[31] model of financial equilibrium.[32] In this setup, different income groups (which face different marginal tax rates due to the graduated structure of the tax system) may form tax clienteles for corporate stock or bonds. Their empirical analysis shows that changes to the progressivity of the income tax have been associated with changes in the patterns of stock ownership across different income groups in the U.S. through the 20th century.

In a related vein, Morck[33] and Morck and Yeung[34] argue that one important reason that the U.S. is an exception to the worldwide pattern of concentrated ownership is a tax reform in the 1930s that discouraged pyramidal ownership. In particular, it is argued that this is the effect of the unique tax treatment of intercorporate dividends in the U.S. Finally, Desai and Gentry show that the tax treatment of corporate capital gains can significantly influence corporate cross-ownership patterns.[35] Specifically, a realization-based capital gains tax paid by corporations appears to create lock-in effects at the corporate level.

---

[28] LA PORTA/LOPEZ-DE-SILANES/SHLEIFER, Corporate Ownership around the World, 54 Journal of Finance 471-517 (1999).

[29] ROE, Corporate Law's Limits, 31 Journal of Legal Studies 233-272 (2002).

[30] *See* BERLE/MEANS, *supra* note 1.

[31] *See* MILLER, Debt and Taxes, 32 Journal of Finance 261-275 (1977).

[32] DESAI/DHARMAPALA/FUNG, *supra* note 1.

[33] MORCK, How to Eliminate Pyramidal Business Groups: The Double Taxation of Inter-corporate Dividends and Other Incisive Uses of Tax Policy, in: POTERBA (ed.), 19 Tax Policy and the Economy 135-179 (2005).

[34] MORCK/YEUNG, Dividend Taxation and Corporate Governance, 19 Journal of Economic Perspectives 163-180 (2005).

[35] DESAI/GENTRY, The Character and Determinants of Corporate Capital Gains, in: POTERBA (ed.), 18 Tax Policy and the Economy 1-36 (2004).

The role of taxes in shaping ownership patterns has yet to be explored in other countries, but some current evidence is suggestive of the potential of such investigations. For example, Edwards, Lang, Maydew, and Shackelford investigate market reactions to the 1999 announcement of a major German tax reform that repealed the sizable capital gains tax on sales of corporate crossholdings.[36] They report a positive association between firms' event period abnormal returns and the extent of their crossholdings, consistent with taxes acting as a barrier to the efficient allocation of ownership. Subsequent anecdotal evidence is consistent with the tax reform leading to a major overhaul of the ownership patterns in Germany. Holmen and Högfeldt also trace out the role of tax changes in influencing pyramidal ownership in Sweden.[37] Morck, Percy, Tian, and Yeung emphasize the role of estate taxes in shaping ownership patterns in Canada.[38] While much remains to be done on the international front, it appears that taxes can have a first-order effect on the ownership patterns that are a critical component of the corporate governance environment.

One further connection between ownership patterns and taxes has yet to be fully explored. The private benefits enjoyed by controllers can take either pecuniary forms (such as through tunnelling into firms where the controller has high cash flow rights) or nonpecuniary ones (such as the power and prestige associated with domination of a large firm). The tax system only burdens the pecuniary forms, and so implicitly subsidizes nonpecuniary private benefits. This bias may, in turn, influence the nature of ownership patterns in economies.

The nature of ownership patterns may also have implications for the workings of tax policy. For example, pyramidal ownership forms may have profound implications for tax policy, particularly in developing countries. For example, transfer pricing issues that are typically considered with regard to cross-border activities become primary aspects of enforcing a corporate tax domestically. In a related vein, the agency perspective on tax avoidance suggests that concentrated ownership leads to a greater incentive to avoid taxes. The dominance of concentrated owners and family firms may lead to distinctive patterns of tax revenue sources and may affect the feasibility of corporate taxes in many economies.

Finally, cross-border activities may be shaped by governance institutions and then have implications for tax policy. For example, weak institutional arrangements have been found to lead to greater intrafirm transactions, as by Desai, Foley, and Hines.[39] This increased reliance on intrafirm transactions, such as intrafirm borrowing, may also be associated with greater tax avoidance activity. Antras, Desai, and

---

[36] EDWARDS/LANG/MAYDEW/SHACKELFORD, Germany's Repeal of the Corporate Capital Gains Tax: The Equity Market Response, 26 Journal of the American Taxation Association, Supplement 73-97 (2004).

[37] HOLMEN/HÖGFELDT, Pyramidal Discounts: Tunneling or Agency Costs, ECGI Working Paper Series in Finance (2005) (available at SSRN: http://ssrn.com/abstract=676506).

[38] MORCK/PERCY/TIAN/YEUNG, The Rise and Fall of the Widely Held Firm: A History of Canadian Corporate Ownership, in: MORCK (ed.), A History of Corporate Governance Around the World, 65-148 (2004).

[39] DESAI/FOLEY/HINES, The Demand for Tax Haven Operations, 90 Journal of Public Economics 513-531 (2006).

Foley[40] and Ju and Wei[41] also suggest that weak corporate governance environments can lead to a reliance on foreign direct investment or changed patterns of foreign direct investment. As such, corporate governance institutions may give rise to distinct biases between domestic and foreign ownership and this mix of ownership can lead to distinct tax policy issues.[42]

Finally, norms of optimal taxation of foreign source income, such as capital export neutrality and capital import neutrality, have viewed capital flows as generic with limited attention to the identity of owners. If ownership matters for the productivity of capital – a bedrock of corporate governance analysis – then optimal taxation of foreign source income can take on quite distinctive forms, as demonstrated by Desai and Hines.[43] Most ambitiously, optimal taxation analyses could incorporate changes to owner identities in the domestic and foreign setting to arrive at new insights on how to design efficient tax regimes.

4.2 Information Systems

Accounting systems play a crucial role in producing information for both an audience of investors and for the tax authorities. The design of information systems for investors has received much attention in the accounting literature. In contrast, the information system embodied in tax regimes has received limited attention. If one views the state as a shareholder because of the tax system, then the question of the optimal design of information systems for both the state and investors becomes central.[44]

In the American setting, the literature has centered on the degree to which shareholders can infer information about tax payments from public financial statements. Hanlon conducts a detailed review of and handful of public financial statements and concludes that it is very difficult to infer anything consistent from public financial statements about tax payments.[45] Large sample evidence that compares tax returns to public financial statements yields a contradictory set of conclusions on the degree to which public financial statements can yield meaningful informa-

---

[40] ANTRAS/DESAI/FOLEY, Multinational Firms, FDI Flows and Imperfect Capital Markets, NBER Working Paper No. 12855 (2007).

[41] JU/WEI, Domestic Institutions and the Bypass Effect of International Capital Flows, IMF Working Paper (2007).

[42] One aspect of cross-border activity, taxes and ownership patterns that has yet to be explored is the role of taxes in changing foreign portfolio flows.

[43] *See* DESAI/HINES, Old Rules and New Realities: Corporate Tax Policy in a Global Setting, 57 National Tax Journal 937-960 (2004).

[44] For a review of the history of the dual information system, *see* LENTER/SLEMROD/SHACKELFORD, Public Disclosure of Corporate Tax Return Information: Accounting, Economics, and Legal Perspectives, 56 National Tax Journal 803-830 (2003); KNOTT/ROSENFELD, Book and Tax: A Selective Exploration of Two Parallel Universes, Parts One and Two, 99 Tax Notes 865-897 and 1043-1080 (2003); and DESAI, The Degradation of Reported Corporate Profits, 19 Journal of Economic Perspectives 171-192 (2005).

[45] HANLON, *supra* note 16.

tion on tax payments.[46] Recent reforms in tax reporting, as advanced by Mills and Plesko,[47] have led to an increased ability to match public financial statements to tax returns for tax authorities without any increased access to this information for shareholders.

The disparity in these information systems has led to reform proposals to bring the information systems into greater conformity. Desai calls for a restoration of financial reporting as the basis for tax returns to allow for reductions in compliance costs, lower marginal rates, and the benefits of joint monitoring by investors and the state on the same report.[48] Hanlon and Maydew estimate that conformity could result in revenue-neutral corporate tax reductions to a statutory rate of 26%.[49] Critics of conformity, such as Shackelford,[50] emphasize the loss of information to investors from a potential conformed system. Evidence for this point of view draws on studies of several countries with conformity and instances analyses of the imposition of conformity in particular parts of the reporting environment.

The cross-country evidence, unfortunately, is limited by the handful of countries that are analyzed and by the fact that this evidence is most properly interpreted as indicating that a cluster of institutions – concentrated ownership, bank based systems and book-tax conformed income – are associated with less informative earnings. Indeed, studies by scholars in countries with conformity experiences suggest that many of the concerns over conformity are overstated.[51] Examining a narrow change to reporting rules toward conformity may also not be informative about a wholesale change toward conformity – much as narrow tax reforms may lead to misleading implications about the consequences of wholesale tax reforms.

In short, very little is known about the imposition of conformity from an empirical perspective. Recent experience in the U.K., the E.U. and Australia toward conformity, as detailed by Freedman, may offer a promising empirical setting for considering these questions.[52] More generally, there is limited theoretical work on the merits or costs of dual reporting systems. Given the centrality of information sys-

---

[46] GRAHAM/MILLS, Using Tax Return Data to Simulate Corporate Marginal Tax Rates, Working Paper (2007) (available at SSRN: http://ssrn.com/abstract=959245); PLESKO, Corporate Tax Avoidance and the Properties of Corporate Earnings, 57 National Tax Journal 729-737 (2004).

[47] MILLS/PLESKO, Bridging the Reporting Gap: A Proposal for More Informative Reconciling of Book and Tax Income, 56 National Tax Journal 865-893 (2003).

[48] DESAI, Reform Alternatives for the Corporate Tax, Testimony before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means, Washington DC, May 9, 2006 (*see* http://waysandmeans.house.gov/hearings.asp?formmode=view&id=4936).

[49] HANLON/MAYDEW, Book-Tax Conformity: Implications for Multinational Firms (2006) (*see* http://ssrn.com/abstract=983907).

[50] SHACKELFORD, Testimony before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means, Washington DC, May 9, 2006 (*see* http://waysandmeans.house.gov/hearings.asp?formmode=view&id=144).

[51] *See e.g.* SCHÖN, International Accounting Standards – A Starting Point for a Common European Tax Base?, 44 European Taxation 426-440 (2004).

[52] *See* FREEDMAN, Aligning Taxable Profits and Accounting Profits: Accounting Standards, Legislators and Judges, 2 eJournal of Tax Research 71-99 (2004).

tems to both tax systems and investor rights, it would seem that greater empirical and theoretical work is warranted.

4.3 High Powered Incentives

Alignment of managerial and shareholder interests has been a central research agenda for corporate finance scholars interested in the agency problem. Tax rules have the potential to influence the nature of optimal contracting between managers and shareholders by changing the mix between cash and incentives (cash vs. stock), the nature of incentives (stock vs. options), and the timing of compensation (deferred benefit plans vs. current compensation).

Responding to apparent public concern about the size of CEO salaries, Congress in 1993 enacted Section 162(m) of the tax code, limiting firms' deductibility of executive compensation to $1 million, except where the compensation is "performance-based." Perry and Zenner analyze the impact of Section 162(m) on the composition of executive compensation, concluding that it led to an increase in stock-based forms of compensation (and thus contributed to the rapid growth of incentive pay for executives during the 1990s).[53] However, Rose and Wolfram find no such impact, and attribute the contrary findings of Perry and Zenner to mean reversion in executive compensation.[54] The extent of the impact of Section 162(m) on managerial incentives, and the wider question of whether tax incentives can shape the structure of executive compensation, thus remains unclear, and warrants further research.

The personal taxes faced by managers may also have an impact on the optimal compensation contract, and hence the power of managerial incentives.[55] Tax incentives may also be relevant to the choice of the form of stock-based compensation (restricted stock vs. options) and the choice of deferred compensation. Indeed, in recent testimony before the Senate Finance Committee, Lucian Bebchuk has emphasized the tax treatment of executive pensions and defined contribution plans to explain their rapid rise.[56]

Beyond the specific issues discussed above, it may also be the case that the tax system plays an important role in providing the foundations underlying the current system of incentive-based executive compensation. For stock-based compensation to provide high-powered incentives for managers, an essential precondition is that managers are prevented from hedging the stock options that they receive. Schizer argues that the tax system plays an under-appreciated (and perhaps unintended) role

[53] PERRY/ZENNER, Pay for Performance? Government Regulation and the Structure of Compensation Contracts, 62 Journal of Financial Economics 453-488 (2001).

[54] ROSE/WOLFRAM, Regulating Executive Pay: Using the Tax Code to Influence Chief Executive Officer Compensation, 20 Journal of Labor Economics S138-S175 (2002).

[55] *See* KATUSCAK, The Impact of Personal Income Taxation on Executive Compensation, Working Paper (2004) (available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=649851).

[56] BEBCHUK, Testimony before House Financial Services Committee on Shareholder Advisory Votes on Compensation, March 8, 2007 (*see* http://www.law.harvard.edu/faculty/bebchuk/pdfs/2007_HFSC.pdf).

in this context.[57] Tax rules designed to prevent taxpayers from avoiding capital gains taxes also make it costly for managers to hedge their options. While hedging can also be restricted contractually, and certain forms of hedging may be prohibited under corporate law, the tax system may play a role in ensuring that stock-based compensation has the intended effect of incentivizing managers.

4.4 Financing Choices and Payout Policy

Major corporate financing choices – particularly the choice between debt and equity and payout policy – can have important agency dimensions. In particular, debt and dividends have been hypothesized to play a monitoring role that can alleviate agency concerns. Debt is, of course, favored by the tax system due to the deductibility of interest payments,[58] although a longstanding puzzle in the corporate and public finance literatures is why firms do not use more debt. The use of debt potentially has significant governance implications, as monitoring of managers by lenders may serve as a substitute for monitoring by equityholders. However, it is also possible that the use of debt may give rise to a different agency problem, namely that between lenders and shareholders.[59] Graham and Tucker, using a small sample of firms involved in tax shelter litigation, find that firms alleged to be sheltering have lower debt-equity ratios than do otherwise comparable firms.[60] They interpret this evidence as indicating that tax shelters serve as non-debt tax shields that lower the tax benefits of debt, but it may also suggest that sheltering firms may experience a lower degree of monitoring by lenders.

The choice between paying dividends and engaging in share repurchases (and the associated puzzle of the prevalence of tax-disfavored dividends) has dominated the literature on taxes and payout policy. Jensen's well-known model of the agency costs of free cash flow[61] has led to the common argument that dividend taxation discourages the disgorgement of free cash flow by firms, and thus exacerbates agency problems.[62] In 1936, the Roosevelt administration sought to counteract the tax incentive for firms to retain earnings by imposing an additional tax on undistributed profits. Christie and Nanda find that the imposition of this tax led to a positive market reaction, especially among firms that paid low dividends.[63] They interpret this as evi-

[57] SCHIZER, Executives and Hedging: The Fragile Legal Foundation of Incentive Compatibility, 100 Columbia Law Review 440-504 (2000).

[58] Indeed, a large class of hybrid instruments that blurs the distinction between debt and equity appears to have central tax-motivated foundations.

[59] *See* JENSEN/MECKLING, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 Journal of Financial Economics 305-360 (1976).

[60] GRAHAM/TUCKER, *supra* note 18.

[61] *See* JENSEN, Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers, 76 American Economic Review Papers and Proceedings 323-329 (1986).

[62] ARLEN/WEISS, A Political Theory of Corporate Taxation, 105 Yale Law Journal 325-391 (1995) argue that the persistence of the double taxation of dividends is itself attributable to an agency problem, as managers have insufficient incentives to lobby for corporate tax integration.

[63] CHRISTIE/NANDA, Free Cash Flow, Shareholder Value, and the Undistributed Profits Tax of 1936 and 1937, 49 Journal of Finance 1727-1754 (1994).

dence of agency conflicts between shareholders and managers concerning payout policy. Bank provides a broader overview of the evolution of the double taxation of dividends and its interactions with corporate governance during the interwar period.[64]

Researchers analyzing payout policy have been fortunate in recent years in that Congress has provide a major natural experiment through the reduction in dividend taxes in 2003. Chetty and Saez analyze the effects of the tax cut on firms' dividend payments, and find a substantial increase along both the extensive margin (with many firms initiating dividends) and the intensive margin (with previously dividend-paying firms increasing their dividend payments).[65] Brown, Liang and Weisbenner find that firms' response to the tax cut varied according to the structure of executive compensation and ownership.[66] Firms where managers held substantial stock ownership responded with large increases in dividends (which would benefit managers as well as other shareholders) while the response was weaker among firms where managers held stock options (which are typically not adjusted in value for dividends paid out). Thus the recent literature on the effects of taxes on dividend payout has uncovered interactions among the tax system, managerial compensation and ownership, and corporate governance.

The tax system may affect the financing choices not only of established corporations, but also those of new startups. Bankman highlights the anomaly that most Silicon Valley startups during the technology boom were structured as new companies, even though the tax benefits of the deductions for the costs of the new project would typically be more valuable were the project to be undertaken under the aegis of an established company or through a partnership.[67] On the other hand, Gilson and Schizer argue that tax considerations help to explain why most venture capital providers structure their investments in the form of convertible preferred stock.[68]

Finally, economists have explored the role of capital gains taxes in determining the level of venture capital activity. Poterba argues that capital gains taxes may have a significant influence on entrepreneurs' demand for venture capital, and on their decisions to receive compensation in the form of stock rather than cash.[69] More recently, Cullen and Gordon find evidence of large effects of tax rates and the struc-

---

[64] BANK, Is Double Taxation a Scapegoat for Declining Dividends? Evidence from History, 56 Tax Law Review 463, 471-472 (2003).

[65] CHETTY/SAEZ, Dividend Taxes and Corporate Behavior: Evidence from the 2003 Dividend Tax Cut, 120 Quarterly Journal of Economics 791-834 (2005).

[66] BROWN/LIANG/WEISBENNER, Executive Financial Incentives and Payout Policy: Evidence from the 2003 Dividend Tax Cut, 62 Journal of Finance 1936-1965 (2007).

[67] BANKMAN, The Structure of Silicon Valley Startups, 41 UCLA Law Review 1737-1768 (1994).

[68] GILSON/SCHIZER, Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock, 116 Harvard Law Review 874-916 (2003).

[69] POTERBA, Venture Capital and Capital Gains Taxation, in: SUMMERS (ed.), 3 Tax Policy and the Economy 47-67 (1989).

ture of the tax system on entrepreneurial activity,[70] while Keuschnigg and Nielsen develop a theoretical framework for analyzing the effects of taxes on venture capital activity.[71]

4.5 Corporate Control

The market for corporate control constitutes a central pillar of the corporate governance environment by allowing for the threat of management removal. At the same time, the evidence on the massive scale of value destruction through mergers suggests that mergers themselves are a critical domain for managerial misbehavior.[72] Taxation can influence the financing choices for mergers, the desirability of undertaking such transactions and the devices used to deter such transactions. This area represents one of the most underdeveloped areas for understanding how taxation influences corporate governance but a few obvious examples of these interactions are already apparent, though underexplored.

The U.S. tax system differentiates mergers by their financing, creating an incentive to use stock to finance mergers. Stock financed mergers have been found to be the source of a disproportionate share of the value destruction associated with mergers. Indeed, Shleifer and Vishny provide a theoretical model to explain that stock-financed mergers can be used by acquirers to monetize overvalued shares.[73] The tax system may also facilitate mechanisms that entrench managers. For example, poison pills that reduce the vulnerability of managers to outside takeovers have been deemed a non-taxable event, presumably altering the desirability of undertaking such maneuvers. More generally, Gilson, Scholes and Wolfson provide an overview of tax motivations for acquisitions.[74]

5. Conclusion

The historic divide between the study of taxation and the analysis of corporate governance appears to have obscured many fertile areas of research. While some issues at the intersection of taxation and corporate governance have received renewed attention in recent years (primarily due to a concern with tax shelters and managerial malfeasance), taxation can also have significant implications for the various mechanisms that have arisen to ameliorate governance problems.

---

[70] CULLEN/GORDON, Taxes and Entrepreneurial Activity: Theory and Evidence for the U.S., NBER Working Paper 9015 (2002).

[71] KEUSCHNIGG/NIELSEN, Tax Policy, Venture Capital, and Entrepreneurship, 87 Journal of Public Economics 175-203 (2003).

[72] *See* MOELLER/SCHLINGEMANN/STULZ, Wealth Destruction on a Massive Scale? 60 Journal of Finance 757-782 (2005).

[73] SHLEIFER/VISHNY, Stock Market Driven Acquisitions, 70 Journal of Financial Economics 295-311 (2003).

[74] GILSON/SCHOLES/WOLFSON, Taxation and the Dynamics of Corporate Control: The Uncertain Case for Tax Motivated Acquisitions, in: COFFEE/LOWENSTEIN/ROSE-ACKERMANN (eds.), Knights, Raiders, and Targets: The Impact of the Hostile Takeover, 271-299 (1988).

In particular, the impact of tax systems on corporate ownership patterns, and how ownership patterns in turn constrain corporate taxation, appears to warrant further analysis, especially in an international and comparative setting. The relationship between financial reporting and taxation has attracted widespread scholarly and public attention, but the most important empirical issues remain unresolved. Similarly, the role of the tax system in influencing patterns of managerial compensation warrants further analysis, building on an existing empirical literature that has found mixed results. It has also been noted that the well-established literature on the effects of taxes on firms' debt and payout policies is being enriched by the incorporation of considerations relating to corporate governance and managerial compensation. Finally, the impact of the tax system on the market for corporate control remains substantially under-explored.

Tax and Corporate Governance: A Legal Approach

Wolfgang Schön

1. Economic and Legal Perspectives

The analysis of the basic legal framework where the interaction of tax and corporate governance takes place has to commence with the question of whether there exists any difference between the economic perspective presented in the preceding contribution by Mihir Desai and Dhammika Dharmapala[1] and the legal perspective which is the topic of this chapter. In the old days, the distinction has been quite clear: the legal analysis would look at the law as it stands, the statutory and judge-made rules in the field of taxation, company law and financial markets from a normative standpoint, while the economic analysis would focus on the effects of such rules in mathematical models and the real world, trying to describe their impact on efficiency and distribution. Over the years, this distinction has become considerably blurred. Legal scholars employ the tools of economic analysis of law, capital market theory and information economics in corporate affairs[2] as well as the findings of public finance and public choice in tax matters[3] to discuss the current state of their field while economists use their theoretical and empirical findings in order to bring forward normative recommendations for legislation in different areas of the law.[4] Lawyers still feel on their own when they engage in the interpretation and application of existing rules, but they have realized that they have to share the task of public policy recommendations with their economic brethren. It makes no sense any more to separate the theoretical, empirical and normative aspects of tax and corporate governance in this respect.

Nevertheless, it makes some sense for a policy-oriented book like this to find some common legal ground on a comparative basis, starting with a closer look at the legal framework which we currently find in major jurisdictions. In this respect, the focus will be on existing statutory and judge-made rules and standards, putting the emphasis on U.S., U.K. and German law.

---

1 DESAI/DHARMAPALA, Tax and Corporate Governance: An Economic Approach, in this volume, at 13.

2 Impressive examples are: CHEFFINS, Company Law – Theory, Structure and Operation (1997) (for the U.K.) and KRAAKMAN *et al.*, The Anatomy of Corporate Law (2004) (for a comparative view).

3 *See e.g.* SCHÖN, Tax Competition in Europe – the Legal Perspective, 9 EC Tax Review 90 (2000).

4 Major examples are the reform proposals for a "Consumption Tax" and the "Dual Income Tax" which build upon an extensive theoretical foundation.

2. The Taxpayer that Doesn't Exist

2.1 The Corporation – a Nexus of Contracts

Surprisingly enough, we have to start with the fact that the legal rules covering both taxation and corporate governance hypothecate a creature which ceases to exist when you expose it to the sunlight of economic analysis: the legal person, the body corporate. Economic analysis is firmly grounded on "methodological individualism",[5] *i.e.* the assumption that only individuals have to be regarded as economic and social actors: they form preferences, they decide on the use made of resources, they engage in contractual arrangements, they constitute a market of buyers and sellers. Firms have to be regarded as a nexus of contracts, binding together the financiers, the management, the workforce, the creditors and other third parties in a middle or long term relationship.[6] The corporation is nothing more that an abbreviation for this nexus of contracts, a shorthand version of the panoply of individual legal relationships stemming from the fact that it makes economic sense in many situations to concentrate economic resources in a stable organization rather than creating value by on-the-spot transactions.[7]

The law, on the other hand, does not only create the concept of the legal person as such; moreover, there is a deep-seated intuition behind legislation in countries all over the world, that individuals and legal persons have to be treated alike, shall be awarded equal access to rights and be subject to a comparable set of obligations.[8] In our context, it is common ground that tax law regards a corporation as a taxpayer in its own right, including the attribution of income (or wealth or value-added) to the body corporate, followed by the obligation to comply with administrative requirements and to pay the taxes when they fall due. The corporation is the taxpayer, not its directors, its shareholders or other third parties. Putting the economic view and the legal construction together, the corporation seems to be the taxpayer that doesn't exist.

This is where the interaction of tax and corporate governance comes into play: While tax law starts from the premise that the corporation as such is the taxpayer and supports the concept of a level-playing-field for individual and corporate taxpayers, corporate governance has to decide which persons involved in the nexus of

---

[5] For further references *see* STANFORD ENCYCLOPEDIA OF PHILOSOPHY, Methodological Individualism, (first published February 3, 2005) (available at http://plato.stanford.edu/entries/methodological-individualism).

[6] CHEFFINS, *supra* note 2, at 31 *et seq.*; EASTERBROOK/FISCHEL, The Economic Structure of Corporate Law, 1 *et seq.* (1991).

[7] COASE, The Nature of the Firm, 4 Economica 386 (1937).

[8] *See* Art. 19 Para. 3 of the German Constitution (Basic Law): Legal Persons are awarded the same basic rights as natural persons insofar as the substance of these rights does not clash with the specificity of a legal person; in the most recent monography of taxpayers' rights (BENTLEY, Taxpayers' Rights: Theory, Origin and Implementation (2007)) the idea that individual and corporate taxpayers could be treated differently is not even mentioned.

contracts have to take care of the different obligations and entitlements which tax law brings about. As the company as such is not in the position to form a tax strategy, to file declarations or to transfer money to the tax authorities, we have to look for a balanced view of the way tax obligations are allocated within the organizational and legal framework of the corporation. Contrary to the situation of the individual taxpayer, the different aspects of tax life are not concentrated in a single person: While a natural person has to pay taxes on his own income and wealth, has to file her own tax declaration and has to pay her own share of taxes, in the corporate context, responsibilities are dispersed, thus leading to opportunistic behavior, principal-agent-conflicts, moral hazard and other failures well known from the economic theory of the corporation.[9]

2.2 Internal and External Affairs of the Company

In its Seoul Declaration from September 14/15, 2006, the OECD Forum on Tax Administration announced that governments in industrialized countries are beginning to perceive corporate governance rules and standards as a tool to steer the behavior of corporate taxpayers *vis-à-vis* the tax authorities. In this vein, the Seoul Declaration proposes to "encourage top management and audit committees of large enterprises (*e.g.* CEOs and boards of directors) to take greater interest in, and responsibility for, their tax strategies".[10] Moreover, the group recommends to the OECD to engage in "expanding its 2004 Corporate Governance Guidelines to give greater attention to the linkage between tax and good governance".[11]

Yet any discussion on tax and corporate governance has to be aware of the widely acknowledged position that there exists a fundamental distinction between the internal rights and obligations of shareholders and the management under company law and the external obligations of the corporation as such, *e.g.* in the field of tax law.

A well-known example for this division is supplied by securities law. Under securities regulations all over the world, it is the issuer – the listed company – which is bound to comply with the rules and standards of financial markets.[12] It is equally accepted that board members are individually liable towards the corporation for the fulfillment of these obligations. Contrary to this, any individual obligations of the board members or shareholders towards third parties are the exception from this rule and have to be laid down specifically in the law. Insofar, there is no uniform solution: Personal liability of directors for misinformation of the financial markets has

[9] TIROLE, The Theory of Corporate Finance, § 1.1, at 15 *et seq.* (2006).

[10] OECD, Third Meeting of the OECD Forum on Tax Administration, September 14/15, 2006, Final, Seoul Declaration, para. (ii), at 4 (*see* www.oecd.org/dataoecd/38/29/37415572.pdf).

[11] OECD, *id.*, para. (ii), at 5.

[12] *See e.g.* sec. 12 (g) and sec. 13 (a) Securities Exchange Act 1934 (U.S.).

been introduced into U.S. law in the 1930s[13] but is still not commonly accepted in Europe.[14]

In the same vein, the analysis of the interaction of tax and corporate governance should not forget that all obligations of directors and shareholders are in principle directed towards each other, not towards the tax authorities. It goes without saying that the management board of any company is obliged to fulfill the duties of the enterprises *vis-à-vis* the tax authorities.[15] Yet this obligation of directors to administrate the tax affairs of the company are part of the duties they owe in the context of a principal-agent-relationship to the company and the shareholders, not towards the government. This has a threefold effect:

– These duties have to be interpreted and effectuated in order to serve the interests of the shareholders, not the tax authorities;
– It is only the shareholders who are in the position to enforce these obligations; tax authorities have no standing in this respect;
– It is in the hands of the shareholders to deliberately relieve directors from any obligations they have in this context.

If tax law wants to introduce any additional individual obligations of directors, shareholders or other persons in the context of corporate taxation they have to be laid down specifically by the legislator.

2.3 The Corporation as a Social Phenomenon

To be sure, there is no clear dividing line between the contractarian view of the corporation taken by most economists and the general acceptance of its legal personality by most lawyers. A third perspective, which plays a major role in our context, describes the corporation as a real-world-phenomenon, which is more than a nexus of contracts and more than a legal fiction.[16] It is a powerful animal of the business world, setting its own agenda, making its own policy, furthering ends which are different from those envisaged by shareholders, managers, creditors and other stakeholders. This perception of the company as a social institution directly leads to the

---

[13] HAZEN, The Law of Securities Regulation, Chapter 7 (5th ed. 2006).

[14] The European Commission has put forward a proposal to introduce such liability (Communication from the Commission to the Council and the European Parliament: Modernising Company Law and Enhancing Corporate Governance in the European Union – A Plan to Move Forward, May 21, 2003, COM(2003) 284 final, § 3.1.1.; for German law *see*: FLEISCHER, Kapitalmarktrechtliche Informationshaftung gegenüber Dritten, in: FLEISCHER (ed.), Handbuch des Vorstandsrechts, § 14, notes 7 *et seq.* (2006).

[15] OECD, The OECD Guidelines for Multinational Enterprises, 27 (revision 2000) (available at www.oecd.org/dataoecd/56/36/1922428.pdf); *see* also Annotations thereto, notes 60 *et seq.*, at 54 *et seq.*; OECD Principles of Corporate Governance, Annotations, part VI, at 58 (2004) (available at www.oecd.org/dataoecd/32/18/31557724.pdf).

[16] ALLEN, Our Schizophrenic Conception of the Business Corporation, 14 Cardozo L. Rev. 261, 264-276 (1992).

concept of "corporate social responsibility"[17] with respect to the impact of the enterprise on society at large.[18] While most guidelines and literature on "corporate social responsibility" do not deal with tax matters,[19] in recent years governments[20] have started to address this topic as an instrument to reduce the leeway of corporate entities to engage in "aggressive" tax planning strategies.

In Germany, this "social" view of the corporation had its heyday in the 1920s when *Walter Rathenau*, a leading figure in German politics and business, identified the "enterprise in itself"[21] as the major actor of economic life. The German Stock Corporation Act of 1937 obligated the directors of a stock corporation explicitly to take into account the public interest of the *Reich* and public prosecutors were entitled to enforce this obligation. This formula did not survive German corporate law reform in 1965,[22] leaving uncertainty to this day as to how far the corporation as a social institution is entitled or compelled to act in the interest of society at large.[23] In the United States, a long-standing discussion has led to the current Corporate Governance Principles of the American Law Institute; under these rules the board is empowered to show some limited effort of social responsibility.[24] In the U.K., according to leading writers, the concept that public companies face wider social duties seems to be stronger in politics than in the law itself.[25] This analysis is supported by the recent Company Law Reform which is squarely based on the tradi-

---

[17] For a recent account of the "Corporate Social Responsibility" concept *see*: EPSTEIN, The Good Company: Rhetoric or Reality? Corporate Social Responsibility and Business Ethics Redux, 44 American Business Law Journal 207 (2007); FORT, The Times and Seasons of Corporate Responsibility, 44 American Business Law Journal 287 (2007).

[18] AVI-YONAH, Corporate Social Responsibility and Strategic Tax Behavior, in this volume, at 183.

[19] The Ten Principles enshrined in the UN Global Compact for Responsible Corporate Citizenship look at Human Rights, Labour Standards, the Environment and Corruption but do not include any reference to taxation (*see* www.unglobalcompact.org/AboutTheGC/TheTenPrinciples/index.html); for a further analysis *see* DEVA, The UN Global Compact for Responsible Corporate Citizenship: Is it still Too Compact to be Global?, 2 Corporate Governance Law Review 145 (2006); moreover, the European Commission's Green Paper – Promoting a European Framework for Corporate Social Responsibility (COM(2001) 366 final) does not specifically address any ethical obligations in the tax area; it only briefly mentions enterprises as contributors to the tax revenue of their local communities (at note 42).

[20] *See* the contribution by HARTNETT, The Link between Taxation and Corporate Governance, in this volume, at 3.

[21] RATHENAU, Vom Aktienwesen (1917); also available in RATHENAU, Gesammelte Schriften, Vol. 5, 121 *et seq.* (1917).

[22] A similar language survived in Austria (§ 70 Aktiengesetz); nevertheless the Administrative Court decided in 2002 that a state-owned stock corporation is not entitled to supply pro bono services to governmental entities; the statutory goal to act in the "public interest" does not justify this generosity as well (Verwaltungsgerichtshof, February 19, 2002, 2002 ecolex 536 *et seq.*).

[23] FLEISCHER, Leitungsaufgabe des Vorstands, in: FLEISCHER (ed.), Handbuch des Vorstandsrechts, § 1 para. 18 *et seq.* (2006).

[24] § 2 ALI Corporate Governance Principles (1994).

[25] DAVIES/PRENTICE, Gower's Principles of Modern Company Law, 69 (6th ed. 1997).

tional assumption that shareholders are the "lifeblood" of the company;[26] the thrust of this major reform aims at an improvement of shareholder engagement and an investor-friendly legal framework. According to this legislation, directors must primarily act in a way they consider "most likely to promote the success of the company for the benefit of its members as a whole" while merely "having regard" to further constituencies (Companies Act 2006 sec.172 § 1).

This debate on "corporate social responsibility" is deeply related to the highly controversial concept of "shareholder value" as opposed to a "stakeholder perspective". While the first concept stresses the obligation of the management to put shareholder interest in long-term profitability and value first, the "stakeholder perspective" takes into account other constituencies like creditors, the workforce, the general public and – last not least – the state and its financial needs. This stakeholder view is also enshrined in the OECD Principles on Corporate Governance where the board is obligated to "take into account the interests of stakeholders".[27] A more sophisticated – "enlightened" – shareholder perspective regards the inclusion of stakeholder interests as a means to further the reputation and thus the long-term profitability of a corporate actor.[28]

From the perspective of the legal framework it has to be made clear from the start that according to current law as it equivocally stands in the U.K., the U.S. and Germany, the "stakeholder perspective" does not give birth to enforceable rights on the side of the state (and other "stakeholders") which go beyond the entitlements laid down in statutory and judge-made law.[29] Therefore, the paramount legal effect of a "stakeholder view" is simply to broaden the scope of discretion for the board of directors.[30] They get entitled to strike their own balance between the interest of the shareholders in the long-term profitability of the company and the interest of the general public and the state on the other hand. Under a "stakeholder concept", shareholders are not in the position to sue directors when they decide to put stakeholders first from time to time.

---

[26] White Paper – Company Law Reform Bill, 2005, Chapter 1, at 1; for an in-depth analysis of the debate on the shareholder/stakeholder approach in the reform process *see* JOHNSTON, After the OFR: Can U.K. Shareholder Value still be Enlightened?, 7 European Business Law Review 817 (2006).

[27] OECD Principles of Corporate Governance, *supra* note 15, Chapter VI.C.

[28] JOHNSTON, *supra* note 26; FLEISCHER, *supra* note 23.

[29] For the U.S. discussion *see* GEVURTZ, Corporation Law, 306 *et seq.* (2000); HANSMANN/KRAAKMAN, The End of History for Corporate Law, 89 Geo. L.J. 439, 447 *et seq.*; for the U.K. discussion *see* FERRAN, Company Law and Corporate Finance, 127 *et seq.* (1999); for a broad analysis of this problem *see* SABAPATHY, In the Dark all Cats are Grey: Corporate Responsibility and Legal Responsibility, in: TULLY (ed.), Research Handbook on Corporate Legal Responsibility, 235 *et seq.* (2005).

[30] HEFERMEHL/SPINDLER in: MÜNCHENER KOMMENTAR ZUM AKTIENGESETZ, Vol. 3, § 76, note 58 *et seq.* (2nd ed. 2004).

2.4 Allocation or Intensification of Corporate Tax Obligations?

From an analytical point of view, it seems to be important not to mix the corporate governance problems arising from the fictitious character of the company as a taxpayer with the debate on corporate social responsibility in the tax area. The argument on aggressive tax planning and social responsibility of large corporations is not fundamentally driven by the fact that corporations face coordination problems between shareholders, managers, the workforce and other third parties. The public call for "ethical" behavior of companies is merely a consequence of the fact that some big economic actors have the monetary funds to engage in tax planning in order to divert substantial revenue from the government. This situation can be described in terms of "economies of scale" as tax planning only brings about a positive return if large sums are involved and the amount, by which the tax burden is reduced, fairly surpasses the costs involved in a tax strategy, *i.e.* legal and advisory fees, additional administrative costs, losses due to sub-optimal investment and so on. In this respect, a wealthy individual taxpayer is in the same situation as a large corporate entity. We should ask ourselves whether under a concept of "good citizenship" *Microsoft* as a corporate taxpayer should really be subject to higher standards than *Bill Gates*, a super-rich individual. This seems not to be convincing. On the other hand, the specific problems of tax compliance for corporations which result from the disperse allocation of risks and competences have to be neatly distinguished from this general topic.

To conclude this introduction we have to distinguish between the allocation of a taxpayer's obligations in a corporate setting, taking into account the different preferences of shareholders, managers and other involved parties on the one hand, and any intensification of a taxpayer's obligations due to its corporate character or economic strength on the other hand. While the first topic is a natural consequence of the corporate character of a firm, the second topic relates to its economic and social importance.

3. Who Pays the Corporation's Taxes?

3.1 Taxation and *Asset Partitioning*

Let us return to the legal framework of tax and corporate governance. Though it may seem trivial, it does make sense to start with the simple question of who is liable for the tax debts of a corporation. In the case of an individual there is a natural relationship between the allocation of the tax base to a person and his or her obligation to file a tax return and to pay the resulting amount of tax. In the case of a company we have to come to grips with the fact that tax law allocates the tax debt to this fictitious creature. This leads us to the topic of limited liability. As Henry Hansmann and Reinier Kraakman have made clear in their seminal article on the "essential role of organizational law",[31] one of the basic benefits of incorporation

[31] HANSMANN/KRAAKMAN, The Essential Role of Organizational Law, 110 Yale Law Journal 387 (2000).

lies in the concept of *asset partitioning*, *i.e.* the shielding of the company founders' private assets against seizure by the company's creditors and the shielding of the company's funds against opportunistic withdrawal of assets by directors and shareholders. Running a business in corporate form therefore means a deliberate reduction of funds available for creditors when compared to sole traders or partnerships.

Modern theory has it that limited liability does not constitute a problem as long as creditors have the bargaining power to contract around the risks conferred upon them when they deal with a corporation. Yet this does not address the group of *non-adjusting creditors* as they have been called by Bebchuk/Fried,[32] including *involuntary creditors* like tort victims who are not in the position to enter into contractual arrangements with the company, its directors and its shareholders before their damage claims come into existence. Bearing in mind the involuntary character of taxation,[33] the European Court of Justice has accepted in the *Centros* case that the Member States of the European Union can rely on a legitimate public interest when they introduce special measures to strengthen the enforcement of their tax claims against limited liability entities, *e.g.* by additional guarantees.[34] By the same reasoning, the German Federal Tax Court has confirmed that additional measures which shall enforce corporate tax debt do not clash with the principle of equality under German constitutional law.[35]

On second thoughts, the situation is quite ambiguous. In the first place, at the level of legislation, the government is free in the definition of the taxable event. From this starting point one can draw the conclusion that the state seems to be the role model of an *adjusting creditor* who is in full power with respect to the coming into existence of a tax claim. Therefore, the taxman deserves no specific *ex ante* legal protection whenever the activities of an insolvent company bring about a taxable event. On the other hand, under any given tax legislation individual tax claims arise without any further negotiations between the taxpayer and the taxman – the taxpayer is free to arrange his or her affairs in a way that results in a taxable event and the taxman is bound by public law requirements (most specifically revenue considerations and the equal treatment of taxpayers) to enforce any tax claim which has come to life under the relevant tax law. Insofar, *i.e.* in the process enforcing an existing tax claim the tax administration should be regarded as a *non-adjusting creditor*. Against this background, whenever a tax claim has come into existence, it makes sense to protect the tax authorities against any *ex post* opportunism by the taxpayer who might otherwise grant preferential treatment to other business partners (who have some bargaining power, *e.g.* from whom the taxpayer might expect some con-

---

[32] BEBCHUK/FRIED, The Uneasy Case for the Priority of Secured Claims in Bankruptcy, 105 Yale Law Journal 857, 881 *et seq.* (1996); ARMOUR, Legal Capital: An Outdated Concept, 7 European Business Organization Law Review 5, 10 *et seq.* (2006).

[33] Advocate General LA PERGOLA, Opinion of July 16, 1998, note 22, to decision of the ECJ, Case C-212/97 – *Centros*.

[34] ECJ, Case C-212/97, March 9, 1999, note 37 – *Centros* ; *see* also Advocate General ALBER, Opinion of January 30, 2003, note 150, to decision of the ECJ, Case C-167/01 – *Inspire Art*.

[35] Bundesfinanzhof, January 21, 1972, 1972 BStBl. 364.

sideration) while at the same time the tax claim is neglected by him. This leads to the conclusion that the government should not be protected whenever the activities of insolvent corporations give rise to a tax claim as such but that the fiscal interest of the state should be protected when the taxpayer treats an existing tax claim in a discriminatory manner *vis-à-vis* other creditors.

Unlike other creditors, though, the tax authorities do not sacrifice any funds of their own or suffer damages when they acquire a tax claim, so the legitimacy of their expectation to be rewarded in full seems to be less strong than in the case of other involuntary or non-adjusting creditors like tort victims or small lenders.[36] Against this background, one may ask whether it would make sense to grant the claim of a private creditor statutory priority over the tax claim or to empower the taxpayer to grant such priority to private claims in the course of his bargaining with private trading partners. Yet under such a premise corporations which operate in the vicinity of insolvency would have an incentive to regard the tax authorities as "lenders of last resort". As no private bank would grant an unsecured loan to such a corporation, while the taxman could not "bargain" at all, the government would become a large credit institution for ailing companies. This would in the long run undermine the functioning of capital markets as such. Therefore, tax authorities should by law be awarded a position which runs parallel to that of private creditors – they should be neither better off nor worse off.

3.2 Priority Claims on the Company's Assets

When we look at the current legal situation in the U.S., the U.K. and in Germany, the first technique to strengthen the taxman's claim against a corporate entity which springs to mind can be found in preferential treatment of the tax authorities' claims when the taxpayer goes insolvent. This approach is employed in the United States at two levels: Firstly, any lawful tax assessment forms the basis of a secret *tax lien* which is granted priority status in relation to other creditors once notice is given to the general public.[37] This somehow mimics the outcome of a presumptive contractual arrangement between the tax authorities and the taxpayer and leads to the recognition of the tax claim as a "secured claim" (sec. 506 Bankruptcy Code). Moreover, under sec. 507 Bankruptcy Code a broad array of unsecured tax claims of governmental units are placed at No.8 among the claims given priority *vis-à-vis* general creditors.[38]

Such a preference did also have a long-standing tradition in U.K. law where the Crown by virtue of *Royal Prerogative* enjoyed preferential treatment in insolvency proceedings. In the 1980s the *Cork Committee* did not see any justification for this imbalance between public and private creditors,[39] so the 1986 Insolvency Act abol-

[36] SCHÖN, GmbH-Geschäftsführerhaftung für Steuerschulden, in: GRUNEWALD *et al.* (eds.), Festschrift für Harm-Peter Westermann (forthcoming 2008).

[37] §§ 6321 *et seq.* IRC; for an overview *see* NEWTON/LIQUERMAN, Bankruptcy and Insolvency Taxation, § 12.3. (3rd ed. 2005).

[38] NEWTON/LIQUERMAN, *id.*, § 11.2.

[39] DAVIES, Gower's Principles of Modern Company Law, 827 (7th ed. 2003).

ished this preference for individual and corporate income taxes. For withholding taxes like PAYE and VAT it stayed in place for another 16 years until the *Enterprise Act 2002* dismantled the preferred status of tax claims altogether.[40] In Germany the development has been similar: the preferential status of tax claims has been abolished in the course of the insolvency reform of the 1990s which finally entered into force in 1999.[41] Bearing in mind that the tax authorities neither deserve preferential treatment *vis-à-vis* private creditors nor should suffer disadvantageous treatment by the rules under company law, tax law or insolvency law, the solution found in Germany and in the U.K. – to put them on par with private creditors – seems to be the most sensible one.

3.3 Personal Liability of Directors and Officers

A second line of enforcement, which extends the funds available for the fulfillment of the tax claim, can be found in the recognition of personal liability by a company's managers. Starting with the fiction that the corporate entity as such is the relevant taxpayer, the directors and officers of a corporation are not automatically held liable for this entity's tax debts. All legal orders therefore require some additional legal basis for such liability.

To start with, it is common ground in the U.S., the U.K. and Germany – to name but these jurisdictions – that managers owe their general duties of care and of loyalty in the first place towards the company as such, towards its members (although this is disputed) but not towards the company's creditors, including the tax authorities.[42] Thus, the generally accepted rule that the management is responsible for tax compliance – bookkeeping, declarations, tax returns, tax audits, tax payments – does not automatically transform these duties into personal obligations towards the tax inspector. If tax authorities want to enforce corporate tax claims against the directors and officers of the company they have to rely on further reaching mechanisms.

3.3.1 Personal Liability under Company and Insolvency Law

These mechanisms can be found both in the corporate/insolvency area and in tax law itself. Several common law jurisdictions are moving towards the assumption that the fiduciary duty which directors owe towards the company itself transforms into a duty towards its creditors once insolvency is near and the assets of the company virtually "belong" to the creditors.[43] Moreover, in the U.K., Art. 214 Insolvency Act

---

[40] RAJAK, Company Liquidations, note 17-006 (2nd ed. 2006); TOLLEY'S TAXATION IN CORPORATE INSOLVENCY AND RESCUE, para. 2.1, 2.9. (5th ed. 2003).

[41] *See* § 38 Insolvenzordnung.

[42] MACEY, An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties, 21 Stetson L. Rev. 23 (1991).

[43] FERRAN, *supra* note 29, at 137 *et seq.*; CHEFFINS, *supra* note 2, at 537 *et seq.*; GEVURTZ, *supra* note 29, § 4.1.a, at 306 *et seq.*; for an account and critique of the U.S. situation *see* HU/WESTBROOK, Abolition of the Corporate Duty to Creditors, 107 Columbia Law Review 132 (2007).

has introduced personal liability of directors for *wrongful trading* in the vicinity of insolvency which can be enforced by the liquidator.[44] There is evidence that the resulting claims against directors to contribute assets to the company's funds are not only meant to secure the interest of contractual and other private sector creditors. In *Re Purpoint* an insolvent company was heavily indebted with preferential and non-preferential tax debt (PAYE and NIC); the U.K. judge held the director liable under Art. 214 IA in order to secure payment of the outstanding tax debt.[45] In *Re Loquitur Limited*[46] the directors had paid out a dividend which was not covered by the company's profit as they should have made a provision for a tax claim arising out of a misguided tax shelter. The directors were held liable to put the company in funds to make good for the corporate income tax claim. The Court made clear in this respect that the tax authorities are regarded as ordinary creditors under Art. 212 Insolvency Act.

At first glance, there seems to be no difference between the validity of a tax claim and a private creditor position. Yet we have to take into account the above-mentioned distinction that the tax authorities do not need any protection against the taxable event as such while they do need some protection against *ex post* opportunism by the taxpayer. This distinction lies at the heart of judge-made rules in Germany, where personal liability exists for directors who have negligently or deliberately failed to institute insolvency proceedings at the time when it became apparent that the company would not be able to meet its obligations when they fall due. While it is accepted that all – contractual and statutory – creditors will be entitled to claim damages with respect to the (rather negligible) depletion of their share in the company's assets, it is highly disputed whether the directors' failure to shut the company down early enough shall give rise to full compensation for all creditors who got in contact with the company after that date. The Federal Court of Justice in Karlsruhe has granted such full compensation to voluntary creditors who confidentially advance funds to a company which was already insolvent, but the Court has made clear that involuntary creditors – like the taxman – are not covered by the *ratio decidendi* of these judgments.[47] Indeed – the tax authorities cannot rely on the assumption that any company giving rise to taxable events is solvent or – to put it another way – there can be no obligation on a director to close an insolvent company in order to avoid taxable events to happen in the first place.[48]

---

[44] FERRAN, *supra* note 29, at 214 *et seq.*; CHEFFINS, *supra* note 2, at 542 *et seq.*

[45] *See Re Purpoint* [1991] BCLC 491; the author expresses his gratitude to John Armour (Oxford) for helpful information on this point.

[46] *See Re Loquitur Limited* [2003] EWHC 999 (Ch); the author expresses his gratitude to John Tiley (Cambridge) for helpful information on this point.

[47] Bundesgerichtshof, July 25, 2005, 2005 Neue Juristische Wochenschrift 3137 *et seq.*

[48] This has been decided in the context of social security contributions (Bundesgerichtshof, March 8, 1999, 1999 Neue Juristische Wochenschrift 2182 *et seq.*; Bundesgerichtshof, July 7, 2003, 2003 Zeitschrift für Wirtschaftsrecht (ZIP) 1713 *et seq.* with annotation by SCHMIDT; for a full account *see* SCHÖN, *supra* note 36.

3.3.2 Personal Liability under Tax Law

Another legislative option is the introduction of personal liability within the framework of tax law. A fairly well-known example concerns withholding taxes like PAYE and VAT which are collected by a corporation and have to be transferred to the tax authorities. The United States tax rules know a 100% penalty for directors with respect to such entrusted monies both at the federal and the state level.[49] Also in Australia directors are subject to a personal *penalty notice* when such withholding taxes are not paid[50] and in Germany there is a long line of judicature holding directors personally liable for PAYE amounts and social security contributions which the company was meant to pay on behalf of their employees.[51]

Nevertheless, most jurisdictions seem to hesitate when it comes to personal liability of directors for taxes which fall on the profits and assets of the company as such. To be sure, directors and officers have to sign the company's tax returns and they commit an offence when they willfully or negligently file wrong declarations. But there is no liability of the directors concerning the tax claim itself. Germany seems to have the most advanced rule in §§ 34, 69 Levies Act (*Abgabenordnung*) according to which they are not only personally held liable for the tax compliance of the company but also have to pay damages to the treasury once they fail to meet these standards. Interestingly enough, under these rules they are only obliged to make sure that taxes are paid out of the company's funds they are entrusted with. If these funds are not sufficient to meet all liabilities of the company, all they have to do is to ensure equal treatment of creditors.[52] They are not required to grant preferential treatment to the tax authorities but they will have to compensate the tax authorities if they choose to advance funds to other creditors of the company. At face value, this sounds convincing. If under insolvency law the tax claim does not enjoy preferential status, there can be no personal liability of the directors if they treat public and private creditors alike. But if they were allowed to discriminate against tax debt the tax authorities would mutate into "lenders of last resort" and thus distort the functioning of the capital market.

3.4 Personal Liability of Shareholders

Bearing in mind that the basic idea behind creditor protection in corporate cases lies in the separation of assets between the shareholders and the company itself, one has to consider in which cases shareholders shall be held personally liable for a corporation's tax. Again, there is evidence that the legal rules governing the diversion of corporate funds to its shareholders can be applied in the tax area as well. Thus, rules on fraudulent transfers or unlawful profit distributions can be helpful for the tax authorities when they are confronted with siphoning-off in cor-

---

[49] Sec. 6672 I.R.C.; *see* NEWTON/LIQUERMAN, *supra* note 37, at § 11.2 (f).

[50] ALLSWORTH CHARTERED ACCOUNTANTS, Viewpoint – Directors Personal Liability for Corporate Taxes, June 2005.

[51] SCHÖN, *supra* note 36.

[52] SCHÖN, *id.*

porate structures. Moreover, the manifold aspects of "veil piercing" might play a role in this context.

In the U.S., the discussion on limited liability and tort law addresses the question whether company founders are in the position to "externalize" the risks of their business if they are not liable for tort damages committed in the operations of the corporation or whether unlimited liability should be the rule.[53] Is there a similar rationale available in the tax sector which speaks out for personal liability of shareholders for tax debts of the company? This seems not to be the case. Unlike tort victims, tax authorities never suffer any "damages" from the activities of a company; they rather make a windfall profit on the operations it carries out and they are not in a position to complain if the company does not own enough assets to satisfy all claimants in the end. Moreover, tax law itself confers some benefits on the tax authorities when economic actors make use of *asset partitioning*: Costs at the shareholder level are not deductible at the company level and *vice versa*; profits of the corporation cannot be set off against losses of the shareholder and *vice versa*. By this technique, the benefits and risks of *asset partitioning* are shared between the taxpayers and the tax authorities. On the other hand, whenever tax law grants to the shareholders the option to allocate profits and losses directly to them (*e.g.* under U.S. "check-the-box"-rules for S Corporations and Limited Liability Companies) the tax claim will be directed against the shareholders (and their private assets) themselves.

Nevertheless, there might be situations where some veil-piercing might be advisable. An interesting example is enshrined in German tax law: When the owner of a substantial shareholding (exceeding 25%) in a company or another person having substantial influence on the business conduct of the company holds fixed assets which are used by the company in the course of its business, these assets also are subject to the enforcement of a tax claim against the company, provided that the tax claim refers to the business itself (such as trade tax or VAT) and not on the taxable income of the company as such.

4. Allocating (Corporate) Income Tax

Taking a step back, we have to confront the topic of the allocation of tax in the first place. This means leaving behind the question of which persons – shareholders, directors or the company itself – are liable for the payment of a corporate tax debt. We are now dealing with the more basic question of whether it would make sense to tax the shareholders immediately on the profits of the corporation instead of taxing the body corporate.

It is well established that in an ideal tax world the tax on the corporate profits would directly and in real-time fall on the shareholders who – in the end – will enjoy the residual of the company's operations.[54] This would be completely in line with

[53] HANSMANN/KRAAKMAN, Toward Unlimited Shareholder Liability for Corporate Torts, 100 Yale Law Journal 1879 (1991).

[54] For a detailed proposal of shareholder-only taxation with respect to the company's profits *see* DODGE, A Combined Mark-To-Market and Pass-Through Corporate Shareholder Integration Proposal, 50 Tax Law Review 265, 294 *et seq.* (1995).

the economic assumption that the corporation as such does not exist, that it is nothing more than a nexus of contracts between shareholders and other involved parties. It is equally well known that this ideal has never been accomplished. This is mostly due to company law and capital market restrictions. As regards the corporation's profits, the individual shareholder is neither in the position to control the corporate income measurement (which is effected by the management) nor is he in charge of profit distribution (which is in the hands of the management and/or the shareholders' general assembly). Therefore, any across-the-board "pass-through" approach (including large publicly traded corporations) seems inadvisable. As far as the corporation's retained profits lead to capital gains in the hands of the taxpayer, any individual taxation on the unrealized increase in value faces the problem of valuation and liquidity which brings about the highly discussed pros and cons of the realization principle.[55] It is mostly accepted that the realization principle has to be maintained as long as capital markets are not willing to fully accept unrealized capital gains as collateral for borrowing by the taxpayer.[56]

In our context one should not forget that any legislative decision in favor of a look-through approach in corporate tax would bring about additional problems in the area of corporate law with respect to tax liability. This becomes evident when we look at partnership taxation where a "pass-through" approach has a long-standing international tradition. It is widely accepted that a partnership forms a hybrid entity somewhere between a mere contractual relationship of associated businesspeople and a fully recognized legal person. Moreover, there exists sophisticated interaction between the taxation of the business activities of the partnership as such and the unlimited liability of its partners for the partnership's debts. Current tax practice in most countries provides that partners are individually liable for the tax on their share of profits made by the partnership.[57] This technique reduces the number of tax levels from two to one; nevertheless it brings about several problems of civil law which arise from the fact that individual partners are not – like sole traders – in full control of the partnership's management and assets. At the level of the partnership itself, it has to be ascertained whether the partnership as such is liable for tax on these profits which are generated and quite often retained at the level of the partnership. At the level of the partners, they have to be sure that they have enough liquidity in their hands to pay taxes on the partnership's profits as they fall due.

In the U.K.[58] there was – until fiscal year 1996/97 – joint and several liability of the partnership itself and all partners for the tax debt on the partnership's profit. In order to ensure full payment and to relieve individual partners from full liability, the

---

[55] For a critical assessment of the realization principle *see* SCHIZER, Realization as Subsidy, 73 New York University Law Review 1549 (1998); SCHENK, A Positive Account of the Realization Rule, 57 Tax Law Review 355 (2004).

[56] SCHÖN, The Odd Couple: A Common Future for Financial and Tax Accounting?, 58 Tax Law Review 373 (2005).

[57] AULT/ARNOLD, Comparative Income Taxation – A Structural Analysis, 335 *et seq.* (2nd ed. 2004).

[58] RAY, Partnership Taxation (Looseleaf), chapter 12 (2006).

partnership was entitled to create "tax reserves" which were not open to distribution. Today, U.K. law has changed, allocating the tax debt individually to each partner; nevertheless, the necessity to establish tax reserves at the partnership level is undisputed and – in some cases – even required by the Financial Services Authority. In the United States and in Germany, the situation has always been the opposite: there is no obligation at all for the partnership and the other partners to pay the tax on another partner's profit share even if this partner becomes insolvent.[59] Yet this pass-through approach brings about the problem of liquidity if the profit is not (fully) paid out to the partners – this may happen due to statutory reserves or a majority vote of the shareholders to retain profits in the partnership. In these cases, the partners who might not have drawn enough liquidity from the partnership face problems of how to pay their individual tax debts. Academic writers in Germany[60] have supported the view that every partner should be legally entitled to be reimbursed by the partnership if he or she pays taxes on undistributed profits of the entity, but the Federal Court of Justice[61] has so far rejected this proposal, pointing to a basic divide between tax law and company law.

Bearing in mind these problems, the legislative choice to tax corporate profits at the corporate level brings in line the control of the underlying assets and the tax debt without interfering too much with the legal limitations and the individual policy of profit distribution in a company.[62] Moreover, as has been mentioned in U.S. literature, the existence of a tax at the corporate level reduces the power of the management who might otherwise be induced to accumulate profits within the sphere of the company while shareholders are held personally liable for any taxes on corporate profits and capital gains.[63] In their contribution to this volume, Steven Bank and Brian Cheffins take a closer look at the impact of the corporate tax system on the ownership structures in the U.K. and in the U.S. during the 20th century.[64]

---

59 My gratitude for helpful information on U.S. partnership taxation goes to Walter Schwidetzky (Baltimore).

60 SCHÖN, Bilanzkompetenzen und Ausschüttungsrechte in der Personengesellschaft, in: BUDDE *et al.* (eds.), Handelsbilanzen und Steuerbilanzen – Festschrift für Heinrich Beisse, 471, 487 *et seq.* (1997); ULMER, Gewinnanspruch und Thesaurierung in OHG und KG, in: SCHNEIDER *et al.* (eds.), Festschrift für Marcus Lutter, 935, 951 *et seq.* (2000).

61 Bundesgerichtshof, March 29, 1996, 132 Entscheidungen des Bundesgerichtshofs 263, 277 (1997).

62 For a full historical account *see* BANK, Is Double Taxation a Scapegoat for Declining Dividends? Evidence from History, 56 Tax Law Review 463 (2003).

63 AVI-YONAH, The Story of the Separate Income Tax: A Vehicle for Regulating Corporate Managers, in: BANK/STARK (eds.), Business Tax Stories, 11, 22 *et seq.* (2005).

64 BANK/CHEFFINS, Tax and the Separation of Ownership and Control, in this volume, at 111.

5. Profit-oriented Activities and the Corporate Tax

5.1 The Goal of After-Tax-Profit Maximization

The existence of the corporate income tax (and other taxes at the corporate level) makes it necessary to define the division of labor between the shareholders and the management when it comes to the administration of the company's assets and the carrying on of the company's business given the necessity to pay taxes out of profits.

For the management, it is well accepted that they have to conduct the affairs of the company within the framework of the articles of association and general rules and standards of corporate law. With respect to the interest of the shareholders they are bound to fulfill the duty of care and the duty of loyalty widely accepted in common law and civil law jurisdictions.[65] The basic goal which offers guidance for the actions of the management under the "corporate contract" is wealth maximization for investors.[66] This is due to the fact that the paramount incentive for shareholders to invest money in a firm is a high return on investment which is dependent on the dividends and capital gains they derive from the company's operations.[67] As dividends are paid out of profits, which have been subject to corporate income tax, the interest of the shareholders goes for the after-tax profit rather than for the pre-tax profit. The same holds true for capital gains in shares which reflect the increase in value of the company's assets on a net basis. This makes the minimization of the corporate tax burden an integral part of the managers' duty of care.[68] They are not in the position to look for the before-tax profit alone, leaving after-tax results out of sight. Therefore, they – *i.e.* the directors themselves – are legally bound to engage in tax strategies.[69] This brings about the question of to what extent such tax strategies are required and accepted in order to comply with the duty of care and the duty of loyalty in the corporate context.

The duty of care requires the management to take all decisions which are expected to bring about a positive net return on investment. In the context of tax

---

[65] FERRAN, *supra* note 29, at 154 *et seq.*, 206 *et seq.*; FLEISCHER, Sorgfaltspflicht der Vorstandsmitglieder, in: FLEISCHER (ed.), Handbuch des Vorstandsrechts, § 7 (2006); HAMILTON/MACEY, Corporations, Including Partnerships and Limited Liability Companies, 670, 759 *et seq.* (9th ed. 2005).

[66] This is part of the basic contractual relationship between shareholders and the management (if shareholders do not decide otherwise); EASTERBROOK/FISCHEL, *supra* note 6, at 35 *et seq.*

[67] FRENCH/RYAN, Mayson, French & Ryan on Company Law, para. 16.6.5 (24th ed. 2007-2008) on the most recent U.K. legislation (CA 2006 sec.172) that directors have to act for the "benefit of the members".

[68] SCHOLES/WOLFSON/ERICKSON/MAYDEW/SHEVLIN, Taxes and Business Strategy – A Planning Approach, § 1.2, at 5 *et seq.* (3rd ed. 2005); *see* also the contribution by ERLE, Tax Risk Management and Board Responsibility, in this volume, at 205; for an extensive analysis *see* GASSNER, Steuergestaltung als Vorstandspflicht, in: BERNAT *et al.*(eds.), Festschrift Heinz Krejci zum 60. Geburtstag, 605 *et seq.* (2001).

[69] GASSNER, *supra* note 68, at 610 *et seq.*; SLEMROD, The Economics of Corporate Tax Selfishness, 57 National Tax Journal 877 (2004).

management this means that any tax-driven measure shall be taken if the expected amount of tax reduction fairly surpasses the ensuing costs incurred by the corporation. These costs include both the narrow range of advisory and compliance costs for the tax measure itself and the broad range of costs incurred by the tax-driven operation as such. The setting-up of a production site in a low-tax jurisdiction does not only give rise to advisory fees and tax payments in the foreign state and at home but also to substantial capital and current expenditure when it comes to the acquisition of land, the erection of a factory, the hiring of labor and the logistics of transportation. In the end, the management has to decide whether the tax advantage arising from the location of a permanent establishment in a low-tax-jurisdiction exceeds the extra costs incurred when compared to a permanent establishment in the home country of the firm or a third country. In this respect, it becomes evident that in purely financial transactions the tax advantages of strategic investment may rise while the real-world expenditure goes down. The expected net return on a tax measure regarding the financial structure of a corporation can therefore be extremely high. Following common wisdom this obliges the board of management to engage in such structures in order to fulfill their duty of care.

Taking a step back, this is surely a situation where a difference between individual and corporate taxpayers comes up. While for an individual taxpayer there is no legal obligation to engage in tax-reducing activities, the board of management is under pressure to employ these strategies. This is due to the fact that individuals are in the position to form their own preferences – feeling altruistic when they pay high taxes, or devoting their time rather to music and golf than to the administration of their tax life. The corporate management however, is not in the position to deviate from the goal to maximize the after-tax profit of the firm without consent from the shareholders in their entirety.[70]

There are two *caveats* to this standard argument. Firstly, the corporate management is not entitled or expected to change the objects of the company as such. This is up to the general meeting of the shareholders.[71] Therefore, a full-blown move of the corporation to a new line of business for tax reasons would not be covered by the powers of the management. It may even be that wholly synthetic constructions which are not meant to arrange the company's original business in a tax-efficient way but to enter into additional financial activities simply in order to save taxes go beyond the limits set by the articles of association. Nevertheless, the true effect of this limitation might be quite weak depending on the legal situation in a given country. In the United Kingdom and in the United States, the concept of *ultra vires* has been quite strong in the past but has been eroded both by the admission of broad language used in company statutes[72] and by tolerant legislation so that it is not any more perceived as a meaningful boundary against the discretion exerted by the

---

[70] SLEMROD, *id.*, at 884.

[71] FERRAN, *supra* note 29, at 250 *et seq.* (U.K.); GEVURTZ, *supra* note 29, § 3.1.3, at 195 *et seq.* (U.S.); FLEISCHER, *supra* note 23, § 1 para. 51.

[72] FERRAN, *supra* note 29, at 87 *et seq.*

board of directors.[73] In Germany the statutory definition of the company object is still regarded to be a major safeguard for the shareholders against a factual change of the nature of the company itself[74] but again the freedom of a corporation's founders to use very general language in the articles of association is hardly limited. In this respect one has to appreciate why there are boundaries enshrined in the corporation's statute in the first place. The *rationale* behind this limitation lies in the fact that shareholders do not simply decide on the formation of a company or an investment in shares in a very general way, having in mind only the overarching goal of profit maximization; they prefer to put their money into a specific line of business and the risk profile attached to it and want to protect this decision against *ex post* opportunism by the management.[75] Insofar as the company statute identifies the object of the entity, the management has to act within the risk-specific framework of the company statute. Any tax move which substantially changes the risk profile of the corporation might exceed their executive competence.

The second *caveat* refers to the presumptive preferences of taxpayers. One might be inclined to presume that "honest" shareholders do not want their company to engage in more or less strategic tax planning. Yet this assumption is not only based on shaky factual evidence; moreover, it is generally not reflected in the legal framework of the management – be it the articles of association or a formal shareholder vote. As long as shareholders have not declared formally their will in one way or the other that the company shall abstain from certain tax measures, thus "putting tax paying first", management has no justification to do so. The power of the shareholders to insert specific "good corporate citizen" restrictions into the statute of their company is undisputed in all examined jurisdictions but it has to be exercised to gain legal force.[76]

5.2 Setting and Managing Tax Risk

The return on investment which is expected from a tax measure is not a safe bet but rather subject to assumptions as to the probability of its success. It may well be that a tax measure will not be accepted by the tax authorities or finally in the courts. Therefore, the management has to take into account the probability of failure and strike a balance between the upside and the downside potential of this investment. To be sure, this risk analysis is part of every investment and not a peculiarity of the tax sector.[77] Therefore, the existence of tax risk as such does not prevent strategic tax planning as such nor does it urge an extremely cautious line on the management. Moreover, the estimations of the management as to the pros and cons of a particular tax measure are

---

[73] *See e.g.* § 3.02 Revised Model Business Corporation Act and §§ 122, 123 Delaware General Corporation Law; for an account of the "decline" of the *ultra vires* doctrine *see* GEVURTZ, *supra* note 29, § 3.1.4, at 220 *et seq.*; HAMILTON/MACEY, *supra* note 65, ch.6 sec.C, at 223 *et seq.*

[74] FLEISCHER, *supra* note 23, § 1 para. 51.

[75] As to the economic importance of control rights for different investors *see* TIROLE, *supra* note 9, § 10, at 387 *et seq.*

[76] EASTERBROOK/FISCHEL, *supra* note 6, at 35 *et seq.*

[77] GASSNER, *supra* note 68, at 620 *et seq.*

subject to the *business judgment rule*:[78] As long as the management reasonably believes to act in the best interest of the corporation and is informed to the extent it believes it to be appropriate under the circumstances, the decisions made by the board of directors or other officers of the company are protected against personal liability.

Nevertheless, the existence of tax risk and the institutional design which is meant to deal with this source of conflicts within the company or between the company and the tax authorities have been the subject of a highly controversial debate in recent years. There are several aspects which have to be taken into account:

First of all, someone has to decide on the risk profile of a corporation in tax matters. In this respect, three different constituencies have been identified: shareholders, top management and tax departments. While shareholders and top management tend to embrace the overall profit of the enterprise, tax managers are presumed to have an interest in a substantial impact of the company's tax position on the profitability of the corporation. Therefore it has been said that tax managers might be less risk-averse than top managers or shareholders.[79] This factual conflict – if it actually exists – may lead to the necessity to shift the basic decisions on tax policy to the level of the board of directors. It is this shifting of responsibility which leading representatives of tax authorities rely on when they try to curb the activity of aggressive tax planning within the corporate sector.[80] Yet this instrument looks pretty weak. First of all, one should not bet on top management being rather risk-averse because they enjoy the *beneficium* of the *business judgment rule* in this context. Therefore, they have at their disposition a broad range of tax risk profiles to choose from. Secondly, even if there was an obligation of the board to choose a less aggressive tax strategy this should be an obligation towards the community of shareholders, but it is never an obligation towards the tax authorities. The reckless choice of an overambitious tax strategy might therefore give rise to derivative shareholder suits or other corporate and financial law remedies; it does not however, confer upon the tax authorities the power to intervene.

Once top management has opted for a certain tax risk profile of the company, the law requires the board to establish a tax risk management system which keeps them informed about the tax position of the company or a group on a continuing basis.[81] This sort of compulsory risk management has been introduced in many countries, most notably by the Sarbanes-Oxley Act 2002. It may also be that decisions on tax-risk which might affect the whole company or large parts of it have to be taken by the board of directors itself. This is dealt with in Bernd Erle's contribution.[82] At this point it suffices to say that the tax risk has to be treated like any other risk – product liability, inventory risk – which can arise in the course of a business.

---

78 GEVURTZ, *supra* note 29, § 4.1.2, at 278 *et seq.*; FLEISCHER, *supra* note 65, § 7 para. 45 *et seq.*

79 SLEMROD, *supra* note 69, at 885.

80 OECD, Seoul Declaration, *supra* note 10.

81 *See* (among others) ELGOOD, What is Tax Risk?, 31 Tax Planning International Review 3 (2004/6); HICKEY, Tax Risk Management – The Tolerance Factor, 44 Tax Notes International 609 (2006); LAW, Tax Risk Management: The Evolving Role of Tax Directors, 32 Tax Planning International Review 9 (2005/2).

82 ERLE, *supra* note 68.

Again, any failure to introduce a workable tax risk management only relates to the internal legal relationship between the company and its shareholders on the one hand and the management on the other hand. Under recently enacted securities law, Sec.1001 of the Sarbanes-Oxley Act requires the chief executive to eventually sign the tax return for a corporation. This means that he has to take responsibility for the correctness of the tax return – but again this is not meant as a benefit for the tax authorities but for the investors to whom the CEO has to declare that he is in full knowledge of the tax situation of the company.

5.3 Tax Transparency?

For listed companies, another topic would be to go for full transparency and inform the stock market about the risk profile taken in the tax arena.[83] Such move would empower investors to decide whether they want to put their money into a company which has opted for a certain tax risk profile. In current disclosure and accounting rules, there are two avenues for this recent approach:

Firstly, it is widely accepted that the management – in the U.S. as part of the *management discussion and analysis,* in Germany in the *Lagebericht* and under International Financial Reporting Standards in the envisaged *management commentary* – has to disclose substantial risks to the financial markets.[84] There is no evidence that any material risk which arises in the tax position of the company is excluded from this obligation. Moreover, tax risk has to be disclosed if it has a substantial impact on corporate income, as they can give rise to contingent liabilities or tax assets in the framework of the balance sheet itself. Another approach has come up under U.S. GAAP as recently as 2006. In this year, the FASB released Interpretation No. 48 on "Uncertainty in Income Taxes"[85] which requires listed corporations to declare the gross amount of reserves held for tax risks, increases and decreases to those reserves, and other changes such as expected audit settlements. A similar move is expected from the IASB for reporting requirements under IFRS.[86] This has been perceived by practitioners as a significant increase in tax risk disclosure for companies registered with the SEC.[87] Moreover, it seems to play into the hands of the tax authorities which are gratuitously offered a "road map" towards the sensitive

---

[83] BEALE, Putting SEC Heat on Audit Firms and Corporate Tax Shelters: Responding to Tax Risk with Sunshine, Shame and Strict Liability, 29 Journal of Corporation Law 219 (2004).

[84] For an in-depth analysis *see* PALMES, Der Lagebericht – Grundfragen und Haftung (forthcoming 2008).

[85] FASB Interpretation No.48 – Accounting for Uncertainty in Income Taxes (*see* www.fasb.org).

[86] LAFON, FASB, IASB address FIN 48 Measurements, 46 Tax Notes International 550 (2007).

[87] CIGLER, FIN 48 challenges for International Operations, 18 Journal of International Taxation 64 (2007); JAWORSKI/CODER, Panel Debates Effect of FIN 48 on Transparency, Compliance, 116 Tax Notes 237 (2007); NICHOLS/BARIL/BRIGGS, Early Indications of the Impact of FIN 48, 116 Tax Notes 119 (2007); NICHOLS/BRIGGS/BARIL, And the Impact is … First Quarter Results from Adopting FIN 48, 116 Tax Notes 377 (2007); RUSSO/MOERER, Are You "Fin 48" Ready?, 8 Tax Planning International Transfer Pricing 20 (2007/5); WEBER/GETZ, Accounting for Uncertainty in Income Taxes: A Practical Approach for Adoption, 33 Tax Planning International Review 6 (2006/9).

parts of a corporate tax return.[88] In this respect, it is currently highly disputed whether tax authorities are entitled to ask for the "workpapers" behind the bare numbers.[89]

Nevertheless, current securities laws make a difference between the disclosure of risks and the disclosure of strategies. While German law and U.S. law do not require the management to make public its business (and tax) strategies to the capital markets (and, incidentally, to the tax authorities), under the currently discussed future IASB rules the investors shall be in the position "to assess the strategies adopted by the entity and the likelihood that those strategies will be successful".[90] If this trend moves on, it might result in a fully-fledged disclosure rule for the tax policy of a corporate entity. In any case, corporations are entitled to set up a "code of ethics" in tax matters which they disclose on a voluntary basis to the general public.

Again tax authorities should hesitate to employ financial market mechanisms in order to make life easier for them. The aforementioned extension of mandatory disclosure aims at an enhancement of the functioning of the capital market when it comes to the assessment of risk by potential investors and it tries to reduce the information asymmetry in the principal-agent conflict between shareholders and management. They cannot – neither directly nor indirectly – be enforced by tax authorities and should not be interpreted in that way. What is worse – the factual access of tax authorities to the disclosed data will distort the effective functioning of the disclosure rules themselves in the shareholder-manager relationship: Managers will either refrain from embarking on risky tax strategies if they are aware of the increased scrutiny by tax authorities or they will try to conceal the true extent and nature of tax risk to the shareholders in order not to endanger the success of a tax project. If one would ask for the hypothetical will of the shareholders – do they require the managers to disclose all sorts of tax risk if this might lead to an increased audit by the tax authorities? – one might easily reach the conclusion that tax disclosure is not perceived by investors themselves to be in their own best interest.[91]

5.4 Tax Evasion and Aggressive Tax Behavior

5.4.1 Tax Evasion

There is of course no obligation for the board to engage in tax evasion, even if this seems to be a profitable way of generating money for the firm. Economic wisdom has it that taxpayers will start tax evasion if the profit from this activity exceeds the downside risk including the level of penalties and the probability of being

[88] STAMPER, Increased Transparency Still Falling Short, Everson Says, 114 Tax Notes 502 (2007).

[89] CODER, IRS Considering Changing Policy on FIN 48 Workpapers, 115 Tax Notes 1113 (2007); STRATTON, FIN 48 Leading IRS to Reconsider Restraint Policy for Workpapers, 114 Tax Notes 614 (2007).

[90] IASB, Management Commentary – Discussion Paper, para. 119 (October 2005).

[91] SCHÖN, Finanzbeamte auf den Finanzmarkt?, 171 Zeitschrift für das Gesamte Handels- und Wirtschaftsrecht 485 (2007).

detected.[92] Yet there are two reasons why the management is never legally bound to go this way. Firstly, criminal offences bring about personal liability for the management, which they are by no legal means required to incur. Secondly, the financial consequences of tax evasion can be quite catastrophic for the firm as such so the business judgment of the directors will in general lead them to the conclusion that no action is required so far.

This analysis does not logically exclude that the board of directors may have some discretion to embark on this voyage. If the downside risk is remarkably low while the upside potential is correspondingly high, a profit-oriented board of directors might consider tax evasion as a means of increasing the after-tax profit of the firm. If this is the case, corporate law has to decide whether the shareholders are in the position to sue directors which engage in tax evasion even if their decision to do so seems to be justified in the light of after-tax-profit-maximization. From a strict contractarian approach, there would be no liability if the validity of the *business judgment* exercised by the managers is not in question. Therefore defenders of a clear delineation between public interest rules and private law see no reason why corporate recovery should be added to the criminal and administrative sanctions following illegal conduct.[93] Nevertheless, under current legal rules it is widely acknowledged for criminal behavior in general, most notably corruption practices, that the external obligations of directors and other managers to stay within the law are transformed into duties of care towards the shareholders as well.[94] Managers are not in the position to justify their offences towards shareholders with reference to the expected net profit. This is due to the fact that legal obligations are not perceived as simple cost factors but as binding limits under corporate law. Also from an economic point of view, the sanctions laid out in tax and criminal law can hardly be designed as exact "prices" for externalities suffered by society at large.[95] Melvin Eisenberg has compared this to a game: You are allowed to maximize your result, but you have to stay within the rules of the game.[96]

---

[92] As to the economics of tax evasion *see* ALLINGHAM/SANDMO, Income Tax Evasion: A Theoretical Analysis, 1 Journal of Public Economics 323 (1972); SANDMO, The Theory of Tax Evasion: A Retrospective View, 58 National Tax Journal 643 (2005); for a more comprehensive view, including the concept of "fairness", "morale" and "religion" *see* TORGLER, Tax Compliance and Tax Morale, *passim* (2007).

[93] EASTERBROOK/FISCHEL, Antitrust Suits by Targets of Tender Offers, 80 Michigan Law Review 1155, 1168 (1983); GEVURTZ, *supra* note 29, § 4.1.6, at 313.

[94] GASSNER, *supra* note 68, at 620; the current debate in the U.S. is laid out in WILLIAMS, Corporate Compliance with the Law in the Era of Efficiency, 76 North Carolina Law Review 1265 (1998); a broad comparative account and an analysis under German law is supplied by FLEISCHER, Aktienrechtliche Legalitätspflicht und "nützliche" Pflichtverletzungen von Vorstandsmitgliedern, 26 Zeitschrift für Wirtschaftrecht 141 (2005).

[95] For an economic analysis see COOTER, Prices and Sanctions, 84 Columbia Law Review 1523 (1984).

[96] EISENBERG, Corporate Conduct that does not Maximise Shareholder Gain: Legal Conduct, Ethical Conduct, The Penumbra Effect, Reciprocity, the Prisoner's Dilemma, Sheep's Clothing, Social Conduct, and Disclosure, 28 Stetson L.Rev. 1, 3 *et seq.* (1998).

It is needless to say, that the internal breach of the duty of care in the case of tax evasion does not have any external effect towards the tax authorities and their claims against the company itself and its directors. Shareholders are even free to waive any damage claim they have against directors arising out of a failed tax evasion scheme. Against this background, Crocker/Slemrod have advocated for personal penalties against directors rather than corporate penalties against the firm in order to deter managers from tax evasion mechanisms.[97]

5.4.2 Aggressive Tax Behavior

The problematic case is aggressive tax behavior. In recent years, tax administrations in industrialized countries have put forward the assertion that firms are obliged not only to follow the letter of the law itself but to pay a "fair share" *i.e.* a morally appropriate amount of taxes.[98] This shall include an "ethical" obligation to refrain from tax strategies which make use of the legal arrangements to the limit. But this is the tax authorities' view – what does corporate law tell us about it?

Under the duty of care, the management is obliged to employ even aggressive tax strategies if they can be effectuated within the framework of the corporation's objects and if the upside potential of the chosen construction evidently surpasses its downside risk. To be sure, any aggressive tax planning might give rise to some additional costs which have to be included into this standard model. Any efforts by the tax authorities to deter tax planning, *e.g.* by creating additional layers of compliance or by imposing penalties on the use of tax shelters simply increase the expected cost of a certain tax position and therefore have to be taken into account by the management when they assess the net present value of an investment. From a corporate governance point of view, the current U. S. tax shelter rules which are discussed by Dan Shaviro,[99] Don Korb[100] and Michael Desmond[101] in this book merely represent such a "change of the calculus"[102] (which is not dependent on the corporate status of the taxpayer). The pros and cons of the currently used instruments of tax shelters have to be assessed in the context of tax law, not in the context of corporate law.[103]

---

[97] CROCKER/SLEMROD, Corporate Tax Evasion with Agency Costs, 89 Journal of Public Economics 1593 (2005); SLEMROD, *supra* note 69, at 885; *see* also SANDMO, *supra* note 92, at 655; for an analysis of the interdependence of personal tax evasion by a manager and his involvement in corporate tax evasion *see* GOERKE, Corporate and Personal Income Tax Declarations, International Tax and Public Finance 281 (2007).

[98] NADAL/PARILLO, Socially Responsible Taxation – Much Ado about Nothing?, 47 Tax Notes International 791 (2007).

[99] SHAVIRO, Disclosure and Civil Penalty Rules in the U.S. Legal Response to Corporate Tax Shelters, in this volume, at 229.

[100] KORB, Shelters, Schemes, and Abusive Transactions: Why Today's Thoughtful U.S. Tax Advisors Should Tell Their Clients to "Just Say No", in this volume, at 289.

[101] DESMOND, Opinion Standards for Tax Practitioners Under U.S. Department of the Treasury Circular 230, in this volume, at 265.

[102] SAVINA, Changing the Calculus: Making Tax Shelters Unprofitable, 58 National Tax Journal 471 (2005).

[103] For an in-depth-analysis *see* the Articles and Comments from the Symposium "Futures of Tax Shelters" of Minnesota Law School (October2006), 26 Virginia Tax Review 769 (2007).

In this calculation, reputation effects of aggressive tax planning should not be disregarded by the corporate management as they are likely to deter shareholders or customers – particularly private consumers – from business contacts with the firm.[104] These will give rise to explicit costs which have to be taken into account. Moreover, aggressive tax positions might lead to intensified scrutiny by the tax authorities and thus to increased compliance costs. After all – as the OECD Principles on Corporate Governance make clear – sticking to ethical standards might in the long run be in the best interest of the company itself.[105] But these obvious monetary consequences should not be confused with the widely discussed assumption that there exists an ethical borderline which shall not be transgressed.

Therefore, we have to address those situations where aggressive tax behavior looks profitable, even if reputation and compliance costs are taken into account. In these situations, the management has to ask itself whether it is entitled to refrain from such operation in order to show good corporate citizenship. While this case is hardly mentioned in company law literature, it is related to the long-standing discussion of whether the corporate management is entitled to spend the corporation's funds for charitable donations.[106] There exist manifold valid business reasons for corporate giving, most evidently reputation effects, which might have a positive impact on the customer base or the motivation of the workforce. Therefore, in Germany the Federal Court of Justice in Karlsruhe has declared corporate giving to be in line with the legal obligations of the directors as long as one can assume that the perception of the company as a "good corporate citizen" increases the company's economic standing in the long run.[107] This judgment operates still within the framework of the standard model. In the U.K., the courts and academic writers take a similar view.[108]

Although in the real world nearly any measure might be justified by some remote positive long-term effect on the company's profits,[109] there might nevertheless be some residual situations where there is simply no other reason for a donation left but pure altruism.[110] This holds specifically true in the tax arena where the positive publicity effect of corporate giving is much smaller than in the area of true charitable donations.[111] This is where the real problem begins and where German and U.K. law seem to limit the discretion of the management. In the U. S. however,

---

[104] For an empirical assessment of these effects *see* HANLON/SLEMROD, What does Tax Aggressiveness Signal? Evidence from Stock Price Reactions to News about Tax Aggressiveness, Working Paper, University of Michigan (2007).

[105] OECD Principles of Corporate Governance, *supra* note 15, Annotations, part VI.C.

[106] GASSNER, *supra* note 68, at 605 *et seq.*; SLEMROD, *supra* note 69, at 884.

[107] Bundesgerichtshof, December 6, 2001, 2002 Neue Juristische Wochenschrift 1585 *et seq.*; for a comparative view *see* FLEISCHER, Unternehmensspenden und Leitungsermessen des Vorstands im Aktienrecht, 46 Aktiengesellschaft 171 (2001).

[108] FERRAN, *supra* note 29, at 127 *et seq.*

[109] HAMILTON/MACEY, *supra* note 65, at 546 *et seq.*

[110] For a case-by-case analysis of such non-business rationales *see* EISENBERG, *supra* note 96, at 1 *et seq.*

[111] GASSNER, *supra* note 68, at 623.

according to § 2.01 of the American Law Institute's Principles on Corporate Governance the corporation "may devote a reasonable amount of resources to public welfare, humanitarian, educational, and philanthropic purposes" even if there is no remote positive influence on the company's well-being discernible. This goes beyond the cautious remarks one can find in European law and it might well justify conservative behavior of corporations in tax planning. But this U. S. provision requires to apply an extremely vague standard of "reasonableness" in order to set a limit to corporate altruism. As with corporate giving, it will be hard to find out where the reasonableness of paying taxes stops.

While this seems to follow from settled law, it remains unclear whether there are "ethical obligations" discernible which openly prevent corporate management from aggressive tax planning in much the same way as legal obligations prevent them from tax evasion.[112] The legal effect would be that shareholders would be in the position to sue directors if they engage in aggressive tax behavior even if there is a valid *business judgment* case in favor of this strategy. This would be a bridge too far. From a strictly legal point of view, ethical obligations are not enforceable while legal obligations are.[113] Therefore, an individual taxpayer who transgresses the "ethical" borderline but stays within the legal limits of the law does not have to fear any legal sanctions. It would be strange if the existence of a corporate setting, including the agency relationship between shareholders and the management, would transform ethical rules which are not binding at all for the individual taxpayer into enforceable duties of the management towards its shareholders. This can only be the case if the shareholders have formally decided to refrain from such behavior, *e.g.* by referring to specific ethical standards in the articles of association.[114]

5.5 Transparency and Tax-Driven Structures

The situation becomes even more difficult when tax-driven operations lead to a lack of transparency. The most famous case is ENRON which had several hundred subsidiaries in the Caribbean, many of them meant to achieve some tax effect.[115] For the shareholders, there was no realistic perspective to get a picture of the overall situation. This leads to a problem going to the heart of the principal-agent-conflict between owners and managers. Shareholders face a trade-off between the tax advantages which can be derived from complicated corporate group and financing structures on the one hand and the lack of management control resulting from these structures on the other hand. This holds a challenge to the management's duty of loyalty

[112] EISENBERG, *supra* note 96, at 5.
[113] FREEDMAN, Defining Taxpayer Responsibility: In Support of a General Anti-Avoidance Principle, 2004 British Tax Review 332, 336 *et seq.*
[114] SLEMROD, *supra* note 69, at 884.
[115] JOINT COMMITTEE ON TAXATION, 108th Congress Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues and Policy Recommendations (Comm. Print 2003).

as a loss of transparency can lead to opportunistic behavior by the management, including inflation of assets or outright diversion of funds.[116]

Corporate governance has no simple answer to this conflict. At the outset, the transformation of a single-entity business into a corporate group or the establishment of hybrid financial structures do not require the consent of the shareholders' meeting. Only a change of the corporation's objects or a substantial sale of assets might require an affirmative shareholder vote.[117] The current legal framework leaves to the management huge discretion in this context. Under § 12.02 of the U.S. Model Business Corporation Act, only the sale of more than 75% of the company's assets to a third party requires approval from a majority of stockholders.[118] In the U.K., company law itself does not erect substantial obstacles but the Listing Rules of the London Stock Exchange require shareholder involvement in many cases.[119] Under German jurisprudence, only very substantial changes of the company structure are beyond the reach of the board of directors and have to be confirmed by the general meeting of the shareholders.[120] Therefore it should be noticed that most tax-driven operations – the setting up of finance subsidiaries in the Cayman Islands or the decision to locate a production site in a low tax country – are fully in the hands of the management itself.

Against this background, the first limitation to the management's involvement in complicated tax constructions lies in the aforementioned assumption that the management acts contrary to its duty of care when they set up structures where the tax advantages are regularly outweighed by the compliance costs and any negative impact on the real operations of the company.[121] This holds specifically true when the tax construction requires the inclusion of third parties into the arrangement, thus exposing existing or future assets or corporate opportunities to unnecessary risk. Even more relevant is the fact that tax-driven corporate and financial structures regularly distort the organizational matrix of the corporation which is meant to ensure that the decision-making process is optimized. Such interference with useful business hierarchies might well speak out against the tax-driven construction. Yet there will always remain some cases where the tax advantages of a complicated structure fairly exceed its transaction costs. In these settings we have to confront the question whether the management shall refrain from this operation in order to preserve the transparency of their operations. The duty of loyalty seems to clash with the duty of care.

---

[116] For an economic analysis of this point *see* DESAI/DHARMAPALA, *supra* note 1.

[117] For a comparative view *see* PAEFGEN, "Holzmüller" und der Rechtsschutz des Aktionärs gegen das Verwaltungshandeln im Rechtsvergleich, 171 Zeitschrift für das Gesamte Handels- und Wirtschaftsrecht (forthcoming 2008).

[118] The most recent U.S. case on this is *Hollinger Inc. v. Hollinger International Inc.*, 858 A.2d 342 (Del. Ch., 2004).

[119] FRENCH/RYAN, *supra* note 67, para. 15.10.6.

[120] Bundesgerichtshof, February 25, 1982, 83 Entscheidungen des Bundesgerichtshofs 122 *et seq.* (1982) – *Holzmüller*; Bundesgerichtshof, April 26, 2004, 159 Entscheidungen des Bundesgerichtshofs 30 *et seq.* (2004) – *Gelatine*.

[121] *See supra* at 5.1.

This problem of a lack of transparency can be solved if shareholders can be sure that the company's auditors know the full details of the group structure and indicate all problematic points. To be sure, this task must not be confused with the auditing of a tax risk management system. We are not only talking about the tax risks of complicated group structures, but also about the opportunities for the management to tuck away funds in tax-saving devices, thus not only sheltering them from the taxman but also from distribution to the shareholders, making them available for self-serving to the management. Therefore, the auditors should scrutinize whether the opaque construction is necessary to achieve the tax goal in the first place and whether the availability of funds to the shareholders is not seriously endangered. Financial reporting of consolidated entities should give a true and fair view of these structures in order to shed some light on the machinations of the management. If, however, the auditor's work does not suffice to protect shareholders against diversion of company assets because transparency is not even feasible for a professional accountancy firm, the directors should be obliged to refrain from these constructions.

On the other hand, a decentralized group structure might even lead to enhanced tax compliance whenever there are incentives for the (local) management to fully show the true results of the business unit they are responsible for. Against this background, a corporate strategy to regard subsidiaries and permanent establishments as "profit centers" in their own right and to base management remuneration on the financial results of this profit center will give birth to a strong incentive for local management to refrain from profit-shifting in the area of transfer pricing. Therefore, recent material shows that increased managerial autonomy at the level of the subsidiary can lead to increased tax compliance in the field of transfer pricing.[122]

6. Income Measurement in Tax and Financial Accounting

The most important effect of corporate and financial law rules on the way taxable income is measured, is enshrined in the alignment of corporate and taxable profits which we find in several important jurisdictions.[123] In this book, Judith Freedman presents an in-depth analysis of the legal background of such a technique. Under such system, the basic structural elements of financial accounting find their way into tax accounting. Again we can ask ourselves whether financial rules have a positive impact on the tax management of the company and the fulfillment of its obligations under tax law.[124]

The effects are manifold. Firstly, the taxman can rely on a set of financial accounts which have been audited by a public accountant before the tax inspector

[122] CHAN/LO/MO, Managerial Autonomy and Tax Compliance: An Empirical Study on International Transfer Pricing, 28 The Journal of the American Taxation Association 1 (2006).

[123] SCHÖN, *supra* note 56.

[124] The most recent comprehensive economic analysis of the effect of book and tax rules on real investment decisions is presented by SHACKELFORD/SLEMROD/SALLEE, A Unifying Model of How the Tax System and Generally Accepted Accounting Principles Affect Corporate Behavior, Working Paper (2007) (available at http://ssrn.com/abstract=958436).

arrives. This is a valuable starting point in the process of the tax audit itself. Moreover, at the individual level of the company, alignment means that the management will consider the effects of a particular accounting position both on the capital market and on the tax situation. The outcome will depend on the benefits managers receive from different options. If and insofar as the management is paid on the basis of the financial results of the company, there will be a tendency of the management to give an optimistic picture of the company's overall profit, thereby increasing the tax bill as well. Nevertheless, this effect might be mitigated by the fact that management compensation is normally based on after-tax profit. Moreover, in a corporation oriented to the stock market, it is important to show good results to the investors in order to make stocks rise and keep take-overs at bay. In addition, good results can lead to an appreciation of the management's stock options. Again, the taxman should be glad in this respect. On the other hand there might be closely held firms where shareholders do not look at the financial accounts in the first place and where they do not regard dividends to be the most important benefit they receive from the company. In these cases, the shareholders – who are often themselves the managers of the firm – may press for low numbers both in the financial and in the tax accounts, thus distorting both calculations.

7. Tax – An Ally to Corporate Governance?

It is well known that tax rules have a major influence on the way a company's business is conducted, how the corporation is financed and structural changes are brought about.[125] The tax neutrality of company reorganizations is a topic in every tax system and capital gains taxation will surely impact the ownership structure of an enterprise. The deductibility of pension liabilities in German tax law has contributed largely to internal financing of big and small corporations and the choice between a partnership and a company for closely held firms, including the most recent products in the LLC and LLP sector[126] can tell a story about tax reasons for specific legal forms in the same way.

In our context, we find some tax provisions which have a direct impact on the internal governance system of corporations. In this respect we have to distinguish between tax provisions which are specifically aimed at this sort of regulation and others where the positive or negative impact on corporate governance is more or less a side-effect. Tax provisions which are meant to have a direct impact on corporate governance can specifically be found in the United States.[127] Well-known examples for such regulatory taxation include limitations to the deductibility of golden parachute payments in the case of take-overs, greenmail taxation when companies dole out large payments to corporate bidders or the non-deductibility of exaggerated

---

[125] SCHOLES *et al.*, *supra* note 68, at 81 *et seq.*; SCHREIBER, Besteuerung der Unternehmen, 493 *et seq.* (2005).

[126] DAUCHY, Do Tax Considerations Still Matter in Firms' Choice of Organizational Form? in: National Tax Association, Proceedings of the 98th Annual Conference 2005, 495 *et seq.* (2006)

[127] *See* FRIESE/LINK/MAYER, Taxation and Corporate Governance – The State of the Art, in this volume, at 357.

management compensation are widely discussed. Moreover, tax incentives referring to particular stock option schemes try to align shareholder and management interest.

These rules belong to the broad area of regulatory taxation which goes far beyond the topics of corporate behavior. In the U.S. context, these rules are particularly important as corporate law is subject to state legislation while corporate tax is predominantly in the hands of the federal legislator. The case is similar to securities law which is in the hands of Congress and the SEC and therefore serves as a complement to the liberal corporate rules which we find at the state level.[128] The Sarbanes-Oxley Act 2002 is a major example of the strong influence securities regulation can have on the internal affairs of a corporation. Insofar, federal tax rules can influence the internal affairs of a corporation. In Germany and in the U.K. both company and tax law are governed by the same legislative bodies of the central state. Therefore, the legislators do not have a paramount interest in the regulation of corporate governance structures by tax means.

Moreover, there are limits to the functioning of such regulatory instruments. Firstly, they work with pretty broad brushstrokes, thereby catching good and bad cases alike. Secondly, they do not fully prevent unwanted behavior; they simply attach higher after-tax costs to it which finally fall on the shareholder, whose interest was meant to be protected by these rules. If tax law limits the deductibility of high fixed salaries for directors and managers, any increase in the salary will cost the shareholder even more. Dependent on the functioning of the principal-agent-relationship within the company, the respective tax provision will put a brake on the suspect operations of the management or it will not – in this case we end up with a combination of the unwanted behavior and an extra tax cost falling on the shareholders' profit. Tax law restraints on fixed remunerations have strongly supported the rise of stock-options which have themselves led to a widespread transfer of wealth from shareholders to the management. Having in mind these unclear and counterproductive effects, Steven Bank concludes: "Tax can be considered an ally of Corporate Governance, but not a *de facto* system of federal corporate law".[129]

Even more relevant for the overall stability of the corporate law framework seem to be those tax law provisions which are not specifically intended to influence corporate behavior but which simply exert external control on the activities of the management. This starts with the mere existence of the corporate tax which produces the necessity to engage in annual income measurement, to file returns and to have them audited by the tax inspector on a regular basis. This puts an extra layer of "certification" on the calculation of corporate profits,[130] in addition to the control mechanisms applied by shareholders themselves and public accountants. As tax inspectors do not face the same collective action problems which shareholders encounter and – even more important – rarely are subject to the same conflicts of interest as audi-

---

[128] ROE, Delaware's Competition, 117 Harvard Law Review 588 (2003).

[129] BANK, Tax, Corporate Governance, and Norms, 61 Washington and Lee Law Review 1159, 1232 (2004).

[130] DESAI/DYCK/ZINGALES, Theft and Taxes, 85 Journal of Financial Economics 591, 618 (2007); AVI-YONAH, *supra* note 18, at 18.

tors are, the natural process of tax auditing proves to be helpful for the overall framework of corporate governance. It is not extremely rare that tax inspectors detect corporate fraud which has not been unveiled by big accounting firms; the real problem is whether they are bound or entitled – having tax secrecy in mind – to make their findings public in any case.

Again one should bear in mind that the tax rules might have a positive impact on corporate governance but they are not intended to do so and shareholders or creditors are not in the position to rely on them. This is the main topic in the *Flowtex*-Case, which is currently before the courts in Germany. In this €1.1 billion case, the tax inspector had detected criminal activities of a firm, including outright fraud and falsifications of the balance sheet, but did not make an end to these machinations. The District Court in Karlsruhe decided in 2005 that the state of *Baden-Württemberg* is not liable to pay damages to the creditors of an insolvent firm, because the duties of the tax inspector in the context of an audit are strictly owed to the government, not to the general public, including the creditors of a company.[131] The Court of Appeal has confirmed this judgment in October 2007.[132]

From the German perspective, the most important effect corporate taxation exerts on corporate governance refers to hidden distributions of profits. Under company law, it is well known that minority shareholders have to be protected if majority shareholders – often in collusion with directors – divert the company's assets to themselves, departing from arm's-length conditions in their contractual relationships with the company. These hidden withdrawals would hardly be discovered by minority shareholders themselves but regular tax examinations bring them to the surface and put an effective brake on such manipulations. It is widely acknowledged in German company law practice, that the tax authorities are a major player when it comes to the protection of minority interests.

To be sure, there might be some crazy effects of tax law on corporate governance. Germany provides a case in point. Under a long-standing rule, the compensation paid to members of the supervisory board is only partially deductible at the corporate level. This provision stems from the 1920s when large blockholders used excessive honoraria as members of the supervisory board in order to circumvent double taxation of corporate profits paid out as dividends. Under current law, nobody wants to uphold double taxation, therefore this rule only works as an additional cost factor prohibiting the company from hiring and paying high-class people as members of their advisory boards. It is even claimed that this effect runs foul of basic constitutional principles.[133]

---

[131] Landgericht Karlsruhe, July 26, 2005, 58 Neue Juristische Wochenschrift 2625 *et seq.* (2005).

[132] Oberlandesgericht Karlsruhe, October 15, 2007, Börsen-Zeitung of October 16, 2007, 6.

[133] SCHULZE-OSTERLOH, Die Abzugsbeschränkung für Aufsichtsratsvergütungen, das KonTraG und die Widerspruchsfreiheit der Rechtsordnung, in: KIRCHHOF *et al.* (eds.), Steuerrechtsprechung, Steuergesetz, Steuerreform: Festschrift für Klaus Offerhaus, 375 *et seq.* (1999).

8. Conclusion

From a legal point of view, one has to start with the fact that rights and obligations under corporate law are basically different from rights and obligations under tax law. While corporate law looks at the internal affairs of a corporation, dealing with agency problems and some third-party-entitlements, tax law looks at the corporation as such, at the taxpayer that doesn't exist. Any change in the contractual network of the corporation will work to the advantage or to the disadvantage of shareholders, management and some third parties like creditors or the workforce. Tax authorities might reap windfall profits from good corporate governance when shareholders put pressure on managers to refrain from tax saving activities. But it is hard to think of a point where tax authorities themselves can rely on these internal commitments. If tax authorities want to exert pressure on corporate taxpayers they have to find their own way within the framework of tax law as is most impressively shown in their work on tax shelters.

Moreover, any intensification of tax obligations should not look at the corporate character of an entity but rather at its overall financial and economic situation and try to treat all taxpayers alike which are – irrespective of their legal form – in comparable circumstances.

The positive influence of taxation on the internal governance structure of companies is another story. Here we find both explicit *de facto* rules for the corporate sector, disguised as tax incentives or disincentives, and certification procedures which have a positive side-effect on corporate conduct. The question which we have to face in the future is whether we should keep things apart – as they currently stand – or we should opt for stronger interaction between tax and corporate law. This will be the goal of more interdisciplinary work of economists and lawyers.[134]

[134] On the value of increased cooperation among economists and lawyers *see* GENTRY, The Future of Tax Research: A Mostly Economics Perspective, 29 Journal of the American Taxation Association 95 (2007).

Report on the Discussion

Stefan Mayer

1. Introductory Presentations by Dave Hartnett and Jeffrey P. Owens (Chair: Jeffrey P. Owens)

The commentator opening the first round of discussion of the morning session stated that the optimistic statements by *Owens* and *Hartnett* on a cooperation between taxpayers and administrations sounded appealing but that conditions in the United States might be less favorable to such an approach. The larger size of the country might render reputational sanctions for overly aggressive tax planning less efficient, and the lower budget of the IRS in relation to its duties allowed for fewer audits – so he assumed. Furthermore, differences in cultures might have an influence. *Owens* acknowledged that the fact of the U.S. being the economic center of the developed countries and innovation leader might have some impacts on tax behavior. With regards to the resources of tax administrations he emphasized that comparisons over the past five years showed that many tax administrations had to some degree shifted their resources from audit to service activities. He maintained that both good service and effective enforcement were prerequisites for good compliance and that the quality of administrative resources was at least as important as the mere quantity. *Hartnett* added that administrations today also focused to a greater extent on managing the risk of avoidance, thus creating higher risks of detection for aggressive tax shelters and causing more difficulties if such shelters fail.

While *Hartnett* agreed that companies should pay their fair share of taxes, a participant remarked that one had to take into account that similar incentives exist nowadays for governments and taxpayers: in the absence of foreign exchange controls, states seemed to tend to extend their taxing rights. In this context, he stressed, it was important to note that administrations were also obliged to comply with tax legislation. He furthermore addressed the competition of countries for employment opportunities and locational businesses through the tax system. In that context another discussant observed that the reaction of some states to this tax competition seemed to be putting more pressure on taxpayers, not only in the case of business transactions with tax havens, but also within the European Union. *Hartnett* argued that competition was generally healthy and that the OECD had addressed issues regarding harmful tax competition and tax regimes that hinder the creation of a level playing field. *Owens* also agreed that the competition over productive business environments was beneficial but added that in the past tax competition had mainly taken place in the form of a competition in tax rates while in recent times it had taken the more dangerous form of a competition of intransparent niche regimes.

Owens went on to explain that the change from once-closed economic environments to open international economies represented an important challenge to tax systems. For instance, exchange control systems had formerly been useful in gener-

ating information on international transactions. He concluded that the need for international cooperation and some harmonization existed and that it remained to be seen how tax systems, which doubtlessly would remain national, could be able to interact efficiently on an international level in the future. In this respect he deemed closer cooperation with taxpayers and reliance on internationally accepted rules to be vital elements.

Referring to *Owens'* remark that three years ago a conference on taxation and corporate governance would not have attracted much attention, one participant noted that in three years the time might be right for a conference on the good governance of governments in tax issues. He explained that it was important to recognize the conflicting claims in this field. Another discussant illustrated this opinion by expressing his view that it was cynical to emphasize the good relationship between administrations and taxpayers while governments constantly passed tax legislation that breached EU law or OECD standards. *Owens* supported the view that proper dealing in tax matters had to be a two-way street. He also cited the increased use of advance rulings and the emphasis put on taxpayer certainty as examples of tax administrations taking those issues seriously. Another participant added that it was important to focus on the common interests of taxpayers and administrations. He argued that the introduction of a common consolidated tax base in the European Community was a case in point as it would be advantageous both for taxpayers and administrations. In *Hartnett's* view, all involved parties were interested in tax systems that function, but politicians sometimes could "get in the way" and created problems by making high demands on the tax system or trying to implement substantial changes in tax law.

Regarding the relationship between tax administrations and tax advisers, *Hartnett* claimed that administrators were not opposed to open and transparent tax planning. In this context, he maintained that pragmatism, dialogue between the interested parties, and transparency are paramount. In his view, professional ethics had to play a key role in the behavior of advisers. He supported approaches by tax advisers who had begun scoring tax planning opportunities in respect of the risks involved and either set standards as to the degree of risks they were willing to sell, or at least completely disclosed all those risks to their clients. Another participant stressed that advisers were obliged to identify the most effective legal route for tax planning as they might otherwise incur liabilities.

One participant touched upon the role of tax havens in the context of tax compliance. While *Hartnett* opined that tax havens represented an issue quite separate from the other ones discussed in context of the conference, *Owens* conceded that tax havens might make the relationships between taxpayers and tax administrations more difficult, or, in his words, might "taint" it. On the question from another discussant what he meant by the statement that debates on morality might have hindered progress, *Hartnett* explained that in his opinion specific considerations of economics, social responsibility and "what you want from and for society" were more fruitful than discussions of abstract morality.

One participant considered the possibility of abolishing the corporate income tax altogether, taking into account the huge resources and amounts of time that were

spent on compliance. *Hartnett* disagreed, reasoning that the revenues from corporate taxes were increasing and that mutual trust, disclosure and transparency would reduce the intensity and burden of compliance-driven work. He continued by saying that shared risk assessments undertaken by businesses and administrations had showed that in fact taxpayers were also aware of the relevant issues.

Several speakers noted that the separation of tax advice and audit represented a major development in recent years. *Owens* approved of the increased independence of auditors, but one participant emphasized that auditors were in a difficult situation as tax risks were more visible in tax audits if they are openly disclosed in financial reports. *Hartnett* agreed, adding that auditors were under a huge regulatory pressure and had to adhere to high professional standards, but were also sometimes confronted with the expectations of taxpayers and advisers on how to represent certain aspects in the accounts.

2. Presentations by Mihir A. Desai and Wolfgang Schön (Chair: Jeffrey P. Owens)

The discussion on the presentations by *Desai* and *Schön* was started off by a participant asking for the reasons why the massive rise of aggressive tax planning had not taken place earlier. He put forward that part of the explanation might be that markets in tax advice had become more competitive. *Desai* identified several other aspects that in his view could have contributed to this development, *e.g.* the combination of advice with audit services and financial innovations having made recharacterizations of income easier. He mentioned globalization and the increasing dominance of services in modern economies as other potential factors, which, due to long-term contracts and the importance of intangibles, made manipulations easier.

It was also pointed out that agency costs might in some circumstances mitigate tax planning: Managers concerned about their personal reputation might not be willing to take risks in tax matters that a company's shareholders might not mind taking due to their diversified portfolios. The participant raising this point cited anecdotal evidence on companies that took rather risky business decisions and nevertheless were very risk averse in respect of tax issues. *Desai* replied that this would explain to a certain extent the fact that some managers refrained from using tax shelters and that it would also justify the special attention paid to the dealings of small businesses and self-employed taxpayers.

One participant was critical of the claim that the use of tax shelters by corporations was in principle against their shareholders' interests. He argued that the evidence cited by *Desai* in support of this allegation was not sufficient, as the sample of companies used by him was taken from companies that specifically had been found out engaging in book fraud. He also called attention to the fact that in the case of Enron, some of the tax sheltering that had taken place had not been book driven. Regarding corporate inversions, this participant also mentioned that cases existed (*e.g.* Tyco) in which stock prices even had risen, and that it was even more surprising that the change from Delaware corporate governance to, *e.g.*, Bahamas corporate governance had not actually decreased the stock price of the companies engag-

ing in such inversions. In more general terms the discussant would not have attributed the same importance in the evaluation of economic evidence to the book-tax gap as *Desai* had done and considered scrutiny of the companies' tax returns an important element of research in that field.

Another participant put forward that it would be advisable to substantially reduce the tax rates of the corporate income tax, instead abolish the Parent Subsidiary Directive and introduce high withholding taxes. He reasoned that it would be sensible if states received tax revenues at the same time as shareholders receive their dividends and that taking this step would reduce opportunities for tax avoidance as well. *Desai* replied that corporate income taxes still accounted for 8% to 12% of tax revenues in the United States and that they furthermore remained crucial as an instrument of fiscal policy. In this context *Schön* raised the question whether the degradation of capital income taxation was a realistic prospect. *Owens* replied to these comments by stating that abolishing the corporate income tax was politically not feasible but he conceded that it was the most expensive tax to collect. He also warned not to expect too much from a reduction of tax rates in respect of a decrease in tax avoidance as tax rates had declined substantially over the last 15 years and the incentive to minimize taxes nevertheless existed, even in low-tax countries such as Ireland.

Desai pointed out that the tendency to levy taxes at lower marginal rates was linked to the trend of states using broader tax bases. He also put forward that book profits would be a good starting point for broad tax bases. *Owens* also stated that it was important that tax bases can be reconciled with book profits, and that this was a crucial aspect of base broadening. In contrast, another participant commented on book-tax conformity by saying that the U.S. Congress would not allow accounting firms decide what is taxable income.

Desai explained that there was no clear economic evidence on the effects of book-tax conformity and that Germany was perceived by many authors as an example of conformity making financial statements less informative. He proposed analyzing the tax accounting rules of the Internal Revenue Code (IRC) and rectifying diversions from generally accepted accounting principles wherever possible. In his view the effect of the current IRC tax base represented a way of taxing different types of income differently by varying their treatment in the tax base while applying the same rate. Another commentator remarked that in Germany the tendency existed to move away from book-tax conformity.

Furthermore *Desai* called attention to the fact that corporate income taxes had historically been introduced in the United States in order to obtain more information on companies' activities. This aspect was further illustrated by *Schön*, who agreed that corporation taxes could play a helpful role as "certification taxes". In Germany, for instance, the activities of tax auditors had a positive effect on the accuracy of companies' books, especially in the case of small companies, which were not legally obliged to have their annual accounts audited.

Schön also stressed the fact that in cases such as Enron, the duty of managers to increase earnings by reducing taxes had conflicted with their duty of loyalty, which also encompassed a responsibility to maintain the transparency of their business

activities. *Desai* added that the intuition that tax planning shifted power away from the board to inside managers was supported by the experience from past scandals. For instance, the business of Tyco had been structured in such a complex way and with so many subsidiaries that hardly anybody had had a complete picture of the enterprise's activities. *Owens* perceived this as a proof that integrity was indivisible. Another discussant stated that the message in this to boards was that they had to "know their structure."

One participant emphasized the important role of managerial opportunism, especially in large companies, and reasoned that in the case of small and medium-sized enterprises, which represented an important element in many European economies, completely different issues might arise. *Schön* opined that managerial opportunism represented only one aspect of limited importance for aggressive tax planning and that also tax planning undertaken in the interest of shareholders should be taken into account.

Desai remarked that the influence of institutional investors on corporate governance was increasing. He cited the report of Henderson Global Investors, a large global institutional investor, on aspects of tax, risks and corporate governance as evidence for this trend. However, *Schön* reported that the author of this report was no longer employed by this company and that the relevant department had been closed down.

Several speakers addressed the role of disclosure. Most discussants deemed disclosure beneficial both for corporate governance reasons and in tax matters. However, one participant drew attention to the fact that disclosing facts on a company's business might clash with the necessities of competition. *Schön* highlighted that it was important to differentiate: while it was good in his opinion that tax risks were reported to shareholders and in this way were also put on boardroom agendas, he argued that this objective should not mainly be pursued in order to make life easier for tax authorities.

When asked to comment on the discussions from the perspective of a corporate governance expert, one speaker observed that differentiating between tax policy and tax administration was vital. In his view, it was not likely that tax policy makers would soon take the implications of tax issues on corporate governance into account. Regarding corporate governance structures, he called attention to the importance of accountability: managers had to be accountable to the board, and boards had to be accountable to the shareholders. In his view debates on internal control were currently centered too much on SOX 404, which was based on a very restricted standard of internal control set up for banking structures. On the broader stakeholder approach to corporate governance he commented that it might sound nice in theory, but in the end "accountability to everybody is accountability to no one."

When closing the Friday morning session *Owens* drew attention to two other current issues that deserved closer scrutiny: tax debt and non-corporate entities.

Part 2:

The Influence of Tax on Corporate Behavior

Financial and Tax Accounting: Transparency and "Truth"

*Judith Freedman**

In the USA there have been calls for greater conformity between the rules producing tax accounts and those used for financial reporting purposes. A number of benefits are claimed for this so-called "book-tax conformity", including reduced compliance costs and better opportunities for monitoring. In Europe, the debate around use of the financial accounts for tax purposes has arisen from a different conceptual starting point as well as differences in surrounding circumstances. Linkage between tax and financial accounts is common in Europe, although it takes varying forms. This does not result in complete book-tax conformity, however, and recent developments in accounting may be increasing divergence rather than reducing it. Despite the strong arguments in favor of conformity, there are also good reasons for some divergences, meaning that the most likely outcome in any system, whatever the starting point, is partial convergence. The problem with a hybrid outcome of this kind is that, at the point of divergence, there can be conceptual confusion and difficulties in integrating and managing two conceptually very different rule systems. Clarity of the relationship between the rules and improved accounting disclosure requirements might be more important than convergence, and might be achieved with less distortion to either tax or financial accounting. The current U.K. position is used to illustrate these points.

1. Introduction: Key Issues

It may seem logical to argue that having separate systems for financial accounting and for tax accounting leads to obfuscation and confusion and thus detracts from good corporate governance. Total convergence of accounting methods for both purposes might seem to promise an increase of transparency and to simplify compliance. There is a persuasive argument that, if there were a single method of accounting for tax and financial reporting, pressures to increase reportable profits for the markets on the one hand, and to minimize taxation on the other, might balance each other to create a healthy equilibrium in listed companies and produce a set of figures closer to "true" profits than results from separated systems.

Prima facie this is convincing, but there is a flaw. If total conformity could be achieved then some benefits might accrue, although other problems would arise as

* The author thanks the organizers and participants of the Symposium on Tax and Corporate Governance at the Max Planck Institute for Intellectual Property, Competition and Tax Law in Munich for the helpful discussion. She has also benefited from the Kari Tikka Memorial Lecture delivered by Professor Claes Norberg at the University of Helsinki in June 2007 and the debate which followed.

explained below. Most important, however, is the point that the most likely consequence of attempting to introduce book-tax conformity is partial rather than complete convergence. There is a danger that purported convergence with exceptions could be confusing. Separate rules could be preferable to a system that purports to integrate two sets of rules but does so without clarity. Far from removing opportunities for manipulation, the interaction of two systems based on very different concepts and cultures could increase the available opportunities for obfuscation. There might be issues about the scope of a specific tax rule and of the corresponding accounting practice, or concerning the applicability or interpretation of an accounting rule in a tax context. Each system might use "different criteria of validity, different forms of authority and different codes for deriving meaning from and assessing the value of information."[1]

Moreover, in the European context it is misleading to see the options and contrasts as being simply between financial accounting and tax accounts. This is because many jurisdictions have both national accounting standards and International Financial Accounting Standards (IFRS).[2] In other words, there may be divergence between different types of accounting standard as well as between tax accounting and financial accounting. There are always several possible ways of calculating a profit and the method adopted by the relevant standard will reflect policy choices made by the standard setters.[3] The differences in accounting standards have come to the forefront in the debate in Europe, due to the adoption of IFRS by the EU.[4] The result is that the U.S. and the European debates have a very different flavor. While a key issue in the USA is whether book-tax conformity would be an aid to improved corporate governance,[5] in most European countries the debate on the use

---

1 KING/THORNHILL, Niklas Luhmann's Theory of Politics and Law (2003).

2 IFRS as used here should be taken to include International Accounting Standards (IAS). The International Accounting Standards Board (IASB) publishes its Standards in a series of pronouncements called IFRSs. It has also adopted the body of Standards issued by its predecessor, the Board of the International Accounting Standards Committee (IASC). Those pronouncements continue to be designated "International Accounting Standards" (IASs).

3 MILLER, Accounting as Social and Institutional Practice: an Introduction, in: HOPWOOD/MILLER (eds.), Accounting as Social and Institutional Practice, 13 (1994).

4 The IAS Regulation (EC)1606/2002 was adopted on July 19, 2002 by the European Parliament and the Council (*see* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32002R1606:EN:NOT). It sets out a procedure for the adoption of IAS by the Commission and sets out the purposes for which the standards are to be used by companies in the Member States.

5 For some of the literature on this debate *see* KNOTT/ROSENFELD, Book and Tax: A Selective Exploration of Two Parallel Universes, pts 1 & 2, 99 Tax Notes 865 and 1043 (2003); DESAI, The Degradation of Reported Corporate Profits, SSRN working paper (2005) (available at http://ssrn.com/abstract=758144) and DESAI/DHARMAPALA, Tax and Corporate Governance: An Economic Approach, in this volume, at 13; HANLON/SHEVLIN, Book-Tax Conformity for Corporate Income: An Introduction to the Issues, NBER Working Paper No 11067 (2005); PLESKO/MILLS, Bridging the Reporting Gap: A Proposal for more Informative Reconciling of Book and Tax Income, 56 National Tax Journal 4 (2003); JOINT COMMITTEE ON TAXATION, Staff Report, Present Law and Background Relating to Corporate Tax Reform: Issues of Conforming Book and Tax Income (2006) (available at www.house.gov/jct/x-16-06.pdf#search=%22staff%20of%20joint%20committee%20on%20taxation%20book%20tax%20conformity%22); WALKER, Financial Accounting and Corporate Behavior, Boston Univ. School of Law Working Paper No. 06-05 (2006) (available at SSRN: http://ssrn.com/abstract=894002).

of accounting standards for tax purposes centers on the suitability of accounting standards as a method of defining the tax base; perhaps even as a mode of harmonizing the computation of taxable profits across Europe.[6]

In the U.K. there is considerable degree of conformity between tax and financial accounts but there are major exceptions, so that the ultimate position is one of partial conformity.[7] This gives scope for a gap between the profits stated for financial reporting purposes and the amount of tax actually paid. Whether and to what extent this is an indicator of avoidance activity is tied up with the vexing question of what amounts to tax avoidance and the extent to which tax avoidance (as opposed to illegal evasion) is undesirable and "unacceptable".[8] There are no official published figures in the U.K. on this "gap". The Tax Justice Network (TJN) reports that the U.K.'s fifty largest companies have paid an average of 5.7% less corporation tax than "expected rates" from 2000 to 2004, but much depends upon what is "expected" and some of the assumptions made are questionable. In particular the TJN refer to "excessive corporate tax allowances given to encourage investment in plant and machinery, resulting in high levels of deferred taxation".[9] Capital allowances (accelerated depreciation) are an example of the various express tax reliefs and incentives which are considered by most governments to be desirable in the context of their economic policies. Similarly, a recent report of the National Audit Office that around 220 of the U.K.'s 700 largest companies paid no tax at all in 2005-6 led to concerns expressed in the media that there were high levels of corporate tax avoidance.[10] Whilst this has some substance, the reasons for this might be, in part at least, that the companies concerned were benefiting from intentional reliefs and incentives. If some of the gaps arise from deliberate differences between the tax base and the definition of profit for financial accounting purposes, care must be taken in using this gap in too crude a way as a proxy for tax avoidance activity. The U.S. literature adopts more sophisticated methods for arriving at the book-tax gap, making adjustments for differences caused by differential treatment of depreciation, for example, but care is still needed in making assumptions about the reasons for any differences.[11]

---

[6] *See* SCHÖN, International Accounting Standards – A "Starting Point" for a Common European Tax Base?, 44 European Taxation 426 (2004); SCHÖN, The Odd Couple: A Common Future for Financial and Tax Accounting?, 58 Tax Law Review 111 (2005); FREEDMAN, Aligning Taxable Profits and Accounting Profits: Accounting Standards, Legislators and Judges, 2 eJournal Tax Research 71 (2004). *See* also the debate on a Common Consolidated Corporate Tax Base, discussed below.

[7] The U.K. system is described further below.

[8] For further discussion of this problem *see* FREEDMAN, The Tax Avoidance Culture: Who is Responsible?, in: HOLDER/O'CINNEIDE (eds.), Current Legal Problems 2006 (2007).

[9] TAX JUSTICE NETWORK, Mind the Tax Gap (2006).

[10] NATIONAL AUDIT OFFICE, HM Revenue & Customs Management of large business Corporation Tax, HC 614 Session 2006-2007, (The Stationery Office) July 2007; HOULDER, "One-third of biggest U.K. businesses pay no tax", Financial Times, August 28, 2007.

[11] For a much more sophisticated use of the book-tax gap to construct a proxy for tax avoidance in the USA, which attempts to isolate only that part of the book-tax gap not attributable to accounting accruals *see* DESAI/DHARMAPALA, Corporate Tax Avoidance and High Powered Incentives, 79 Journal of Financial Economics 145 (2006); DESAI/DHARMAPALA, *supra* note 5. The difficulties involved in producing these figures are discussed in depth in HANLON/SHEVLIN, *supra* note 5.

There may be good reasons why complete book-tax conformity cannot, and even should not, be achieved, as discussed below. Stronger disclosure requirements and better education of those who analyze accounts, so that any differences can be properly understood, might be a more fruitful way forward than arguing for greater conformity in the USA as well as in Europe.

2. Conformity of Financial and Commercial Accounts: In Search of "True Profit"

2.1 Conformity – The Issues

There are arguments in favor of alignment, based on simplicity and convenience. If there was only one profit figure and no adjustments were needed, compliance costs would be saved. These benefits would be significantly reduced if complete conformity could not be achieved, since some adjustments would then be needed and the simplicity of one figure would disappear immediately. There could be reductions in compliance costs in some areas if only one set of records was needed, and in relation to certain types of transaction where very complex records are required this may be an overriding consideration.[12] Overall, however, if there are good reasons for divergence of financial and tax accounts, arguments based on convenience should not be allowed to distort the tax base so that problems of another kind are produced, such as lack of equity or impracticality of collection.

The more fundamental arguments are those relating to the nature of profits and their definition. Underlying the views of those who would conform book and tax accounts is the notion that we can achieve an optimal definition of profit: one which brings us closer to "true economic profit" than other definitions. This is a questionable assumption, since the proper definition of profit depends to some extent on the purpose for which it is to be used.[13] Does the profit figure need to be historical or forward-looking? Is the business continuing as a going concern or is the issue its break-up value? In each case valuations will need to be carried out differently.

The objectives of commercial accounts and of tax accounts may well differ. Tax must raise revenue and do so equitably and efficiently as between taxpayers. These requirements point to the need for reasonably objective rules that take account of taxable capacity and administrative efficiency and provide a workable set of rules on the basis of which tax can be calculated and – importantly – collected. For example, to operate fairly and efficiently, it is often argued that a tax system must recognize ability to pay and subject the taxpayer to tax when it is most convenient to pay the

[12] In the U.K., many financial institutions have chosen to follow accounts for tax purposes in relation to hedging transactions even though they have been given a choice by the legislation to deviate from that treatment since it was thought by many to result in volatility which was not appropriate for taxation purposes. *See* text to note 64 below.

[13] *See* MILLER, *supra* note 3; HICKS, Maintaining capital intact: a further suggestion, Economica IX 174-79 (1942), cited in: MACDONALD, *HMRC v William Grant & Sons Distillers Ltd and Small (Inspector of Taxes) v Mars U.K. Ltd*: accountancy practice and the computation of profit, 2007 British Tax Review 366.

tax.[14] These concepts are linked to the realization principle, since without liquid assets there is an obvious difficulty in paying taxes. Whilst in a perfect market this problem of liquidity might be met by borrowing by the taxpayer against unrealized profits, in practice financing taxes in this way not only creates transaction costs but can also be risky as the value of the security for the borrowing may fall. For this reason, the realization principle seems more important for tax purposes than it is for accounting purposes, particularly as we move towards fair value accounting, as discussed below.[15] The volatility inherent in fair value accounting reflects volatility in the market and so, arguably,[16] should be reflected in the commercial accounts. It is less clear, both from the point of view of the taxpayer and the government, that it is sensible to tax on the basis of volatile accounts. In addition, tax accounts are affected by the facts that tax avoidance opportunities must be blocked and that governments may want to use the tax system to deter or incentivize certain behavior and for public policy purposes, for example in disallowing certain expenses.

Financial accounts, on the other hand, need to give a range of relevant and reliable figures to a variety of stakeholders. To achieve this, accounting standards often give guidance rather than detailed rules and make available a range of options to be applied according to the judgment of the company directors (advised by their auditors). Figures in accounts may be augmented by notes; a method which cannot assist in the case of taxation, where a definitive figure is required. IFRSs/IASs give primacy to the balance sheet rather than the profit and loss account: the profit and loss account looks set to disappear altogether.[17] This contrasts with the obvious needs of any tax system based on profit[18] to have a profit and loss account, which is charged on a periodic basis. It may be possible to carry losses or other allowances forwards and back from one period to another, but essentially each period is taken in isolation because taxation needs to operate in this way to be manageable. This means that tax accounts take an historical perspective and are concerned with the profits and losses in an (artificial but important) period.

In each case the differing objectives are perfectly valid, but the functions performed by the accounts for these two purposes dictate some differences, despite a central core of similarity. Further, in addition to the need to keep each system true to its objectives, it needs to be robust against any pollution by considerations more relevant to the other system. At present, international and U.S. accounting standard set-

---

[14] Adam Smith's Canons of Taxation, SMITH, The Nature & Causes of the Wealth of Nations, Book V, Chap. 11, Part II "Of Taxes", paras. 1-7.

[15] Deborah Schenk argues that the justifications for the realization rule are not as persuasive as has been thought, but even she agrees that there are valuation and political difficulties in taxing paper gains, making it difficult to abandon realization as a basis for taxation; SCHENK, A Positive Account of the Realization Rule, 57 Tax Law Review 355 (2004).

[16] Though some would argue not, *see* below.

[17] *See* WILSON, Financial Reporting and taxation: marriage is out of the question, 2001 British Tax Review 86; PATERSON, A taxing problem, 130 Accountancy Magazine 94 (11/2002).

[18] Of course it could be argued that a tax system based on expenditure or some other base would be preferable to one based on profit, particularly in view of the difficulties experienced in defining profit and locating it. Clearly then this issue of alignment would be seen very differently, but this is outside the scope of this article.

ters pay little regard to tax implications. They would be unlikely to take kindly to the suggestion that they needed to add this issue to the list of considerations and pressures they must take on board already.[19] Commercial accounting considerations could be distorted by tax pressures and this might have the perverse effect that even less information was released to the markets because those fearing tax consequences would oppose the establishment of standards that suited commercial purposes but that would result in a higher tax payment. A similar point is made by Hanlon and Shevlin.[20] They argue that in a U.S. context, conformity would result in greater control by Congress rather than the independent Financial Accounting Standards Board (FASB),[21] and that the conformed measure would be closer to the current measure of taxable income than the financial reporting measure, thus depriving the markets of information. This relates to an important constitutional point that will be discussed further later. Who is to control the tax base, the legislature or the accounting standard setters?

2.2 The Nature of Profits

The idea that a gap between taxable profits and book profits reveals tax avoidance activity, as discussed in the introduction above, suggests that book profits are somehow closer to the economic profits upon which tax should be paid than are the taxable profits. This is a questionable assumption given that the special rules for computing taxable profits have been devised to reflect policy decisions about what ought to be taxed. It is true that the U.S. literature on the implications of the book-tax gap has attempted to allow for that by removing certain differences such as depreciation, and still finds a residual difference, but it is very hard to be sure that that is not also the result, at least in part, of deliberate policy decisions about the tax base rather than exploitation of technical loopholes.[22]

It may also be the case that there are some areas where accounting standards can result in figures which are less reliable than tax figures. So, in a U.S. context, following the WorldCom and Enron scandals, the Wall Street Journal of January 29, 2003 stated that "Profits reported to the IRS, where firms have less discretion in making calculations, are considered to be closer to the truth [than financial accounting profits] …"[23]

Developments in accounting standards both in Europe and in the USA are attracting serious questions about the reliability of the figures being produced under new standards. Fair value accounting is particularly problematic and continues to be the subject of heated debate in the accounting world.[24] IFRSs require fair value account-

---

[19] WILSON, *supra* note 17; NOBES, A Conceptual Framework for the Taxable Income of Businesses, and How to Apply it under the IFRS, 38 (2003).

[20] HANLON/SHEVLIN, *supra* note 5.

[21] For details of the U.S. standard setting structure *see* KNOTT/ROSENFELD, *supra* note 5.

[22] *See* material cited *supra* note 11.

[23] Cited in PLESKO/MILLS, *supra* note 5.

[24] HUGHES, "What do users really want from 'fair value' accounting?", Financial Times, September 13, 2007.

ing, as opposed to historic cost accounting, in a number of areas, especially in relation to financial instruments, as do standards recently introduced in the USA.[25] Further work is under way, led by the IASB, to improve guidance and disclosures on fair value and for IASB and the Financial Accounting Standards Board in the U.S. to produce converged standards and so modifications may occur.[26] At present, however, the critics of the standards argue that fair value accounting leads to difficulties in measurement (where there is no market) and to volatility of profits.[27] Fair value accounting also has other curious consequences; for example, if the creditworthiness of a company falls, the market price of its bonds drops, so that these are written down in the balance sheet with a resulting profit in the profit and loss account, despite the fact that the company is still liable on the full amount of the bond.[28] Sir Michael Rake, the former head of KPMG and now Chairman of BT has urged standard setters to slow the pace of change and to be careful about rushing into fair value accounting, saying that

> "Moving to fair value is going to require a high degree of subjectivity, which will mean less direct comparability [between companies]."[29]

So, although the accounting profession has expertise in defining profit, it does not necessarily lead to universally agreed figures. Indeed in a report in November 2006 the Chief Executive Officers of the major auditor networks stated that "Today's rules can produce financial statements that virtually no-one understands."[30]

The fact that there is not one definitive set of figures representing "true" profit does not entirely deal with the argument that having one set of figures would be better than having two. It is arguable that some kind of middle way might be achieved through the balance of the competing pressures to ensure that financial accounts show high earnings and healthy balance sheets whilst tax accounts take a very prudent view of taxable profits. The hope would be that this would reduce avoidance opportunities[31] but the problem might be that the resulting composite set of accounts

---

[25] IAS 39; Statement on Financial Accounting Standards (SFAS) 157 and SFAS 159, effective for fiscal years beginning after November 15, 2007.

[26] IASB, Fair Value Measurements Discussion Paper (2006) (available at www.iasb.org/Current+Projects/IASB+Projects/Fair+Value+Measurements/Fair+Value+Measurements.htm).

[27] There was strong resistance to IAS 39 in Europe for this reason, spearheaded by French banks: MURRAY/CLARK, IAS 39, cash flow hedges and tax, 8 Financial Instruments Tax and Accounting Review 1 (2003); PARKER, "Compliance costs soar for new IAS rules", Financial Times, November 24, 2003. This forced an amendment of IAS 39 by the IASB to enable the European Commission to adopt the standard.

[28] HUGHES, *supra* note 24.

[29] HUGHES, "Former KPMG head calls for fix in system", Financial Times, October 11, 2007.

[30] *See* Global Capital Markets and the Global Economy: A Vision From the CEOs of the International Audit Networks (2006) (available at www.deloitte.com/dtt/cda/doc/content/dtt_CEOVision110806(2).pdf).

[31] This seems to be the assumption of the U.K. Government in their consultation papers on Corporation Tax Reform, supporting alignment: Inland Revenue and H.M. Treasury (2002) Reform of Corporation Tax (London); Inland Revenue and H.M. Treasury (2003) Reform of Corporation Tax, London.

might lose some of its efficacy both for tax and for financial accounting purposes. The resulting lack of information to the market and obfuscation of detail might actually open up avoidance opportunities instead of removing them.[32]

This is not to say that tax and financial accounting should operate in isolation from each other. The financial accounts will always be the starting point for taxable profits. There are justifiable differences, however, reflecting government policy and differences between the nature of the tax base and the informational purposes of financial accounting. Rather than arguing for conformity, which would then be the subject of exceptions so leaving the position unclear, it would be better to accept that there are differences and to make these explicit and rooted in established principles.

3. Trends and Developments: National Jurisdictions, the EU and IFRS

The financial accounts are a starting point when drawing up the tax accounts in any jurisdiction. Although systems vary, it is important not to draw too sharp a dividing line between different approaches or to be over-simplistic in the characterization of these systems. It is customary to divide European jurisdictions between those where there is dependence and those where there is independence.[33] In 1996, in a comparative study, Hoogendoorn reported a "clear recent development towards more independence between accounting and taxation" especially in Scandinavian and Eastern European countries.[34] At the same time, there have been some apparent movements towards greater dependence, in the U.K. for example. The overall movement seem to be towards partial alignment. The stereotypical extreme cases do not seem ever to have been entirely accurate and are becoming less so.

Given this move towards a middle way, three key questions arise. First, how and to what extent are the financial accounts modified for tax purposes? Secondly, which financial accounting standards are relevant for tax purposes and what difference is made by the adoption of IFRS? Thirdly, what are the constitutional implications of following accounting standards for tax purposes, whether they be national or international standards? These questions are distinct and yet intricately related.

3.1 To What Extent are Financial Accounts Modified for Tax Purposes and How?

Most countries, even the USA, which has the "most advanced separation between different sets of books",[35] have a residual rule that the commercial accounts will be followed if there is not a rule of some kind to the contrary.[36] Sometimes the modi-

---

[32] *See* HANLON/SHEVLIN, *supra* note 5.
[33] HOOGENDOORN, Accounting and Taxation in Europe- A Comparative Overview, 5 The European Accounting Review, Supplement 783 (1996).
[34] HOOGENDOORN, *id.*
[35] *See* SCHÖN, The Odd Couple, *supra* note 6.
[36] IRC § 446(a).

fying rule has to be statutory but in other jurisdictions, such as the USA, it can arise from the case law.[37]

In the past the U.K. was sometimes seen as an example of a jurisdiction where the approach was one of independence, but this was never the case and, arguably the element of alignment has recently been strengthened by statute and case law.[38] As discussed further below, the interesting issue in the U.K. now is to what extent, if at all, the commercial accounts are subject to principles of law *not* derived from statute. There have always been statutory differences between tax and commercial accounts in the U.K., but it was at one time thought that there might also be general principles of tax law to which commercial accounting was subject. There are some judicial statements to support this but also many which do not.[39] The starting point is certainly generally accepted accounting practice, which includes IAS/IFRS where these standards are being used.[40] There are, however, various statutory modifications. These range from fundamental differences in regime, as in the areas of depreciation and capital gains, to adjustments, as in the areas of financial instruments taxation or finance leasing.

In Germany, generally seen to be at the other extreme from the USA as a jurisdiction where there is a strong linkage, the close connection between commercial or financial accounts and tax accounts is manifested not only in the *"Maßgeblichkeitsprinzip"* which means that commercial accounting rues are binding for tax purposes but perhaps even more importantly on the *"umgekehrte Maßgeblichkeit"* principle, or reverse conformity, which allows tax rules to influence commercial accounts and results in very conservative profit figures for all purposes.[41]

Even in Germany, however, there has never been total conformity and Schön comments that the number of adjustments since the late 1990s has been increasing, often in an effort to increase revenue.[42] Similarly, in Sweden, which is sometimes classified as having strong linkage, certain types of asset, that is financial instruments and real estate, are taxed on a realization basis on capital gains tax principles, whilst other types of asset such as stock in trade, construction contracts, machines and equipment are covered by special tax rules.[43] In the Netherlands, on the other hand, where there is no formal link between tax accounts and financial accounts, the

---

37 *Thor Power Tool Co. v Commissioner*, 439 US 522 (1979) and *see* SCHÖN, The Odd Couple, *supra* note 6.

38 Discussed below.

39 For some cases where the courts have not followed accounting practice in assessing taxable income *see Minister of National Revenue v Anaconda*, [1956] AC 85; *Sharkey v Wernher*, [1956] AC 58; *BSC Footwear Ltd v Ridgway*, 1971 2All ER 534 (HL); *Willingale v International Commercial Bank Ltd.*, [1978] 1 All ER 754; however there is debate about the rationale for some of these decisions.

40 Section 42 Finance Act 1998 as amended by section 103 (5) 2002 Finance Act, section 50 of the Finance Act 2004 and section 25 of the Income Tax (Trading and Other Income) Act 2005.

41 HERZIG, Tax versus Commercial Accounting in Germany, in: THORELL (ed.), The Influence of Corporate Law and Accounting principles in determining Taxable Income, IFA Congress 1996, Vol. 21b (1996).

42 SCHÖN, International Accounting Standards, *supra* note 6; and SCHÖN, The Odd Couple, *supra* note 6.

43 NORBERG, Kari Tikka Memorial Lecture, EATLP Helsinki, June 2007.

Supreme Court ruled many years ago that commercially accepted methods of calculating profits are acceptable as methods of calculating taxable profit unless the spirit of the tax legislation suggests otherwise.[44] Once again this results in partial conformity. Here, as elsewhere, not only are there legislative modifications to financial accounts for tax purposes but also the courts play a role in interpreting the requirements of financial accounting and their relationship to the objectives of the taxable concept of "profit" or "income".

3.2 Which Accounting Standards?

In some jurisdictions the answer to the question of which accounting standards are to be used for tax purposes is straightforward. There may be only one set of applicable accounting standards, as in the USA, or it may be that IFRS are applicable only to consolidated accounts which are not used for tax purposes. In the EU, use of IAS has been mandatory for the consolidated accounts of all listed companies since 2005[45] but various options are in use in respect of unlisted companies and single company accounts.[46] In the U.K. and the Netherlands, to take two examples, all companies are permitted to use IAS for not only their consolidated accounts but also their individual accounts. Moreover in the U.K. there is a reducing difference between IFRS and domestic standards. A convergence program is under way and it is anticipated that IFRS based U.K. standards will be operative for the financial year commencing January 2009, although for small and medium sized companies there would be a simplified Financial Reporting Standard for Smaller Entities.[47]

In a very different mode, Sweden allows IAS to be used only for consolidated accounts. Germany permits the use of IAS for individual company accounts but only for the purposes of information, and national accounting standards continue to apply for tax law and profit distribution purposes. Clearly these different approaches mean that the impact of new accounting developments has differential effects. In the U.K. there is a need to confront the new approaches and consider whether they are appropriate for tax purposes,[48] whereas in dependence countries like Sweden, as Norberg points out, the consequence of new developments in IFRS is that the differences between consolidated accounts and annual accounts are increasing.[49]

This has the curious result in corporate governance terms that the accounts used for investor purposes are becoming *more* detached from those used for tax purposes in so-called dependence countries than they are in the U.K. The remaining focus on

---

[44] H.R May 8, 1957, BNB 1957/208; information taken from a questionnaire prepared by Dr. R. Russo of Tilburg University.

[45] *See supra* note 4.

[46] EUROPEAN COMMISSION: Table on use of IAS in the EU (2006) (*see* http://ec.europa.eu/internal_market/accounting/docs/ias/ias-use-of-options_en.pdf).

[47] ASB, Convergence of U.K. standards with IFRS (2006) (*see* www.frc.org.uk/asb/technical/projects/project0072.html).

[48] The U.K. revenue authority (Her Majesty's Revenue and Customs (HMRC)) has published guidance: "U.K. tax implications of international accounting standards" (*see* www.hmrc.gov.uk/practitioners/int_accounting.htm).

[49] NORBERG, *supra* note 43.

dependence in the former countries is not a form of alignment that would satisfy the U.S. critics of book-tax divergence. It simply produces single level company accounts that deviate from the consolidated accounts. This explains why the problem of dealing with new accounting standards may be seen as greater in the U.K. than in the so-called dependence countries and may also be a partial explanation of the wariness in the U.K. about the Common Consolidated Corporate Tax Base (CCCTB) proposed by the EU Commission.[50]

3.3 Constitutional Issues

In most of Europe and in the USA, one major concern about using accounting standard as a tax base relates to constitutional issues. This is not an issue which has caused major concerns in the U.K., where in its normal pragmatic way, the tax community and government seem to be largely unworried about the constitutional issues and the legislature has happily incorporated references to generally accepted accounting standards in the tax legislation, making it clear that this refers to international accounting standards where these are being used.[51] In the USA, the issue is one of significance, however. Knott and Rosenfeld write,

> "An aligned book-tax system would require one body to be the ultimate rulemaking authority. Raising revenue through taxation is such a fundamental governmental function that granting principal authority on measurement of taxable income to a private sector body such as FASB seems untenable".[52]

In many European jurisdictions likewise, the fact that the IASC is a private organization formed by the International Accounting Standards Committee Foundation, a not-for-profit Delaware corporation, not under any governmental control,[53] has raised concerns about the status of IFRS/IAS even for accounting purposes, despite the fact that there is a procedure to be followed before the EU adopts these standards. For tax purposes, it would seem impossible in many jurisdictions to follow these international accounting standards without approval by national parliaments.[54]

3.4 CCCTB

Views emanating from the European Commission on the use of international accounting standards as a means to achieve tax harmonization have shown some interesting twists over the past few years. In 2001 an EU Commission staff working paper saw globalization of accounting standards as a catalyst for the development of harmonized, but independent, tax accounting principles, stating that[55]

---

[50] That is not to argue that this is the only reason for U.K. opposition to the CCCTB.

[51] *See supra* note 40.

[52] KNOTT/ROSENFELD, *supra* note 5, at 1060.

[53] *See* IASB, About Us (available at www.iasb.org/About+Us/About+Us.htm).

[54] *See supra* note 4, and SCHÖN, International Accounting Standards, *supra* note 6.

[55] EU COMMISSION STAFF, working paper, Company Taxation in the Internal Market, SEC(2001) 1681, 322-324 (2001) (available at http://ec.europa.eu/taxation_customs/resources/documents/company_tax_study_en.pdf).

> "Generally, it is clear that there is no prospect of fully matching tax and financial accounting in the future… To the extent that tax accounting will develop independently from financial accounting, Member States will be obliged to find autonomous rules for tax accounting purposes. In looking for such rules there is an opening for co-ordination and co-operation to start with common base rules, instead of each of the Member States trying to pursue individual solutions."

Subsequently, however, the EU Commission formed the contrary view that globalization of accounting standards might be an opportunity for finding a common base for tax across the EU, with a starting point in accounting profits, but it always recognized that this was only a starting point and that some deviation was likely to be necessary.[56] In 2004, it proposed the use of IAS as a tool for designing a common consolidated tax base but stressed that the discussions should be guided by "appropriate tax principles" and that any such base, once established, would not be systematically linked to accounting standards as any further development would need to be driven by tax and not accounting needs.[57]

The Commission has now accepted that there can be no formal link between the proposed new CCCTB and IAS/IFRS. This is because, as explained above, many Member States do not permit the use of these international accounting standards for tax purposes. Thus companies would start from accounts prepared in accordance with a number of different national generally accepted accounting principles and then make adjustments towards the tax base as defined by the European Directive. This European base would make some references to IFRS/IAS but with many tax adjustments, so in each case the company concerned would need to adjust its individual company accounts to arrive at this base.[58] Thus we can see that, whether or not the CCCTB is a worthwhile experiment in the use of accounting ideas to move towards a harmonized tax base in Europe, it is not going to produce one set of accounts for all purposes. In fact in some jurisdictions the move will be towards three sets of accounts: consolidated accounts based on IAS/IFRS; individual company accounts based on national generally accepted accounting practice, and the CCCTB accounts. It is hard to see how this will improve simplicity or transparency, unless the hope is that it will result in modification to national generally accepted

---

[56] For example the European Commission in its proposals for a consolidated tax base: *see* European Commission Consultation Document, The application of International Accounting Standards in 2005 and the implications for the introduction of a consolidated tax base for companies' EU-wide activities (2003) and EUROPEAN COMMISSION, Summary report on results of consultation (2003) (both to be found on www.europa.eu.int/comm/taxation_customs/taxation/consultations/ias.htm); Communication from EU Commission (2003) (COM 2003 726 final) An Internal Market without company tax obstacles: achievements, ongoing initiatives and remaining challenges (*see* http://europa.eu.int/eur-lex/en/com/cnc/2003/com2003_0726en01.pdf).

[57] Commission Non-Paper to informal Ecofin Council, September 10 and 11, 2004, A Common Consolidated EU Corporate Tax Base (*see* http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/common_tax_base/CCTBWPNon_Paper.pdf).

[58] European Commission CCCTB Working Group, Possible Elements of a Technical Outline, CCCTB/WP057\doc\en, July 26, 2007 (available at http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/common_tax_base/CCCTBWP057_en.pdf).

accounting practices. It should be noted that the individual company accounts will have uses in some jurisdictions related to distributions as well as to taxation. Thus the comment by Desai in his testimony to a U.S. Senate Committee that the European Union is contemplating "aggressive conformity of tax and accounting rules" perhaps oversimplifies the position.[59]

4. The U.K. – Problems with Partial Conformity

4.1 Current Position

There is now a considerable degree of conformity between tax and financial accounting in the U.K., but there are many instances of statutory divergence. The U.K. has a separate system entirely from income tax for capital gains and this is governed by special statutory rules rather than accounting practice.[60] Depreciation is also dealt with by completely separate tax provisions.[61]

For corporations there has been some movement away from the capital/revenue divide and towards accounting practice, especially in the area of loan relationships, derivatives and intangible fixed assets, but the fundamental distinction remains.[62] Even where there is legislation based on accounting practice there are some deviations from accounting practice for tax purposes; for example if the accounting practice is not considered to be sufficiently robust to prevent tax avoidance.[63] Thus new divergences are created from a starting point of conformity.

Alternatively the legislation may require conformity with accounting standards but it may then be decided to permit deviations because conformity turns out to be inappropriate. For example, IFRS hedge accounting has proved to be unsuitable for tax purposes because IFRS follows a mixed model; using fair value for some assets and some not. There can be an accounts mismatch despite the existence of a commercial hedge and the hedge accounting rules in IFRS do not cover every case. Since the changes go to the profit and loss account, this can prove problematic. Therefore, tax rules were introduced to reduce tax volatility by disregarding fair value move-

---

[59] Testimony of Mihir A. Desai before the Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, U.S. Senate, June 5, 2007 (*see* www.people.hbs.edu/mdesai/DesaiTestimony060507.pdf).

[60] The Taxation of Chargeable Gains Act 1992.

[61] Capital Allowances Act 2001. Accounting standards are also irrelevant to tax deductions for share based payments as these are governed by specific legislation in Schedule 23 Finance Act 2003.

[62] Corporate debt and currency accounting (Finance Act 1996 as amended by Finance Act 2002); derivatives (Schedule 26 Finance Act 2002); intangibles (Schedule 29 Finance Act 2002). *See* MACDONALD/MARTIN, Taxing Corporate Gains: Proposals for Reform, 2005 British Tax Review 628, for proposals to further align capital gains taxation with corporation tax. These proposals have not been adopted to date.

[63] For an example *see* the Finance Act 2006 definition of funding leases which goes beyond the accounting definition of finance lease: CARSON, Traditional Equipment Leasing, The Tax Journal, October 23, 2006, 11.

ments on certain contracts for tax purposes.[64] However it was then found that these special tax rules created compliance costs for some taxpayers, who preferred to use IAS despite its flaws rather than keeping special records and so these taxpayers were then permitted to elect out of the special tax rules. Hence, from a position of conformity, a very complex situation arose in which taxable profits might or might not diverge from financial profits, depending upon a taxpayer election. Despite the appearance of greater conformity, neither full alignment nor simplicity has been achieved.

In the case of statutory deviations, the position may be complex but at least the rules are stated. The situation is more complex where case law is concerned. Most of the text books will now take their starting point on the question of conformity as being section 42 of the Finance Act 1998 as amended. This states that

> "…the profits of a trade, profession of vocation must be computed in accordance with generally accepted accounting practice, subject to any adjustment required of authorized by law in computing profits for those purposes".[65]

Generally accepted accounting practice is defined to mean IFRS/IAS, where a company is making up its accounts in accordance with IAS, and U.K. generally accepted accounting practice (GAAP) in other cases[66] but, as explained above, these standards are converging in any case.

Clearly the provision permits statutory modification of accounting standards for tax purposes, but the extent to which case law can provide such modifications is unclear. Section 42 was not supposed to alter the law,[67] but even before it was introduced the evidential value of formally decided accounting standards was becoming increasingly persuasive[68] and the statutory statement of the position has supported the view held by many that the U.K. had reached a position in which accounting standards would always be followed, subject only to statute. To many commentators this position now seems to have been confirmed by the decision of the House of Lords in *Her Majesty's Revenue and Customs* (*HMRC) v William Grant & Sons* and *Small v Mars U.K. Limited* (here together called the *Mars* case), but even a strong supporter of the view that there are no general principles of tax law with the power to modify accounting standards has expressed his doubts about the solidity of this position in the long term.[69] Thus, Graeme MacDonald in a note on the *Mars* case states

---

[64] The Loan Relationships and Derivative Contracts (Disregard and Bringing into Account of Profits and Losses) Regulations 2004 (SI 2004/3256) as amended.

[65] For a more detailed history of the introduction of this provision *see* FREEDMAN, *supra* note 6.

[66] Finance Act 2005 s. 50.

[67] Explanatory Notes to clause 42 Finance (No 2) Bill 1998 (but note that this is unlikely to be taken into account by the U.K. Courts under the rules of statutory interpretation).

[68] *See Gallagher v Jones* [1993] STC 537; other cases discussed in FREEDMAN, *supra* note 6. For a contrary view *see* FREEDMAN, Ordinary Principles of Commercial Accounting – Clear Guidance or a Mystery Tour?, 1993 British Tax Review 468.

[69] [2007] UKHL 15.

"…it does seem from both Lord Hoffmann's interpretation of section 42 and from the dicta that it is said to codify, that intervention in GAAP profit computation can only be justified by statute. Nevertheless, can we really conclude from this that the Courts will never develop constraints on the application of GAAP in computing taxable profits?"[70]

It is noteworthy that the case of *Mars* was only decided after a lengthy progression through the courts and that, although the court of first instance (the Special Commissioners) found for the taxpayers,[71] the distinguished judges in the High Court in *Mars* (an English case)[72] and the Court of Session in *William Grant* (a Scottish case)[73] found for HMRC. It was HMRC which was arguing that accounting practice should not be followed in this instance. Ultimately they lost when the cases were re-joined in the highest court, the House of Lords, but the lack of a common view amongst distinguished members of the judiciary does suggest that there is still going to be scope for argument over the application of accounting standards. It will be hard for the judiciary to deny themselves a jurisdiction, especially when the issue is one of statutory interpretation or interpretation of a contract, or the characterization of a relationship or the nature of an asset – whether it is capital or revenue for example.[74] Thus although the courts may state that they will follow accounting practice, it will continue to be for them to decide what amounts to a correct application of such practice within a tax context.

To understand this debate it is necessary to look back at some previous case law.[75] The suggestion that there might be some general principles of tax law reached their height in the 1970s. So, according to Lord Reid in the House of Lords in *BSC Footwear v Ridgeway*[76]

"The application of the principles of commercial accounting is, however, subject to one well established though non-statutory principle. Neither profit nor loss may be anticipated... But it is admitted that this matter is not governed by any rigid rule of law. It depends on general principles which have been elaborated by the courts for the purpose of ensuring that so far as practicable profits shall be attributed to the year in which they were truly earned."

Note that even this statement of a principle denied the existence of rigid rules of law, so that if there was a principle it was one susceptible to change. Nevertheless the

---

[70] MACDONALD, *supra* note 13.

[71] [2004] STC (SCD) 253.

[72] [2005] STC 958.

[73] [2006] STC 69.

[74] For some examples of such cases *see* FREEDMAN, *supra* note 6. On the question of the capital/revenue divide being a question of law *see* the unequivocal statement of Lord Denning in *Heather v P E Consulting Group Ltd*, [1972] 48TC293: "The courts have always been assisted greatly by the evidence of accountants. Their practice should be given due weight; but the courts have never regarded themselves as being bound by it. It would be wrong to do so. The question of what is capital and what is revenue is a question of law for the courts. They are not to be deflected from their true course by the evidence of accountants, however eminent".

[75] For a detailed account of the older cases *see* FREEDMAN, Profit and Prophets – Law and Accountancy on the Timing of Receipts, two parts, 1987 British Tax Review 61 and 104.

[76] (1972) 47 TC 495 (Lord Reid, dissenting, but not on principles).

House of Lords in *BSC Footwear* (although not in the end Lord Reid, who dissented) did refuse to follow accounting evidence. They supported a system of stock valuation which they saw as being less artificial and unreal than the one used by the taxpayer for financial accounting purposes, but this was before the days of fully formulated and institutionalized accounting standards. It is interesting to note also that the House of Lords in *BSC Footwear*, sitting in May 1971, did not have put to them a comment that has been made in the High Court (a lower court in the hierarchy) in November 1970 in *Odeon Associated Theatres Ltd v Jones*[77] by Pennycuick VC. This judge is often quoted as stating that

> "The concern of the court in this connection is to ascertain the true profit of the taxpayer... In so ascertaining the true profit of a trade the court applies the correct principles of the prevailing system of commercial accountancy... At the end of the day the court must determine what is the correct principle to be applied."

Pennycuick VC also stated, however, that he was unable to accept the suggestion that the Court must ascertain the profit of a trade on some theoretical basis divorced from the principles of commercial accountancy, which he said was an entirely novel contention. Unfortunately the House of Lords did not get the chance to comment on that point in *BSC Footwear*, but Lord Hoffmann revived it with his approval in the *Mars* case in the House of Lords. Relying on this, he roundly rejected the view that there have ever been fundamental principles of accounting additional to the best practice of accountants.[78] Nevertheless he did not go so far as to say that the courts will always follow an accounting standard. For those who were hoping for a thorough analysis of the legal position, the *Mars* case is a disappointing one, dealing briefly with the issue and not commenting upon the older cases.[79] It must be doubted now whether cases such as *BSC Footwear* and *Minister of National Revenue v Anaconda*[80] (where the courts rejected the use of LIFO for tax purposes in the U.K.) *would* be decided in the same way today.[81] Almost certainly greater weight would be placed on the accounting practice now, since it would be more formalized and sophisticated. Nevertheless we do not have certainty on this point and it seems highly likely that professional advisers and HMRC will continue to argue for deviations where that suits their case.

---

[77] [1973] Ch 288, 48 TC 257 (Pennycuick VC at first instance).

[78] Lord Hoffmann at para. 15.

[79] As J. Collins and D. Dixon commented in COLLINS/DIXON, Open and Shut case?, The Tax Journal, April 9, 2007, 6, their Lordships made the case seem so simple that they left us with a real problem to understand why it ever got as far as it did; this suggests some over-simplification of the issues.

[80] [1956] AC 85.

[81] Following this decision, LIFO was rarely considered to be good accounting practice either: contrast the U.S. where LIFO appears to have been used for tax reasons and attempts to limit this by a statutory conformity requirement failed because everyone accepted that this figure would be tax driven and accounts provided additional information in other ways; *see* SHAVIRO, The Optimal Relationship between Taxable Income and Financial Accounting Income: Analysis and a Proposal, NYU Law & Economics Working Paper No. 07-38 (2007) (available at http://ssrn.com/abstract =1017073).

4.2 The Problems with Partial Conformity

In the long run, the importance of *Mars* may lie not in the apparent statement of conformity by their Lordships but in the way it reveals the difficulties inherent in *partial conformity*. One of the difficulties in the case can be seen to be the problems experienced by the courts in understanding the intricacies of accounting and by those giving accounting evidence in understanding the way a lawyer would look at the facts.[82] The simplified way in which the House of Lords eventually dealt with the decision is a reflection of this and was an entirely predictable outcome according to systems theory. The accounting evidence needed to be internalized into a form of legal methodology, which follows what the courts understand as good accounting practice.[83] The analysis of the accounting standards derives from the accounting evidence but is translated into a narrative which interweaves statutes, cases and accounting standards and is transformed into a version of accounting practice understood from a legal perspective.

What was not brought out in the case at any level of the hearings, or in the commentary so far, is the fact that this was not a case about achieving conformity at overall. It was about the management of non-conformity, or partial conformity. The case related to depreciation in the financial accounts and it was agreed by all that this had to be added back into the tax accounts at some point, so conformity overall was not the aim. Allowances for capital expenditure for tax purposes are available under the Capital Allowances Act 2001 which is completely separate from accounting depreciation. The question was when the accounting depreciation should be added back in for tax purposes (or perhaps when it should be treated as having been deducted), so the issue was one of timing only and not *whether* an amount was taxable or not in the long run. In the end this may be seen as the central reason why the taxpayer won. The problem was one of the interaction of the statutory prohibition of deduction of depreciation for tax law purposes with accounting practice.

It was accepted by both sides in the case that U.K. GAAP provides for the inclusion of depreciation as an overhead cost in valuing stock. Thus, applying proper accounting practice, stock was valued at a cost figure which included an element derived from depreciation and this was the cost carried forward in the financial accounts.[84] To accountants (and ultimately to the House of Lords) it seemed obvious that the part of the depreciation cost carried forward as cost of stock had not been deducted in the year of the expenditure and so did not need to be added back in until the stock was sold and the deduction made. To HMRC, however, it seemed that the whole depreciation figure should have been added back in immediately. In their view, the part carried forward took on a different character as income once included

---

[82] The attempts of the lower courts to introduce their own analysis were subject to a considerable amount of criticism from accountants in the professional press but it was mainly accountants who commented and, arguably, they did not understand the legal perspective. *See* TRUMAN, Mars barred, Taxation, June 30, 2005; Accounts don't contain whisky, Taxation, October 27, 2005; WINGFIELD in The Tax Journal, April 12 and 19, 2004 and April 25, 2005.

[83] KING/THORNHILL, *supra* note 1, and *see* the discussion of systems theory in FREEDMAN, *supra* note 6, at 96 and below.

[84] Statement of Standard Accounting Practice 9 and 12 and Financial Reporting Statement 15.

in the cost of stock.[85] The view of the High Court judge in the U.K. and the majority of the Court of Session in Scotland was that the statutory prohibition on deduction overrode accounting practice. As Lightman J put it

> "It is not to be expected that Parliament intended that (save as expressly provided) any sum deducted in respect of depreciation should avoid being added back merely because it was reflected as an item of cost in the figure shown for stock."[86]

To Lightman J this was a question of statutory construction and therefore one of law and not accounting, as was the conversion of the depreciation cost into an income cost, issues of capital and income being clearly a question for the courts,[87] but to the accountants[88] and eventually to the House of Lords, the decision as to what had actually been deducted was a question of accounting principle. To them the amount carried forward had not been deducted and so could not be added back. The lawyer representing HMRC in the *Mars* case argued that it was relevant to consider the capital allowances legislation. Capital allowances were given without any reduction for depreciation carried to stock and so the add back should be for the full amount of the depreciation.[89] This argument, which attempted to look at the accounts and tax legislation as a whole, was not remarked upon by the House of Lords. In one sense this was understandable, because the capital allowances legislation is quite separate from the question of stock valuation. The outcome in the House of Lords is widely considered to be correct on the facts. On the other hand, the decision to follow the financial accounts for tax purposes in one respect whilst it does not govern depreciation more generally results in difficulties at the point of interaction as shown by this case and does not produce conformity or a simple relationship between the tax accounts and the financial accounts.[90]

This phenomenon can also be seen in other cases also involving the capital/income divide. In *Gallagher v Jones*,[91] although the court purported to be following the accounting standard for finance leasing, part of that standard – the element which regarded a proportion of rental payments to be capital rather than income – was ignored. This was accepted without argument so that the relevant standard (SSAP 21) apparently applied in so far as it applied to timing, but not in relation to the recharacterization of a revenue payment as capital.[92] A fuller (although still not

---

85 As explained by Lightman J [2005] STC 958 at para. 39.

86 [2005] STC 958 at para. 36.

87 *See supra* note 74.

88 *See* TRUMAN, *supra* note 82.

89 [2004] STC (SCD) 253 at para. 267.

90 Similarly in the case of *Gallagher v Jones*, accounting standards were in fact followed only in part – *see* FREEDMAN, *supra* note 68.

91 *See supra* note 68.

92 *Id.*, at 544, line h. In another case dealing with the conversion of rental payments into a capital lump sum by way of assignment, the entire question was treated as one of law, to the surprise of the dissenting judge in the Court of Appeal, Arden LJ, who thought that the accountancy treatment was a relevant consideration: *IRC v John Lewis Properties*, [2003] STC 117. Legislation has not introduced a solution to the issue addressed in that case which comes close to the accounting treatment.

complete) alignment with accounting practice had to be achieved subsequently by legislation to produce a coherent solution.[93]

The consequence of this partial conformity with accounting standards is that there is no certainty about when the courts will decide that a matter falls within their jurisdiction and when they will follow accounting practice, as we can see from the very different views of the judges at different levels in the *Mars* case as just one recent example. The direction from Lord Hoffmann in the House of Lords suggests that only legislative qualifications of accounting practice are likely to be considered valid, yet this was not fully explored and the older cases may yet be raised up by taxpayers or HMRC in the future. Even if a legislative provision stated expressly that only statutory deviations from accounting practice would be permitted, this would be unlikely to bring an end to the uncertainty, since issues of interpretation and scope would still arise and the courts would still be inclined to find points of law on which they could opine. As now though this would be a partial exercise resulting in a hybrid system. Thus there would be a tendency for the courts to seize back jurisdiction by finding that the accounting standard was not applicable to the situation or by converting the issues into ones with which they were familiar, such as the capital/income divide, as discussed above, or a contractual or legal ownership question. This might be done by finding that there was an issue as to the nature of a payment for tax purposes which must be decided as a pre-requisite to deciding whether or not the accounting standard applies at all.[94]

5. Conclusion and Issues for the Future

It has been argued here that full convergence of commercial and tax accounts will not be achieved and should not be the aim. Convergence with adaptations to take account of necessary differences might seem to be a sensible compromise, but this will bring with it its own difficulties as systems which have apparently similar objectives and use similar language in fact are based on different principles, making interaction problematic. In particular, any notion that there is one true "profit" figure will be an unhelpful over-simplification. Systems theory suggests that integration of the tax and accounting systems is not possible; they are separate "closed" systems which inevitably see things differently and this needs to be recognized in policy formulation.[95] "All that one system is able to achieve is an internalization according to its own 'way of seeing' of what it understands from the communications of the other system".[96] As can be seen from the decided cases, the interaction of two very different systems will result in a tendency for the courts to simplify accounting principles in order to absorb them into a legal decision making process.

---

[93] Finance Act 2006, Schedule 8 amending Capital Allowances Act 2001.

[94] For examples of such a response under the present system, *see*, in addition to *Gallagher v Jones*, the cases on "judicial gap filling" discussed in FREEDMAN, *supra* note 6, at 87 *et seq.*

[95] KING/THORNHILL, *supra* note 1, at 26-27; NOBLES/SCHIFF, A Sociology of Jurisprudence (2006).

[96] KING/THORNHILL, *id.*

A judicial decision needs to give a definitive, one figure answer to questions that in accounting terms may be dealt with in a more nuanced way by use of a package of figures and notes to the accounts. In picking and choosing issues on which they will follow accounting practice as they see it, the courts may fragment the overall picture, and this process, combined with statutory modifications to the commercial accounts for tax purposes, is highly unlikely to produce conformity, transparency or simplicity.

Despite a starting point of conformity in many European countries, in practice there is considerable statutory divergence and this is likely to increase rather than decrease if national accounting standards used for tax purposes follow the path of IAS/IFRS in the use of fair value accounting and other developments that are not easily applicable to taxation. Countries in which individual company accounts as used for tax and company law purposes vary from IAS/IFRS may not experience this difficulty, but their individual company accounts will then not be aligned with their consolidated accounts which, at least in the case of listed companies, will be made up according to IAS/IFRS. In the U.K., where use of IAS/IFR is already permitted for individual company accounts and where U.K. accounting standards are converging with IAS/IFRS in any event we see a starting point of convergence but many examples of divergence. Issues are arising about the point at which questions of law about the nature of receipts and expenses might interact with the application of accounting standards. Yet further complexities will arise should issues of interpretation of IAS/IFRS reach the European Court of Justice, as well they might now these have been adopted at European level. Should the CCCTB be implemented, there will be yet another layer of accounts which will follow IAS/IFRS in part but not completely and further issues of interpretation for the ECJ.[97] There is little evidence that Europe is moving towards a simpler system.

In the United States, as we have seen, there are calls by some for greater conformity in order to prevent tax avoidance and the manipulation of financial accounting income. Desai and Dharmapala suggest that there exists a relationship between aggressive tax sheltering activity and diversion of corporate profits from shareholders and that the opportunities for this could be decreased by book-tax conformity and greater transparency.[98] For the reasons explained here, it is not clear that a sufficient degree of conformity could be achieved to ensure the lack of divergence that would be necessary to remove these opportunities and it is very unlikely that the degree of simplicity these writers hope for would be attained; at least this has not been the result in the U.K., where complexity remains and there

---

[97] It has been suggested that a specialist court at EC level might be needed to deal with interpretations of accounting standards: Philip Baker QC at the CCCTB Conference organized by the German Federal Ministry of Finance in cooperation with the ZEW Centre for European Economic Research and the Max Planck Institute for Intellectual Property, Competition and Tax Law in May 2007.

[98] DESAI/DHARMAPALA, *supra* note 5; DESAI, *supra* note 59.

still seems to be a gap between taxable and financial accounting profits that is not always easy to explain.[99]

If the standards regulating financial accounts are designed to bring as much information to the market as possible then this must be good for corporate governance and it is not desirable to muddy the waters by insisting on conformity with the tax accounts. Nevertheless, if there are large differences between book and tax accounts which cannot be explained in terms of deliberate divergences in the rules there are governance concerns of the type described by Desai and Dharmapala. Greater disclosure of information from the tax accounts might be necessary to enable the authorities, analysts and researchers to investigate this.

There are various routes to achieving this.[100] There could be greater or better disclosure to the tax authorities (in the USA through improvements to the Schedule M-3),[101] there could be increased disclosure of tax information to the public or to agencies regulating the securities markets or there could be inclusion of increased disclosure in financial reports with respect to book-tax differences.[102] The Securities and Exchange Committee (SEC) and the U.S. Treasury have expressed doubts about the value of disclosure of the entire voluminous tax accounts, largely on the grounds that the complexity and length of them made them of limited value to the authorities, although potentially useful to competitors. They believe that specific information is more useful and this can be requested by the SEC if necessary.

Elsewhere, the effective tax rate is sometimes used by revenue authorities as one measure of tax compliance and this requires examination of the relationship between the tax and financial accounts, the effective tax rate of corporations being the corporation tax liability declared as a percentage of pre-tax company profit. This measure is already used in Australia and Canada and the U.K. National Audit Office has recommended that HMRC should

---

[99] *See* SHAVIRO, *supra* note 81, who considers the difficulties created by conformity make it inferior to partial conformity. By this he means, however, a form of partial conformity, this would not be based on altering the detailed rules for profit computation but would take the form of an adjustment of the final figures. This is a practical proposal to address the tax avoidance problem although the rationale is not entirely clear. If it is reasonable to have a tax base which differs from the financial accounting base, why should it be justifiable to have an adjustment? *See* also MCCLELLAND/MILLS, Weighing Benefits and Risks of Taxing Book Income, 2007 TNT 35-61, Special Reports.

[100] HUBBARD (panel member), Presentation on Tax Accounting versus Commercial Accounting, IFA Congress 2006.

[101] KNOTT/ROSENFELD, *supra* note 5, Part II, discuss the issues of publication of tax returns and the Schedule M-1 reconciliation of book and tax accounts. *See* also MANZON/PLESKO, The Relation Between Financial and Tax Reporting Measures of Income, 55 Tax Law Review 175 (2002); LENTER/SLEMROD/SHACKLEFORD, Public Disclosure of Corporate Tax Return Information: Accounting, Economics and Legal Perspectives, 56 National Tax Journal 803 (2003).

[102] There are already requirements to account for uncertainty in relation to tax positions under FIN 48.

> "assess the usefulness of monitoring businesses' effective tax rates over time, as an indicator of potential compliance risk behaviour and to develop better understanding of the drivers behind those rates."[103]

The differences between the financial accounts and the tax accounts may be based on a good rationale. If so, any cost resulting from having two separate figures is likely to be outweighed by the benefits of providing appropriate information and figures for the different stakeholders in question. If the differences in the accounts are not based on reason but on some form of manipulation, the answer seems to lie in ascertaining the causes of this and changing whichever set of rules is inappropriate for its purpose. The best way to discover why the differences are arising is by improving transparency and disclosure. The existence of two systems side by side will result in complexities and issues of interaction. It should not be assumed that this interaction can be managed without legislation, nor that it will be simple, even where there is an initial presumption of convergence.

[103] NATIONAL AUDIT OFFICE, *supra* note 10.

Taxation, Accounting and Transparency: The Interaction of Financial and Tax Accounting

Martina Baumgärtel

1. Introduction

In the last years, economic areas have constantly moved together. As a consequence, companies, especially the big players in the markets, have headed towards using the international capital markets and to get access to stock exchanges in different jurisdictions. As a prerequisite, the prevailing international accounting standards, be it IFRS and/or U.S. GAAP, have to be followed. On the other side, as tax legislation is still "local" and not harmonized, the companies always have to look for getting the best tax environment they can for carrying on their businesses. The following article tries to summarize shortly the influence of internationalization on taxation and accounting in general and with regard to transparency of tax effects in the international accounts in particular. As a consequence of more transparency, it is important to be aware of possibilities and boundaries of existing influences on the tax rate as well and to clearly define a framework for tax planning, which not only is in line with legal requirements, but as well with ethical standards, as each individual company cannot afford loosing its good reputation.

2. Taxation and Accounting – Two Different Worlds ?

2.1 *Status Quo*

As taxation is still local, multinational corporations have to align business opportunities and needs with finding the suitable tax environment for doing business and structuring their business activities. Needless to say that national and international rules of allocating profits have to be taken as unchangeable preconditions, but nevertheless tax planning is crucial. It is not the local tax rate, but the effective tax burden that in the end really counts, taking always the tax bases as well into account. And there is still flexibility how to structure the business activities, *e.g.* with regard to setting up the whole group structure, financing, choosing the appropriate legal form. Taking the complexity of the local tax systems and the shortcomings of the existing double taxation treaties, the avoidance of double taxation is one of the most important goals in this context – and it is clearly not getting to tax-exempt, nowhere taxed "white" income. There is no doubt: The key objective for tax planning is to support business. Each business decision has to make sense without a look at the tax burden. However, if a business decision is taken, the most efficient structure from a tax point of view has to be chosen.

From the view of a global player, and as tax rates are only rough indicators for the effective tax burden, the political demand with regard to taxation at least medium

or long term should clearly be world-wide harmonization of the tax systems. Then, a fair tax competition via tax rates, not via complex and non-transparent tax bases would be carried out. Therefore, the industry highly welcomes the thoughts of the EU Commission towards a Common Consolidated Corporate Tax Base (CCCTB). Even if this CCCTB is restricted to Member States of the European Community, it would be a big step forward. Unfortunately it looks as if a lot of the EC countries take this approach not too serious, as tax revenues might be threatened. But this shows clearly the necessity of a CCCTB: If companies were taxed on their EU-wide consolidated income, *e.g.* taxes on non-realized profits arising as a consequence of intra group transactions would be avoided. Transfer Pricing adjustments which very often lead to double taxation would be at least within the EU obsolete. The reluctance of some Member States even proves the necessity: taxation should always and only be based on profits realized through a market transaction.

2.2 Outlook

Fortunately enough, the jurisdiction of the European Court of Justice might put pressure towards harmonization: As the Court takes the basic principles of the Internal Market very serious, the Court puts always emphasis on basic Community Law, especially on non discrimination of EC residents, free movement of capital and freedom of establishment. As a consequence, a lot of restricting national tax laws have already been challenged. Especially with regard to cross border transactions, this jurisdiction will lead by itself on the long run towards a forced harmonization. Therefore, it would from this point of view as well be in the interest of the EC Member States to actively support the EU Commission towards a joint tax jurisdiction.

In this context, it is fair to say that some taxation principles have definitely to be taken into account, even if this might be self-evident: Taxation must always be based on the individual ability to pay taxes. In Germany, this principle is even anchored in the Constitutional Law. As a consequence, taxes should only be levied on realized profits. Mark to market valuation would generally not adequately reflect the ability to pay taxes, as the then potentially taxed unrealized gains are volatile. Taxation has to be based on net income, and not on substance. Business expenses must therefore always be wholly deductible. This means an unrestricted loss carry forward as well. Third, taxation has to be based on objective criteria, and the accruals principle has to be taken into account.

Additionally, avoidance of double taxation means avoidance not only of legal, but as well of economic double taxation. Therefore, *e.g.* dividends should be excluded from taxable income, as the underlying profits have already been taxed in the hands of the distributing corporation. The treatment of capital gains should always follow the treatment of dividends. Capital gains on the sale of participations should therefore be exempt as well, as they either represent already taxed retained earnings or hidden reserves which materialize and lead to taxes in the future.

From an accounting point of view, it is fair to say that some countries – by far not all – define their tax basis based on national GAAP (principle that the tax base follows accounting principles; *e.g.* Germany). However, there exists a tendency to

modernize the national GAAP and to integrate thoughts of international accounting, especially IAS/IFRS as well into this modernization. The same is true with regard to the EC Directives on the Accounts and Consolidated Accounts (4th and 7th EC Directive). If a modernization took place it is definitely sure that the modernization will be based on IAS/IFRS as well.

As, however, the targets of international accounting and taxation do not match, the principle that taxation follows accounting is always dependent on the underlying local GAAP and questionable in case of any changes with regard to these principles. Take as an example Germany: The national accounts have been so far suitable for taxation as the underlying principles have complied with taxation principles. Especially the targets of capital maintenance, protecting the rights of creditors and being the instrument to determine the possible dividend distributions have lead to a basis that complies with the ability to pay taxes as well. On the contrary, IAS/IFRS are rather a tool for information and take therefore unrealized gains as well into account. If the German accounting principles get modernized towards IAS/IFRS, then as a consequence the principle that tax follows accounting has at least partially to be given up. At least, each individual law has to be reviewed and evaluated according to its suitability for taxation.

A CCCTB must be based on similar views. First, IAS/IFRS can from a mere formal point of view never be taken as basis for calculating taxable profits. A democratic authorization of the IASB does not exist. Besides, *e.g.* Germany applies the principle of legislative sovereignty. Therefore, a transformation into national law would always be necessary. Taking IAS/IFRS as tax base would mean endless and ongoing processes of adapting the national law to changes in IAS/IFRS. Secondly, and more important, IAS/IFRS are from a material point of view in general not suitable either: The IAS/IFRS principles can lead to a taxation of unrealized gains, which is in contrast to the ability to pay taxes principle. They contain a lot of management judgments which contradict uniform tax treatment of all taxpayers as the tax basis would then depend on individual judgment. And partially, a taxation of mere profit projections would be the result. However, IAS/IFRS can be taken as starting point for taxation: Each standard should then be evaluated whether or not it is compliant with basic taxation principles. This judgment seems now to be consensus on EC level.

When describing the tax base, the EU Commission tends either to define a separate independent tax balance sheet law, or a separate set of tax rules that define the tax base not based on the accounts, but rather on profits and losses, with description of income, tax-exempt income, deductible and not-deductible business expenses.

At the moment, the EU Commission seeks a solution rather based on defining taxable profits and losses. This approach makes uniformity on EC level more likely; however, this approach is more difficult in application for the companies, as in the end they must calculate – if there are timing differences compared to accounting – deferred taxes as well. By filing a tax balance sheet control and substantiation of potential differences and the deferred tax assets/liabilities thereon is much easier.

3. Transparency of the International Accounts and Influence of Transparency on Tax Planning

3.1 Actual versus Effective Tax Rate

As the tax burden constitutes a cost factor to all business activities, the effective tax rate plays an important role for management, and not just the current tax payments have to be looked at. The local accounting principles, but much more IAS/IFRS and U.S. GAAP lead to showing the "right" tax burden, taking temporary differences between accounting and taxation as well into account, followed by numerous information on taxes. This transparency of the accounts further leads to analysts challenging the tax burden and management needs for explanations of the tax line. Thus, information that was only a decade ago due to the tax secrecy in a lot of countries confidential constantly becomes more and more public.

Take the concept of deferred tax assets and tax liabilities. Postponed or up-front tax payments due to differences in calculating taxable profits and losses which reverse over the time loose importance. These timing differences lead only to temporary tax savings/tax burden and as a consequence, a deferred tax liability/tax asset has to be accounted for. The accounts show in these cases the overall tax burden that would arise based on the accounts of the prevailing year (*i.e.* current taxes and deferred taxes).

An example for timing differences which lead to setting up a tax asset are write downs that are not at once acknowledged for tax purposes, but reverse over time. As current taxes are higher than the tax burden that matches with the accounts, a deferred tax asset can be set up. A deferred tax liability may result from reserves which are tax deductible according to national law, but constitute equity according to IFRS/U.S. GAAP.

According to international accounting principles, a tax asset on losses carried forward has as well to be set up: loss carry forwards lead to potential tax savings in the future, as the underlying net business expenses are therefore not lost, but can be used against future, not yet realized profits. However, the company has to examine the realization possibility of this tax asset, and in case that realization seems not/not fully realistic, make a total/partial valuation allowance.

Let me give two examples for permanent differences and their impact on the effective tax rate: Tax exempt dividends or capital gains lead to a tax rate below the actual tax rate in the prevailing country. The effective tax rate takes this into account. In case of additional profit distributions or capital gains that were not planned the effective tax rate is even lower than the expected effective tax rate. Interest expenses, which in some countries are not tax-deductible if in direct connection with tax-exempt income lead to a higher effective tax rate than the normal local tax rate. If refinancing is shifted to another location (*e.g.* debt push down), and the interest burden is in this country deductible, then the overall tax burden decreases.

Of course one has always to be aware of so-called quasi-permanent differences, *i.e.* differences that never reverse due to the prevailing individual situation of the company: As an example, the minimum taxation in Germany might lead to a situa-

tion, especially with regard to volatile businesses, that loss carry forwards can be used up in theory, but not in practice, as profits have always to be integrated to 40% in taxable income regardless of a still existing loss carry forward.

3.2 Disclosures and Notes to the Accounts

In the international accounts, an explanation of the main drivers of the effective tax rate (compared to the expected tax rate) is done in a so-called "reconciliation". As far as this information has to be disclosed (*e.g.* Form 20-F), this transparency leads to a deeper analysis and understanding of the tax situation, as well as of business decisions: *e.g.* in case of high tax-exempt income the analysts might assume that extraordinary (not operating) income was earned (*e.g.* additional profit distribution or additional capital gains).

In case tax assets on loss carry forwards are written down, this might be a consequence of too aggressive multi year plans in the past. However, it might also be the consequence of tax rate changes (*e.g.* the tax reform 2008 in Germany will lead to a write down on tax assets on losses and other temporary differences of around 25%), as the tax rate differential is 10% (40% to 30%). If the company that suffers the write down as a consequence of the tax rate decrease shows operating profits, this effect should then be interpreted in a positive way, as this means a lower tax burden in case of profitability in the future. Thus the hit has rather to be taken as a one time effect.

A write back on deferred tax assets on losses might have different reasons as well: It might be a consequence of overachieving on plans and targets and therefore higher taxable operating income. It might be the consequence of structures to use up losses, *e.g.* buying in of income or selling of loss carry forwards to external parties.

And of course, effects of tax audits might be open to the analysts in case of materiality as well. In this context, the question might arise, whether or not tax planning was too aggressive. The setting up of tax contingency reserves might also have quite different reasons: It can be an indicator for too aggressive tax planning, but as well of uncertain tax interpretation or change in jurisdiction.

3.3 Possibilities and Boundaries for Tax Rate "Management"

Of course, earnings as well as tax rate "management" is strictly forbidden. But with *e.g.* postponing or accelerating business decisions in cases where the tax treatment does not follow the accounting treatment, the effective tax rate could of course be influenced. *E.g.*, the decision to additionally sell tax-exempt stock might be taken shortly prior or after year-end, leading to effects on the effective tax rate in the old or new business year. Tax planning strategies, *e.g.* the sale of loss carry forwards – if possible –, might lead to a revaluation of tax assets and therefore to a lower effective tax rate. But companies always have to bear in mind that too aggressive tax planning might lead to high contingency reserves or tax expenses for prior years, yet alone perhaps interest on delayed tax payments.

In the insurance markets as well as in the hedge fund area, a market for insuring tax risks is currently developing. However, taking out insurance of tax risks – if possible at all – is very complex. First of all, the contracts and documentation behind

require a lot of thoughts, are technically complex and must reflect all possible risks – in order to avoid problems with the insurer afterwards. Second, the advantage of insuring tax risks is still questionable from the insurer's side. Offering insurance does only make sense if the insurer is more convinced than the insured that potential negative tax consequences do not arise. Otherwise, the premium could be as high as the discounted worst case scenario, which would be unacceptable for the insured. Finally the insurer will always look for a self-retention of the insured, or at least for the full right to settle the case with the tax authorities, as otherwise the insurer's position might be rather weak. This to some extent contradicts the interests of the insured, who very often seeks to get rid of the whole risk, or will at least try to further on lead the negotiations with the fiscal authorities.

From an accounting point of view, insurance of tax risks might influence the effective tax rate as well: Insurance premiums as well as claims settlements lead to expenses/income in the pre-tax result. However, it depends on the prevailing jurisdiction and prevailing single case whether or not the insurance premium is tax deductible. The same is true for any claims settlements: If these payments are taxable, it is necessary to get an insurance cover on the "grossed-up" amount, as tax payments on settlements would otherwise lead to losses even in case of insurance. Any tax payments as a consequence of settlement very likely go in general through the tax line. This would result in a distortion between pre-tax income and tax line. So, even if from an economic point of view insurance of tax risks could make sense, the effects on the effective tax rate have to be evaluated as well, even if these effects are potentially not decisive for the decision to take out insurance on tax risks.

4. Framework for Tax Planning

4.1 Technical Issues

Tax planning must always follow business needs. It can be aggressive, but must always be well-founded. In this context basic principles in the following areas should be taken into account: Technical soundness of the tax analysis, steady business link, adequate risk attitude and flexibility.

First, international tax planning requires a fundamental analysis of the tax environment and international tax legislation that exist in the various countries. But just as important is the analysis of the prevailing very individual tax situation a Group is in.

In a world where tax legislation seems to get even more complex and complicated, it is important to assure having the right people working in the tax department. But even if this is the case, and even if the quality of a tax department is on a high standard, outside advise gets more and more important – due to the aforementioned complexity and the time pressure the in-house tax department very often faces. And especially with regard to international transactions different tax jurisdictions – not just the well-known home country tax legislation – have to be looked at. If one takes interest payments on delayed tax payments or even penalties as well into account, the involvement of an outside advisor should really pay off.

Notwithstanding the aforesaid, from an accounting point of view documentation and so-called unqualified should level opinions – whether written in-house or externally – are crucial. This is the basis for calculating current and deferred taxes and for setting up necessary tax reserves.

Second, each tax decision must comply with the business needs. Therefore, a permanent review of the overall tax and business framework and direct access of the tax department to the decision taking bodies is required because tax laws change as well as business goals and decisions. Information should be in time and tax-oriented as well as business-oriented. The tax department needs an information flow back and forth – one could call this "management by walking around". The tax department cannot expect everybody to call whenever there might be a tax problem. It is however the tax department's task to develop a basic understanding and awareness for tax questions in the company in order to get the information needed and all potential problems addressed. This in the end means to get the tax information in such a simple way across that also the non-tax experts understand them.

Third, it comes to risk taking with regard to decisions on tax questions. In this context I really like to point out that each tax director runs a high risk that he or she is afterwards blamed for having been not cautious enough. But the tax environment and the attitude of fiscal authorities towards a transaction/interpretation may have changed with the time and transactions which were two years ago generally accepted with virtually no risk involved, might at once get under scrutiny and different judgment. But even external should level opinions are not the universal remedy. The world of taxes is too complex and difficult. As a tax director, he or she must himself or herself feel comfortable with the chosen decision. An external opinion might help in finding this decision, but he or she has to take the final decision in the end and the risk connected herewith. The tendency towards "re-delegating" this task to external advisors gives perhaps some comfort, but is not sufficient. Also, "re-delegating" the decision on tax questions to the CFO or Finance Committees as a "strategy" to get comfort might be understandable, but is in the end rather "unfair", as non-tax specialists are forced to decide. If a tax director wants to take only decisions with absolutely no risk, he/she is on the wrong place. If processes and diligence are on a high standard, and decisions on tax questions well founded, no reproach should be made. However, potential even remote risks have to be made transparent as well.

Fourth, flexibility. Flexibility is a valid ammunition against locking the company or the whole Group into a tax situation where restructuring is not or only at high cost possible. We always have to comply with changing tax environments. The optimal solution from today's view may quickly turn into a disaster if tax legislation changes and there is no way out. "Over-optimization" very often leads to inflexible and complicated structures and downsides in case the tax legislation changes.

4.2 Reputation

Enjoying a good reputation should be a core element of each company's attitude towards taxes and tax planning. Everybody – whether in a national or international company – has to assume responsibility for the preservation of the company's good reputation, thus contributing to the economic success.

Reputation risks relating to taxes can easily occur – be it in the field of business decisions or with regard to services or products offered. Therefore, it is so extremely important to do nothing just for the sake of saving taxes, but always have sound economic business reasons. Financial institutions run potentially a higher risk than other business segments, especially with regard to products offered. These institutions could hurt their reputation if employees or business partners with the help of the company either violate existing tax laws by acting or omission or if they carry out transactions which are generally considered as tax critical, and thus causing a negative effect on the good reputation. Such risks could *e.g.* derive from the production, the purchase, the advice or the marketing of products and services. There are some basic principles, however, which should shelter the good reputation of the Group or the individual company with regard to taxes as far as services or products are concerned:

First, it should always be omitted to execute transactions or to provide services which might qualify as a tax offence or a tax administrative offence as well as any abetting if a violation cannot be excluded after careful analysis. The company has to ensure adequate professional and organizational structures for such scrutiny.

Second, a company should never give tax advise to their clients. The decision how a service or product is treated on the clients' side, must always be taken by the client or his tax advisor.

Third, if possible, rulings from the tax authorities should be asked for.

Fourth, all products and services must have economic background and not be done just for the sake of tax savings. The underlying reasons should always be transparent and easily to communicate. Getting pre-tax profits is the main prerequisite for a structure that is not done only in order to reduce the tax burden.

If all these prerequisites are fulfilled, the company's good reputation should not be endangered with regard to tax questions. We all have to be aware, however, that in the next few years integrity issues will definitely gain even more importance than today.

Taxation, Accounting and Transparency: The Missing Trinity of Corporate Life

*Christian Nowotny**

1. Introduction

Without doubt, taxation is one of the most powerful motivational forces in corporate life. Tax consequences are important determinants of capital structure, dividend payments and the arrangement of groups of companies, amongst many other things. In view of this, it seems quite surprising that codes of "good" corporate governance promulgated in many European countries during the past years typically do not mention taxation explicitly.

There are various possible explanations, all of which remain speculative. First, the issue of taxation may be too complicated for the addressees. Members of the supervisory board or non-executive directors will typically leave issues of tax planning to the firm's managers, as these are much better informed about available opportunities. This confirms the statement in the contribution to this conference by Pekka Timonen that "taxes are recognized merely as a standard cost related to profits, the specialty of which is that it is sometimes avoidable or at least possible to reduce by tax planning." Second, as corporate governance codes are designed as signals seeking to attract investment (typically from abroad), any references to a corporation tax obligation under national law may confuse or even deter foreign investors.

Third and most of all, the discussion of issues of taxation in a firm's publicly disclosed corporate governance report may attract the unwanted attention of tax authorities. Still, taxation has important implications for corporate governance and should not be overlooked by board members or investors.

2. The Shifting Corporate Governance Paradigm

The conception of corporate governance has changed in a remarkable way in the last fifteen years in continental Europe. In countries such as Germany and Austria, the corporation used to be perceived as a "business as such" (*Unternehmen an sich*), *i.e.* an entity with its own legal existence and goals irrespective of the interests of the members of the underlying business association.[1] More recently the corporation's

* The author would like to thank Martin Gelter for his valuable assistance.

[1] *See* RATHENAU, Vom Aktienwesen – Eine Geschäftliche Betrachtung (1917); HAUSSMANN, Vom Aktienwesen und vom Aktienrecht (1928). Rathenau believed that the interests of long-term stockholders, managers and the public where largely coherent and had to be protected from the interests of short-term speculators. For a historical overview *see e.g.* GROẞMANN, Unternehmensziele im Aktienrecht, 141 *et seq.* (1980).

"*Unternehmensinteresse*" has been understood as the amalgamation of the interest of various stakeholders.[2] This view is of course intimately linked to the longstanding influence of large shareholders, creditors, employees, and in some cases the government representing the "public interest", which was realized either through legal rules, or through formal or informal systems of influence, such as codetermination or the practice to appoint bank representatives to the board.[3]

At least in academic circles and on the surface of corporate rhetoric, this view has to some degree succumbed to the pressure of capital markets. Although many aspects of continental corporate governance systems have remained intact (including the presences of large blockholders, codetermination and the bulk of legal rules), corporate law is increasingly seen as an instrument to attenuate the agency problem between investors on the one hand and managers and large shareholders on the other hand. More often than in the past, managers publicly emphasize the importance of creating shareholder value, and legal scholars have begun to ask whether a commitment to shareholder value is compatible with (or can replace) the traditional doctrine of *Unternehmensinteresse*.[4] Some have observed changes in German corporate governance practices[5] or the unwinding of concentrated ownership structures.[6]

Two aspects of this development, which is linked to corporations' increased reliance on capital markets,[7] are the "Codes of Corporate Governance" movement, and the demand for more transparent accounting, which has led to a convergence with Anglo-Saxon standards and practices.[8]

3. The Shifting Accounting Paradigm

Continental accounting has moved towards more transparency in recent years. German (and Austrian) accounting has long rested on the traditional "principles of proper bookkeeping" (GoB) and, beginning with the German AktG of 1965 and the implementation of the Fourth EC Company Law Directive of 1978 (Accounting Directive)[9] and the Seventh EC Company Law Directive of 1983 (Consolidated

---

[2] *See e.g.* ZÖLLNER, in: ZÖLLNER (ed.), Kölner Kommentar zum Aktiengesetz, Einleitung, notes 129-136 (1984).

[3] On the composition of German supervisory board, *see e.g.* HOPT, The German Two-Tier Board: Experience, Theories, Reforms, in: HOPT/KANDA/ROE/WYMEERSCH/PRIGGE (eds.), Comparative Corporate Governance – The State of the Art and Emerging Research, 227, 245-249 (1998).

[4] *See e.g.* MÜLBERT, Shareholder Value aus rechtlicher Sicht, 1997 Zeitschrift für Gesellschafts- und Unternehmensrecht 129.

[5] CHEFFINS, The Metamorphosis of "Germany Inc.": The Case of Executive Pay, 49 Am. J. Comp. L. 497 (2001).

[6] WÓJCIK, Change in the German Model of Corporate Governance: Evidence from Blockholdings 1997-2001, 35 Env't & Plan. A 1431 (2003).

[7] CROMME, Corporate Governance in Germany and the German Code of Corporate Governance, 13 Corp. Governance 362, 362-363 (2005).

[8] HERTIG/KRAAKMAN/ROCK, Issuers and Investor Protection, in: KRAAKMAN *et al.* (eds.), The Anatomy of Corporate Law, 193, 201-202 (2004).

[9] Fourth Council Directive 78/660/EEC of July 25, 1978, based on Article 54(3)(g) of the Treaty on the Annual Accounts of Certain Types of Companies, arts. 2(3), 47(1), 1978 O.J. (L 222) 11.

Accounts Directive),[10] on extensive statutory regulation. These European Directives were historically strongly influenced by the previous German law.[11]

During the 1990s, the demand for accounting standards tailored to the needs of capital markets rose, and criticism of traditional accounting law began to mount. A larger number of critics began to argue that the accounting regime of the Directives, and more specifically, national accounting systems such as the German or Austrian ones, did not provide adequate transparency, in particular with a view to the informational needs of the participants of international capital markets.[12]

At the same time, the continental focus on conservatism, or prudence, came under attack, as an increasing number of practitioners and scholars found that the link between conservative accounting, capital maintenance and the (reverse) principle of authoritativeness and the use of financial statements as the tax base led to a distortion of the "true and fair view",[13] which financial statements were actually supposed to convey to an educated and informed reader.

The laws of several Member States were brought into line with this trend by allowing some (or all) parent firms to use "internationally recognized accounting standards" for their consolidated accounts (as long as they were compatible with the 7th Directive).[14] In 2002, the EU reacted by passing the IAS Regulation,[15] which requires listed companies to use IAS/IFRS in their consolidated accounts since 2005, but also permits Member States to require or allow (some or all) firms to use IFRS for consolidated accounts and even individual accounts. Several countries have implemented these options by either allowing or even requiring certain or even all

---

[10] Seventh Council Directive 83/349/EEC of June 13, 1983, based on Article 54(3)(g) of the Treaty on Consolidated Accounts, arts. 16(3), 38(6), 1983 O.J. (L 193) 1.

[11] *See* generally NOBES, The Evolution of the Harmonising Provisions of the 1980 and 1981 Companies Acts, 1983 Acct. & Bus. Res. 43; EVANS/NOBES, Some mysteries relating to the prudence principle in the Fourth Directive and in German and British law, 5 Eur. Acct. Rev. 361, 363 (1996).

[12] HALLER, Financial accounting developments in the European Union: past events and future prospects, 11 Eur. Acct. Rev. 153, 160-168 (2002).

[13] Art. 2(3) of the Fourth Directive.

[14] *E.g.* HGB (Germany) § 292a, as amended by the Gesetz zur Verbesserung der Wettbewerbsfähigkeit deutscher Konzerne an internationalen Kapitalmärkten und zur erleichterten Aufnahme von Gesellschafterdarlehen (Kapitalaufnahmeerleichterungsgesetz) [Law to Improve Competitiveness of German Groups of Companies in International Capital Markets and to Facilitate the Acceptance of Shareholder Loans], April 20, 1998, BGBl I, at 707 (F.R.G.); HGB (Austria) § 245a, as amended by Bundesgesetz über Änderungen des Handelsgesetzbuches, des Bankwesengesetzes, des Wertpapieraufsichtsgesetzes und des Versicherungsaufsichtsgesetzes betreffend die Anwendung international anerkannter Rechnungslegungsgrundsätze bei Konzernabschlüssen – Konzernabschlußgesetz [Law on Consolidated Financial Statements], March 26, 1999, BGBl 1999 I/49 (Austria).

[15] Regulation (EC) No 1606/2002 of the European Parliament and of the Council of July 19, 2002, 2002 O.J. (L 243) 1.

firms to use IAS/IFRS for their individual accounts.[16] Others, such as France, Germany and Austria, allow IFRS only for consolidated accounts.

For Member States, the crucial policy question underlying this choice is what conception of a link between financial accounting on the one hand and capital maintenance and corporate taxation on the other hand they intend to pursue. The shifting accounting paradigm raises the question whether the traditional accounting system, which has traditionally emphasized prudence in German-speaking countries,[17] should be replaced by IFRS also for individual accounts, and whether the system of conservative accounting should be abandoned altogether.

4. The Link between Prudence, Capital Maintenance and Taxation

In German-speaking countries, accounting standards have traditionally been codified by statute, and have been intimately linked to both capital maintenance and taxation. With respect to capital maintenance, this connection has made its way into the first generation of European Company Law Directives. Art. 15(1)(a) of the Second Directive[18] provides that "[…] no distribution to shareholders may be made when on the closing date of the last financial year the net assets as set out in the company's annual accounts are, or following such a distribution would become, lower than the amount of the subscribed capital plus those reserves which may not be distributed under the law or the statutes."

Since corporations may not distribute their stated capital, and since distributions are limited to accounting profits, financial accounting (*i.e.* the firm's individual accounts) forms the basis of the computation of the amount of profits that can be distributed to shareholders. The emphasis of prudence in accounting has long been considered an important element of the capital maintenance and therefore creditor protection system, both under national law and the Directives. While revenues may only be shown when they are "made" (Art. 31(1)(c)(aa) of the Fourth Directive) or "realized", adequate provisions must be recognized for probable expenses. Naturally, this leads to the question when revenues can be considered to have been "realized". The traditional view requires the transaction to be in a relatively late state of performance, *i.e.* when the firm had already done everything to obtain the claim.[19] By contrast, in the case of a liability or a contingent liability, the traditional position was to

---

[16] A survey published by the European Commission (Planned Implementation of the IAS Regulation in the EU and EEA, May 15, 2006) lists 11 EU and EEA countries permitting IAS for the annual accounts of all firms and two countries (Cyprus, Malta) requiring them. Besides these, Germany allows the use of IAS for information purposes only (HGB § 325(2a) [Germany]).

[17] *See e.g.* EVANS/NOBES, *supra* note 11; VAN HULLE, Prudence: a principle or an attitude, 5 Eur. Acct. Rev. 375 (1996) (both comparing the British and German attitude towards prudence in accounting before the backdrop of the Fourth Directive).

[18] Council Directive 77/91/EEC, Second Company Law Directive, Art. 1, 1977 O.J. (L 26) 1.

[19] *See e.g.* PELLENS/SELLHORN, Improving Creditor Protection through IFRS Reporting and Solvency Tests, in: LUTTER (ed.), Legal Capital in Europe, 365, 372 (2006); FERRAN, The Place for Creditor Protection on the Agenda for Modernisation of Company Law in the European Union, 3 Eur. Company & Fin. L. Rev. 179, 209-210 (2006).

show a loss rather early than late. Creditors were therefore supposedly protected because rather less than more liquidity could be transferred to shareholders.

Capital maintenance has come under attack for entirely different reasons during the past years. With *Centros* and subsequent cases of the ECJ,[20] at least in some countries, including Germany, a wave of new foundations of firms has emerged, whose founders decided to use English Limited Liability companies instead of the GmbH,[21] partly because of the absence of a minimum capital requirement in the latter. This led to a discussion on the current regulatory framework and a surge of literature. As a result, we may see the end or fundamental transformation of the capital system during the coming years. However, even if the legal capital system were to remain in place as it is, it would be undermined by the use of IFRS in individual accounts, unless such a reform was coupled either with the requirement to create non-distributable reserves corresponding to the amount recognized as positions that could not be shown in a "traditional" balance sheet, or if the firms using IFRS were required to draw up a reconciliation with more traditional accounting standards for purposes of determining the distributable profit.[22] However, the current debate seems to indicate that we may in the future see the introduction of a solvency test to replace or to complement accounting-based limits to distributions.[23] In fact, such an instrument may be more beneficial because its actual aim is to preserve liquidity, which is more important to creditors than an artificial capital figure.

Book-tax conformity has often been seen as another piece of the same puzzle. While the principle of authoritativeness has been an element of German tax law for over a hundred years,[24] Georg Döllerer is often credited with the idea that the government should be seen as another "dormant partner" of the corporation.[25] Since both distributions to shareholders and tax payments result in the withdrawal of funds from the firm and reduce liquidity available to make repayments to creditors, and both calculations determining these payments should be based on the firm's ability to pay, they should be made on the same basis. Döllerer warned against the danger that, without the binding power of financial accounting, tax law would entirely fall under the influence of political forces that would not take the firm's payment capa-

---

20 ECJ, March 9, 1999, Case C-212/97, 1999 ECR I-1459 – *Centros Ltd. v. Erhvervs-og Selskabsstyrelsen*; November 5, 2002, Case C-208/00, 2002 ECR I-9919 – *Überseering BV v. Nordic Construction Co. Baumanagement GmbH*; September 30, 2003, Case C-167/01, 2003 ECR I-10155 – *Kamer van Koophandel en Fabrieken voor Amsterdam v. Inspire Art Ltd.*

21 *See e.g.* BECHT/MAYER/WAGNER, Where Do Firms Incorporate? ECGI Law Working Paper No. 70/2006 (2007) (available at http://ssrn.com/abstract=906066).

22 *See e.g.* NOWOTNY, Muss die Übernahme internationaler Rechnungslegungsstandards an der Ausschüttungsbemessung scheitern?, in: HALLER (ed.), Internationale Rechnungslegungsstandards für Österreich, 143, 154-155 (2004); GELTER, Kapitalerhaltung und internationale Rechnungslegung, 33 Der Gesellschafter 177, 185-187 (2004); PELLENS/SELLHORN, *supra* note 19, at 377-379.

23 *E.g.* PELLENS/SELLHORN, *id.*, at 380-389.

24 *See e.g.* SCHÖN, The Odd Couple: A Common Future for Financial and Tax Accounting?, 58 Tax. L. Rev. 111, 115 (2005).

25 DÖLLERER, Maßgeblichkeit der Handelsbilanz in Gefahr?, 26 Betriebs-Berater 1333, 1334 (1971).

bility into account. Needless to say, conservative accounting plays into the hands of managers and owners of a firm, who are typically happy to reduce the tax base.

5. Risks and Problems Resulting from Book-Tax Conformity

5.1 Managerial Conduct

Bookkeeping, accounting and financial reporting are among the primary duties of a corporation's managers, or board of directors.[26] EU Directives, national laws and IAS[27] instruct them to pursue the goal of showing a "true and fair view" or giving a "fair presentation" of the firm's state of affairs. At least deliberate attempts to "cook the books" and to give a grossly distorted picture will typically result in civil and penal liability.[28]

The inclusion of taxation into the goals of accounting creates a managerial standard of conduct riddled with conflicts. The late Wolfgang Gassner expounded that, in order to pursue the interests of the company (however defined), one of the managerial board's duties was to minimize the tax burden.[29] In a legal system where a principle of authoritativeness is in place, the inevitable result is that the role of the "true and fair view" principle as the standard for accounting policies will be diluted. For example, when a decision on the depreciation period of an asset is to be made, the asset's usability in the company or its ability to generate cash should be the relevant criterion determining the accounting policy decision from an information perspective. However, in the presence of a principle of authoritativeness, managers will and must take into account whether the selected allocation of expenses over the coming financial years will be tax-minimizing.[30]

5.2 Transparency and Corporate Finance

The effects of the principle of authoritativeness on transparency largely depend on the firm's financial situation. In a profitable business, the mutually conflicting obligations to minimize taxes and to show a true and fair view arise. While managers generally want to show good results and a viable financial position in order to foster

---

26 *See* Directive 2006/46/EC, 2006 O.J. (L 224) 1 (introducing, among other things, new Art. 10a into the Fourth Directive and Art. 36a into the Seventh Directive, which provide collective responsibility of members of administrative, management and supervisory boards for financial statements).

27 Fourth Directive, Art. 4(3); IAS 1.13.

28 Directive 2006/46/EC, *supra* note 26, introduces an explicit requirement for Member States to provide effective, proportionate and dissuasive penalties in a new Art. 60a of the Fourth and Art. 48 of the Seventh Directive. In the *Berlusconi* case (May 3, 2005, Case C-387/02, note 65), the ECJ had already affirmed that penalties for infringements of accounting provisions must be effective, proportionate and dissuasive, but concluded that the Directives cannot require Member States to set aside the principle of the retroactive application of the more lenient penalty.

29 GASSNER, Steuergestaltung als Vorstandspflicht, in: BERNAT/BÖHLER/WEILINGER (eds.), Zum Recht der Wirtschaft, Festschrift für Heinz Krejci, 605, 610-613 (2001).

30 *See e.g.* ROHATSCHEK, Die handelsrechtliche Generalnorm und das Maßgeblichkeitsprinzip im Spannungsfeld, 48 Journal für Betriebswirtschaft 242 (1998).

the development of the firm's stock price and to avoid being ousted (by a controlling shareholder or hostile bidder), they also prefer to retain funds within the company. All other things being equal, book-tax conformity can be expected to increase the tendency to create and retain hidden reserves. By contrast, in an unprofitable business (with only small prospects of offsetting current losses against future profits for tax purposes), the *de facto* reverse principle of authoritativeness does not create any tax incentives, since no taxes are paid. However, the incentive to convey a good impression of the firm in financial statements is particularly strong, as managers are subject to heightened pressure and risk to lose their jobs. In that situation, the incentive to realize and show hidden reserves reemerges where allowed by the applicable law. The possibilities to that effect may be stronger than without strong book-tax conformity where an incentive to create hidden reserves did not exist in the first place. Managers may even be induced to enter into transactions facilitating realization.

The likely financial effect is twofold, at least in profitable firms. First, managers may be forced to create purely discretionary, disclosed reserves that are needed to obtain certain tax benefits. Second, in the course of the firm's business activity, hidden reserves will develop. Both types result in a reduction of payable dividends and tax income, which increases the free cash flow available to managers. This may aggravate agency problems, as managers have a larger amount of funds at their disposal, as the typical desire not to distribute will be supported by the legal requirement to retain funds. In consequence, they may be able to use a larger amount of funds without being constrained by the owners' request for dividends.[31]

5.3 Dangers to Auditor's Independence

As discussed by other contributions to this conference, book-tax conformity is weaker in the U.S. than in countries such as Germany or Austria.[32] There is one curious effect that is hardly ever observed in specialist literature. Under the Sarbanes-Oxley Act and the SEC Auditor Independence Regulations,[33] auditors may in principle provide tax services to their audit clients as long as the audit committee approves of it.

In countries with stronger book-tax conformity such as Germany and Austria, tax services pose a greater danger to the auditor's independence than in the U.S. Through

[31] WAGNER, Die umgekehrte Maßgeblichkeit der Handelsbilanz für die Steuerbilanz, 1990 Steuer und Wirtschaft 3, 9-10. This point is equivalent to the agency theory of free cash flow, according to which managers are more constrained by debt than by equity, as they have more free cash flow at their disposal in the second case. *See* generally JENSEN, Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers, 76 Am. Econ. Rev. 323-329 (1986). Agency cost of free cash flow should be even greater in the case of equity managers can avoid to distribute by reference to tax law.

[32] Also *see* LISCHER/MÄRKL, Conformity Between Financial Accounting and Tax Accounting in the United States and Germany, WPK-Mitteilungen, Special Edition June 1997, 91; SCHÖN, *supra* note 24, at 115-123.

[33] § 10A(h) of the Securities Exchange Act, as amended by § 201 of the Sarbanes-Oxley Act of 2002.

the *de facto* reverse principle of authoritativeness, any tax advice has an effect on the firm's financial statements, which is the main subject of the audit. German and Austrian law reflects this insofar as auditors of listed (and in the case of Austria, certain other large firms) are prohibited from giving tax advice if it goes beyond showing alternatives in structuring a transaction or using accounting policies *and* if its effects on the firm's financial position, assets, liabilities, income and expenses (as shown in the financial statements) are not immaterial.[34]

As a matter of legal policy, there are good reasons to ask whether giving tax advice should be entirely prohibited to the auditor as long as book-tax conformity remains intact. On the other hand, book-tax conformity creates an additional level of control for financial statements, as the prospect of a possible tax inspection always looms over the firm. The loss of the auditor's independence may thus be substituted by more intense public enforcement.

6. Potential Benefits of Book-Tax Conformity

There are various reasons to believe why strong book-tax conformity may be beneficial to corporate governance.

The Institute "Finanzen and Steuern" (Bonn) has recently pointed out that the replacement of traditional accounting standards by IFRS would result in an abolition of the principle of prudent accounting as understood in Germany.[35] However, in order to maintain the current level of tax receipts, the earlier taxation of profits that have traditionally been considered non-realized would have to be offset by the permission of an unlimited carrying forward of losses or other new measures of tax law. Alternatively a concept could be considered which makes sure that certain unrealized profits are eliminated by allocation to a mandatory reserve. The effect on corporate governance, of course, would be beneficial due to increased transparency.

Institutional investors are typically interested in transparent and timely information. From their perspective, the effects of taxation must be shown clearly. Transactions with no economic reason *per se* that are only justified by tax considerations should be discouraged, but in any case shown clearly in financial reporting. Generally, shareholders will want taxation not to influence management decisions and avoid a negative impact on transparency. Corporate dividend policy also matters to shareholders, who will generally prefer earlier distributions – or increased stock prices in earlier periods – to later ones.[36] Taxation also should not negatively affect the market for takeovers.

---

[34] HGB § 319a(1)(2) [Germany]; UGB § 271a(1)(2) [Austria].

[35] INSTITUT „FINANZEN UND STEUERN" E.V., Bilanzierung nach IAS/IFRS und Besteuerung, 76 (2005).

[36] *Cf.* LA PORTA/LOPEZ-DE-SILANES/SHLEIFER/VISHNY, Agency Problems and Dividend Policies Around the World, 55 J. Fin. 1 (2000) (suggesting that shareholders' ability to force directors to pay dividends – particularly in countries with strong minority protection – prevents managers using a high proportion of gains for their own benefit). Different arguments are expounded by BREALEY/MYERS, Principles of Corporate Finance, 427 *et seq.* (7th ed. 2003).

Professional creditors (such as banks) will typically have the market power to request financial information from corporate lenders even without legal financial reporting requirements.[37] Hence, they would normally be able to obtain any financial information they need. Book-tax conformity should therefore be largely irrelevant as long as interest payments are deductible for tax purposes (which favors lending over equity finance) and distributions to shareholders and to the tax authorities do not render the firm insolvent or otherwise endanger the recovery of claims.

Management will want to avoid a negative impact on stock options, *e.g.* because of unfavorable tax treatment or types of disclosure that may convey an unfavorable picture of this form of executive compensation to shareholders.

Professor Schön has suggested that book-tax conformity could have a positive impact on transparency. Without it, management will typically be overoptimistic or inclined to show rather more than less in the capital market context. This bias could be balanced by conservative estimates that are driven by the desire (and obligation) to reduce the corporate tax load.[38]

However, management is required to distribute profits only when liquidity and the going concern are not endangered. Since dividends normally cannot be recovered from recipients, distributions putting these at risk may even result in managerial liability. This is an important corrective of over-optimism and may create a natural substitute for conservative accounting in the context of creditor protection. By contrast, it is not a substitute for conservative accounting in the context of the determination of taxable profits, as managers have no discretion whether to pay corporate tax or not. The underlying objective in both contexts, namely that shareholders and the state should participate only in the total profit over the lifetime of the enterprise, is hard to transpose into legal rules or principles, as distributions are not recoverable. Hence, while *ex post* liability of managers is needed for excessive distributions, *ex ante* mechanisms are needed to prevent excessive tax payments.

7. The Road Ahead: IFRS, Taxation and SMEs

IFRS are primarily of interest to large firms tapping the capital markets and are of particular significance for group accounts. Typically these firms will have sophisticated accounting systems, and the reduction of administrative costs by having a separate system of accounting for purposes of taxation will not be a significant burden. The reduction of administrative costs is important for small and medium-sized companies and is increasingly becoming a topic that is recognized as important at EU level. On the one hand, book-tax conformity and the possibility to prepare only a single set of accounts both for purposes of financial accounting and taxation provides obvious administrative relief. On the other hand, the introduction of IFRS could be a sound way to bring financial accounting and managerial accounting into

---

[37] *E.g.* SCHÖN, Corporate Disclosure in a Competitive Environment, 6 J. Corp. L. Stud. 259, 291 (2006).

[38] SCHÖN, *supra* note 24, at 142-144; also *see* BALLWIESER, Ist das Maßgeblichkeitsprinzip überholt?, 1990 Betriebswirtschaftliche Forschung und Praxis 477, 493-494.

convergence. This might be beneficial for corporate governance, as it decreases information asymmetries between shareholders and management. Further it has to be considered that typically within small and medium sized companies, shareholders are involved in the daily business so that the importance of asymmetries might be rather small. In recent years, a debate has emerged about to what extent it would be feasible to equally apply IFRS to individual accounts of SMEs. The IFRS has recently issued an exposure draft on this topic.

However, on a more general note, there are good reasons to question whether mandatory disclosure of financial statements for all limited liability companies is a sound legal policy. Disclosure has met enormous resistance in several continental European countries, most of all in Germany, where less than 10% of GmbHs comply.[39] In a recent article, Wolfgang Schön has convincingly made the case that there is little to justify mandatory disclosure for non-public-interest firms.[40] It would suffice to require firms to submit accounts to shareholders only, which could be used for tax purposes at the same time. Banks and other creditors could require extended private disclosure if they believe that it is necessary for an appropriate estimate of the debtor's risk of failure. The exact extent could therefore be left to the market. However, this solution would require a decision at European level. The European Commissioner for Internal Market and Services has recently announced that the European Commission is focusing in the areas of accounting and auditing the possibilities of reducing costs for SMEs and therefore to submit the existing rules to a detailed scrutiny.[41] This could be the first step into this direction whereby always the whole picture (and this includes accounting for the purposes of taxation) has to be kept in mind.

---

[39] *See* MARX/DALLMANN, Jahresabschlusspublizität mittelständischer Unternehmen, 59 Betriebs-Berater 929 (2004) (reporting that less than 5% of entities required to disclose accounts fulfill this duty). In Austria, the compliance rate is at about 75%, although some notable for prefer paying fines to disclosure.

[40] SCHÖN, *supra* note 37, at 290-292.

[41] MCCREEVY, Speech at the European Parliament's Legal Affairs Committee, March 20, 2007, SPEECH/07/159.

Tax and the Separation of Ownership and Control

*Steven Bank and Brian R. Cheffins**

While generally the impact tax has on patterns of corporate ownership and control has received little attention, this paper argues that tax is potentially an important determinant of ownership patterns in large companies. The paper focuses mainly on historical developments in Britain, where an "outsider/arm's-length" system of corporate governance began to take shape in the years leading up to World War I and became fully entrenched by the end of the 1970s. Taxes imposed on corporate profits, taxation of managerial and investment income and inheritance taxes do much to explain why during this period blockholders sought to exit and why there was sufficient demand for shares among investors to permit ownership to separate from control. The paper also discusses developments in the United States and argues that tax helped to foster the separation of ownership and control that reportedly occurred in larger American companies after World War I.

1. Introduction

As debates about corporate governance have intensified over the past couple of decades, potential explanations why patterns of ownership and control differ around the world have captured much attention from academics and policymakers. Economists Alexander Dyck and Luigi Zingales have shown that among potential variables likely to influence private benefits of control – a key incentive for blockholding in public companies – tax, measured by compliance rates, has considerable explanatory power.[1] Generally, however, little has been said about the impact tax regulation potentially has on the configuration of share ownership in large firms.[2] We argue here the topic is deserving of further attention, and make our case by use of historical examples.

In putting tax in the limelight, we focus primarily on the United Kingdom and show how tax contributed to the emergence of a corporate economy dominated by widely held public companies. The choice is apt because leading theories on why ownership separates (or does not separate) from control in a country's larger companies fail to account adequately for developments in Britain. As we show, taking tax into account helps to explain how ownership separated from control when conditions, theoretically speaking, were not particularly favorable. The point is made by

---

* A revised analysis of developments in the U.K. discussed in this chapter appears in CHEFFINS/BANK, Corporate Ownership and Control in the U.K.: The Tax Dimension, 70 Modern Law Review 778 (2007).

1 DYCK/ZINGALES, Private Benefits of Control: An International Comparison, 59 Journal of Finance 537 (2004).

2 DESAI *et al.*, Theft and Taxes, unpublished paper, 1 (2005). Some isolated exceptions are discussed in Parts 6 and 7 of this paper.

relying on tax to help to answer three core questions one must address to understand why ownership separates from control in a particular country: 1) Why did those owning large blocks of shares want to exit? 2) Why were investors willing to buy the shares blockholders wanted to sell? 3) Why didn't the new investors begin to exercise control themselves?

While we focus primarily on Britain in this paper, we also offer a brief historically-oriented assessment of the contribution tax made to the rise of the widely held company in the United States. For both Britain and the U.S. we consider a range of tax laws, including not only corporate tax but also personal income tax, capital gains tax and inheritance tax. Corporate taxation is an important part of the analysis, especially to the extent it had an effect on the profit generating capacity of companies and the availability of profits for distribution to shareholders. Nevertheless, extending the analysis beyond corporate tax is necessary because many of the tax rules that "mattered" were those influencing decisions by individuals to buy or sell shares rather than those applicable directly to corporate entities.

We do not argue that tax is, or has been, the sole or even the prime determinant of ownership structure in the U.K. or the U.S. and do not make claims about the impact tax might have had in other countries. We also do not purport to offer a comprehensive analysis of the relationship between corporate ownership structure and tax. For instance, an issue we only canvass briefly in the conclusion is potential reverse causality, in the sense that, just as tax can help to dictate ownership and control patterns, the configuration of corporate structures in a country can influence the formulation of tax regulation. Despite these caveats, the paper shows that tax is a potential determinant of ownership structure in large companies and argues that further research on the topic is merited.

Parts 2 to 6 of the paper discuss the U.K. Parts 2 and 3 set the scene, with Part 2 providing the relevant chronology and Part 3 indicating that the current literature on comparative corporate governance does not explain satisfactorily why the widely held company became dominant in Britain. Part 4 outlines how tax provided blockholders in the U.K. with incentives to exit, Part 5 discusses how tax influenced the demand for shares from potential investors and Part 6 describes how tax potentially might have deterred activism by Britain's institutional investors. Part 7 addresses similar points, albeit more briefly, for the United States. Part 8 concludes.

2. The Evolution of Ownership and Control in the U.K.

The United Kingdom shares with the United States an "outsider/arm's-length" system of ownership and control, with ownership in large companies typically being dispersed among a large number of individuals and institutional intermediaries rather than being concentrated in the hands of "core investors" (*e.g.* a family) and with shareholders rarely being poised to intervene and take a hand in running a business.[3]

---

[3] ARMOUR/CHEFFINS/SKEEL, Corporate Ownership and the Evolution of Bankruptcy Law: Lessons from the United Kingdom, 55 Vanderbilt Law Review 1699, 1704, 1715, 1750-1752 (2002).

Though 19th century railways anticipated the trend,[4] the U.K.'s outsider/arm's-length system of ownership and control took shape primarily during the 20th century. The number of industrial and commercial companies quoted on the London Stock Exchange reflects this, as the figure rose from 70 in 1885 to 571 in 1907 and again to 1,712 in 1939.[5] There were 4,409 companies quoted on the London Stock Exchange in 1963, a figure that had dwindled to just under 2,000 by 2000.[6] Mergers were the primary cause of the decline. Between 1948 and 1970 40% of quoted manufacturing companies left the stock market after being taken over and between 1975 and 1990 the figure was 33%.[7]

There was clearly some ownership dispersion prior to World War I since there were some examples of companies with a few thousand shareholders and since companies using a prospectus to carry out a public offering of ordinary shares on the London Stock Exchange had to offer a minimum of two-thirds of the shares to the public.[8] The available empirical data suggests, however, that original proprietors of publicly quoted companies often retained significant blocks of shares and the companies frequently continued to be managed and owned on a local basis.[9] The investor base was generally composed of friends and regional business contacts of the proprietors, perhaps in combination with wealthy clients of well-connected stockbrokers, such as aristocratic landowners seeking to spread their investments due to falling rental incomes.[10]

---

4 GOURVISH, Railways 1830-70: The Formative Years, in: FREEMAN/ALDCROFT (eds.), Transport in Victorian Britain, 57, 83 (1988).

5 FRANKS/MAYER/ROSSI, Spending Less Time with the Family: The Decline of Family Ownership in the United Kingdom, in: MORCK (ed.), A History of Corporate Governance Around the World, 581, 587-588 (2005).

6 *Id.*

7 COSH/HUGHES/SINGH, The Causes and Effects of Takeovers in the United Kingdom: An Empirical Investigation for the Late 1960s at the Microeconomic Level, in: MUELLER (ed.), The Determinants and Effects of Mergers, 227, 234-35 (1980) (using data from 1948-72 to illustrate that "deaths" by merger outnumbered initial public offerings); DICKERSON/GIBSON/TSAKALOTOS, Is Attack the Best Form of Defence? A Competing Risks Analysis of Acquisition Activity in the U.K., 27 Cambridge Journal of Economics 337, 337 (2003) (providing statistics on the percentage of quoted companies being taken over).

8 HANNAH, The Divorce of Ownership from Control from 1900: Re-calibrating Imagined Global Historical Trends, CIRJE Discussion Paper, 20-26 (2007).

9 FRANKS/MAYER/ROSSI, Ownership: Evolution and Regulation, working paper, 30-31, Table 4, Table 10 (2005) (reporting from a sample of 40 companies incorporated around 1900, many of which were publicly traded by 1920, that the directors owned 54 per cent of the shares as of 1910 and 49 per cent as of 1920 and that, based on a sample of 26 of the 40 companies, the proportion of ordinary shareholders living within six miles of the city of incorporation as of 1910 was 56 per cent); for further background *see* DAVIS/GALLMAN, Evolving Financial Markets and International Capital Flows: Britain, the Americas, and Australia, 1865-1914, 160-163 (2001).

10 JEFFREYS, Business Organisation in Great Britain 1856-1914, 329-330, 339-340, 359-362, 373, 401, 409-10 (1977); COTTRELL, Industrial Finance 1830-1914, 153-154 (1980); ARMSTRONG, The Rise and Fall of the Company Promoter and the Financing of British Industry, in: VAN HELTEN/CASSIS (eds.), Capitalism in a Mature Economy: Financial Institutions, Capital Exports and British Industry, 1870-1939, 115, 121-122 (1990); THOMPSON, English Landed Society in the Nineteenth Century, 307-8 (1963).

During the years between World War I and World War II share ownership became commonplace among a considerably wider circle of investors, in particular the middle classes.[11] A 1932 sample of ten leading British industrial and commercial companies illustrates, as eight of the companies had more than 10,000 shareholders and four had 50,000 or more.[12] The Board of Trade, the government department with responsibility for regulation of companies, remarked on the trend in a 1943 discussion paper on company law reform, referring to "(t)he small investor whose numbers are now legion".[13] Still, it does not appear an outsider/arm's-length system of ownership and control was fully in place, with a study of ownership patterns in the U.K.'s largest industrial and commercial companies based on mid-1930s data indicating a majority likely had a "dominant ownership interest".[14]

Family control of some form continued in many U.K. public companies at the beginning of the 1950s.[15] Nevertheless, among Britain's very largest industrial and commercial firms a trend towards a divorce between control and ownership had become clear, with a study using 1951 data finding that only a minority had a dominant ownership interest.[16] The unwinding of voting control in U.K. public companies continued apace through the 1950s, 1960s and 1970s and by the end of the 1970s, family ownership had been largely displaced.[17]

The final demise of family capitalism was accompanied by the exodus of private investors and the rise of institutional investment, with the percentage of shares owned directly by individuals dropping steadily from 66% in 1957 to 20% in 1991 and the percentage of shares owned by institutional investors rising from 21% to 60% over the same period.[18] Institutional shareholders in turn proved to be, for the

---

[11] COLE, The Evolution of Joint Stock Enterprise, in: COLE (ed.), Studies in Capital and Investment, 51, 89-90 (1935).

[12] PARKINSON, Scientific Investment: A Manual for Company Share and Debenture Holders, 4 (1932).

[13] Quoted in BIRCHER, The Adoption of Consolidated Accounting, 19 Accounting & Business Research 3, 10 (1988).

[14] FLORENCE, Ownership, Control and Success of Large Companies: An Analysis of English Industrial Structure and Policy 1936-1951, 240-241 (1961).

[15] HANNAH, Visible and Invisible Hands in Great Britain, in: CHANDLER/DAEMS (eds.), Managerial Hierarchies: Comparative Perspectives on the Rise of the Modern Industrial Enterprise, 41, 53 (1980) (119 of the largest 200 British firms had family board members in 1948); CHANNON, The Strategy and Structure of British Enterprise, 75, 161 (1973) (finding in a study of the largest 100 manufacturing companies in the U.K. as of 1970 that 92 were carrying on business as of 1950 and that 50 of the 92 were under family control at that point).

[16] FLORENCE, Ownership, *supra* note 14, at 186-87. Florence based his claim on his study of the share ownership structure in all 92 of the U.K.'s manufacturing and commercial companies having over £3 million of issued share capital as of 1951.

[17] JONES/SLUYTERMAN, British and Dutch Business History, in: AMATORI/JONES (eds.), Business History Around the World, 111, 116-18 (2003).

[18] For 1957, *see* MOYLE, The Pattern of Ordinary Share Ownership, University of Cambridge Department of Applied Economics Occasional Paper #31, 18 (1971). Otherwise, *see* National Statistics Online database: http://www.statistics.gov.uk/statbase/TSDTimezone.asp, "Share Ownership" release/Table A: Beneficial Ownership of Shares, 1963-2006.

most part, passive investors. According to a 1978 report prepared for the Institute of Chartered Accountants of England and Wales,

> "(i)nstitutional participation in managerial decision-making has been favored generally (but)…(f)inancial institutions have generally been unwilling to act collectively in the use of their voting strength, or to accept those responsibilities which others would assign to them".[19]

With institutional investors shying away from direct involvement in the management of U.K. public companies, Britain's version of "outsider/arm's-length" corporate governance was firmly entrenched by the end of the 1970s.

3. Pre-Conditions for a Separation of Ownership and Control

Over the past decade, there has been extensive analysis of why the configuration of ownership and control differs across borders. Following on from well-known research done by economists Rafael La Porta, Florencio López-de-Silanes, Andrei Shleifer and co-authors of theirs, the dominant explanation offered has been that the "law matters" in the sense that the quality of corporate and securities law within a particular country dictates whether large business enterprises will have diffuse or concentrated share ownership.[20] Another theory is that financial services regulation does much to dictate whether a separation of ownership and control will occur, with the logic being large financial institutions will tend to emerge as key blockholders unless the law deters them from doing so.[21] An additional hypothesis is that "left-wing" social democracies will have fewer publicly quoted firms and significantly higher levels of ownership concentration than "right-wing" countries because executives in a social democracy will tend to cater to employee preferences and give dispersed shareholders short shrift, thereby increasing substantially the disadvantages associated with being an outside investor.[22]

None of these theories have much explanatory power in the British context. Corporate law provided scant protection to prospective buyers of shares or minority shareholders during the decades when ownership separated from control.[23] During

---

[19] BRISTON/DOBBINS, The Growth and Impact of Institutional Investors, 54 (1978).

[20] On the popularity of this explanation, *see* ROE, Corporate Law's Limits, 31 Journal of Legal Studies 233, 236-37 (2002); ENRIQUES, Do Corporate Law Judges Matter? Some Evidence from Milan, 3 European Business Organization Law Review 756, 766-67 (2002). The leading papers by La Porta *et al.* on point were LA PORTA *et al.*, Law and Finance, 106 Journal of Political Economy 1113 (1998); LA PORTA *et al.*, Corporate Ownership Around the World, 54 Journal of Finance 471 (1999); LA PORTA *et al.*, What Works in Securities Laws?, 61 Journal of Finance 1 (2006); DJANKOV/LA PORTA/LÓPEZ-DE-SILANES/SHLEIFER, The Law and Economics of Self-Dealing, unpublished working paper (2005).

[21] ROE, Strong Managers, Weak Owners: The Political Roots of American Corporate Finance (1994).

[22] ROE, Political Determinants of Corporate Governance (2003).

[23] FRANKS/MAYER/ROSSI, Ownership, *supra* note 9, at 12-16; CHEFFINS, Does Law Matter?: The Separation of Ownership and Control in the United Kingdom, 30 Journal of Legal Studies 459 (2001).

the period when ownership structures were unwinding neither the U.K.'s commercial deposit-taking banks nor the financial institutions which emerged as the key owners of British publicly quoted companies – primarily insurance companies and pension funds – faced significant regulatory constraints likely to deter activism.[24] As for politics, contrary to what theory would predict, a strong leftward trend coincided with the separation of ownership and control. The politicians in office in Britain during the years between World War I and World War II eschewed Victorian *laissez-faire* principles as they presided over a significant growth in government spending financed largely by increases in income tax and their counterparts after World War II swung further to the left, evidenced by continued growth of government, nationalization of key industries and a highly redistributive tax regime.[25]

Given that corporate law in the U.K. was not highly protective of minority shareholders and that the regulatory and political setting apparently was not congenial for the unwinding of control blocks, what explains the separation of ownership and control that occurred? To answer this question, it is instructive to identify three conditions that must be satisfied for ownership to become separated from control in a particular company. First, the dominant shareholders must decide to exit, which can be done by selling in stages into the market or by liquidating their entire stake all at once. Until the dominant shareholder is prepared to exit, though, nothing can change.

Second, there must be buyers. A blockholder seeking to exit will find this impossible to do unless there is demand for the shares. This condition can be satisfied either by parties looking to buy the company (or at least the blockholder's stake) outright or by stock market investors being prepared to buy the company's shares as and when equity is made available to the public.

Third, the buyers of the shares must not be inclined to exercise control themselves. Otherwise, "insider/control-oriented" corporate governance will continue unabated.[26] If the company's incumbent blockholders exit by selling shares into the market, a single investor potentially could accumulate a substantial ownership stake and then seek to dictate how the company will operate, perhaps in tandem with a formal takeover offer to remaining shareholders. In the case of an exit by merger, the firm carrying out the acquisition typically will be inclined to exercise close control over the relevant assets. This implies insider/control-oriented corporate governance, but if the purchaser is itself a widely held company outsider/arm's-length corporate governance in effect results.

---

[24] CHEFFINS, History and the Global Corporate Governance Revolution: The U.K. Perspective, 43 Business History 87, 103-4 (2001).

[25] On the interwar years GLYNN/BOOTH, Modern Britain: An Economic and Social History, 47-52 (1996); DEWEY, War and Progress: Britain 1914-1945, 66, 71 (1997). On the situation after World War II, *see* CHEFFINS, Putting Britain on the Roe Map: The Emergence of the Berle-Means Corporation in the United Kingdom, in: MCCAHERY *et al.* (eds.), Corporate Governance Regimes: Convergence and Diversity, 147, 160-63 (2002).

[26] On differences between "insider/control-oriented" and "outsider/arm's-length" corporate governance, *see* BERGLÖF, A Note on the Typology of Financial Systems, in: HOPT/WYMEERSCH (eds.), Comparative Corporate Governance: Essays and Materials, 151, 157-64 (1997).

Extrapolating from an individual company's situation, the three questions one needs to address to explain why the widely held company might move to the forefront in a particular country are: 1) Why would those owning large blocks of shares want to exit? 2) Why were investors willing to buy the shares blockholders wanted to sell? 3) Why did the new investors fail to exercise control themselves? Considering events in the U.K. through this analytical prism illustrates tax made a significant contribution to the separation of ownership and control in the U.K. With each of the three questions, and particularly the first two, tax reinforced trends precipitated by other factors. Tax did not in isolation cause the widely held company to move to the forefront in the U.K. However, tax did play a significant supplementary role.

4. Tax as a Catalyst for Exit by Blockholders

Being a blockholder is attractive in various ways. There potentially will be pecuniary private benefits of control that can be secured through one-sided "sweetheart" deals between a public company and its "core" investors. Also, blockholders can treat their public companies as a personal fief and bestow upon themselves various desirable corporate perks, such as generous managerial pay, lavish offices and luxurious business travel. Private benefits of control can also be of the non-pecuniary sort,[27] including the "buzz" associated with running a major company and a potential entrée to "elite" circles occupied by leading politicians and the wealthy. Circumstances at Marks and Spencer, a successful and widely admired retailer that went public in 1926 but remained firmly under family control until the mid-1960s through the use of shares with multiple voting shares, illustrate:

> "Simon Marks, who, as 'proprietor' of the business, enjoyed the trappings of wealth, the influence it gave him with politicians and the allure of film stars and celebrities … The Sieffs, the Sachers and the Laskis, as big shareholders in the company, came to believe that a luxurious lifestyle both inside and outside the office was their proprietorial right …"[28]

Despite the benefits of blockholding, there will be instances where exit will become a desirable option. For instance, under buoyant markets conditions blockholders might opt to sell out because the terms on offer are simply too generous to ignore.[29] Also, founders who lack a suitable heir to take the helm will generally look for a way out. Jaguar, a successful U.K. automobile manufacturer, merged with a competitor in the mid-1960s because the founder's heir had been killed in an automobile crash a decade earlier.[30]

Disappointing financial results can also prompt a desire to exit. Individuals owning a large block of shares in a public company will typically have much of their capital tied up in the company, which means they run the risk of a precipitous decline in

---

[27] GILSON, Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy, 119 Harvard Law Review 1641, 1663-64 (2006).

[28] BEVAN, The Rise and Fall of Marks & Spencer, 68 (2001).

[29] HANNAH, The Rise of the Corporate Economy, 59 (2nd ed. 1983).

[30] "Jaguar to Join Up With B.M.C.", Times, July 12, 1966, 1; "Jaguar's Driving Force", Daily Post (Liverpool), October 24, 2001, 9.

their personal wealth if the company encounters hard times.[31] Hence, sustained erosion of profit margins brought on by competitive forces can force a dominant shareholder's hand.[32] As a 1969 book on business in Britain said

> "family businesses face increasing pressures; tougher competition … (and) the need for expensive new investment. Many have disappeared under these pressures … The family empire … is being steadily swept away by the forces of nature."[33]

Tax is a related factor that can affect decisions blockholders make about unwinding their stake partially or to exit completely. Taxes can, on one hand, be a deterrent to exit, with an obvious circumstance being where capital gains arising from the sale of shares are heavily taxed. On the other hand, taxes can in various ways induce shareholders to contemplate exit. For instance, they can erode the returns companies deliver to the point where dominant shareholders conclude it is no longer worthwhile having most or all eggs in the same basket. The experience in the U.K. shows this can happen not only because of taxes imposed at the corporate level in the form of taxation of corporate income or "excess" corporate profits, but also because of taxes imposed at the individual level in the form of taxation of dividends, capital gains and managerial compensation.

Tax policy can also make alternative investments more attractive to blockholders. If, for instance, taxes are reduced or exempted for investments in asset classes other than shares for investments designed to deliver benefits upon retirement rather than immediately and for assets transferred to others prior to death, blockholders subject to tax may choose to exit partially or fully to take advantage of these tax-preferred options. Also important is that individuals owning big blocks of shares in a large company will generally be badly diversified, and to make this sacrifice there needs to be the potential for a significant "upside". If tax largely precludes blockholders from benefiting substantially from the large stake they own, they might well be motivated to exit the business so they can benefit from risk-spreading – even if only by investing in a portfolio of assets taxed on a similar basis. Finally, at certain levels of taxation, individuals may choose to increase their current consumption – including their consumption of leisure – rather than to reinvest or save the proceeds from a sale of their assets.[34]

---

[31] BECHT/DELONG, Why Has There Been So Little Block Holding in America?, in: MORCK, History, *supra* note 5, at 613, 618-19 (discussing why lack of diversification gives blockholders an incentive to exit).

[32] DYCK/ZINGALES, *supra* note 1, at 577.

[33] TURNER, Business in Britain, 239 (1969).

[34] For a discussion of the tradeoff between high taxes on capital and the incentive to save or invest rather than consume currently, *see* FELDSTEIN/TSIANG, The Interest Rate, Taxation, and the Personal Savings Incentive, 82 Quarterly Journal of Economics 419, 434 (1968). Contemporaries recognized that the U.K.'s high taxes affected choices about how hard to work; *see*, for example, TREASURE, "The Toll Our Taxes Take", Times, January 12, 1968, 21.

4.1 Corporate Income Tax

If companies hand over most of their profits in the form of tax payments there is likely to be little left over for shareholders. As a result, income tax payable by companies, particularly to the extent that it is higher than the burden on alternative forms of investment, is one type of taxation that can influence a blockholder's decision to exit. In Britain, however, it is unlikely that corporate income taxation in isolation did a great deal to motivate blockholders to exit, in large part because of the system of corporate taxation that was in place.

The corporate income tax system in the U.S. operates as economic double taxation since corporate income is subject to tax at the corporate level where it is earned and at the shareholder level when distributed as a dividend. In Britain, by contrast, corporate income tax has traditionally operated on an "imputation" basis, reducing or eliminating the second layer of tax.[35] Under the British version of this system of corporate tax, at least with profits distributed in the form of dividends, companies operated as *de facto* collecting agencies, nominally paying dividends "gross" but withholding on behalf of shareholders tax pegged at a prescribed standard rate. Shareholders could then claim a partial or full credit against their dividend income, depending on their income level. Hence, corporate taxation generally only impinged directly on the profitability of companies when earnings were retained.[36]

During the period when ownership separated from control, U.K. public companies tended to distribute a large percentage of their reported profits, with decade by decade averages reaching as high as 80% in the 1920s and 1930s before falling to approximately 40% in the 1960s and around 30% in the 1970s.[37] Also, the standard rate of taxation was generally not particularly high, with the rate fluctuating between 20% and 30% throughout much of the 1920s and 1930s, and generally being set between 39% and 45% from the late 1940s to the early 1970s.[38] Under such condi-

---

35 For basic comparisons of the "classical" and imputation systems, *see* BANK, The Dividend Divide in Anglo-American Corporate Taxation, 30 Journal of Corporation Law 1, 2-3 (2004); KAY/KING, The British Tax System, 184-85 (1978).

36 PARKINSON, Scientific, *supra* note 12, at 199. The tax burden was alleviated still further by permissible tax deductions. For instance, amounts companies paid as managerial remuneration were deductible in calculating taxed profits but dividends were not. This distinction potentially mattered greatly for smaller companies – various rules were introduced with the express intention of precluding smaller companies from distributing profits in the form of managerial salaries – STANLEY, "Basic Rules Prescribing a Director's Pay", Times, March 3, 1969, 22. The distinction, however, was of limited significance for larger companies since revenues typically dwarfed managerial salaries.

37 On the 1920s and 1930s, *see* BANK, Dividend, *supra* note 35, at 11-12; THOMAS, The Finance of British Industry 1918-1976, 89 (Table 4.2) (1978). On the 1950s, the average for the decade was calculated on the basis of annual figures set out in ROYAL COMMISSION ON THE DISTRIBUTION OF INCOME AND WEALTH, Report No. 2: Income from Companies and its Distribution, 161, Table P7 (1975). On the 1960s and 1970s, *see* TOMS/WRIGHT, Corporate Governance, Strategy and Structure in British Business History, 1950-2000, 44 Business History 91, 105 (2002).

38 For data on the standard rate, *see* PARKINSON, Scientific, *supra* note 12, at 208 (1920s and early 1930s); "Proposed Changes in Taxation", Times, April 27, 1938, 10 (reporting an increase in the standard rate of taxation from 30% to 35%); THOMAS, Finance, *supra* note 37, at 230 (Table 8.4) (1947-48 to 1975-76).

tions, the burden imposed by "mainstream" corporate tax was not particularly onerous and likely did not, in isolation, precipitate blockholder exit.

4.2 Corporate Profits Taxation

While corporate tax on its own typically should not have provided the impetus for exit by blockholders, additional "profits" taxes imposed on companies, most notably to finance the war effort in World War I and World War II, might well have had this effect. In 1915, to increase revenues to pay for World War I and to preclude politically controversial "profiteering" in trades and industries benefiting form the war-time conditions, the U.K. government imposed on all trading concerns an Excess Profits Duty (E.P.D.) of 50% on profits above a prescribed pre-war standard.[39] The E.P.D. rate was raised to 60% in 1916, increased again to 80% in 1917, cut to 40% for 1918 and 1919 and then raised again to 60% for 1920/21, when the tax was abolished.[40]

The E.P.D. was a lucrative tax for the government, yielding 25% of tax revenue raised between 1915 and 1921.[41] Concomitantly, it had a strong impact on the bottom line for companies. According to a 1999 study of corporate accounts of 30 leading industrial companies for 1910 to 1924, the pre-tax return on equity was significantly higher from 1915 to 1920 (23.8%, on average, annually) than it was from 1910 to 1914 (10.5%).[42] Tax, primarily in the form of the E.P.D., did much to reduce the differential, with post-tax return on equity averaging 13.9% annually between 1915 to 1920 and 10.0% for 1910 to 1914. Once inflation was taken into account, return on equity was lower during the war years (8.7% on average annually) than it was prior to World War I (9.9%). Moreover, averages are somewhat deceptive since the burden the E.P.D. imposed hinged on profits earned in the benchmark pre-war years. As one critic of the tax said in 1920, "(o)ld established and prosperous firms…got off lightly, while new and struggling firms had the breath knocked out of them."[43] Exit might well have been an appealing option for blockholders in companies having their breath knocked out by the E.P.D.

The E.P.D. also made the future more precarious for blockholders than it otherwise might have been. As an American economist observed in 1920, "huge sums, a substantial portion of which would have otherwise gone toward strengthening and

---

[39] DAUNTON, Just Taxes: The Politics of Taxation in Britain, 1914-1979, 41, 55-57 (2002). "Excess profit" was defined as an increase over the profit of the three years before the war or above 6% on prewar capital.

[40] *See* DAUNTON, How to Pay for the War: State, Society and Taxation in Britain, 1917-24, 111 English Historical Review 882, 896 (1996).

[41] HICKS/HICKS/ROSTAS, The Taxation of War Wealth, 71 (1941).

[42] ARNOLD, Profitability and Capital Accumulation in British Industry During the Transwar Period, 1913-1924, 52 Economic History Review 45, 58-62 (1999).

[43] Quoted in "Excess Profits A 'Lottery'", Times, May 8, 1920, 11. *See* also STRACHAN, Financing the First World War, 74 (2004) ("new businesses with low profits before the war but which became established during it were hit harder than pre-existing large and over-capitalized firms."). Some allowances were made in calculating the pre-War benchmark for "abnormal depression": STAMP, Taxation During the War, 156 (1932).

expanding business undertakings, have been rendered unavailable for this purpose and consequently business in the aggregate must be less well established and safeguarded than would have been the case if the tax had not been imposed at all."[44] For those businesses – and blockholders – that were suffering, there was a tax-driven exit option. Under the E.P.D. when one company bought out another the pre-war records of the two were amalgamated to form the standard by which the "excess" war profits of the combined businesses was measured. As a result, there was a "lively trade" for companies that had been prosperous before the war but had struggled from then on.[45]

In 1920, the U.K. imposed a new levy on profits – the Corporation Profits Tax (C.P.T.) – designed to supplement and ultimately replace the E.P.D.[46] While the E.P.D. was imposed on all businesses, as the name of the tax implies, the C.P.T. applied only to limited liability entities such as corporations. Moreover, rather than being linked to pre-war profits, the C.P.T. was a flat 5% levy on all corporate profits, with the amount payable being capped at 10% of net profits, calculated after deducting fixed interest on bonds and dividend payments on preferred shares.[47]

The 1921 abolition of the E.P.D. was much welcomed, particularly since the government retained the tax after World War I ended and had even increased the rate of tax. As the Times newspaper said, repeal would be "hailed with satisfaction in business circles, and it should go a long way towards reviving that spirit of enterprise which its retention, and increase last year did much to destroy."[48] The C.P.T. was hardly a popular alternative, though, being labeled by some as "more vicious and more destructive of the spirit of enterprise than the much-condemned E.P.D."[49] The Federation of British Industries denounced the tax as "fundamentally unsound",[50] predicting that "industry should be absolutely crushed under a load they cannot carry."[51]

A point the Federation and other critics of the C.P.T. made was that it had a disproportionate effect on holders of ordinary shares.[52] As the vice-chairman of a railroad corporation explained in denouncing the tax, since dividends paid to ordinary shareholders were not deductible when computing the maximum 10% tax on net profits, "in nearly every case [the profits tax] is paid entirely by the Ordinary share-

---

44 HAIG, British Experience With Excess Profits Taxation, 10 American Economic Review, Papers and Proceedings of the Annual Meeting of the American Economic Association, 1, 6-7 (1920).

45 HAIG, *id.*, at 9.

46 DAUNTON, How to Pay for the War, *supra* note 40, at 901.

47 TUCKER, The British Finance Act, 1920, 35 Quarterly Journal of Economics 167, 170 (1920).

48 "The End of E.P.D.", Times, February 4, 1921, 11.

49 "City Notes; Important New Issues; The Corporation Tax", Times, March 1, 1921, 18.

50 DAUNTON, How to Pay for the War, *supra* note 40, at 902.

51 *Id.*; "Lighter Burden of Taxes; Appeal by F.B.I. to Government", Times, Jan. 31, 1923, 7.

52 *See*, *e.g.*, "Company Meetings: The Costa Rica Railway Company, Limited", Times, July 20, 1921, 19; "City Notes; Important New Issues; The Corporation Tax", Times, March 1, 1921, 18. Labour's Hugh Dalton called the tax "especially objectionable, discriminating against ordinary shareholders in joint-stock companies as compared with other property owners, and discouraging, in a specially high degree, the taking of business risks." DAUNTON, How to Pay for the War, *supra* note 40, at 914.

holder."[53] The point was potentially telling for blockholders, since the voting control they would have exercised would have been derived from owning a substantial percentage of ordinary shares rather than other securities, such as preference shares and debentures (*i.e.* corporate bonds).

The C.P.T. not only was unpopular with business but also failed to generate the tax revenue that had been predicted and was repealed in 1924.[54] The fact the C.P.T. was in place during "one of the worst recessions in history"[55] likely depressed the revenue generated since the adverse business conditions cut sharply into profits companies were generating.[56] For instance, according to the 1999 study of the accounts of 30 leading industrial companies cited earlier, the average annual after-tax inflation adjusted return on equity between 1921 and 1924 was a meager 3.1%, well below the figures for 1910-14 and 1915-20. The recession, rather than the C.P.T. apparently was to blame, since there was only a small difference between the pre-tax and post-tax return on equity (6.9% on average annually, unadjusted for inflation, vs. 6.2%). Regardless, the fact remains that due to tax and adverse business conditions, the decade following the start of World War I was a difficult period for U.K. companies. Operating under such conditions likely would have prompted numerous blockholders to contemplate exit, particularly in favor of investments not subject to the profits taxes, such as war bonds.

A similar combination of war-time taxation and adverse economic conditions likely prompted blockholders to do likewise during the World War II era. An economic recovery occurring throughout the mid-1930s came to an abrupt halt in 1938, and corporate profits dropped sharply.[57] The difficulties for business were compounded by increased taxation. To help pay for rearmament in preparation for the looming war against Germany, Parliament introduced in 1937 a National Defence Contribution (N.D.C.) that was similar to the C.P.T. except that it imposed a levy of 5% on profits of all businesses rather than just companies.[58]

The N.D.C., as with the C.P.T., was criticized on the grounds the tax fell entirely on ordinary shareholders.[59] However, of much greater practical significance for companies and those owning blocks of shares in them was the Excess Profits Tax (E.P.T.), introduced in 1939 to raise revenue for fighting World War II and mute hostility towards anticipated war-time profiteering. The E.P.T. constituted a tax on prof-

---

[53] "Company Meetings", *supra* note 52.

[54] DAUNTON, How to Pay for the War, *supra* note 40, at 914 (calling the tax's yield "disappointing"); "Lighter Burden of Taxes; Appeal by F.B.I. to Government", Times, Jan. 31, 1923, 7 (noting that while it was originally estimated that the tax would yield £50 million annually, the actual yield was only £17.5 million at its height).

[55] ALDCROFT, The British Economy, Volume 1: The Years of Turmoil 1920-1951, 6 (1986).

[56] An alternative explanation for the reduced revenues from the C.P.T. is that the tax was "easily evaded" because of the ability to reclassify profit as something else. HICKS *et al.*, The Taxation of War Wealth, *supra* note 41, at 90.

[57] THOMAS, Finance, *supra* note 37, at 104-5; THORPE, Britain in the 1930s: The Deceptive Decade, 62-66 (1992).

[58] DAUNTON, Just, *supra* note 39, at 173; FARNSWORTH, Some Reflections upon the Finance Act 1937, 1 Modern Law Review 288, 290-91 (1938).

[59] "Industry and War Taxation", Times, September 28, 1945, 2.

its exceeding a benchmark fixed by reference to a company's profit levels in prescribed pre-war years, with the rate being set initially at 60% and increased in 1941 to 100%, subject to a 20% credit on the tax paid when the war ended.[60] Companies potentially liable for both the N.D.C. and the E.P.T. paid only the higher of the two.[61] Due to the high E.P.T. rates, if there was any sort of meaningful difference between the pre-war benchmark and war-time profits levels, the E.P.T. was the tax companies would have to pay.

The E.P.T.'s 100% rate of taxation on profits above a prescribed pre-war level constrained substantially the return companies could generate for shareholders, particularly for firms that could not take advantage of high pre-war profits to establish a favorable benchmark.[62] Operating under the uncertainties created by World War II combined with this tax burden likely prompted numerous blockholders to think of exit, but orchestrating this was not straightforward. For instance, selling out by way of a merger was problematic because the E.P.T. rules were enacted to close the E.P.D. loophole that allowed businesses to establish a favorable excess profits benchmark by acquiring companies which prospered during the relevant pre-war years.[63] As for exiting by selling shares to outside investors, this was difficult but not impossible. Full-scale public offerings of shares were officially discouraged to ensure adequate investor backing for the sale of government debt being issued to finance the war effort.[64] However, it was possible to launch stock market trading in a large block of shares that had been tightly held (*e.g.* by a family) by the "placing" of shares privately with a small syndicate of investors, usually followed by seeking permission for dealings to begin on the Stock Exchange.[65]

The E.P.T. was abolished by the Finance Act 1946, thus theoretically easing conditions for business.[66] However, a backlog of placings had built up due to a 1944 "grey market agreement" orchestrated by the Treasury, which had become con-

---

[60] SAYERS, Financial Policy 1939-45, 40, 86, 88-89, 118-19 (1956).

[61] SPICER, Excess Profits Tax and National Defence Contribution, 109 (1940).

[62] A concession was made available for businesses with fluctuating profits, but this provision was "bitterly criticized" since relief was only offered up to the point where a company could satisfy its obligations to pay interest on its debts, satisfy its preferred dividend obligations and distribute a 6% dividend for ordinary shareholders (8% in the case of director-controlled companies): Hicks *et al.*, *supra* note 41, at 96.

[63] SAYERS, Financial, *supra* note 60, at 122; FARNSWORTH, The Finance Act, 1941, 5 Modern Law Review 128, 132 (1941).

[64] SAYERS, Financial, *supra* note 60, at 164, 172-74 (discussing the work done by the capital issues committee struck by the Treasury); MICHIE, The London Stock Exchange: A History, 314 (1999) (of securities quoted on the London Stock Exchange between 1941 and 1945, 86% by value were issued by the British government).

[65] GRANT, A Study of the Capital Market in Britain From 1919-1936, 161-62 (2nd ed. 1967); KYNASTON, The City of London: Volume III, Illusions of Gold 1914-1945, 421 (1999). Blockholders wanting to carry out a placing during World War II without confronting Stock Exchange constraints could tap a "grey market" where shares were sold "off market": SAYERS, Financial, *supra* note 60, at 178-79; "Black Markets and Grey", Times, November 19, 1943, 9.

[66] Finance Act 1946, s. 36.

cerned about the impact such transactions were having on capital markets.[67] The backlog, combined with a partial relaxation of war-time restrictions on the raising of capital, contributed to a new issue boom in the late 1940s characterized by a large number of share offerings by family-owned companies.[68]

The difficult business conditions that would have prompted blockholders to contemplate exit from the late 1930s until the end of World War II eased substantially in the 1950s. A flourishing domestic market where customers "just got into the queue" and a rapid acceleration of export demand helped U.K. companies to prosper throughout the decade.[69] From a tax perspective, however, the repeal of the E.P.T. proved to be only a short-lived reprieve for companies, particularly with respect to dividends. In 1947, the N.D.C. became a permanent tax on profits, but with a twist, namely differentiation between retained earnings and profits distributed as dividends. Initially, the tax rate on distributed profits was increased to 12.5% while the rate for undistributed profits remained 5%, but the rates were soon doubled to 10% on retained earnings and 25% on profits distributed as dividends.[70] For the following decade, distributed profits were consistently taxed at a significantly higher rate than undistributed profits.[71] The policy was explicitly designed to discourage dividends, which were criticized on the basis that they incited employees to make high wage demands, fostered inflation by increasing consumer spending and constituted "unearned" (and implicitly undeserved) income in the hands of shareholders.[72]

In 1958, the profits tax was restructured to abolish the differential between retained and distributed earnings but an explicit corporate tax bias against dividends soon reappeared.[73] In 1965 the Labour government replaced the profits tax and the imputation version of corporate income tax with what is typically known as a "classical" system of corporate tax under which corporate profits were subject to tax at the corporate level and were then taxed again fully at the shareholder level as income when dividends were paid. James Callaghan, Labour's Chancellor of the Exchequer at the time, freely acknowledged the reforms reintroduced an explicit corporate tax bias against dividends and justified this on the basis that the pre-existing regime did "not provide sufficient incentive to companies to plough back profits for growth

---

[67] On the "grey market" agreement, *see* SAYERS, Financial, *supra* note 60, at 179-80. On the backlog, *see* "Fresh Ruling on New Issues", Times, April 5, 1945.

[68] On conditions after the war ended, *see* THOMAS, Finance, *supra* note 37, at 146-48; "New Issue Boom Goes On", Times, July 23, 1947, 8; "'The Times' Book of New Issues", Times, June 24, 1949, 9; ROGOW, The Labour Government and British Industry 1945-1951, 27-29 (1955).

[69] TURNER, Business, *supra* note 33, at 59-60; LITTLEWOOD, The Stock Market: 50 Years of Capitalism at Work, 122 (1998).

[70] DAUNTON, Just, *supra* note 39, at 200-1.

[71] For a year-by-year breakdown of the differential, *see* THOMAS, Finance, *supra* note 37, at 230; KING, Public Policy and the Corporation, 258 (1977).

[72] DAUNTON, Just, *supra* note 39, at 249; BANK, Dividend, *supra* note 35, at 37; RUBNER, The Ensnared Shareholder: Directors and the Modern Corporation, 191-93 (1965); *see* also ROYAL COMMISSION ON THE TAXATION OF PROFITS AND INCOME, Final Report, Cmnd. 9474, 158-59 (1955) (explaining rather than agreeing with the policy justifications).

[73] On the 1958 change, *see* DAUNTON, Just, *supra* note 39, at 252-53; BANK, Dividend, *supra* note 35, at 41.

rather to distribute them as dividends".[74] The change was not permanent, as the U.K. abandoned the classical system of corporate taxation in 1973 and restored the imputation system of corporate tax without reintroducing any sort of profits tax. From this point onwards U.K. corporate taxation did not impose any sort of special burden on profits distributed as dividends.[75]

The explicit tax bias against dividends in place between 1947 and 1958 and 1965 and 1973 provided blockholders with a potentially potent incentive to exit. Dividends can be a significant source of income for any blockholder but they can gain special importance when a successful business reaches its second and third generation. Under such circumstances, many of the shareholders within the company's founding family will lack an operational role with the company, and the only ongoing source of return they will derive from the shares they own will be cash distributions the company makes to shareholders.

U.K. company law prohibited companies from repurchasing shares until the early 1980s, so as a practical matter dividends constituted the only cash flow shares generated for shareholders.[76] Thus, to the extent the tax system was biased against the payment of dividends, this could have provided second and third generation family owners with an incentive to sell out. Empirical studies done on the impact the 1947-58 differential profits tax and the 1965-73 classical system of corporate tax had on dividend payouts do not conclusively establish that the tax rules actually affected dividend levels.[77] Nevertheless, investors, including blockholders, might reasonably have surmised that government policy would depress dividend pay-outs and thus may well have taken the presence of tax rules biased against dividends as their cue to exit in search of better investment options.

---

[74] 701 Parl. Deb., H.C. (5th Ser.) (1964) 1041 (statement of Mr. Callaghan). For further background on the rationale underlying the change, *see* DAUNTON, Just, *supra* note 39, at 291-92; THOMAS, Finance, *supra* note 37, at 233-34.

[75] KAY/KING, *supra* note 35, at 188.

[76] *Trevor v. Whitworth*, 12 App. Cas. 409 (1887) (establishing the common law rule prohibiting the repurchase of shares); Companies Act 1981, c. 62, ss. 45-62 (authorizing share buy-backs under prescribed circumstances).

[77] *See* RUBNER, The Irrelevance of the British Differential Profits Tax, 74 Economic Journal 347 (1964) (abolition of the differential profits tax had no impact on dividend-profits ratios); FELDSTEIN, Corporate Taxation and Dividend Behaviour, 37 Review of Economic Studies 57 (1970) (the U.K.'s differential profits tax had an effect on corporate saving and dividends); BRISTON/TOMKINS, The Impact of the Introduction of Corporation Tax upon the Dividend Policies of United Kingdom Companies, 80 Economic Journal 617 (1970) (the introduction of the classical corporate tax system in the U.K. in 1965 was not a significant factor in determining dividend policy). For studies covering from 1950 through the 1970s, compare POTERBA/SUMMERS, The Economics Effect of Dividend Taxation, in: ALTMAN/SUBRAHMANYAM (eds.), Recent Advances in Corporate Finance (1985) (dividend taxes affected the dividend policy of U.K. public companies); BANK/CHEFFINS/GOERGEN, Dividends and Politics, unpublished working paper (2004) (not finding a statistically significant correlation between tax and dividend policy).

4.3 Shareholder-Level Taxation of Dividends

During the period when ownership separated from control in the U.K., the tax bias against dividends extended beyond corporate-level tax to the taxation of personal income at the shareholder level. For instance, the rules governing personal income tax imposed an explicit penalty against dividends, but it was not until 1973 that a distinction between earned and unearned income would have motivated blockholders to consider exit. As part of tax reform carried out that year, a 15% income tax surcharge was imposed against unearned income that applied regardless of income levels. Hence, between 1974 and 1979 for taxpayers who earned more than £21,000 annually (about £87,400 in current terms)[78] dividends were taxed at 98%: the top tax rate of 83% plus the investment income surcharge of 15%.[79] Dividends obviously were of little practical value for blockholders in this predicament, and for those whom receipt of dividends was a high priority tax would have given them a motive to exit.

Prior to 1973, in contrast, the manner in which the tax system distinguished between earned income and dividends would have been of little concern to blockholders, largely because owners of a substantial block of shares in a larger public company generally would have had an income sufficient to place them in a high income tax bracket.[80] From 1909 to 1973 U.K. income tax had two elements, income tax set at the "standard rate" and "supertax", generally known as "surtax".[81] Surtax was imposed on taxpayers with incomes exceeding a prescribed level and was levied on a rising scale on successive slices of income above that level. Prior to World War II, the tax break for earned as opposed to unearned income was achieved by setting income tax rates for earned income at a rate below the "standard rate" that applied to investment income up to a specified income level (*e.g.* £2,500 in 1919).[82] Since surtax was set at the same rate for earned and unearned income for those with high incomes the total tax due varied little depending on whether their income was earned or derived from investments.[83]

---

[78] Historical currency calculations have been done with http://www.measuringworth.com/calculators/ukcompare/, using the retail price index to calculate the relative value of £s and 2005 as the "current" year, which was the latest available at the time of writing. 1977 was used as the "original" year for the purpose of the currency conversion in this instance.

[79] KAY/KING, *supra* note 35, at 51.

[80] *See* MERRETT, Executive Remuneration in the United Kingdom, 33, 38 (1968) (of 51 executive directors interviewed for a survey on executive pay in the U.K., 19 were probably blockholders, as 13 were categorized as "self made" and 6 were categorized as "inherited". On average, the marginal tax rate was 76% for "self-made" executives and 69% for "inherited" executives.).

[81] For a nutshell history of "super tax", *see* LEWIS, British Tax Law – Income Tax: Corporation Tax: Capital Gains Tax, 14 (1977).

[82] COMSTOCK, British Income Tax Reform, 10 American Economic Review 488, 496 (1920). For numerical illustrations, *see* DAUNTON, Just, *supra* note 39, at 47 (setting out income tax rates and allowances for 1913/14 and 1918/19); CAUDWELL, A Practical Guide to Investment, 10-11 (1930) (providing a table of income tax payable on earned and investment income with total incomes of between £135 and £150,000).

[83] For instance, while as of 1930, £32 2s 6d was taxed on £500 of earned income and £50 17s 6d was taxed on £500 of unearned income, the corresponding figures for £5,000 were £1,313 7s 6p (earned) and £1,369 12s 6p (unearned): CAUDWELL, Practical, *supra* note 82, at 10-11.

After World War II, the nature of the tax bias against "unearned" income changed, as deductions that were made available for "earned" income were not available for investment income.[84] Again, though, the distinction mattered little for those with high incomes, since the "earned income allowance" was capped in a way that meant for individuals at or near the top income tax bracket dividends were taxed at effectively the same rate as earned income.[85] Blockholders typically would have had high incomes, so for them dividends would have been taxed no more harshly than salaries.

While the explicit income tax bias against dividends likely would not have induced blockholders to exit, the rates at which income – whether earned or unearned – was taxed reduced considerably the after-tax value of dividends in the hands of investors in high income brackets, and thus likely induced blockholders to contemplate selling out. There is generally little data available comparing pre-tax and post-income from dividends but statistics compiled on behalf of a royal commission studying the distribution of wealth and income revealed that in 1972/73 for those earning more than £12,000 (£106,000 currently), post-tax net income from dividends and interest was a mere 28.5% of the pre-tax figure.[86] The 1972/73 figures are not entirely typical, since rates of income taxation varied through the 20th century. However, throughout the period when ownership separated from control a general trend in favor of a "progressive" graduated system of tax rates meant income taxation cut substantially the net income dividends yielded in the hands of any blockholder with high personal income.

Aside from abatement of income tax for low incomes, there was no graduation of income tax in the U.K. until the introduction of surtax in 1909.[87] The financial demands of World War I prompted the government to introduce a markedly more progressive income tax regime, with the top rate of tax rising from 8.3% on an income of £5,000 or more in 1913 (£328,000 in current terms) to 52.5% on an income of over £10,000 in 1918 (£324,000 currently).[88] The end of the war did not yield significant tax relief for the wealthy. Instead, the Conservative government of the time, to paraphrase Chancellor of the Exchequer Winston Churchill, opted to leave the very rich "stranded on the peaks of taxation to which they have been carried by the flood".[89] The Labour party, during a short spell in office, took the opportunity in 1930 to increase the tax burden on the well-off by boosting the tax rate on income between £15,000 (£631,000 currently) and £20,000 from 42.5% to 50% and by setting the top rate of tax at 60% on income greater than £50,000.[90] Income tax rates were hiked yet again in the late 1930s to finance rearmament, so that in 1938 tax pay-

---

84 PLUNKETT/NEWPORT, Income Tax: Law and Practice, 394-95 (29th ed. 1961).

85 PLUNKETT/NEWPORT, *id.*, at 30.

86 Derived from ROYAL COMMISSION ON THE DISTRIBUTION OF INCOME & WEALTH (Lord Diamond, chairman), Report No. 2: Income from Companies and its Distribution, Cmnd. 6172, 23, 27 (1975).

87 COMSTOCK, British, *supra* note 82, at 497.

88 DAUNTON, Just, *supra* note 39, at 47 (Table 2.5).

89 DAUNTON, *id*, at 133.

90 Extrapolated from "The Budget", Times, April 15, 1930, 11.

able on income above £6,000 (£255,000 currently) was 50% or more and the top marginal tax rate, applicable to income greater than £50,000, was set at 72.5%.[91]

Taxes were increased still further during World War II, with high rates of income tax being applied at much lower levels of income than had been the case previously and the top rate of income tax being increased substantially. From 1941 throughout the war income above £2,000 (£65,800 currently, using 1941 as the base year) was taxed at a rate of 60%.[92] The top rate of income tax throughout this period was 95% for all taxable income above £20,000, which meant that whereas in 1938 a gross income of £12,000 would have yielded a net income of £7,000 during the war years roughly £150,000 was required.[93]

The Labour government elected in 1945 had no intention of providing any sort of tax breaks for the rich.[94] The Labour government did reduce the standard rate of income tax from 50% to 40%. At the same time, though, it increased surtax rates on higher levels of income, meaning that there was no tax break for those with incomes of £12,000 (£313,000) or more annually.[95] During Labour's tenure (1945-51), the tax rate for income above £12,000 was set at 85% and the top marginal rate of 90% applied to income above £15,000.

Labour's decision to tax heavily those with high incomes set the tone until the 1980s, with the top rate of income tax being 83% or more until Margaret Thatcher's Conservative government began cutting it dramatically in the 1980s.[96] Hence, aside from any explicit tax bias in favor of earned income, for a period of more than four decades taxation of income reduced dramatically after-tax return from dividends in the hands of blockholders. This, in turn, would have given blockholders who assigned a high priority to the income derived from dividends a tax-oriented incentive to unwind their holdings.

Taxation of capital gains (or lack thereof) likely reinforced the bias in favor of exit created by taxation of dividends since those owning a large block of shares in a company could reap a one-off tax windfall by selling out. Capital gains were untaxed until the early 1960s and even after capital gains were taxed generally from 1965 onwards, the rate was set at 30%, which at least for those in higher income tax

---

91 Extrapolated from "War Budget/Proposed Changes in Taxation", Times, September 28, 1939, 4.

92 For income tax and surtax rates throughout World War II, *see* ROGOW, Taxation and 'Fair Shares' Under the Labour Government, 21 Canadian Journal of Economics and Political Science 204, 204-5 (1955).

93 SAYERS, Financial, *supra* note 60, at 49; SHIRRAS/ROSTAS, The Burden of British Taxation, 26-27, 72 (1942).

94 As Hugh Dalton, Chancellor of the Exchequer, explained in Parliament in 1946, an "awakened and war scarred generation" was demanding the government "close from both ends the gap which separates the standard of living of the great mass of our fellow citizen from that of a small privileged minority": quoted in FIJALKOWSI-BEREDAY, The Equalizing Effect of the Death Duties, 2 Oxford Economic Papers (N.S.) 176, 177 (1950).

95 "Tax Changes", Times, October 24, 1945, 7; "Surtax Increased", Times, October 24, 1945, 7.

96 *See* http://www.ifs.org.uk/ff/income.xls (individual tax rates, 1973-74 to 2005-2006). The one exception was the 1973 tax year, when the top marginal rate was set at 75%.

brackets was considerably lower than the tax burden on income.[97] Moreover, if a blockholder had the opportunity to exit by way of a merger and the purchase price took the form of shares of the acquiring company, the transaction did not constitute a taxable capital gain for the target shareholders and the exiting blockholders would not have to pay any tax until they sold their shares in acquiring company.[98] Mergers of this sort were common, as between 1955 and 1985 one in four successful U.K. takeovers of public companies were "all-equity" offers and in two out of three deals there was some form of equity component.[99]

The tax advantages of exit would have been neutralized if former blockholders had to invest the proceeds in assets fully exposed to income tax on investment income. This, however, was unlikely to occur since those in high income brackets were prepared to go to great lengths to side-step the penal tax liability on income. One option was to take advantage of tax relief on interest and use borrowed funds to finance the purchase of durable goods that yielded no regular taxable income, would retain their real value over time and would give pleasure to the owner and his family.[100] Land, antiques, and works of art were prime examples. Also, as section 5.2 discusses, life insurance based savings schemes and contributions to pension plans offered potentially significant tax advantages.[101] Moreover, former blockholders could reduce income tax payable by transferring income-generating assets to a trust established on behalf of individuals (*e.g.* children) with little or no other taxable income.[102] Hence, for blockholders discouraged by heavy taxes on dividends, the tax treatment of capital gains gave them a good reason to unwind their stake in the company and invest their capital in ways that ensured not all of their eggs were in one basket.

---

[97] On the position prior to the early 1960s, *see* ROSE, The Economic Background to Investment, 335 (1960). On the change to the law, *see* Finance Act 1965, c. 25, ss. 19, 20, 22.

[98] SPOLIANSKY/BUCKLEY, Practice and Procedures for Takeovers in England, 28 Business Lawyer 63, 74-75 (1972-73).

[99] FRANKS/HARRIS/MAYER, Means of Payment in Takeovers: Results for the United Kingdom and the United States, in: AUERBACH (ed.), Corporate Takeovers: Causes and Consequences, 221, 236 (1988). "All equity" takeovers were highly conducive to separating ownership from control since not only would blockholders in the target exit but if the acquiring company had blockholders, their stake would typically be diluted as part of the deal since the company would be issuing new shares to finance the acquisition. *See*, for example, FRANKS/MAYER/ROSSI, Spending Less Time with the Family: The Decline of Family Ownership in the United Kingdom, in: MORCK, History, *supra* note 5, at 581, 600-1; "Cadbury Shares over 83s in Heavy Trading", Times, January 30, 1969, 17 (discussing how the 1969 merger of Cadbury Ltd., a chocolate manufacturer, with Schweppes, a drinks company, diluted the percentage of shares owned by the families controlling Cadbury).

[100] NELSON-JONES, "Unremitting Search for Surtax Relief", Times, July 1, 1972, 22; KAY/KING, *supra* note 35, at 51, 55.

[101] TITMUSS, Income Distribution and Social Change, 167 (1962) (saying that in 1959-60 life assurance relief cost the government £49 million, about one-seventh of which was received by the top 1% of taxpayers).

[102] WHEATCROFT, The Attitude of the Legislature and the Courts to Tax Avoidance, 18 Modern Law Review 209, 210-11 (1955).

In circumstances where taxes on dividend income were high and there was no taxation of capital gains (or the rate was low compared to the rate imposed on income) a top marginal rate taxpayer had an incentive to create "homemade" dividends by carrying out "dividend stripping", which in this context meant avoiding the payment of income tax on dividends paid by converting income into capital gains. The fact that U.K. public companies made a practice of announcing the value of a dividend a few weeks before the payment is due created an obvious way for individuals to "launder" dividends. Assuming a reasonably generous dividend had been announced and market conditions did not change, the price of a company's shares "pregnant with dividend" or "full of dividend" would rise in anticipation of the payment and fall sharply when payment day arrived.[103] To avoid the income tax on the dividend payment, an investor could sell his shares "cum dividend" – with the right to receive the forthcoming dividend attached – immediately before the dividend payment date.[104] The inflated price of the shares at that date would often mean the investor would have a capital gain on the holding, which until the early 1960s was not taxable.

For this sort of scheme to work, there needed to be investors willing to purchase the shares "pregnant with dividend". Obvious candidates were investors exempt from paying income tax on dividends, which included pension funds and charities, and marketmakers (stockbrokers specializing in making a market for shares) who could offset the dividend received for tax purposes with a capital loss incurred from selling the shares subsequently.[105] To complete the circle, the top marginal rate taxpayer would return to the buyer of the shares or to the stock market and purchase the company's shares "ex dividend" (after the dividend had been paid) at a price that had declined due to the payment of the dividend.[106] The result would be ownership of the equity with the dividends "stripped".

While in theory "dividend stripping" could be used to sidestep high taxes on dividends, it is doubtful blockholders engaged in the practice with sufficient frequency to blunt tax incentives to exit. The Finance Act 1961 added a draconian anti-tax avoidance provision addressed specifically to the dividend stripping scenario.[107]

---

[103] ROSE, Economic, *supra* note 97, at 306; ARMSTRONG, The Book of the Stock Exchange, 248 (5th ed. 1957). On the "pregnant with dividend" metaphor, *see* MONROE, Intolerable Inquisition? Reflections on the Law of Tax, 74 (1981).

[104] This could occur because public companies customarily closed their transfer registers on a specified date shortly before a dividend payment and would not reopen their books until the dividend had in fact paid out: ROSE, Economic, *supra* note 97, at 306; ARMSTRONG, Book, *supra* note 103, at 244; NAISH, The Complete Guide to Personal Investment, 20 (1962).

[105] ROYAL COMMISSION ON THE TAXATION OF PROFITS AND INCOME, Final Report, Cmd. 9474, 369 (minority report) (1955); BEATTIE, Elements of the Law of Income and Capital Gains Taxation, 236 (9th ed. 1970); HOSKING, Pension Schemes and Retirement Benefits, 170 (1956).

[106] If there was an agreement at the time of sale that the taxpayer would repurchase the shares, the payment of dividends was treated as income of the seller. *See* Income Tax 1952, s. 203, which was enacted in 1937. *See* PLUNKETT, The Income Tax Act 1952, § 203 (1952); PLUNKETT/NEWPORT, Income Tax: Law and Practice, 223 (29th ed. 1961).

[107] Finance Act 1961, s. 28; for analysis *see* TAPPER, Finance Acts, 1961 and 1960, 25 Modern L. Rev. 64 (1962); POTTER, A Counterblast to Tax-Free Profits, 1960 British Tax Review 248, 259-67.

Even prior to this, dividend stripping in public companies was not particularly prevalent. Between 1955, when the government introduced an easily evaded provision designed to preclude dividend stripping, and 1958, the total loss to the Inland Revenue as a result of dividend stripping was estimated to have been between only £4 million and £10 million, and a significant proportion of the lost revenue likely involved shares in private companies rather than public companies.[108] This likely was due to costs arising from stamp duty (a tax on share transactions), stockbroker commissions and the "turn", this being the difference between the buying and selling prices quoted by those making a market in the company's shares (known as "jobbers").[109] Investors reportedly had to make a profit of at least 10% on the sale of shares to cover relevant transaction costs.[110]

4.4 Taxation of Managerial Income

The manner in which employment income was taxed potentially provided blockholders with a strong incentive to exit, particularly from World War II onwards. For major shareholders who worked in a managerial capacity – typically the founder of a company and, in subsequent generations, members of a blockholding family deemed qualified – employment income was potentially a significant perk associated with blockholding. As with dividends, however, the punishing income tax rates the U.K. government imposed ensured that if executives were highly paid they handed over much of what they earned.

Changes in government, as we have seen, provided little respite for those in top income brackets in the decades following World War II. Also, since the U.K. had an effective apparatus for tax-gathering, including not only the Inland Revenue but a "fiscal establishment" consisting of lawyers, accountants, taxation departments of banks and wage and salary departments of companies, the well-off, including blockholders, could not ignore the rules.[111] Hence, during the late 1960s, when the top marginal rate of income tax was 91% and became effective as gross income reached £19,000 (£221,000 in present-day terms), an executive earning £20,000 paid 62.8% of this amount in income tax and received £7,445 net while an executive earning £50,000 paid out 80% to the government and only received £10,070 net.[112] Indeed, it was virtually impossible for an executive of a public company to earn much more than £10,000 (£116,000 currently) after tax.[113]

---

[108] FLETCHER, Retrospective Fiscal Legislation, 1959 British Tax Review 412, 424 (discussing revenue lost); ROYAL COMMISSION ON THE TAXATION OF PROFITS AND INCOME, *supra* note 105, at 369 (indicating the most extreme forms of dividend stripping involved private companies mainly).

[109] On the terminology, *see* ROSE, Economic, *supra* note 97, at 301.

[110] On the 10% figure, *see* NAISH, *supra* note 104, at 25; GLEESON, People and Their Money: 50 Years of Private Investment, 136 (1981). Another estimate was 19%: WINCOTT, The Stock Exchange, 141 (1946).

[111] "A Charter for Tax Reform", Times, April 10, 1967, 17.

[112] TREASURE, Toll, *supra* note 34.

[113] TREASURE, *id. See* also TURNER, Business, *supra* note 33, at 435 (discussing how the chairman of British Petroleum received in 1939 £10,000 out of a salary of £25,000 and was paid £50,000 in 1968 and had a take-home pay of £9,700).

There were means by which companies could remunerate executives so as to diminish the tax burden partially, such as the awarding of stock options in lieu of payment of salary and the provision of benefits in kind, such as expense accounts for meals and entertainment, a company car and guaranteeing housing loans.[114] The government, however, was prepared to crack down on such techniques, as it did with changes to tax law in the mid-1960s that eliminated the tax advantages of stock options.[115] As a result, accumulating substantial wealth purely through executive remuneration was difficult to achieve.[116] A 1968 study of executive directors in U.K. companies found that nearly two-thirds would never obtain disposable wealth in excess of £20,000.[117]

It was well-known the high rates of income tax standard during World War II and the decades following discouraged those otherwise inclined to manage companies from doing so.[118] As the Federation of British Industries put it in 1951, "If this situation continues that, to young men of character and ability, endeavour in this country does not offer the same rewards in others, then the spirit of enterprise which has been characteristic of British industry for so long must inevitably suffer".[119] The tax regime would have been discouraging for executives who happened to be major shareholders as well as for other managers, which implies income tax provided blockholders in the U.K. who otherwise might have been inclined to stay and work for their company with a potent incentive to exit.

4.5 Death Duties

In the U.K. the number of publicly quoted companies more than doubled between the late 1930s and early 1960s.[120] This can be attributed to a significant extent to estate tax – charges imposed on assets transferred on or shortly prior to death. As the Economist observed in 1968, "(n)ew flotations (initial public offerings) tend to have been built up by one man or a group since before or just after (World War II), going public to avoid death duties, actual or prospective".[121]

While estate taxes were first introduced in the U.K. in 1894, their impact in this context was greatest from the end of World War II onwards. Even though estate taxes had already been increased during World War II, the Labour government of 1945-51 stiffened them again, boosting the death duty rate for estates with a value of between £100,000 (£2.611 million)[122] to £150,000 from 27% to 50%, dropping the class of estate where the top rate applied from £2 million to £1 million and increasing the top

---

[114] TITMUSS, *supra* note 101, at 123-24, 176-82.
[115] MARLEY, "Entrepreneurial Aid for the Ailing Economy", Times, March 21, 1969, 27.
[116] GRIERSON, "The Case for Incentives Now", Times, August 11, 1967, 19; "Why High Pay Pays Off at the Top", Times, January 4, 1968, 21.
[117] MERRETT, *supra* note 80, at 40.
[118] ROGOW, Taxation, *supra* note 92, at 206.
[119] Quoted in ROGOW, *id. See* also BEDDINGTON-BEHRENS, "Need for Incentives at the Top", Times, February 2, 1967, 13.
[120] *Supra* notes 5-6 and related discussion.
[121] "New Issues – Less Important and Much Less Fun", The Economist, March 16, 1968, 107.
[122] Using 1947 for the purposes of conversion.

rate from 65% to 80%.[123] The rates remained unchanged until estate duty was replaced by capital transfer tax in 1975, which taxed transfers made on or within three years before death at 60% for estate values between £250,000 and £1 million and 65% beyond that.[124]

With careful planning, rich individuals could leave estates that for tax purposes bore little relation to their real wealth.[125] For blockholders in family companies, unwinding their ownership stake often was a key step in minimizing death duties. As the chairman of a leading issuing house said in 1951,

> "Not only is the splendid habit of building up out of retained profits rendered impossible by income and profits tax but the very fabric of these concerns is being torn to pieces by death duties. Hardly a working day passes but we are asked if we can help the proprietors of a private company to dispose part of their holdings so as to prepare for or to pay death duties."[126]

When the well-off structured their affairs to minimize death duties, they often used trusts under which family members would be the beneficiaries since, prior to the change from estate tax to the capital transfer tax in 1975, assets held in trust were exempt from estate taxes.[127] For blockholders, selling out was an obvious way to generate proceeds to transfer to trusts held on behalf of family members that could in turn be invested in marketable securities.

Death duties provided an additional incentive for those owning a business to exit, at least partially.[128] As the Times observed in a 1951 article on family firms and death duties, when families were planning their affairs to minimize death duties, "the large business is floated as a public company so that shares can be sold in good time to the public and a Stock Exchange price obtained for estate duty valuation."[129] From 1930 onwards, U.K. tax legislation stipulated that in the case of a publicly quoted company where at least 25% (later 35%) of the shares were widely held and traded the valuation of the shares for estate tax could be determined by reference to the

---

[123] FIJALKOWSI-BEREDAY, Equalizing, *supra* note 94, at 182; JEREMY, A Business History of Britain, 1900-1990s, 117 (1998).

[124] JEREMY, Business, *supra* note 123, at 118 (providing a table on estate duty rates, 1894-1975); KAY/KING, *supra* note 35, at 161 (setting out rates of capital transfer tax, 1977-78).

[125] KAY/KING, *supra* note 35, at 161.

[126] "The Charterhouse Investment Trust", Times, January 9, 1951, 8. On the status of the Charterhouse Investment Trust as an issuing house, *see* CHARTERHOUSE FINANCE CORPORATION LIMITED, Corporate Financing in Great Britain, 17 Law and Contemporary Problems 239, 239 (1952). *See* also "Family Firms and Death Duties", Times, July 16, 1951, 8.

[127] TITMUSS, *supra* note 101, at 92, 96-97; WHITING, The Labour Party and Taxation: Party Identity and Political Purpose in Twentieth-Century Britain, 241 (2000). Even after 1975, trusts could operate as partial shields against estate tax: KAY/KING, *supra* note 35, at 55.

[128] The analysis here does not take into account changes introduced in 1975 when estate duty was replaced by the Capital Transfer Tax, which imposed tax on gifts by the deceased not only under the will but up to seven years prior to death.

[129] "Family Firms", *supra* note 126.

stock market price during the year prior to death.[130] Otherwise, the shares were valued by estimating a company's net assets and allocating a fraction of this amount to the estate in accordance with the percentage of shares the deceased owned at the time of death.

Valuation by the stock market was typically advantageous to the deceased's estate. For instance, whereas the share price of a company with shares traded on the stock market was determined in an unbiased fashion by the sources of supply and demand, net asset valuations were made by tax officials typically lacking experience in assessing the market value of shares and facing the temptation to do well for the government by ascribing a high price to equity for death duty purposes.[131] Also, using the share price was advantageous to the estate because in companies with a blockholder the stock market price would typically have incorporated a minority discount due to the controlling block not being "in play". As a result, all else being equal, the share price would have been lower than an asset-based valuation conducted on the basis that all shares were equivalent.[132] Owners of large, successful private firms thus had an incentive to carry out a public offering and then ensure the "free float" met or exceeded the prescribed limits.

5. Taxation and Demand for Shares

Given that the taxation of corporate profits, dividends, employment income and the transfer of assets on death provided blockholders with incentives to exit, tax clearly contributed to the emergence of the U.K.'s outsider/arm's-length system of ownership and control. Willingness by blockholders to unwind their holdings is not a sufficient condition, however, for the diffusion of share ownership. Also crucial is that there must be demand on the part of investors who are prepared to own small percentages of equity in public companies and who are either indifferent or less affected by the tax considerations that helped motivate the blockholders to sell. If there is no such appetite for shares then blockholders eager to exit will either have to transfer the business to a new "core" investor or simply liquidate the firm's assets on a piecemeal basis. Either way, the predominant corporate governance arrangement will remain insider/control-oriented.

It cannot be taken for granted there will be demand for small holdings in publicly quoted companies. Ownership of a tiny percentage of shares in a public company is an investment potentially fraught with risk. Due to information asymmetries, investors can struggle to distinguish "high-quality" companies from their less meritorious counterparts. With a company that has a blockholder, minority shareholders can fall

---

[130] Finance Act 1930, 20 & 21 Geo. 5, c. 28, s. 37; STANFORD, Tax Planning and the Family Company, 124 (2nd ed. 1964). The original statutory provision, enacted in 1922, extended the option to companies that had issued shares to public and otherwise were not under control of fewer than five persons: Finance Act 1922, 12 & 13 Geo. 5, c. 17, s. 21(6).

[131] HADRILL, "Family Businesses" (Letter), Times, January 3, 1953, 7.

[132] "Shell Kernels", The Economist, March 15, 1958, 957. On the fact that an assets value measure did not take into account explicitly the size of the shareholding involved, *see* BAYNES, Share Valuations, 64-65, 115 (1966).

victim to extraction of private benefits of control. Matters are not necessarily any better in a widely held company. Since none of the shareholders is likely to have a stake large enough to justify close monitoring of management, senior executives potentially have a licence to pursue their own interests at the shareholders' expense. Moreover, the tax considerations that induce blockholders to exit can also discourage individuals investors from purchasing shares since their after-tax return will be diminished.

The thesis that the quality of corporate and securities law is the key determinant of ownership structures in a particular country plausibly accounts for how ownership can separate from control despite the difficulties associated with being an outside investor. The logic is that corporate and securities law, by addressing informational asymmetries and imposing constraints on potential insider misconduct, can make investors feel sufficiently "comfortable" about owning tiny percentages of shares in companies to create robust demand for shares in publicly quoted companies.[133] U.K. company law in fact did not provide extensive protection to outside shareholders and disclosure regulation was primitive by contemporary standards as ownership separated from control (*see* section 3). Various other factors, however, encouraged investors to buy shares in sufficient volume to permit blockholder exit. Tax played a significant role in the process due to clientele effects arising from the structure of personal income taxation rates in the interwar period and rules governing institutional investment in the decades following World War II.

5.1 The Interwar Period

While it is unlikely that the U.K. had a fully-fledged outsider/arm's-length system of ownership and control by the end of the 1930s, during the decades following World War I the middle class began investing in shares in a serious way.[134] One reason for the broadening of stock market investment was that shares were generating better returns than obvious alternatives.[135] Swings in investor sentiment further reinforced the momentum in favor of investing in shares, with enthusiasm peaking in stock market booms during 1919-20, 1927-29 and the mid-1930s.[136] A 1930 text on investing in public companies remarked upon how investor sentiment influenced demand for shares, saying "(i)n times when much Stock Exchange activity prevails and prices of stocks generally are rising opportunities for public flotations are exceptionally favorable…(with) the public being, at such times, infected with the

---

[133] The terminology is borrowed from ROE, Political Preconditions to Separating Ownership from Corporate Control, 53 Stanford Law Review 539, 586 (2000).

[134] *Supra* notes 11 to 13 and accompanying text.

[135] Between 1919 and 1939 shares were a good bet since average year-to-year returns for equities were 12.4% compared with 6.5% for consols, a type of U.K. government bond. *See* MERRETT/SYKES, Return on Equities and Fixed Interest Securities: 1919-1966, District Bank Review, June 1966, 29, 36, 41; *see* also SCOTT, Towards the "Cult of the Equity"? Insurance Companies and the Interwar Capital Market, 55 Economic History Review 78, 93 (2002) (reporting that from 1921 to 1938 the average annual return on equities was 10.4% and the average annual return on gilts was 6.5%).

[136] On the timing, *see* THOMAS, Finance, *supra* note 37, at 26-29, 32.

general optimism prevailing on the Stock Exchanges, and therefore specially gullible".[137]

While flourishes of investor sentiment could periodically provide a highly congenial environment in which blockholders could sell out, adjustments to the proportional burden of income tax helped to provide a more enduring source of demand for shares in the interwar period. The experience in the U.S. is instructive on this count. Adolf Berle and Gardiner Means proclaimed in their famous 1932 book *The Modern Corporation & Private Property* that "in the largest American corporations, a new condition has developed … (T)here are no dominant owners, and control is maintained in large measure from ownership".[138] Relying on data Means compiled for a 1930 paper on dividends received by taxpayers in different income brackets, they deduced that the percentage of shares owned by wealthy Americans dropped substantially between 1916 and 1921 and characterized the process as "a shift in corporate ownership…of almost revolutionary proportions".[139]

Berle and Means, again drawing on Means' work, relied on income tax to explain what had occurred.[140] Financial pressures arising from World War I precipitated a dramatic increase on taxation of income of the wealthy, with the federal government boosting the top marginal rate of individual income tax (actually a combination of income tax and surtax) from 7% in 1915 to 54% in 1917 and to 77% in 1918 with an effective rate of 61%, meaning that someone with a taxable income of $100,000 had to pay $61,000 in taxes.[141] The top rate of income tax remained as high as 75% until 1922; by 1925 it had been cut to 33%.

To quote Means' 1930 paper, the increases in income tax made "the rich man a poor market for corporate securities" since they had less after-tax income to invest and new incentives to allocate what they had to invest in tax-favored assets, such as tax-exempt government bonds, real estate and insurance.[142] Banks and life insurance companies apparently were not buying shares in any volume at this time, and foreign demand was negligible.[143] As a result, if companies wanted to raise capital or blockholders wanted to exit, the middle class became the obvious market.

By happy coincidence, according to Means, "the man of moderate means became a potential market for securities of all sorts".[144] Readjustments brought about by World War I – including income tax imposed primarily on the rich – meant the less well-to-do profited economically from the war and had considerable addi-

---

[137] CUTFORTH, Public Companies and the Investor, 149 (1930); *see* also at 50.

[138] BERLE/MEANS, The Modern Corporation & Private Property, 110-11 (1997, originally published in 1932).

[139] BERLE/MEANS, *supra* note 138, at 60; MEANS, The Diffusion of Stock Ownership in the United States, 44 Quarterly Journal of Economics 561 (1930).

[140] BERLE/MEANS, *supra* note 138, at 58-59.

[141] MEANS, Diffusion, *supra* note 139, at 586 (discussing the effective rate for a top marginal rate taxpayer); BANK, Dividend, *supra* note 35, at 17 (setting out individual and corporate tax rates for 1913-35).

[142] MEANS, Diffusion, *supra* note 139, at 586.

[143] MEANS, *id.*, at 587.

[144] MEANS, *id.*, at 586.

tional income at their disposal, part of which could be invested.[145] At the same time, a successful Liberty Bond campaign launched by the U.S. government to finance American participation in World War I was familiarizing millions to securities markets who had previously saved purely through real estate and bank accounts and creating a new class of financial intermediaries that could quickly mobilize Liberty bondholders into other investments.[146] The number of stockholders and the proportion of corporate equity owned by individuals who were prosperous but not rich accordingly increased substantially, providing the platform for what Berle and Means characterized as a separation of ownership and control in large U.S. companies.[147]

A similar tax-supported broadening of the investor base likely occurred in the U.K. during the interwar years. As in the U.S., tax made, in Means' words, "the rich man a poor market for corporate securities". Due in large part to income tax that was very high by pre-World War I standards, the share of wealth held by the top 1% of the population fell from 69% to 56% between 1911/13 and 1936-38.[148] Most dramatically, caught by inflation, falling rents and rising taxes, many wealthy landowners broke up their estates to finance the lifestyle to which they were accustomed and did so at such a rate between 1918 and 1921 there reportedly was a transfer of land "probably not equalled since the Norman Conquest".[149]

In contrast to the situation at the beginning of the 20th century, when the wealthy, through local business connections or as clients of stockbrokers, constituted an integral source of demand for shares, after World War I the rich often became net sellers of securities to pay income tax and anticipated death duties.[150] Moreover, when the rich did buy shares, they were more conservative in their approach than they had been previously.[151] Sir Josiah Stamp, a wealthy industrialist and Bank of England director, made the point in 1930 when giving evidence to a government-appointed committee investigating finance and industry, saying, "you cannot expect these private businesses to be financed as they were by people who knew them once the money has left them by high taxation and…if (rich investors' money) is bid for by home enterprise it goes into the very large concerns."[152]

---

[145] MEANS, *id.*, at 586; WARSHOW, The Distribution of Corporate Ownership in the United States, 39 Quarterly Journal of Economics 15, 37 (1924).

[146] WARSHOW, Distribution, *supra* note 145, at 35; SOBEL, Inside Wall Street: Continuity and Change in the Financial District, 203 (1977); GEISST, Wall Street, A History, 157 (1997).

[147] BERLE/MEANS, *supra* note 138, at 5. For further details on the rise of the private investor, *see* section 6.2 of the paper.

[148] LOWE, Riches, Poverty, and Progress, in: ROBBINS (ed.), The British Isles 1901-1951, 197, 200 (2002) (noting, however, that the data for 1911-13 is probably not as reliable as it was for later years).

[149] THOMPSON, English, *supra* note 10, at 333.

[150] GORDON, The Capital Market of Today, 102 Journal of the Royal Statistical Society 501, 509 (1939).

[151] MICHIE, The City of London: Continuity and Change, 1850-1990, 121 (1992); *see* also THOMAS, Finance, *supra* note 37, at 117.

[152] Quoted in MICHIE, City, *supra* note 151, at 120-21.

At the same time the wealthy receded as a source of demand for shares, "the man of moderate means became a potential market". While the very rich in Britain did poorly relative to others during World War I and the decades following, the merely well-off fared well as the share of wealth held by the top 2% to 10% of the population rose from 23% to 32% between 1911/13 and 1936-38.[153] Things that had generally been the exclusive preserve of the wealthy in turn became dispersed more widely,[154] including ownership of shares among an (upper) middle class with increased capital at their disposal available for investment. The trend was correctly anticipated by a witness giving evidence in 1918 to a committee investigating company law reform, citing the large number of people who invested in bonds the U.K. government issued to finance World War I:

> "We have seen during the War a remarkably widespread diffusion of money, and a wonderful growth in the habit of investment, among classes of the population to whom both are a novelty. It is computed that no less than 13,000,000 people are directly interested in various forms of Government war securities. After the war it may be expected that a large number of people who were never investors before will be willing to entrust their savings to commercial companies …"[155]

A 30% inflation-adjusted increase in average earnings between 1914 and the end of the 1930s, supported by significant increases in GDP per capita, contributed significantly to the new prosperity the middle class enjoyed.[156] Tax also played a role, since the Conservative government of the 1920s that opted to leave the very rich "stranded" sought to give relief to "professional men, small merchants and businessmen – superior brain workers of every kind".[157] For instance, the government cut the standard rate of income tax from 30% to 25% in 1923 and cut it further to 22.5% in 1924 and 20% in 1926.[158] As the 1920s drew to a close, the top marginal tax rate applicable to incomes up to £5,000 (£203,000) was a fairly modest 31% and a single person earning £5,000 paid under £1,200 in income tax.[159]

Income taxes payable by the (upper) middle class did rise somewhat in the 1930s.[160] However, at least until taxes were boosted to finance rearmament just prior to World War II, tax was not really hurting the middle class.[161] For instance, for a single person earning £5,000 in 1937, his "take home" pay still would have been more

[153] LOWE, Riches, *supra* note 148, at 200; THORPE, Britain, *supra* note 57, at 95.
[154] LLOYD, Empire, Welfare State, Europe: History of the United Kingdom 1906-2001, 176 (5th ed. 2002).
[155] Quoted in MICHIE, City, *supra* note 151, at 117.
[156] ALDCROFT, British, *supra* note 55, at 150; LOWE, Riches, *supra* note 148, at 202.
[157] DAUNTON, *supra* note 39, at 133.
[158] On the standard rate of income tax between 1901 and 1930, *see* CAUDWELL, Practical, *supra* note 82, at 11.
[159] "Income Tax and Surtax", Times, April 15, 1930, 11. The precise amount payable would have varied a small amount depending on the proportion of the income was "earned" and "unearned".
[160] GLYNN/OXBORROW, Interwar Britain: A Social and Economic History, 48 (1976) (noting, though, that the government moderately reduced the standard rate of income tax for 1934 and 1935).
[161] GLYNN/OXBORROW, Interwar, *id.*, at 48.

than 70% of his income.[162] Given rising earnings, taxation at this sort of level should have left prosperous members of the middle class with sufficient spare funds to buy shares and other securities in considerable volume. Thus, even during the 1930s a congenial tax environment would have helped to provide a platform for middle class investment in shares.

5.2 Post-World War II

The most important trend underlying the form of outsider/arm's-length ownership and control that ultimately emerged in Britain was the rise of institutional investors, who dominated the U.K. stock market following World War II. As section 2 discussed, between 1957 and 1991 the proportion of U.K. quoted equities owned by institutional shareholders rose from one-fifth to three-fifths and the proportion of U.K. public company shares owned by individuals on their own behalf dropped from two-thirds to one-fifth.[163] Among institutional investors, pension funds and insurance companies were the dominant players, with the percentage of shares owned by pension funds growing from 1% in 1957 to 17% in 1975 and 31% in 1991 and the equivalent figures for insurance companies being 8% (1957), 16% (1975) and 20% (1991). Two trends underpinned the strong demand for shares by pension funds and insurance companies, these being a reallocation of investment priorities by institutional intermediaries and a massive increase in funds available for investment. Tax played a role with both, and was a pivotal cause of the latter.

The activities of U.K. insurance companies have traditionally been divided into "general" and "life" business. "General" insurance comprises contracts that pay a sum if a misfortune occurs within a specific period of time (*e.g.* insurance against accidents and property damage) whereas "life" insurance (technically "assurance") provides coverage for a certain event occurring at an uncertain time, namely death.[164] In the U.K. life insurance has been by far the more important from an investment perspective, with life offices being much better positioned to accumulate substantial funds earmarked for long-term investment because hasty liquidation of investments to meet outstanding commitments is a much more remote prospect.[165]

Life insurance companies first began to treat shares in U.K. companies as a serious investment option during the interwar years, as a number of advocates of an "enlightened" investment policy emphasized the merits of shares and a number of

---

[162] The taxpayer would have been liable to pay £1,465 in income tax: "Higher Rate of Income Tax", Times, April 27, 1938, 10.

[163] For more precise figures, *see supra* note 18 and related discussion.

[164] SAMPSON, Anatomy of Britain, 398-401 (1962); RUTTERFORD, Introduction to Stock Exchange Investment, 339 (1983).

[165] *See* COMMITTEE ON THE WORKING OF THE MONETARY SYSTEM (Lord Radcliffe, Chairman), Report, Cmnd. 827, 82 (1959); COMMITTEE TO REVIEW THE FUNCTIONING OF FINANCIAL INSTITUTIONS (Sir Harold Wilson, Chairman), Evidence on the Financing of Trade and Industry, vol. 3, 46-47 (1977), making the point by indicating that, as of 1957, life fund investments amounted to £4.042 billion whereas general fund investments were only £399 million and that, as of 1978, life fund investments were £37.8 billion and general fund investments were £7.1 billion.

insurance company pioneers followed up by investing significant sums in equity.[166] As a result, by 1937, nearly 10 per cent of British life assurance assets were invested in ordinary shares.[167] This figure remained unchanged in 1946 but rose to 12% in 1951, 16% in 1956 and 21% by the beginning of the 1960s when insurance companies in effect called a halt to the expansion in the proportion of shares in the portfolios.[168] In the years immediately following World War II, however, insurance companies stood out as the major source of fresh funds for the capital market.[169]

With pension funds, during the opening decades of the 20th century the trust deeds governing investment usually precluded buying shares and those trustees vested with wide discretion generally shunned "risky" equity investments.[170] By the 1950s, the custom was for private pension funds to have the full power of an ordinary investor and investing in equity became fashionable as trustees became aware that shares were steadily delivering better returns than fixed income securities.[171] By 1953 pension funds of commercial and industrial companies had 19% of their assets invested in ordinary shares of companies, and this figure rose to 30% by 1955 and 48% by 1963.[172] Over the next decade, further reallocations in favor of equity were primarily carried out by local authority pension funds, which had been prohibited from owning shares until the mid-1950s but had almost as high a proportion of shares in their portfolios as did private pension funds by the mid-1970s.[173]

The manner in which dividends were taxed in the hands of pension funds contributed to the popularity of shares as an investment. While for individuals earning high incomes punishing income tax rates detracted considerably from the value derived from dividends (*see* section 4.3), for pension funds dividends were tax-friendly. Beginning in 1921, pension funds meeting criteria stipulated by tax legislation qualified as zero-bracket taxpayers, meaning they were not liable to pay

---

[166] PAISH/SCHWARTZ, Insurance Funds and Their Investment, 92-93, 97 (1934).

[167] SCOTT, *supra* note 135, at 98; COMMITTEE ON THE WORKING OF THE MONETARY SYSTEM, *supra* note 165, at 86.

[168] On the data, *see* COMMITTEE ON THE WORKING OF THE MONETARY SYSTEM, *supra* note 165, at 86; MENNELL, Takeover: The Growth of Monopoly in Britain, 1951-61, 87-88 (1962); BRISTON, The Stock Exchange and Investment Analysis, 411 (3rd ed. 1975). On the change in investment policy *see* CLAYTON/OSBORN, Insurance Company Investment: Principles and Policy, 135-36 (1965).

[169] CHARTERHOUSE FINANCE CORPORATION LIMITED, *supra* note 126, at 245.

[170] COMMITTEE ON THE WORKING OF THE MONETARY SYSTEM, *supra* note 165, at 89; HANNAH, Inventing Retirement: The Development of Occupational Pensions in Britain, 74 (1986).

[171] On permitted investments, *see* COMMITTEE ON THE WORKING OF THE MONETARY SYSTEM, *supra* note 165, at 89. On the switch to equities, *see* LITTLEWOOD, Stock, *supra* note 69, at 107-8; PLENDER, That's the Way the Money Goes: The Financial Institutions and the Nation's Savings, 40-41 (1982).

[172] COMMITTEE ON THE WORKING OF THE MONETARY SYSTEM (Lord Radcliffe, Chairman), Minutes of Evidence, 501; BLEASE, Institutional Investors and the Stock Exchange, District Bank Review, September 1964, 38, 45.

[173] On the position up to the mid-1950s, *see* COMMITTEE ON THE WORKING OF THE MONETARY SYSTEM, *supra* note 165, at 88. On the situation in the mid-1970s, *see* MIDGLEY/BURNS, Business Finance and the Capital Market, 363 (3rd ed. 1979).

income tax on dividends they received.[174] As a result, when companies under the imputation system of corporate tax deducted at source part of the income tax shareholders were obliged to pay on dividends, pension funds could in effect demand from U.K. tax officials a refund for amounts notionally deducted on their behalf.[175]

Events occurring during the 1990s confirm that pension funds took into account the tax-advantaged status of dividends when buying shares. In 1993, the government placed limits on the refund pension funds could claim, and the availability of a tax refund was abolished entirely in 1997 although pensions remained exempt from further tax on dividends received.[176] This coincided with pension funds winding down considerably their investment in U.K. public companies, with the proportion of U.K.-quoted shares pension funds owned dropping from 28% in 1994 to 16% in 2001.[177] The abolition of the tax break for dividends was one factor that helped to prompt the switch out of equities,[178] though a desire on the part of pension fund trustees to achieve greater diversification and to meet funding commitments looming due to the ageing process and tightened regulation of pension fund investments also played an important role.[179]

While readjustments in asset allocation contributed significantly to the rise of institutional investors as shareholders in the U.K., just as important was a large increase in the volume of cash to invest. Annual growth in assets held by life insurance companies and pension funds rose each year from 1948 (a combined £218 million) to 1952 (£351 million)[180] and the pattern held thereafter. The total financial holdings of insurance companies grew more than tenfold between 1952 and 1979, and more than doubled in real terms (£4.0 billion in 1952, or £77 billion in today's currency; £52.8 billion in 1979 or £178.9 billion now).[181] The trend was even more dramatic with pension funds, with total financial assets of pension funds growing 32 times over the same period, or more than five times in inflation-adjusted terms

---

[174] BLAKE, Pension Schemes and Pension Funds in the United Kingdom, 38-39 (2nd ed. 2003); COMMITTEE ON THE TAXATION TREATMENT OF PROVISIONS FOR RETIREMENT (James M. Tucker, Chairman), Report, Cmd. 9063, 22 (1954).

[175] This option was not available during the U.K.'s 1965-73 experiment with corporate tax.

[176] On the effect of the 1993 reforms, *see* RILEY, "Second Thoughts on the Dividend Tax Dangers", Fin. Times, June 18, 1997, 29. On the repeal of the refundable tax credits in 1997, *see* BANK, The Dividend Divide in Anglo-American Corporate Taxation, 30 Journal of Corporation Law 1, 47-48 (2004).

[177] On ownership data, *see* sources cited *supra* note 18.

[178] SEARJEANT, "Seven Years On, Brown's Swoop on Pensions Looks Less Clever", Times, October 15, 2004, 58; *see* also COHEN, "End Nostalgia for a Tax Break", Financial Times, August 11, 2003, FT fm, 6 (acknowledging the popularity of the argument, but casting doubts on its validity).

[179] FIFIELD, "Pension Funds Shun Equities for Bonds", Financial Times, December 23, 2003, 4; COGGAN, "Pension Funds Steadily Forsaking U.K. Equities", Financial Times, June 19/20, 2004, M28; KALETSKY, "Regulation Killed the Pensions Industry", Times, October 16, 2006, 35.

[180] WRIGHT, The Capital Market and the Finance of Industry, in: WORSWICK/ADY (eds.), The British Economy in the Nineteen-Fifties, 461, 482 (1962).

[181] On the data, *see* PRAIS, The Evolution of Giant Firms in Britain: A Study of the Growth of Concentration in Manufacturing Industry in Britain 1909-70, 116 (1976); POLLARD, The Development of the British Economy, 332 (4th ed. 1992).

(£1.3 billion in 1952, or £25.0 billion today; £41.0 billion in 1979, or £138.9 billion now).[182]

The massive increase in assets in institutional hands was pivotal because it meant robust institutional demand for shares existed, in a sense, by default. The period between the mid-1960s and mid-1970s illustrates. During these years the percentage of total assets under management by key institutional investors – insurance companies, pension funds and the U.K. equivalents to mutual funds, known as investment trusts and unit trusts – invested in shares remained virtually unchanged.[183] Regardless, due to a steady increase in funds to invest, collectively institutional investors were net purchasers of shares in each and every year throughout this period.[184] The authors of a 1978 study on the rise of institutional investment put this data into context, saying:

> "The continuous net acquisitions of company…securities by institutional investors is the result of the increased total assets held by financial institutions, the increase in total assets being financed by the contractual savings of the personal sector."[185]

Tax does much to explain why institutional investors grew so rapidly in the U.K., as there was a strong bias in favor of investment via institutional intermediaries as compared with direct ownership of shares. As the Economist magazine said in a 1977 survey of investment in Britain, "the enormous advantages of institutional saving for the rich who might once have invested in equities but who are now prevented from doing so by tax, explains the overwhelming dominance the institutions have acquired in the stock market."[186] The punishing taxation of dividends was one key factor that "prevented" direct investment in shares, but there were other tax-related constraints. There were transaction costs, of which stamp duty formed a part.[187] From 1965 onwards, investors had to pay capital gains tax of 30% on profits derived from selling shares, which though lower than income tax was higher than rates imposed in other countries, leading the Economist to observe when the tax was introduced that "Britain has gone from virtually nowhere to the top of the major international league".[188] Also, from 1962 to 1971 capital gains derived from "short term" dealings (six months initially, extended to twelve in 1965) were deemed to constitute income and thus were subjected to taxation at the same punitive levels as dividends.[189]

---

[182] On 1952, 1962, 1967, 1972, *see* PRAIS, Evolution, *supra* note 181, at 116. On 1979, *see* COAKLEY/HARRIS, The City of Capital: London's Role as a Financial Centre, 96 (1983).

[183] BLUME, The Financial Markets, in: CAVES/KRAUSE (eds.), Britain's Economic Performance, 261 (1980).

[184] BRISTON/DOBBINS, *supra* note 19, at 189.

[185] BRISTON/DOBBINS, *id.*, at 18.

[186] "Investment in Britain: A Survey", The Economist, November 12, 1977, 49.

[187] *Supra* notes 109-110 and related discussion.

[188] "Missed Opportunity", The Economist, April 10, 1965, 210, 210.

[189] Finance Act 1962, 10 & 11 Eliz. 2, c. 44, ss. 12-16, sch. 9; Finance Act 1965, s. 17; for background, *see* BEATTIE, Elements of the Law of Income and Capital Gains Taxation, 6, 106-9 (9th ed. 1970).

Given the unfavorable climate for direct investment in shares, private investors not surprisingly turned to forms of savings that received more favorable tax treatment.[190] From the end of World War II onwards, direct ownership of shares by individuals plummeted. As the Economist noted in 1953:

> "In the last five years there has been no net personal investment on the Stock Exchange. Sales of securities from private portfolios seem to have clearly exceeded the purchases that individuals have made."[191]

A 1980 survey of U.K. financial markets, relying on data from a study of the flow of funds prepared by the Bank of England, confirmed individuals were net sellers of corporate equity. Each year between 1963 and 1977 individuals sold more shares than they bought, with the amounts involved varying from a low of £1.22 billion in 1969 to a high of £3.79 billion in 1973.[192] The persistent trend of net selling can be fairly attributed to tax rather than other investment considerations. A 1952 survey of corporate finance in the U.K. noted "(t)he private investor, owing to the incidence of high taxation, has to a large extent ceased to have surplus funds available year by year out of income"[193] and through the 1950s, 1960s and 1970s shares steadily outperformed obvious alternate investments, such as government bonds and corporate debentures.[194]

When investors gave up on shares in search of other more tax-friendly investments, pensions were one of the principal beneficiaries.[195] In the years following World War II the dramatic growth of pension fund assets was partly due to a significant expansion in the percentage of employees covered by company pension funds and an "immature" demographic pattern in which cash inflows greatly exceeded outflows.[196] Tax, however, also channeled funds towards pension funds, as the tax treatment of pensions was, given the robust taxation of investment income, strikingly benign.

An expert on pension funds observed in 1974 that some advertisements for retirement savings plans were "so absurdly generous that the reader must feel there must somehow be a snag" but assured readers that this was not the case due to tax advantages afford to pensions.[197] To be more precise, assuming a pension fund met a series of Inland Revenue criteria, all employer contributions were excluded from the recipient's income until withdrawal and employee contributions were deductible from

---

[190] GLEESON, *supra* note 110, at 136.

[191] "Corpse in the Capital Market", The Economist, February 7, 1953, 375, 375.

[192] BLUME, Financial, *supra* note 183, at 276-77, 294 (only citing precise amounts for 1966 to 1977).

[193] CHARTERHOUSE FINANCE CORPORATION LIMITED, *supra* note 126, at 245.

[194] DIMSON/MARSH/STAUNTON, Triumph of the Optimists: 101 Years of Global Investment Returns, 153, 303 (2002); PRATTEN, The Stock Market, University of Cambridge Department of Applied Economics Occasional Paper No. 59, 75 (1993) (offering data on investment returns for shares, government bonds and debentures for the 1950s, 1960s and 1970s).

[195] For an overview, *see* BLAKE, Pension, *supra* note 174, at 38-41.

[196] LITTLEWOOD, Stock, *supra* note 69, at 255; HANNAH, Inventing, *supra* note 170, at 66-67.

[197] GILLING-SMITH, Pensions, in: STANLEY (ed.), The Creation and Protection of Capital, 109, 110 (1974).

employment income.[198] Also, pension funds were “gross funds”, meaning that no tax was levied on their investment income or on capital gains.[199]

Given the fiscal benefits associated with pension funds, “top hat” pension schemes, which involved employees in higher income brackets agreeing to accept a reduced salary in return for their employer increasing its pension contribution, proved very popular.[200] Similarly, employees who were part of approved schemes and had cash available for investment could reap tax advantages by forgoing direct investment in shares or other financial assets in favor of making additional pension contributions. Individuals who were not members of a pension fund lacked similar incentives until the mid-1950s. Reforms carried out then and subsequently meant that by 1971 money they set aside in an approved form for retirement purposes received much the same tax benefits as private contributions to an employee-established approved scheme.[201]

Life insurance was another example of a tax advantaged investment vehicle that helped hasten the decline of direct ownership of equity by personal investors and the rise of institutional investment.[202] Up to 1984, an individual received on premiums paid a partial allowance against the basic rate of income tax, generally in the neighborhood of 15%. Also, so long as certain statutory criteria were met, with life insurance policies structured so as to deliver an investment-driven return rather than simply pay out upon death, the amounts distributed to policyholders were “tax free” in the sense that they were not subject to income tax or capital gains tax. Insurance companies were liable to tax on the returns earned from invested funds but since insurers were not taxed heavily, for investors purchasing life insurance significant tax advantages remained.

Life insurance companies exploited the tax rules to market as life assurance *de facto* contractual savings plans with only a nominal link to paying a guaranteed sum in the event of the premature death of the policyholder.[203] For instance, with unit-linked life insurance, a “potent innovation” of the late 1950s,[204] only a tiny percent-

---

[198] On employer contributions, *see* BEATTIE, Elements, *supra* note 189, at 129-30; COMMITTEE ON THE TAXATION TREATMENT OF PROVISIONS FOR RETIREMENT (James M. Tucker, Chairman), Report, Cmd. 9063, 21 (1954). On employee contributions, *see* BLAKE, Pension, *supra* note 174, at 38-40; HOSKING, Pension Schemes and Retirement Benefits, 63-65 (1956).

[199] PILCH/WOOD, Pension Schemes: A Guide to Principles and Practice, 113 (1979).

[200] TITMUSS, *supra* note 101, at 148-50; “Advantages of a ‘Top Hat’ Pension Scheme”, Times, December 4, 1967, 26.

[201] On the changes made in the mid-1950s, *see* HANNAH, Inventing, *supra* note 170, at 49-50. On the 1971 reforms, *see* GILLING-SMITH, Pensions, in: STANLEY (ed.), *supra* note 197, at 109, 109-10.

[202] On the tax advantages life insurance traditionally offered, *see* KAY/KING, *supra* note 35, at 62-63, 210; SIMPSON, Life Policies and Annuities, in: STANLEY (ed.), *supra* note 197, at 133. On the partial erosion of the tax-favored status of insurance from the 1970s onwards, *see* SOLE, The Puzzle of Life Office Tax, 1 British Actuaries Journal 79, 97 (1995); ARMITAGE, Returns After Personal Tax on U.K. Equity and Gilts, 1919-1998, 10 European Journal of Finance 23, 29, 32 (2004).

[203] KAY/KING, *supra* note 35, at 64; SIMPSON, *supra* note 202, at 133.

[204] GLEESON, People, *supra* note 110, at 74.

age of regularly paid premiums were used to purchase insurance and the remainder was invested in a unit trust, with the benefits payable to the policyholder at the end of the term of the contract being determined by reference to the value of the units underlying the policy.[205] The tax advantages of life insurance were not lost on the British public, as they invested massively in this sector during the decades following World War II. By the mid-1970s, life assurance premiums constituted a higher percentage of gross national product in the U.K. than they did in the U.S., Canada, Japan or any western European country.[206]

Since life insurance was much more important from an investment perspective than "general" insurance the tax rules that induced investment in life insurance contributed to the accumulation of funds that underpinned institutional demand for shares following World War II. With the pattern being the same for pension funds, tax helped to fortify the institutional wall of money that by default ensured there were buyers for shares in U.K. public companies during the period when Britain's outsider/arm's-length system of ownership and control became entrenched. Hence, tax was fostering demand for shares while simultaneously providing blockholders with incentives to exit.

6. Why Did New Investors Fail to Exercise Control?

In order for an outsider/arm's-length system of ownership and control to take shape in a particular country, incumbent blockholders must be looking to exit and there must be buyers willing to purchase the available equity. Fulfillment of these conditions is merely necessary, however, not sufficient. The new investors may be intent on exercising control themselves, in which case they would either buy all of a company's shares available for sale or accumulate holdings large enough to exercise a dominant influence. If this in fact is the standard operating procedure, insider/control-oriented corporate governance will continue to prevail despite the exit by incumbent blockholders. As matters transpired, those buying shares in U.K. public companies were not inclined to exercise control, thus ensuring the final of the three conditions precedent for ownership to separate from control was satisfied. There were various reasons for this, but in this particular instance tax did not have a major role to play.

6.1 General Factors Deterring Intervention by Investors

Up to World War II blockholders continued to hold sway in many U.K. public companies, thus necessarily limiting the scope for outside investors to wield meaningful influence. Regardless, those buying shares during the interwar years were generally ill-suited to step forward and exercise control. During this period, middle and upper-

---

[205] MIDGLEY/BURNS, Business, *supra* note 173, at 436-37; BLUME, Financial, *supra* note 183, at 287-88; BROWN/TRIMM, Life Assurance: Its Tax Implications and Practical Uses, 5 (1977).

[206] COMMITTEE TO REVIEW THE FUNCTIONING OF FINANCIAL INSTITUTIONS, *supra* note 165, at 66; CLARKE, Inside the City: A Guide to London as a Financial Centre, 102 (1983).

middle class investors constituted the primary source of demand for shares (*see* sections 2 and 5.1). As economist P. Sargant Florence observed in a 1953 book on the organization of British and American industry, private investors were too "ignorant, business-shy or *too* busy – or any two of them or even all three" to take any sort of active role in the governance of the companies in which they owned shares.[207] Even among those with business expertise, it was standard practice to diversify by buying shares in a variety of different companies, meaning the fate of any one would not have a significant impact on their personal financial circumstances.[208] Moreover, as Hargreaves Parkinson said in a 1932 book on investment, if a shareholder lost faith in a company's directors he would "usually cut his loss and sell out".[209] The "natural and inevitable" result, as economist G.D.H. Cole said in a 1935 paper on a share ownership in Britain, was that those buying shares "ceased…to regard themselves in any way responsible for the conduct of the enterprises which were legally their property."[210]

Given the rapid rise of institutional shareholders after World War II, if they had chosen to act collectively they could have used their voting power to dictate how U.K. public companies would be run, thus creating a system of corporate governance that would have been "control-oriented" rather than "arm's-length". This, however, did not occur. Instead, institutional shareholders were "the sleeping giants of British corporate life".[211]

Fear of government intervention was one deterrent to activism. There was concern among institutional investors that if they sought to influence business policy regularly and openly, resentment of institutional power would build and prompt government interference in the affairs of the institutions.[212] Insurance companies were affected particularly since they had to engage in a fierce anti-nationalization campaign to counteract a plan announced by Labour in 1949 to take the industry into public ownership.[213]

A strongly entrenched belief among institutional shareholders that they were investors, not proprietors, was a further obstacle to activism. The institutions considered themselves well-placed to understand markets and implement trading strategies but felt they lacked the manpower, training and experience to involve themselves in the management of public companies.[214] The idea that expertise limitations accounted for institutional passivity was accepted in official circles. While a committee struck by the U.K. government to review the functioning of financial institutions and chaired by former Prime Minister Harold Wilson urged institutional shareholders in its 1980 report to be more activist, it excused past passivity on the grounds

[207] FLORENCE, *supra* note 14, at 179.
[208] COLE, Evolution, *supra* note 11, at 58; FLORENCE, *supra* note 14, at 181-82.
[209] PARKINSON, Scientific, *supra* note 12, at 13.
[210] COLE, Evolution, *supra* note 11, at 59.
[211] KYNASTON, The City of London, Volume IV: A Club No More 1945-2000, 434 (2001).
[212] SAMPSON, Anatomy, *supra* note 164, at 412; PLENDER, *supra* note 171, at 20.
[213] DENNETT, A Sense of Security: 150 Years of Prudential, 298-301 (1998); HOBSON, The National Wealth: Who Gets What in Britain, 1005 (1999).
[214] SPIEGELBERG, The City: Power Without Accountability, 57 (1973); COMMITTEE TO REVIEW THE FUNCTIONING OF FINANCIAL INSTITUTIONS, *supra* note 165, at 90, 122.

"(t)he institutions are still to some extent feeling their way, which may inhibit them intervening at an early enough stage".[215]

6.2 Tax as a Potential Deterrent to Blockholding by Investment Trusts and Unit Trusts

Did tax have any role to play in deterring U.K. institutional shareholders from exercising control over the companies in which they owned shares? In the U.S., as section 7 discusses, regulatory constraints helped to deter financial institutions from becoming "hands on" investors in large companies, and tax law was part of this regulatory matrix. At first glance, there were British parallels, since from the mid-1960s onwards tax law contained a potential deterrent against blockholding by investment trusts and unit trusts, the British collective investment vehicles equivalent to mutual funds in the U.S. In practice, though, tax likely did little to deter activism by U.K. institutional shareholders.

An investment trust is a company whose business is to invest money in equity and fixed-income securities on behalf of its shareholders. Unit trusts perform much the same function, with the basis being a trust deed rather than a company. Coinciding with the introduction of capital gains tax in 1965, U.K. tax law began to distinguish between "approved" investment trusts and unit trusts on the one hand and other investment companies on the other. When an investment trust or unit trust was "approved," profits derived from the sale of shares could be taxed at the more favorable capital gains rate rather than being taxed as corporate income.[216] Investors in approved investment trusts and unit trusts could also claim credit against their own capital gains liability for any tax already paid by the investment trust or unit trust. In 1972, the nature of the tax break was changed as approved investment trusts and unit trusts paid tax on capital gains at a reduced rate of 15% and holders of shares or units were entitled to a potential 15% credit for capital gains tax already paid by their investment trust or unit trust.[217]

The price for receiving the tax advantages of being an "approved" investment trust or unit trust was that these investment vehicles had to meet a series of prescribed criteria. One such requirement was that no more than 15 per cent of a unit trust or an investment trust's assets could be invested in the shares of a single company.[218] This meant if an investment trust or unit trust that otherwise qualified for approved status was a major shareholder in a company it would lose its tax advantages if the ownership stake formed too large a proportion of its investment portfolio.

---

[215] COMMITTEE TO REVIEW THE FUNCTIONING OF FINANCIAL INSTITUTIONS (Sir Harold Wilson, Chairman), Report, Cmnd. 7937, 311 (1980).

[216] Finance Act 1965, c. 25, ss. 37-38, 67-68; for background, *see* WHEATCROFT, Capital Gains Tax, 127 (1965). The position was complicated further by a tax on "short-term" profits in place between 1962 and 1971, discussed *supra* note 189 and related text.

[217] REVELL, The British Financial System, 447 (1973).

[218] Finance Act 1965, s. 37. Other requirements were that the investment trust or unit trust had to derive its income mainly from shares and securities, had to be quoted on a recognized stock exchange, could not distribute dividends from profits arising from the realization of investments, and could not retain more than 15% of its income from shares in any accounting period.

Thus, tax theoretically constituted a potential obstacle to investment trusts or unit trusts achieving blockholder status.

In practice, the tax rules appeared to have little effect on institutional blockholding as a whole. One reason is that as ownership separated from control in the U.K., investment trusts and unit trusts were something of a side-show compared to insurance companies and pension funds. During the interwar period, the influence of investment trusts on capital markets allegedly matched that of insurance companies and during the late 1950s and early 1960s an average of 15 new investment trust companies were formed each year.[219] Generally, however, in the decades following World War II, investment trusts were eclipsed by other institutional shareholders.[220] Government regulations precluded investment trusts from issuing shares to raise capital during the late 1940s and early 1950s and subsequently investment trusts failed to market themselves effectively among private investors, were handicapped in managing foreign investments by exchange controls and struggled to cope with the tax and administrative burdens imposed by the 1965 introduction of capital gains tax.[221]

In contrast, unit trusts, due to a combination of clever marketing, reliable price quotations and the pricing of units in small denominations that facilitated regular purchases by individuals, grew considerably beginning in the late 1950s.[222] Unit trusts were, however, starting largely from scratch, as doubts about their legality arising in the latter part of the 19th century derailed their use as a vehicle for collective investment until the 1930s.[223] The fact that neither investment trusts nor unit trusts constituted tax-favored investments in the manner of life insurance or pension funds also diminished their popularity.[224]

---

[219] On the interwar period, *see* COMPTON/BOTT, British Industry: Its Changing Structure in Peace and War, 195 (1940); WILLIAMS, Insurance Companies and Investment Trusts, in: COLE, Studies, *supra* note 11, at 139, 154. On the formation of investment trusts in the late 1950s and early 1960s, *see* NEWLANDS, Put Not Your Trust in Money, 256 (1997).

[220] BRISTON/DOBBINS, *supra* note 19, at 17; LITTLEWOOD, Stock, *supra* note 69, at 262.

[221] On the impact of capital controls, *see* MACRAE, The London Capital Market: Its Structure, Strains and Management, 85-86 (1955). On the difficulties investment trusts had on the marketing front, *see* BRISTON/DOBBINS, *supra* note 19, at 17; LITTLEWOOD, Stock, *supra* note 69, at 262. On the effect of exchange controls and capital gains tax, *see* NEWLANDS, Put, *supra* note 219, at 268-70, 279-80, 297-302.

[222] LITTLEWOOD, Stock, *supra* note 69, at 260; SAMPSON, The New Anatomy of Britain, 479-80 (1971).

[223] HADDEN, Company Law and Capitalism, 385 (1972); GOWER, The Principles of Modern Company Law, 266 (4th ed. 1979).

[224] Investment companies were liable to pay income tax and any applicable profits taxes, but could deduct taxes on profits and dividends already paid by companies in which they invested: GIFFORD/STEVENS, Making Money on the Stock Exchange: A Beginners' Guide to Investment Policy, 162 (1955). Cash distributions made by unit trusts and investment trusts generally were taxable in the hands of investors in the same way as a dividend received from a normal U.K. company: MERRIMAN, Mutual Funds and Unit Trusts: A Global View, 54 (1965); ADAMS, Investment, 24, 187, 199 (1989). Once capital gains tax was introduced in 1965, it applied to dispositions of holdings in investment trusts and unit trusts in the same manner it applied to a sale of equity in a public company, though during the 1970s credits potentially available could make the effective rate lower. *See* BEATTIE, Elements of the Law of Income and Capital Gains Taxation, 271-72 (8th ed. 1968); CARMICHAEL, Capital Gains Tax, 356-57 (2nd ed. 1974); CRETTON, Practical C.G.T., 107-8 (1982).

The percentage of shares of U.K. public companies unit trusts owned rose from 0.5% in 1957 to a still-modest 4.1% in 1975 before falling back somewhat by 1981.[225] Precise data is harder to come by for investment trusts, but they likely owned somewhere between 5% and 10% of U.K. public companies between the late 1950s and the early 1980s.[226] While certainly not trivial, with share ownership on this scale neither unit trusts nor investment trusts were primary candidates to take a dominant role in U.K. corporate governance.

Even if investment trusts and unit trusts had been major players, it is unlikely that the tax rules introduced in 1965 would have had a major impact on the manner in which they operated. A 1965 text on capital gains speculated that many investment companies would have to alter their shareholding patterns to comply with the new rules.[227] This, however, generally proved unnecessary. With unit trusts, even prior to 1965 it was nearly universal practice for trust deeds to impose limits on the proportion of assets a unit trust could invest in any one security, so the reforms would not have affected investment policy significantly.[228]

With investment trusts, only a minority had internally generated pre-1965 limitations on the amount that could be invested in one type of security.[229] Nevertheless, it evidently was rare for investment trusts to have more than 15% of their assets tied up in a single company. If blockholding of this kind had been common, it should have taken investment trusts some time to respond to the 1965 tax changes since such large stakes would have been difficult to liquidate promptly without forcing down drastically the share prices of the companies involved. No such difficulties seem to have arisen, since within a year of the tax changes, fewer than 5% of publicly quoted investment trusts, representing less than 2% of total assets held, had failed to qualify for approval.[230] Thus, for investment trusts, as with unit trusts, the tax advantages bestowed on "approved" schemes apparently did little to deter institutional activism in the decades following World War II.

***

While tax played at best a minor role in deterring U.K. institutional investors from exercising substantial control over the companies in which they owned shares, more generally tax contributed significantly to the emergence of Britain's outsider/arm's-length system of ownership and control. High income tax rates, corporate tax rules biased against dividends and estate taxes worked in tandem with other factors to

---

[225] For sources, *see supra* note 18.

[226] Investment trusts, in the available data, are encompassed within "other financial institutions". MOYLE, *supra* note 18, provided a separate breakdown within this category for investment trusts and other owners, with the figures being 5.2% (investment trusts) and 1.6% (other) for 1957 and 7.4% (investment trusts) and 2.6% (other) in 1963.

[227] WHEATCROFT, Capital, *supra* note 216, at 202.

[228] BURTON/CORNER, Investment and Unit Trusts in Britain and America, 291 (1968).

[229] BURTON/CORNER, *id.*, at 4; GLASGOW, The English Investment Trust Companies, 110-88 (1930) (of 76 investment trusts listed, 10 restricted investments in any one security to 10% of total issued funds, 15 imposed a limit of 5% and 12 had a lower percentage limit. The remaining 39 had no restrictions).

[230] BURTON/CORNER, *id.*, at 150.

induce blockholders to exit. At the same time, tax fuelled the rapid growth of institutional investors, which provided the only meaningful source of demand for shares as Britain's outsider/arm's-length system of ownership and control became entrenched. Tax, then, helps to answer why ownership separated from control in Britain in a way currently fashionable explanations of ownership structure do not.

7. Tax and the Rise of the Widely Held Company in the U.S.

Events in the United States confirm that tax can help to cause a separation of ownership from control to become the norm in a country's bigger companies. The United States, it is said, experienced a "corporate revolution" between 1880 and 1930.[231] While family-oriented companies were the norm at the beginning of this period,[232] share ownership became increasingly diffuse and by the end, according to Alfred Chandler, the distinguished business historian, "the great majority of industrial enterprises…came to be controlled by managers".[233] Or as Berle and Means put it in their well-known 1932 book *The Modern Corporation and Private Property*, America's "corporate system" was characterized by a "separation of ownership and control".[234]

The causes of the separation of ownership and control in an American context have not been identified fully.[235] Even the chronology is not entirely clear. While Berle and Means were proclaiming in 1932 that ownership had separated from control in the U.S., a study carried out by the Securities and Exchange Commission implied differently, finding that as of 1937 there was "ownership control" in seven out of ten of the country's 200 largest non-financial companies.[236] It is beyond the scope of this paper to offer any sort of definitive account of what occurred in the United States, with respect to tax or otherwise. The existing literature on the rise of the widely held company in the U.S. nevertheless confirms that tax played a role, and in particular helps to explain why blockholders wanted to exit and why new owners of shares failed to step forward and exercise control themselves.

---

[231] ROY, Socializing Capital: The Rise of the Large Industrial Corporation in America, 3, 16-18 (1997); O'SULLIVAN, Contests for Corporate Control: Corporate Governance and Economic Performance in the United States and Germany, 75-77 (2000).

[232] BASKIN/MIRANTI, A History of Corporate Finance, 193 (1997).

[233] CHANDLER, The United States: Seedbed of Managerial Capitalism, in: CHANDLER/DAEMS (eds.), Managerial Hierarchies: Comparative Perspectives on the Rise of the Modern Industrial Enterprise, 9, 30-31 (1980).

[234] BERLE/MEANS, *supra* note 138, at 5.

[235] BECHT/DELONG, *supra* note 31, at 651.

[236] BURCH, The Managerial Revolution Reassessed: Family Control in America's Large Corporations, 3-4 (1972), discussing TEMPORARY NATIONAL ECONOMIC COMMITTEE, The Distribution of Ownership in the 200 Largest Nonfinancial Corporations, Monograph, No. 29 (1940); LEECH, Ownership Concentration and Control in Large U.S. Corporations in the 1930s: An Analysis of the TNEC Sample, 35 Journal of Industrial Economics 333 (1987).

7.1 Tax and Blockholder Exit

As sub-sections 4.3 and 4.4 outlined, in the U.K. high taxes on income likely provided an incentive for blockholders to exit during the period when the country's outsider/arm's-length system of ownership and control became entrenched since much of what they would have received in the form of dividends or managerial remuneration would have been handed over to the government. A similar process may well have been at work in the United States about the time of World War I.

Berle and Means, as discussed in section 5.1, relied on data on dividends received by taxpayers in different income brackets to argue that a "revolutionary" shift in corporate ownership occurred in the U.S. between 1916 and 1921 and attributed the change largely to a dramatic increase in income tax at higher income levels. Berle and Means' data does not indicate whether the wealthy individuals transferring their shares were blockholders unwinding their holdings or merely rich individuals selling out. Means nevertheless did speculate in the 1930 paper that provided the basis for Berle and Means' analysis that blockholders were exiting. He argued a significant increase in income tax in 1916 "concentrated the attention of the former owners of industry on the possibility of retaining control without important ownership…thereby accelerat(ing) that separation of ownership and control which has become such a marked feature of our modern economy."[237]

The effect of the rise in top marginal rates for blockholders may have been exacerbated by the onset of the double taxation of corporate dividends. When the corporate income tax was first introduced in 1913, corporate income was taxed at 1%, which also served as the normal base rate for the individual income tax.[238] Since corporate income had already been taxed at the normal rate, dividends were exempt from the normal tax in the hands of individuals and only subject to the surtax imposed on taxpayers with high incomes, with the top rate at that point being 6%. In 1917, however, the corporate rate was set at 10%, two percentage points over the then prevailing individual normal tax of 8%.[239] Though the differential was small, establishment of the principle of double taxation of corporate dividends led to denunciation of the reforms as unprincipled "discrimination" against corporations and their stockholders.[240]

---

[237] MEANS, Diffusion, *supra* note 139, at 591-92. For shareholders in companies with large accumulated profits, there was some expectation that the effect of the higher rates would be mitigated by a provision in the 1917 Revenue Act that tied the rate of dividend tax to the rate of tax in effect in the year when the profits were earned. *See* ADAMS, Principles of Excess Profits Taxation, 75 Annals of the American Academy of Political and Social Science 147, 149 (1918); SELIGMAN, The War Revenue Act, 33 Political Science Quarterly 1, 23 (1918).

[238] Tariff Act of 1913, ch. 16, § II(B), (G), 38 Stat. 114, 166, 172.

[239] War Revenue Act of 1917, ch. 63, 40 Stat. 300.

[240] ZOLLER, A Criticism of the War Revenue Act of 1917, 75 Annals of the American Academy of Political and Social Science 182, 186-87 (1918) (Zoller was a tax attorney for General Electric corporation); TAUSSIG, The War Tax Act of 1917, 32 Quarterly Journal of Economics 1, 20 (1917) (calling the differentiation "indefensible as a matter of principle."). The prejudice to taxpayers was contained to some degree because corporations were retaining an increasing amount of earnings, all of which avoided the surtax until distribution. BANK, A Capital Lock-In Theory of the Corporate Income Tax, 94 Georgetown Law Journal 889, 918 (2006).

Wartime taxes on profits compounded the tax "hit" blockholders took. For 1918 there was a war profits tax (W.P.T.) in place that was based on the British E.P.D., with profits exceeding a benchmark based on pre-war profits by more than $3,000 being taxed at 80%.[241] For this one year, the W.P.T. constituted a supplement to an excess profits tax already in place, with corporations only paying the W.P.T. if the tax due was higher than it would have been under the excess profits tax.[242] The U.S. version of the excess profits tax, which was imposed on all businesses from 1917 to 1918 and on corporations only from 1918 to 1921, used as its basis "invested capital", a complex concept redefined over time but which generally had as its foundation cash paid for shares issued by a corporation, undistributed profits, and the value of property owned by a corporation.[243] Excess profits tax was generally imposed at a rate of 65% on profits exceeding 20% of invested capital, with the rate being less on profits below the 20% threshold.[244] Critics claimed the 65% rate was high enough to create a *de facto* upper limit on profits companies could generate for shareholders.[245]

The war-induced combination of high income tax rates, the introduction of double taxation of dividends and the introduction of excess profits tax meant the tax burden on corporate investment was unprecedented, especially for shareholders in higher income brackets, as blockholders typically would have been. As the New York Times account of a 1919 memorandum issued by a partner of investment bank Kuhn Loeb said, "the owner of industrially invested capital has suffered (diminished purchasing power of the dollar) while in addition thereto he is subject to a heavy excess profits tax and, if his income is large, to an income tax of unparalleled severity".[246] Blockholders thus had a series of novel incentives to exit and shift into tax-friendly investments such as government bonds, life insurance and real estate.[247]

During the 1920s, income tax rates were cut substantially from the levels in place in 1921,[248] which would have reduced the pressure on blockholders to exit. With the bull market of the 1920s boosting stock prices, a different incentive would have come into play, namely that the price potentially offered to sell out could be too good to ignore. Numerous blockholders apparently took advantage of the buoyant stock market conditions to liquidate at least part of the holdings through distributions of stock to the public, with the number of initial public offerings and amount of common stock issued both skyrocketing.[249]

---

[241] HICKS *et al.*, *supra* note 41, at 123-24. On the fact that this tax was based on the British tax, *see* "Committee Plans Alternative Tax on War Profits", New York Times, July 30, 1918, 1.

[242] For an example illustrating the point, *see* BLAKEY/BLAKEY, The Revenue Act of 1918, 9 American Economic Review 213, 226-27 (1919).

[243] On the components as of 1919, *see* BLAKEY/BLAKEY, *id.*, at 228.

[244] BLAKEY/BLAKEY, *id.*, at 226 (indicating the tax rate on profits below 20% of invested capital was 30%, subject to an excess profits tax credit of $3,000).

[245] "Otto Kahn Attacks War Tax System", New York Times, September 2, 1919.

[246] "Otto Kahn", *id.*

[247] "Otto Kahn", *id.*; MEANS, Diffusion, *supra* note 139, at 587-89.

[248] MEANS, Diffusion, *supra* note 139, at 589-90.

[249] GEISST, Wall Street, A History, 178 (1997) (describing an eight-fold increase in I.P.O. activity between 1926 and 1928); MYERS, A Financial History of the United States, 297 (1970) (indicating the amount of common stock issued increased from $200 million in 1921 to $2.094 billion in 1928 before peaking at $5.062 billion in 1929).

Other blockholders exited all at once by way of a merger, with acquiring companies taking advantage of their high stock prices to raise capital to pay cash or to offer share-for-share exchanges on terms seemingly too generous to turn down. On the latter count tax came into play, since due to tax reform carried out between 1918 and 1924 share-for-share exchanges became tax-favored in a way that would have made offers put on the table easier to accept. When the federal government introduced the contemporary version of income tax in 1913 it considered the receipt of stock or securities in a merger, consolidation, or other acquisitive transaction to be a taxable event. There were concerns that, as one commentator later observed, stock ownership "would tend to become fossilized" under such circumstances.[250] In 1918, Congress began the process of classifying corporate reorganizations as "non-recognition" events,[251] and further liberalized the rules in 1921 and 1924, making it clear that those owning shares in a target company would not be taxed when they transferred their stock to an acquiror in a merger transaction in exchange for shares in the acquiring company.[252] As economist T.S. Adams testified in hearings prior to the 1921 amendments, the goal was to remove the obstacles for "desirable business readjustments."[253]

Between 1919 and 1930, nearly 12,000 manufacturing, mining, banking and public utility concerns disappeared as a result of approximately 2,100 mergers.[254] Many of these transactions presumably would have occurred regardless of the tax treatment of corporate reorganizations. Nevertheless, there likely were numerous instances where the classification of share-for-share exchanges in corporate acquisitions as non-recognition events helped to ensure the terms on offer were sufficiently attractive to induce blockholders to sell out.

The special treatment of share-for-share exchanges aside, capital gains tax reform in 1921 eliminated considerable uncertainty about the tax treatment of capital gains and provided a congenial environment in which blockholders could exit by selling their shares on the open market or in a cash merger. Despite case law potentially suggesting to the contrary, up to 1921 the federal government maintained capital gains were fully taxable as income under federal income tax, meaning those with high incomes would pay tax on capital gains at the top marginal rate (58% in

---

[250] HENDRICKS, Developments in the Taxation of Reorganizations, 34 Columbia Law Review 1198, 1222 (1934).
[251] Revenue Act of 1918, ch. 18, § 202(b), 40 Stat. 1058 (1919).
[252] SANDBERG, The Income Tax Subsidy to "Reorganizations", 38 Columbia L. Rev. 98, 102 (1938); BANK, Mergers, Taxes, and Historical Realism, 75 Tulane Law Review 1, 9, 11 (2000).
[253] Hearings on H.R. 8245 Before the Senate Comm. on Finance, 67th Cong. 29 (1921) (statement of Dr. T.S. Adams, advisor to the Treasury Department).
[254] MARKHAM, Survey of the Evidence and Findings on Mergers, in: Business Concentration and Price Policy, 141, 168-69 (1955).

1921).[255] However, when the Supreme Court affirmed the legality of federal taxation of capital gains in a 1921 decision, Congress quickly eased the potential blow by introducing capital gains tax at a modest 12.5% rate, the "normal" rate of taxation for corporate income at the time. As Treasury advisor Randolph Paul later explained, "[i]t was believed that this provision would stimulate profit-taking transactions."[256] Blockholders, thus reassured, likely would have deduced that capital gains tax was not a serious deterrent to exit even if they could not postpone payment of the tax with a share-for-share exchange.

7.2 Tax and the Exercise of Control by New Owners

During the 1920s, the rise of the private investor provided the impetus behind the demand for shares that created such a promising environment for exit by blockholders in U.S. companies. The number of individuals owning shares grew dramatically, with one estimate being that while only a half million Americans owned shares of publicly traded stock as of 1900 and only 2 million did so in 1920, there were 10 million individuals owning stock by 1930.[257] As described earlier, middle class investors accounted for much of this increase, with part of the reason likely being that they were less affected by the tax factors that potentially motivated blockholders to exit.[258] Moreover, these new investors, due to a lack of information, time and expertise, combined with a rational reticence to be activist when they would incur the bulk of the costs and receive only a tiny fraction of the benefits, were not about to exercise control in any sort of meaningful way.[259]

Other potential types of new owners may have been better positioned to step forward but arguably were discouraged from doing so by an inhospitable regulatory environment, of which tax played a part. Mark Roe in his 1994 book *Strong Managers, Weak Owners* analyzes why outsider/arm's-length corporate governance became dominant in the U.S. and does so primarily by explaining why major financial players, such as banks, insurance companies and mutual funds, failed to step for-

---

[255] On the position the federal government took, *see* "Income Taxpayers to Suffer Penalty", New York Times, Mar. 17, 1921, 17. On the doubts that existed about the tax status of capital gains under federal income tax legislation, *see* "To Ignore Tax Decision", New York Times, Feb. 12, 1921, 17. The cases which cast doubt on whether capital gains were taxable under income tax were *Gray v. Darlington*, 82 U.S. (15 Wall.) 63 (1872) (ruling on the tax status of capital gains under a Civil War income tax statute); *Hays v. Gauley Mountain Coal Co.*, 247 U.S. 189, 192-94 (1918); *Doyle v. Mitchell Bros.*, 247 U.S. 179, 183, 185 (1918) (both ruling on the Corporate Excise Tax Act of 1909, ch. 6, § 38, 36 Stat. 11, 112); *Brewster v. Walsh*, 268 F. 207 (D. Conn. 1920) (ruling on the federal income tax statute introduced in 1913).

[256] PAUL, Taxation in the United States, 129 (1954).

[257] BASKIN/MIRANTI, *supra* note 232, at 190. Other estimates vary substantially, but the trend is the same. Means estimated in his 1930 article that the number of stockholders rose from 4.4 million in 1900 to 8.6 million in 1917 to 14.4 million in 1923: MEANS, *supra* note 139, at 595. On the other hand, SOBEL, *supra* note 146, estimates there were 100,000 shareholders prior to 1900 and three million shareholders by 1929.

[258] *See supra* text accompanying notes 144 to 147.

[259] ROE, Strong, *supra* note 21, at 6-7.

ward as activist owners.[260] In so doing, he focuses on regulatory constraints financial institutions faced, such as laws that precluded banks from owning and dealing in shares in industrial companies and imposed tight restrictions on stock ownership by insurance companies.[261]

Tax plays a role – if only of a supporting nature – in Roe's story. For instance, to explain why mutual funds did not step forward as activist investors he draws attention to rules adopted in the 1936 Revenue Act concerning the passing of income up to mutual fund investors.[262] With mutual funds there can in theory be triple taxation for the same income: when a corporation in a mutual fund's investment portfolio pays taxes on its earnings, when the fund pays taxes on dividends received from companies in its portfolio and when shareholders in the mutual fund pays tax on income derived from the fund. The 1936 Revenue Act eased the tax burden for "diversified" mutual funds by permitting them to pass income up to investors untaxed. Initially, a mutual fund could only qualify as diversified if no investment in a corporation constituted either more than 5% of the funds' investment portfolio or more than 10% of the corporation's shares. In 1942, Congress relented partly, permitting half of a mutual fund's portfolio to be more concentrated. Roe concedes the tax rules did not stymie fully corporate governance activism by mutual funds. Nevertheless, he claims they imposed costs on ownership of large blocks of shares and, in tandem with restrictions on mutual fund investment patterns imposed by the Investment Company Act of 1940, created "a framework that made it difficult or impossible for mutual funds to actively enter the governance structure of their portfolio firms".[263]

Roe, in *Strong Managers, Weak Owners*, also draws attention, albeit briefly, to tax changes introduced in the mid-1930s that discouraged public companies from holding substantial ownership blocks in other companies.[264] Corporate cross-ownership was an important feature of the corporate landscape in the U.S. during the 1920s. Berle and Means reported in their study of the ownership structure of the 200 largest companies in the U.S. finding many instances where immediate control was exercised by a corporation through a dominant minority stock interest.[265] Of 573 active corporations with securities listed on the New York Stock Exchange in 1928, 92 were pure holding companies, meaning they did nothing other than own shares in other firms, 395 were holding and operating companies, and only 86 were operating companies alone.[266] With manufacturing and industrial concerns, holding companies were generally only used for the sake of managerial or ownership con-

[260] Roe implicitly treated this question as being the most important in the U.S. context, saying "I shifted the emphasis to what seems the deeper cause: the historical inability of major financial institutions to own big blocks of stock and to become active in the boardroom": *id.*, at xii. Some of the gaps in Roe's analysis are filled by BECHT/DELONG, *supra* note 31.

[261] ROE, Strong, *supra* note 21, at 55, 60-61, 80-88, 95-96.

[262] ROE, *id.*, at 106-7, 122-23.

[263] ROE, *id.*, at 102.

[264] ROE, *id.*, at 107.

[265] BERLE/MEANS, *supra* note 138, at 109.

[266] KLEIN, Rainbow's End: The Crash of 1929, 152 (2001).

venience but complex, pyramidal structures assembled to permit capital to be raised without compromising control were a hallmark of large railways and public utilities.[267]

During the 1930s, a number to changes were made to tax law to "strike at the holding company system".[268] For instance, the filing of consolidated tax returns, which were commonly used by holding companies, was prohibited for most companies until the early 1940s.[269] Using a consolidated return offers tax advantages for a parent company in a corporate group since the parent can offset the gains of one subsidiary against the losses of another as part of a single tax return. On the other hand, when corporations that are part of the same group are under an onus to file separate returns, profitable subsidiaries will potentially be subject to high rates of taxation on their income while subsidiaries that serve merely supporting roles will often be left with unused loss carry-forwards. The 1930s tax rules precluding the filing of consolidated returns thus should have discouraged use of corporate groups oriented around a holding company.[270]

The tax treatment of inter-corporate dividends was also changed in a way that discouraged complex holding company arrangements. In the opening decades of the 20th century, with federal taxes on corporate income, inter-corporate dividends were fully deductible, meaning that for a parent company in a corporate group there was no tax penalty imposed on dividends received from the companies in which the parent company owned shares.[271] The tax reforms introduced in the mid-1930s put in place a large but not full deduction, meaning dividends paid to parent companies by subsidiary companies were partially taxable in the hands of the parent company even though the subsidiaries would have each individually already paid tax on their profits.[272]

Policymakers defended the inter-corporate dividend reform partly on the basis that corporate pyramids, which were widely criticized in the wake of the 1929

---

[267] BERLE/MEANS, *supra* note 138, at 69-71; COCHRAN, American Business in the Twentieth Century, 42-43 (1972).

[268] "Tax Bill Changes Offered by Borah", New York Times, March 2, 1934, 38.

[269] From 1932 to 1934, companies paid high rates of corporate tax for the privilege of filing a consolidated return and in 1934 this option was denied to all companies except railway corporations. *See* BANK, Tax, Corporate Governance, and Norms, 61 Washington & Lee Law Review 1159, 1164 n. 13 (2004). The rules precluding the use of consolidated returns was reversed partially in 1940 and then completely in 1942: MUNDSTOCK, Taxation of Intercorporate Dividends Under an Unintegrated Regime, 44 Tax Law Review 1, 10 (1988). The 1942 change, though, effectively introduced a 100% exclusion for inter-corporate dividends in companies filing a consolidated return. *Id.*, at 11.

[270] MAGILL, Effect of Taxation on Corporate Policies, 1938 United States Law Review 637, 642.

[271] MORCK, How to Eliminate Pyramidal Business Groups: The Double Taxation of Inter-corporate Dividends and Other Incisive Uses of Tax Policy, working paper (published in 2005 NBER Tax Annual), 8-9 (2004).

[272] The legislation lowered what was called the dividends received deduction from a 100% exclusion to a 90% exclusion. *See* Revenue Act of 1935, Pub. L. No. 74-407, § 102(h), 49 Stat. 1016 (reducing the dividends received deduction from 100% to 90%). In 1936, the exclusion was further reduced to 85%. *See* Revenue Act of 1936, Pub. L. No. 74-740, § 26(b), 49 Stat. 1648, 1664.

stock market crash, would be discouraged.[273] Roe argues the change helped to deter companies from acquiring large ownership blocks in other companies, reasoning that subsidiaries in a holding company structure would only rarely deliver sufficient benefits to compensate for the tax penalty on dividends paid out.[274] Economist Randall Morck has similarly identified the abolition of consolidated tax returns for corporate groups and the introduction of taxation of inter-corporate dividends as agents of change, saying they do much to explain the current absence of corporate pyramids in the U.S., a hallmark of blockholder-oriented corporate governance.[275]

As Morck notes, a rapid dissolution of pyramidal groups followed on the heels of the changes to the tax rules abolishing the use of consolidated returns and introducing the taxation inter-corporate dividends.[276] One cannot take a causal connection for granted, given that the tax burden on inter-corporate dividends was not hefty and that other reforms, such as strict federal regulation of public utilities companies, helped to discourage the use of corporate pyramids.[277] Morck nevertheless argues that tax was the key, noting the absence of renewed pyramiding after public utility holding company regulation declined in importance.[278] Morck maintains the tax on inter-corporate dividends was especially important, saying it "was largely responsible for producing the country's highly exceptional large corporate sector composed of free-standing widely-held firms."[279] The fact a number of companies that unwound complex corporate structures after the tax changes in the mid-1930s explicitly cited the new law as the impetus lends credence to this claim,[280] as do assertions by contemporary commentators that the tax change had reduced the attractiveness of the holding company structure.[281]

8. Conclusion

This paper has drawn upon the historical experience in the two countries where the widely held company is most dominant – the United Kingdom and the United States – to argue that tax can help to explain ownership structures in large companies in a particular country. The evidence presented here suggests tax indeed might matter, but certainly cannot be taken as settling the issue. Instead, further investigation of

---

[273] MORCK, How, *supra* note 271, at 9, 11-12.
[274] ROE, Strong, *supra* note 21, at 107-8.
[275] MORCK, How, *supra* note 271; MORCK/YEUNG, Dividend Taxation and Corporate Governance, 19 Journal of Economic Perspectives 163 (2005).
[276] MORCK, How, *supra* note 271, at 9-13, 27, 35.
[277] *See* SCHAFFER, The Income Tax on Intercorporate Dividends, 33 Tax Lawyer 161, 164 (1979) (noting that with a 90% exclusion for inter-corporate dividends, the tax cost to dividends was likely offset by the savings from not having income subject to the higher marginal corporate income tax rates).
[278] MORCK, How, *supra* note 271, at 28.
[279] MORCK, *id.*, at 27.
[280] MORCK, *id.*, at 13, 35.
[281] MAGILL, *supra* note 270, at 642.

the interaction between tax and the evolution of ownership patterns is required to establish the extent to which tax is a determinant of ownership structure in larger companies.

Case studies from additional countries constitute one promising line of inquiry. There already is fragmentary cross-border evidence indicating that tax may help to determine the extent to which the widely held company moves to the forefront within a particular country. For instance, Randall Morck, Michael Percy, Gloria Tian and Bernard Yeung have argued that in Canada a temporary shift towards dispersed ownership and a subsequent retreat to blockholding can be accounted for partly by succession taxes taking a substantial bite out of corporate groups in the 1950s and by the 1972 abolition of estate duties making it easier for family business dynasties to endure generational transitions.[282] Similarly, Germany's 2002 abolition of a capital gains tax of 50% for profits generated when companies sold shares they owned in other companies has been frequently cited as a key catalyst for a widespread unwinding of cross-holdings occurring.[283] On the other hand, the cohesion and density of the German network of interlocking ownership – sometimes characterized as "Germany Inc." or "Deutschland AG" – was already decreasing prior to 2002, so tax's contribution to changes occurring in Germany cannot be taken for granted.[284]

The experience with inter-corporate dividend taxation also reveals how case studies can serve to shed light on the potential impact of tax on ownership structure. Morck draws on comparative evidence to buttress his claim taxation of inter-corporate dividends discouraged corporate pyramids in the U.S., citing the fact that in other developed countries corporate pyramids are commonplace and tax is typically not levied on inter-corporate dividends received by a parent company once the parent's stake in the subsidiary exceeds a minimum designated threshold (generally 10% or 20%).[285] The comparative evidence does not all go one way, however. In Italy, inter-corporate taxation of dividends was introduced in 1955 and abolished in 1977, and these changes to the law failed to have a marked impact on extensive pyramiding in Italian public companies.[286]

On the other hand, a country Morck concedes creates some problems for his argument – Britain – is not as troublesome as he fears. The received wisdom is that

---

[282] MORCK/PERCY/TIAN/YEUNG, The Rise and Fall of the Widely Held Firm: A History of Corporate Ownership in Canada, in: MORCK, History, *supra* note 5, at 65, 113-15.

[283] PFEIFER, "Anglo-Saxon Attitudes are Forced on Deutschland AG", Telegraph, May 15, 2005; DAUER, "Corporate Germany Ups Pace on Disposal of Cross Holdings", Business, July 3, 2005, 10; DOUGHERTY, "Less 'Germany Inc.' More Openness", International Herald Tribune, September 3, 2005, 9.

[284] FOHLIN, The History of Corporate Ownership and Control in Germany, in: MORCK, History, *supra* note 5, at 223, 233 (Table 4.2, providing percentages of shares owned by non-financial companies 1990-98), 245.

[285] MORCK, How, *supra* note 271, at 5-7; MORCK/YEUNG, *supra* note 275, at 176.

[286] AGANIN/VOLPIN, The History of Corporate Ownership in Italy, in: MORCK, History, *supra* note 5, at 325, 348-50.

corporate pyramids do not exist in the U.K.[287] From the 19th century onwards, British tax law exempted inter-corporate dividends from taxation.[288] Morck concedes accordingly that developments in Britain indicate "business groups can be eliminated in more than one way".[289]

In fact, the situation in the U.K. can be squared quite readily with Morck's argument that inter-corporate taxation of dividends discourages the use of corporate pyramids. While in both the U.S. and the U.K. the norm is for public companies to be widely held, in both countries a significant minority of public companies do have blockholders.[290] According to Morck "(f)inding anything approximating a business group in the United States is a painstaking labor".[291] The British situation is different. Contrary to the received wisdom, the available data suggests when British public quoted companies have blockholders pyramids as control devices are used as often as they are elsewhere in Europe.[292] This suggests that a country can develop an "outsider/arm's-length" system of ownership control without taxing inter-corporate dividends but corporate pyramids may nevertheless continue to remain part of the corporate governance landscape. More broadly, the experience in Britain shows care must be used in drawing suitable inferences from case studies on tax and ownership structure.

Researchers seeking to investigate tax's impact on ownership structure should also consider empirical tests. A potential stumbling block will be a lack of suitable data. In principle, a good way to test to our conjectures would be to carry out time-series analysis to find correlations between changes in ownership structure and tax policy. Mihir Desai, Dhammika Dharmapala and Winnie Fung's work on the relationship between the progressivity of U.S. income tax and the dispersion of stock ownership across households illustrates, as they use dividend income reported in individual tax returns to calculate stock ownership for five different income fractiles from 1916 to 2000.[293] However, for researchers wanting to test potential determinants of blockholding, there is a dearth of empirical data on the ownership structure of large companies. For instance, the few studies that purport to offer any sort of rep-

---

[287] FRANKS/MAYER/ROSSI, Spending, *supra* note 5, at 582.
[288] MORCK, How, *supra* note 271, at 7.
[289] MORCK, *id.*, at 7.
[290] On the U.S., *see* HOLDERNESS/SHEEHAN, The Role of Majority Shareholders in Publicly Held Corporations: An Exploratory Analysis, 20 Journal of Financial Economics 317 (1988) (reporting that as of 1984, 663 of 5240 companies traded on national stock markets had a majority owner); ANDERSON/DURU/REEB, Corporate Opacity and Family Ownership in the U.S., unpublished working paper (2006) (finding that of the largest 2000 U.S. firms as of 2001-03, 48% had continued family involvement, with family ownership averaging 20%). On the U.K., *see* FACCIO/LANG, The Ultimate Ownership of Western European Corporations, 65 Journal of Financial Economics 365 (2002) (reporting that of 1,953 U.K. public companies 63% were widely held in the sense they lacked a 20% shareholder, 24% had a family owner, 9% had a public company blockholder and 4% had a blockholder of a different sort).
[291] MORCK, How, *supra* note 271, at 5.
[292] FACCIO/LANG, *supra* note 290, at 389.
[293] DESAI/DHARMAPALA/FUNG, Taxation and the Evolution of Aggregate Corporate Ownership Concentration, NBER Working Paper Series No. 11469 (2005).

resentative coverage of the corporate population in the U.K. and U.S. simply provide "snap-shots" for a tiny number of individual years rather than the continuous coverage that is required for econometrically sound time-series research.[294] The situation is much the same with other countries. In their study of the history of corporate ownership in Canada, Morck, Percy, Tian and Yeung do offer data on the percentage of companies that were widely held, part of a pyramid, family controlled and state owned over time, but it is unclear whether this could form the basis for methodologically sound time-series analysis.[295]

Another challenge for researchers is that a wide array of tax rules potentially affect companies and investors, and selecting those most likely to "matter" for ownership structure is not straightforward. The survey provided here has identified a wide range of potential candidates, including personal income tax, estate tax, taxation of corporate income, the tax treatment of institutional investment and taxation of inter-corporate dividends. Thus, researchers cannot simply begin investigating on the basis of the intuition that tax "matters". Instead, careful thought will be required to identify the types of tax that could play a role, including taking into account the interaction of tax rules that might not make an impact in isolation (*e.g.* high rates of income tax operating in tandem with tax breaks for institutional investment).

Further complicating the analysis are potential feedback loops between tax and ownership structure. It may well be the case that the manner in which companies and investors conduct themselves helps to determine the nature of tax policy, as well as vice versa. For instance, the rise of retained earnings as a financing strategy at the beginning of the 20th century in the U.S. may have prompted the federal government to develop the country's "stand alone" classical system for taxation of corporate profits, with the objective being to ensure retained earnings would be taxed but without crippling corporate investment by imposing the high rates applicable to well-paid individuals.[296]

While ascertaining with precision the impact tax has on corporate ownership structures will no doubt be a challenging exercise, the evidence presented here suggests that further investigation would indeed be worthwhile. In both the U.K. and the U.S., debates about corporate governance generally take as their departure point the

---

[294] On the U.K., for example, the only systematic study from prior to the 1970s offered only data for 1936 and 1951: FLORENCE, Ownership, *supra* note 14. FRANKS/MAYER/ROSSI, *supra* note 9, offers data on trends throughout the 20th century, but the sample size is far too small (40 companies incorporated around 1900, 20 of whom survived to 2000, and 20 incorporated around 1960 that survived to 2000) to offer any sort of representative picture of ownership patterns in U.K. companies. In the U.S., there were only three pre-1970 studies of the ownership structure of large companies, in each instance focusing on the ownership patterns in the 200 largest non-financial companies. These were BERLE/MEANS, *supra* note 138; TEMPORARY NATIONAL ECONOMIC COMMITTEE, *supra* note 236 (offering data for 1937) and LARNER, Ownership and Control in the 200 Largest Nonfinancial Corporations, 1929 and 1963, 56 American Economic Review 777 (1966) (offering data for 1963).

[295] MORCK/PERCY/TIAN/YEUNG, *supra* note 282, at 100 (providing a graph). A key potential difficulty is that they were only able to compile data for every ten years until 1960, and every five years thereafter – *id.*, at 98.

[296] *See* BANK, Capital Lock-In Theory, *supra* note 240, at 914.

widely held company,[297] and this paper has shown that tax rules likely contributed to the rise of this particular form of business organization to prominence in both countries. Tax also seems likely to continue to influence corporate ownership structures going forward. In the U.K. and the U.S. there is currently much speculation that buy-out activity by private equity firms could displace the publicly quoted company as the centerpiece of the corporate economy,[298] and private equity's rise to prominence has been partly tax driven. For instance, the ability of private equity funds to finance their deal-making is dependent partly on the tax deductibility of debt interest payments and the fact that "carried interest", the key performance-related means by which private equity partners are remunerated, is taxed as capital gains rather than income due to the tax status of partnerships helps to explain why private equity firms are organized as partnerships rather than public companies.[299] Hence, despite methodological challenges, researchers seeking to understand the configuration of corporate ownership in large companies should in the future take tax into account as part of their investigations.

[297] CHEFFINS, Current Trends in Corporate Governance: Going from London to Milan via Toronto, 10 Duke Journal of Comparative and International Law 5, 13-26 (1999) (U.K.); DENT, Corporate Governance: Still Broke, No Fix in Sight, 31 Journal of Corporation Law 39, 40-45 (2005) (U.S.).

[298] SEARJEANT, "Plc is Ready to Join Mutuals in Land of the Dodo", Times, April 21, 2006, 71; JENKINS, "The Market to End All Markets", Wall Street Journal, December 6, 2006, A17.

[299] HARDING, "Unions Expose Inequity in U.K. Corporate Taxation", Times, February 8, 2007 (discussing the tax subsidy to private equity from the interest deduction); FLEISCHER, Two and Twenty: Taxing Partnership Profits in Private Equity Funds, University of Colorado Law Legal Studies Paper No. 06-27, 20 (2006). *Cf.* RIBSTEIN, The Important Role of Non-Organization Law, 40 Wake Forest Law Review 751, 767 (2006) (arguing that partly for tax reasons managers of public companies want the businesses to continue to operate as incorporated entities rather than converting to partnerships).

Tax and the Separation of Ownership and Control – Comment on the paper by Steven Bank and Brian R. Cheffins

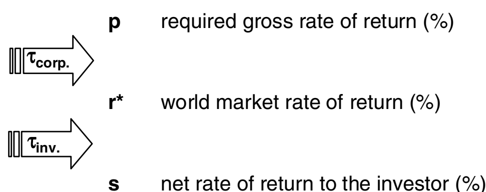
Krister Andersson

This paper, by Steven Bank and Brian Cheffins, brings out the impact tax has on pattern of corporate ownership and control. It shows that taxes played an important role in the development of ownership in Britain and in the United States.

The paper is particularly interesting since it takes into account not only taxes levied at the corporate level but also at the shareholder level. Unfortunately, most studies have analyzed the effect of corporate taxes only. For instance, the well-known literature on the cost of capital[1] typically only addresses the impact of taxes on corporate behavior as an endogenous effect of tax levied at the corporate level. In general, the role of taxes on corporate social responsibility need to be explored more in future research.

In my comments, I will focus on the link between this paper and the cost of capital literature. I will try to highlight some of the benefits as well as limitations of the approach taken by the authors compared to this literature. In the cost of capital literature, tax wedges are defined using a set of rates of return.

Ownership and Taxes



where $\tau_{corp.}$ = corporate income tax, including taxation of inter-corporate dividends and, $\tau_{inv.}$ = personal income tax, dividend and capital gains taxation, estate taxes.

---

[1] The first work in this field was reported by MUTÉN, The Corporation Income Tax and The Cost of Capital (1968). It was followed by a strictly formalised analysis by KING/FULLERTON, The Taxation of Income from Capital: A Comparative Study of the United States, the United Kingdom, Sweden and West Germany (1984). This framework was developed to an open economy setting by BOVENBERG/ANDERSSON/ARAMAKI/CHAND, Tax Incentives and International Capital Flows: The Case of the United States and Japan, in: RAZIN/SLEMROD (eds.), Taxation in the Global Economy (1990). By focusing not only on the marginal effective tax rate but also on the average marginal effective tax rate, new measures were developed by DEVEREUX/GRIFFITH, Taxes and the location of production: evidence from a panel of U.S. multinationals, 68 Journal of Public Economics 335 (1998).

While most economists have stopped their analysis at **r**, Bank & Cheffins carry the analysis through to **s**. Quite a number of economists (including myself from time to time) have furthermore assumed that the required rate of return for any investor would be given from the world market required rate of return, in particular in small open economies. By assuming rational investors, it has sometimes even been argued that the required rate of return in small, closely held companies, should be the same as **r***. This is clearly not the case, since investing in a small closely held company involves an investment that can not be undertaken piecemeal and the asset invested in may not be a liquid asset. The required rate of return will therefore not be identical for investments in assets were the usual assumptions are fulfilled.

In any case, it is important not to stop the analysis by considering the required rate of return, r, but to consider all taxes relevant in the investor's investment decision. The investor is faced with the basic question of whether to invest or not, *i.e.* to consume all income presently earned or to postpone consumption to a later stage and invest in the meantime. This is typically expressed as the intertemporal decision. A tax system should not distort this decision unless there is a need to increase or decrease savings for reasons of externalities. For an analysis of the basic decision making process, *see* Appendix.

In short, taxation of savings affects the wealth accumulation of the households. Households shift away from a good which through taxation is relatively more expensive (future consumption or savings) in favor of the good that is not affected by the introduction of taxation in the planning. This conclusion is of course closely linked to investment decisions since savings finance investments. On the other hand, if the impact on the investor is excluded, the analysis does not offer a complete picture. As mentioned before, most of the cost of capital literature does not carry the analysis through to the necessary level of also considering taxes at the investor level. However, the paper by Bank and Cheffins does indeed capture these effects of taxation as well.

Accordingly, they study the net rate of return at the investor level, s, and the opportunity to sell off holdings at a reasonable price.

The fact that the required rate of return in a closely held company typically differs from the prevailing world market rate of return (however defined) is explicitly recognized as well as the difference in taxation between direct and indirect holdings. Many countries have favored indirect holdings, by having lower effective tax rates on savings in pension funds, *etc.* compared to the taxation of dividends and capital gains on outright stock holdings.

The paper convincingly argues that taxes played an important role in the change of ownership and control in corporate Britain.

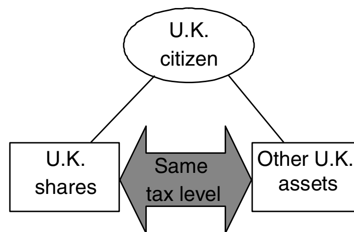
Taxes contributed significantly to the emergence of Britain's outsider/arm's-length system of ownership control

- corporate taxes
- taxes on earned income
- tax bias against dividends
- introduction of capital gains taxes
- estate taxes
- lower effective taxes on institutional investors

The arguments presented are very convincing, maybe with the exception of the role of the corporate tax. Since corporate taxes would be levied also on alternative portfolio allocations, the impact of corporate taxes may be rather small. Special circumstances can apply to closely held companies, *e.g.* through rules forcing capital income to be taxed as earned income. The corporate tax does also play a role for these companies. However, the classification of income as earned income, and thereby, in a dual income tax system, subjecting it to a higher tax rate, as well as taxes on dividends and capital gains would typically be an incentive for holding assets in the corporate sector. Combined with a lower effective tax on an institutional investor, this would also lead to an incentive to disinvest in closely held companies in favor of indirect portfolio holdings.

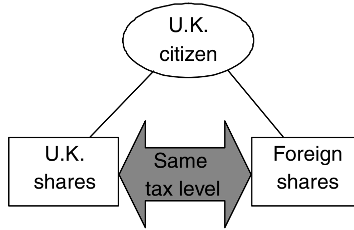
Many governments, including the British, have failed to achieve neutrality in the taxation of various assets. "Tax neutrality", often so well spoken of, has in many countries remained a nice theory but has not been implemented in practice.

Domestic Tax Neutrality



Many countries have instead been more concerned about protecting the short-term revenue base by advocating Capital Export Neutrality (CEN). Citizens have been expected to report foreign income and this income has been taxed at the same rate as if it had been invested within the national borders in a similar asset category. In relatively closed economies, or economies still regulated, the effect on portfolio allocation has probably been rather limited. However, as economies open up and competition increases, the impact on ownership structure and tax revenues can be dramatic.

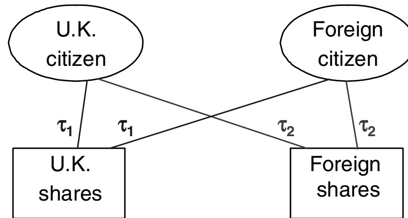
Capital Export Neutrality



Since the taxation at the shareholder level varies across countries, the required rate of return on a corporate investment will also vary. Asset holders in countries with lower taxes on dividends and capital gains, will find themselves having a competitive edge over asset holders in high tax countries. This will have an impact on the ownership structure and the control in the corporate sector. It will also influence the opportunities for existing asset holders to dispose of their assets. As financial markets open up, it will be increasingly easy to dispose of assets at a reasonable price. The effect will be particularly pronounced in high tax countries (countries with high tax rates on dividends, capital gains and wealth taxes).

In highly integrated economies, ownership neutrality requires that the Capital Export Neutrality approach in tax policy is replaced by Capital Import Neutrality (CIN).

Capital Import Neutrality



To achieve Capital Export Neutrality at the same time; $\tau_1 = \tau_2$

By trying to achieve CIN, countries in reality also achieve Capital Ownership Neutrality, at least as far as foreign and domestic owners are concerned. Unless the government of a particular country knows that some owners are superior to others, domestic or foreign, there is no economic rationale to discriminate between different owners. However, foreign owners can typically only be taxed by applying source taxes, *i.e.* corporate taxes and withholding taxes on dividend income. The room for applying withholding taxes in a European context is very limited and withholding taxes are challenged on economic grounds as well. Inevitably, this will lead to a shrinking tax base for high tax countries. Therefore, the ownership structure will

have an impact on the potential of governments to collect taxes on the return of corporate assets. With an increase in foreign ownership, national tax revenues tend to be reduced. This situation also has bearing on the privatization of state owned enterprises. If a sell-out to the private sector will mainly result in foreigners buying the asset, the medium to long term tax revenues may suffer.

The role of applying world-wide taxation schemes is not explicitly elaborated upon in the paper. Both the U.S. and the U.K. have used such a tax concept in their international taxation. World-wide taxation can be seen as an extreme form of CEN. It tends to disfavor domestic asset holders, in terms of both domestic investments and investments overseas to the extent the system can be enforced.

The reader may wonder whether the examples of the U.K. and the U.S. are representative for the effects of taxation on ownership and control. I am in no position to give a general answer but I can just do the same analysis for my own country, Sweden, and confirm that increased taxes on direct shareholders and ownership control have led to an even more pronounced development than in the cases studied in the paper.

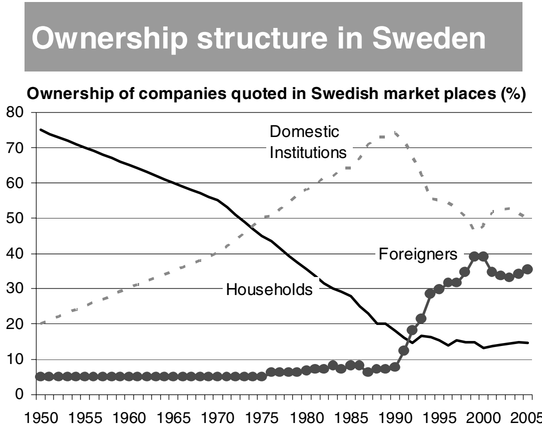
From being a relative low tax country up to the middle of the last century, Sweden progressively increased its tax burden and during the last two decades it has had the highest tax burden among the OECD-countries. Private savings and closely held companies have in particular seen a sharp increase in their taxes. However, not only taxes have played a major role on the ownership structure in Sweden. Up to the time of deregulation of capital markets and the foreign exchange market, the share of foreign ownership was kept very low. Sweden did not liberalize financial markets until the very late 1980s and early 1990s. Since the liberalization, foreign ownership has increased significantly. Foreign owners have taken over the role of domestic institutional investors as buyers of privately controlled companies.

The lack of a neutral tax treatment between indirect holding through insurance and pension funds and direct ownership resulted in an increase in indirect holdings at the expense of direct holdings. Double taxation in a classical corporate tax system in combination with increase in capital gains taxation propelled this development.

In an attempt to maintain high tax revenues in a deregulated economy, Sweden has, like the U.S. and the U.K., tried to use the tax system to recapture control over capital flows in such a way that taxes can still be collected. Sweden has strongly advocated the role of exchange of information. After deregulations in the early 1990s, there seems to be a shift away from ensuring a level playing field for Swedish corporations in their activities in third countries by promoting tax credit rather than exemption in tax treaties and also by imposing CFC (Controlled Foreign Companies) taxation on activities in low tax countries. To some extent, a re-regulation is taking place, not in terms of capital market controls or foreign exchange controls but rather through the tax code.

The U.S. has in a much more pronounced way consistently used the tax code in its pursuit of CEN and world-wide taxation. In the same way as regulations of capital markets lower the welfare of households, the use of the tax system in an attempt to achieve similar limitations on capital flows, are equally reducing welfare. Economic efficiency could be increased by allowing for CIN and a level playing field also in

terms of taxation. These aspects are not covered in the paper but would be suitable topics for future research.



Concluding Remarks

This paper is worth reading both due to its historical overview with interesting details, and due to its clear and interesting analysis of the role of taxes in social corporate governance. The conclusions that taxes play an important role in the ownership structure are very convincing and merit policy considerations at ministries of finance around the world. Capital gains taxes as well as dividend taxes play a key role in explaining corporate ownership and control. The introduction or changes of the tax treatment of entrepreneurs and closely held companies may trigger a sell-off, provided there is a capital market facilitating the change of ownership.

Appendix: The Role of Taxes at the Investor Level – The Consumption-Savings Decision[2]

This decision will depend on preferences and the prices (rates of return after taxes). It can be expressed as having preferences for consumption over time, where U represents the utility derived from consumption today and later on:

$$U = U(C_1) + \beta U(C_2)$$

The utility function is maximized subject to

$$C_1 + \frac{C_2}{1 + r(1-\tau)} = y_1 + \frac{y_2}{1 + r(1-\tau)}$$

where y_1 is income in period 1 and y_2 is income in period 2. r is the world market interest rate and τ is the tax rate on savings (investments).

2 This appendix is based on the paper ANDERSSON/FALL, Capital Taxes and Wealth Accumulation (2001). It was presented at the SNEE conference in Mölle in May 2001.

First order condition is

$$U'(C_1) = (1 + r(1-\tau))\beta U'(C_2)$$

Let us assume an isoelastic utility function of the form:

$$U(C) = \frac{C^{1-1/\sigma}}{1-1/\sigma}$$

Then

$$U'(C) = C^{-1/\sigma}$$

and we can express C_1 in terms of C_2 as

$$C_1^{-1/\sigma} = (1 + r(1-\tau))\beta C_2^{-1/\sigma}$$

which implies that

$$C_2 = (1 + r(1-\tau))^{\sigma} \beta^{\sigma} C_1$$

By using the budget constraint we can derive the following expression:

$$C_1 + \frac{(1 + r(1-\tau))^{\sigma} \beta^{\sigma} C_1}{1 + r(1-\tau)} = y_1 + \frac{y_2}{1 + r(1-\tau)}$$

and

$$C_1 = \frac{1}{1 + (1 + r(1-\tau))^{\sigma-1} \beta^{\sigma}} * \left(y_1 + \frac{y_2}{1 + r(1-\tau)} \right)$$

There is no need to assume that households in different countries need to have the same preferences over the consumption profile. Economies are assumed to be open and therefore investments are assumed to be financed from abroad if domestic savings are insufficient. The households' preferences for consumption in the two periods are captured in the coefficient β as a time preference factor and their willingness to substitute consumption between periods is reflected by σ.

The parameter values are to a large extent an empirical question. The willingness to substitute consumption between periods is influenced by the ability to preserve the value of savings. In an economy were it is only possible to save commodities for barter trade, it may not be wise to save even if there is a large need to secure future consumption.[3] In a world with developed and deregulated financial markets, the opportunities to diversify and allocate risk in a coherent way have improved immensely. As a consequence, tax differences between different assets and countries have probably increased in relative importance for savings decisions.

If a country decides to tax postponed consumption, the relative price between consumption today and tomorrow will be affected. There will be both an income and

[3] Take as an extreme case that it is only possible to save bananas. Rotten bananas are of little help satisfying consumption needs in the future.

a substitution effect. Given the uncertainty of the parameter values, sensitivity analysis is presented below.

If we assume that incomes in period 1 and 2 are equal, the world market interest rate to be equal to 10 percent and the tax rate 30%, the allocation of consumption over time will depend on the values for β and σ.

If we assume that beta is equal to 1 and sigma to 1.2, the savings ratio in period 1 will be 3.93 percent. If the tax rate is reduced to 10 percent, the savings ratio increases by one percentage point to 4.95 percent.

For a broad range of parameter values, with this utility specification, lower taxes on savings are associated with an increase in savings. If a country increases its tax rate on savings, its residents will hold less assets or claims abroad. They will also own less of the domestic capital stock.

However, a lot of factors are left out in such a simple model. Distortions on the labor market may be an important factor also in savings decisions, as will expectations about future earnings and tax rates. One effect in particular is worth mentioning.

When new technology is introduced, productivity in the corporate sector tends to increase. The increase in productivity will eventually lead to higher wages, but for some period profits usually tend to increase. The profits will be allocated to the owners, and if the tax system in one country discourages savings, its residents may hold less of the capital stock, and are therefore receiving only a small portion of the productivity gains.

It is possible that households take this into account when they make their intertemporal consumption decisions, but since a technology breakthrough is a discrete event, households may not properly discount the chances for achieving such extra rates of return on their savings.

The conclusion that a lower tax rate on savings would increase the wealth accumulation of the households in that country is not in any way a unique result. One would expect households to shift away from a good which becomes relatively more expensive in favor of the good that is made less expensive through a tax change.

Tanzi showed that countries with a high tax rate on savings, and therefore also favoring indebtedness through generous deductions for interest payments, tended to have considerably lower household savings rate than countries with lower taxes on savings.[4] Both the income- and the substitution effect would tend to increase the savings rate for indebted households as the tax rate on savings is reduced.

To sum up, a considerably higher level of savings taxes is likely to reduce ownership of corporate assets, not only in the residence country but also abroad.

[4] TANZI, Taxation in an Integrating World (1995). He also compared countries over time and found that the savings ratio remained low for countries that maintained high tax rates on savings.

Tax and the Separation of Ownership and Control – Comment on the paper by Steven Bank and Brian R. Cheffins

Norbert Herzig

1. The Evolution of Ownership and Control in Germany

Commenting on the British and the American system of corporate governance is a challenging task from a German perspective. As Prof. Bank and Prof. Cheffins outlined, the United Kingdom's as well as the United States' economies are dominated by public companies with a broad shareholder structure. However, the patterns of ownership and control vary around the world. Germany, for instance, can be seen as one of the countries where a different system emerged; even though the starting positions had substantial similarities within the 19th century.

In my opinion, the main differences stem from the diverse basic models of organization of ownership and control underlying the two economies. Of course, there are also large companies in Germany with ownership dispersed among a large number of individuals and institutional investors. However, this is not the typical case like in the U.K.

According to current research[1] we primarily have to consider four basic aspects in order to describe the situation in Germany. First, there is still a high concentration of ownership and control. Although the structure of ownership differs in the course of time, block holdings are still common in Germany. Second, the importance of family-ownership slightly decreased in the course of time, but families are still a considerable force in building up large corporate dynasties or pyramids. Third, a pretty close network of cross ownerships among firms still exists. This network of crossholdings, which is often referred to as "Deutschland AG", shrunk over the last years but is still notable. Fourth, the capital market did not work efficiently in the past to build up a well functioning system of corporate control.

At the beginning of the industrialization in the 19th century, ownership and control used to be in the same hands in Germany; famous examples include Krupp, Thyssen, Stinnes, Wolff, Stumm, Klöckner, Siemens and Bosch. In this respect, starting points in the U.K. and Germany were similar to each other. However, from then on developments went separate ways. In Germany concentration of ownership stayed at a very high level concerning corporations, even after de-concentration was tried to be enforced after World War II. Furthermore, partnerships, with ownership and control being in one hand, retained their dominating position amongst legal forms for many reasons.

---

[1] *See* FOHLIN, The History of Corporate Ownership and Control in Germany, in: MORCK (ed.), A History of Corporate Governance around the World, 223-277 (2005) with further references.

The dominance of partnerships seems to be amazing at first glance, since entrepreneurial activity carried out by a publicly held corporation offers advantages like raising funds through the capital markets. However, raising funds through the capital markets, being a catalyst for the rise of corporations in the U.K., did not bear a meaning in Germany, since capital markets in Germany were not as developed as in Anglo-Saxon countries and debt-financing by banks was dominant. Instead, partnerships often offered more favorable conditions in many tax-related core issues.

- There was a tax bias against dividends and an advantage of partnerships until 1977 because of a classical corporate tax system. In this period of time distributed profits were taxed twice, first at corporate level and a second time at shareholder level.
- One of the main tax advantages that partnerships offer is the treatment of losses. This is because losses of a partnership are tax-relevant for the partners, whereas the losses of a corporation are not tax-relevant for the shareholders.
- Another advantage of partnerships is the favorable tax treatment of foreign investments. This aspect was of great importance in Germany.
- Furthermore, inheritance taxes are of big significance in Germany for the choice of the legal form. Once again partnerships offer substantial tax advantages.

The following comments are focusing on the question which impact tax had on the development of corporate ownership and control in legal forms apart from partnerships. In this context, it is important to bear in mind that tax is only one aspect alongside others. However, basic differences between the German and British fiscal system may have contributed to the diverse developments of corporate governance systems in the two countries.

Now I would like to touch upon the question whether tax was a catalyst for the exit of block holders. Since taxation of corporate profits was a key catalyst for the exit of block holders in the U.K., it is worthwhile to have a look at the German corporate income tax regulations. Prior to 1977 corporate taxation was based on a classical corporate income tax system which led to economic double taxation because the corporation's income was first taxed at corporate level and another time at shareholder level. In the case of a shareholder being an individual, dividends were taxed within the scope of personal income tax at pretty high tax rates. Also, the corporate income tax rates were relatively high with rates of 50% in 1948 and even 60% in 1951. From 1953 onwards, a split tax rate with a discount for distributed profits was in place. This was an unfavorable situation compared to the British imputation system, which did not trigger double taxation. This unfavorable situation could have incited block holders to sell their equity stakes or to foster the building of corporate pyramids. Subsequent corporate income tax systems, namely the imputation system implemented in 1977 and the shareholder relief model implemented in 2001 also did not trigger the intention for individuals to exit. This was because compared to other countries tax rates were high, but finally did not have a throttling effect. Hence, similar to the British situation corporate income tax burdens did not have the power to force block holders to exit. It also has to be mentioned that there were not similarly grave additional tax burdens to finance World War II in Germany.

Beside bearable charges at corporate level, subsequent taxation of dividends at shareholder level might cause a potential impulse for block holders to exit. This applies especially to the situation until 1977, because full personal income tax was levied on dividends. The situation improved after 1977 due to the implementation of the imputation system and the succeeding shareholder relief model. Therefore there was no economic obligation for shareholders to exit. However, traditionally it was standard practice in Germany to retain most of the profits at the corporate level and to distribute only a smaller part.

If we look into exit-taxation, tax legislation did not prevent disposals of share-blocks but even promoted them. Until the end of 1998 disposals of share-blocks comprising less than 25% of the shares were absolutely free of tax, as long as the disposal was not a matter of speculative gain. In the case of equity stakes bigger than 25% a yearly disposal of 1% of total nominal equity was tax-exempt. If a block holder owning a stake of more than 25% of total equity sold his stake or more than 1% of it, the transaction was taxed at half of the average income tax rate, always less than 30%. In my opinion this is a very favorable exit-taxation.

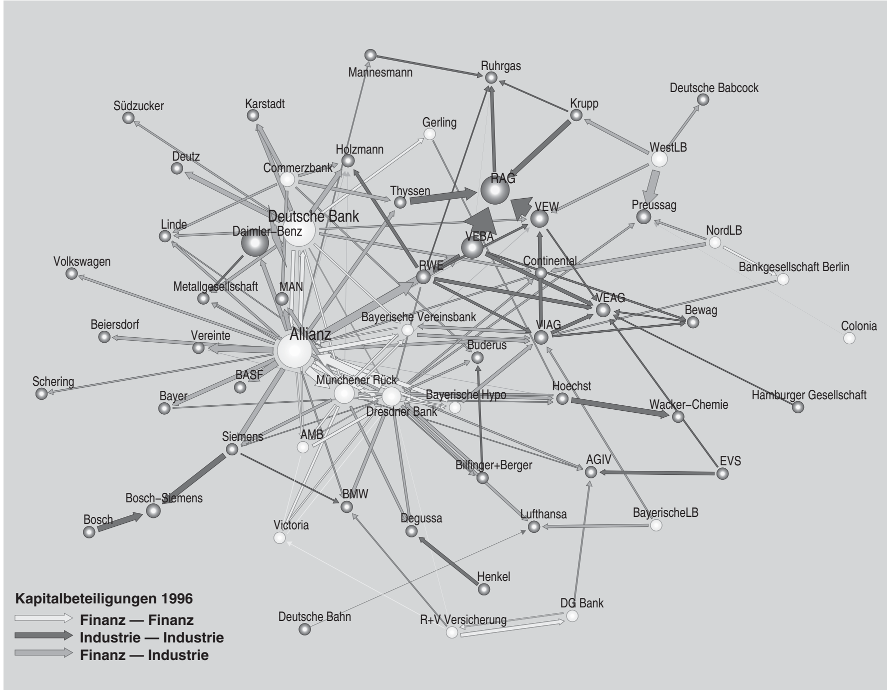
In case of a corporation being the shareholder, until 1977 treatment of dividends depended on which kind of equity holding the corporation owned. In case of a holding of less than 25%, dividends were fully taxed. However, in case of a material holding of at least 25% dividends were tax-exempt due to an affiliation privilege. Under the regime of the imputation system, distributed dividends did not cause any multiple-taxation at all. Since 2001, inter-corporate dividends are tax-exempt by Art. 8b Para. 1 ITA as well as disposals of equity-stakes are tax-exempt by Art. 8b Para. 2 ITA within the scope of the shareholder relief model. The general tax-exemption of share disposals can be considered a substantial tax incentive for block holders to sell their stakes. Latest research suggests that there has not been an equivalent shift in the structure of German share ownership for decades as compared to the break up of crossholdings in the period starting 1997 until today.[2]

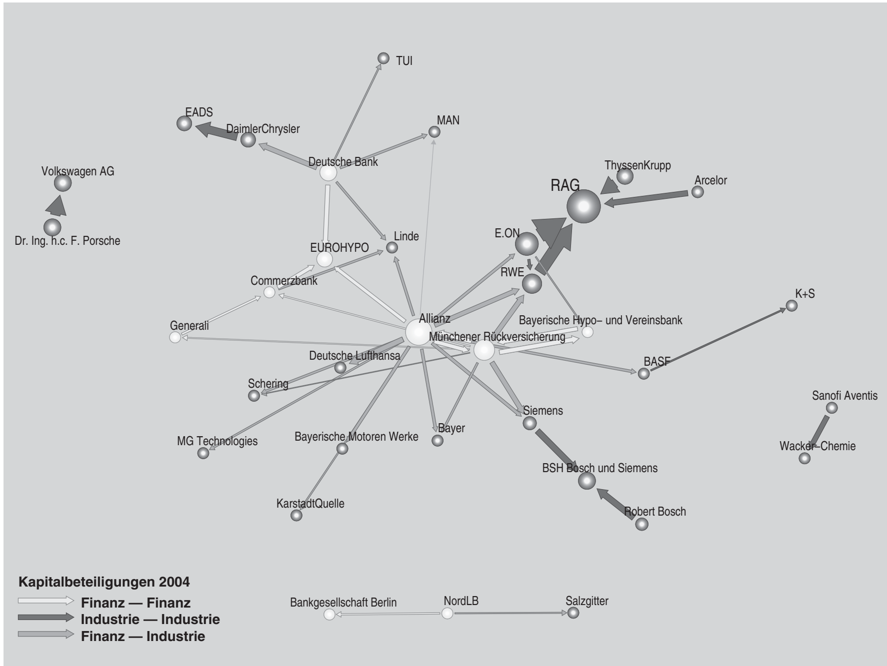
However, disposals of block holdings already began around 1997 when a general tax-exemption for share disposals had not yet been implemented. Therefore, tax certainly contributed to the reduction of crossholdings, but apparently was not the sole motivation for the selling activities of block holders.

To summarize, tax could have been a motive for block holders to exit and furthermore provided them with attractive incentives for disposals.

---

[2] *See* also the charts on the following page, taken from HÖPNER/KREMPEL, The Politics of the German Company Network, 8 Competition and Change 229 (2004); KREMPEL, Die Deutschland AG 1996-2004 und die Entflechtung der Kapitalbeziehungen der 100 größten deutschen Unternehmen, in: REHBERG (ed.), Die Natur der Gesellschaft (2008).





Crossholdings in Germany 1996 and 2004.

2. Taxation and Demand for Shares

Given the previous findings, we have to evaluate the impact tax had on the demand for shares. In doing so, a distinction between demand of individuals and of corporations has to be made, since results clearly differ.

2.1 Demand of Individuals

As already presented, due to the double taxation and high income tax rates investments in shares were not tax-attractive for individuals within the scope of the classical corporate income tax system. Demand for shares therefore was restricted instead of fostered. In 1977, the imputation system was implemented in order to foster individual share ownership and thereby let the population participate in the productive property of the economy. Looking back in history this target was missed, since share ownership of individuals further shrunk until the emergence of the new economy bubble. Reasons for this development are not completely obvious, but different other tax-aspects might have mattered to some extent. First, alternatives existed that were more attractive for individuals, like buying tax-exempt life insurances. Also, investments in partnerships in general and tax shelter companies (loss allocating companies) in particular were more attractive.

2.2 Demand of Non-Financial Corporations and Financial Institutions

In contrast to individuals, non-financial corporations as well as financial institutions increased their share property significantly. After World War II, non-financial companies became Germany's dominant shareholders by boosting their equity participation in German corporate economy from 18% in 1950 to 41% in 1996. Banks and insurers increased their equity participation from around 11% in 1960 to 23% in 1998 whereas private households halved their equity participation to 15% until 1998. Considering the significant demand for shares of corporations and financial institutions the role tax played is not absolutely clear. Until 1977, acquisition of shares was not sponsored by tax-incentives. On the contrary, the classical corporate income tax system punished inter-corporate dividends by multiple taxation as long as the stake owned in a different company did not reach 25%, the threshold for the affiliation privilege. Therefore, tax might have contributed to the emergence of major crossholdings among companies, since dividends between affiliated companies were tax-exempt in the case of stakes bigger than 25%. In the period after 1977, also acquisitions of smaller stakes were favorable regarding tax-considerations. The same situation was given for insurance companies because of special tax rules for these corporations.

3. Conclusion

To summarize, tax might have played a role for the development of the German system of corporate governance. However, contrary to the British situation, tax does not seem to be a dominant force for the German pattern of ownership and control.

Especially the persisting concentration of ownership and the densely networked cross-ownership among companies cannot be explained in isolation by tax-matters.

The most obvious influence tax might have had on ownership and control presumably has to be seen in the tax-exemption of share disposals in 2001, which fostered de-concentration among German companies. However, developments caused by this regulation might be too young to be entirely explainable today.

Report on the Discussion

Arne Friese

1. Presentations by Judith Freedman, Martina Baumgärtel and Christian Nowotny (Chair: Hugh Ault)

The first speaker referred, firstly, to the aspect of book-tax conformity and defended this idea by pointing to the following aspects: the link to the tax books could have a positive effect for the results of the financial accounts as well, because it reduces arbitrariness with respect to tax-profit. He pointed to the different levels of arbitrariness in countries without conformity (such as the U.S.) and with conformity (such as in Europe). Secondly he supported the comment of *Baumgärtel* with respect to contingency reserves: a serious step-by-step report in the financial accounts on contingency reserves would mean a dramatic change in reporting standards and should be discussed.

The next speaker introduced a differentiation in terms of a compromise as to the art of tax structures: the concerns of people in favor of book-tax conformity regarding the arbitrariness could be reduced by simply addressing artificial tax deductions such as losses and deductions without financial accounting purposes. Those should not be allowed. That would prevent transactions driven by tax reasons. This differentiation between tax planning and artificial tax structures was also stressed by other following speakers.

In the following discussion the advantages of book-tax conformity were stressed by many speakers and in particular the aspect of "simplification" as a consequence of only one type of rules for both books was stressed positively. At least for small companies the tax figures should, according to one participant, be usable for accounting purposes to reduce the administrative burden. The similarity of both systems was seen in the claim on residuals as being the same goal.

One participant stressed the importance of transparency for corporate governance and supported that at least with respect to public companies, all reported figures should be transparent to the general public. However, he would accept limitations in cases of business secrets in relation to which he pointed to the danger of abuse of the revealed information.

The notion that there might be a "true income" was hotly debated and that accountants were best suited to determine what that income is; at least compared to what could be defined as income in the code. That was mentioned in favor of conformity because the true income would then be used for both purposes. Although the discussant who argued in favor of this notion acknowledged different preferences of tax authorities and shareholders, he supported the idea of conformity as a "measurement system" of the "true income".

However, almost half of the participants were opposed to book-tax conformity. The main argument was that both systems had different purposes – information

towards shareholders and creditors on the one hand and tax on the other hand – and hence should not be linked legally, although it was accepted that there might be practical reasons in favor of conformity. One should, according to one participant, distinguish between legal links of tax and financial books and practical connections of both. For practical reasons financial reporting could be the starting point but it should be modified as far as required by the different purposes.

The next speaker also stressed the positive impact the obligatory reporting on the book-tax gaps would have on corporate governance: the transparency would lead to increased control by shareholders. In fact, the tax accounting figures were considered to be of much more relevance for shareholder control than the information reported according to IFRS. To deal with the differences of IFRS and tax books the obligation to explain the differences was considered a tool of corporate governance because it would lead to transparency. That was considered a better solution than disclosure of the structures as such.

One participant explained that larger shareholders in the U.S. had the right to look into the tax accounts and considered that to be of high importance for corporate governance due to ensuing transparency.

Freedman perceived very different problems with respect to book-tax conformity in the U.S. and in Europe, and from her point of view there were subsequently "language problems" in the discussion, because some of the problems discussed in the U.S. did not exist in Europe. As a consequence there should be further research on the real gaps between financial and tax books.

2. Presentation by Steven Bank and Brian R. Cheffins and Comments by Krister Andersson and Norbert Herzig (Chair: Hugh Ault)

The first question that was raised was whether it was possible to distinguish between intended and unintended effects of tax rules for corporate governance. The question was mainly addressed to ownership changes following changes in tax law. *Bank* confirmed that at least in the U.S. some provisions were explicitly enacted to change ownership structures, for example to increase individuals as shareholders rather than corporations. A historic example would be provisions that were part of the so-called "New Deal". In the U.K. tax rules were enacted to prevent dividend pay-outs in favor of corporate stability. What *Bank* denied to be able to answer was whether *in fact* the intended effects resulted from the change of law. However, at least where intended effects were communicated by the legislator, shareholder reaction as intended was evident. *Cheffins* supported this view with respect to the U.K.

Both *Bank* and *Cheffins* stressed the idea of dividends as information about the situation of the company in the absence of other information systems as a historical phenomenon.

A question regarding the sale of block-shares was brought up by one speaker. It was questioned whether these sales were effected for restructuring purposes and whether the persons behind seller and buyer were often the same. Then there would be a "circular situation". The concern of dispersion of corporate control as a result

of such "circular situations" was expressed. A redistribution function of the sale of shares was equally discussed. The existence of bonus shares where shareholders have the option of either reinvesting or selling was pointed out as constituting an important difference between the German and the Anglo-American system.

The "circular" point was also stated by *Bank* and *Cheffins* with respect to pension funds and life insurances. However, they explained other important aspects of reinvestment following a sale of shares, such as the very positive impact of tax privileged liberty bonds in the U.S. where a lot of investors, who had previously not invested, placed their money. As for the U.K., the situation was described where the money received from the sale of block-shareholders was often reinvested in various investments, so that the circular point was very small.

The next speaker made a comment with respect to the situation of corporate structures in the U.K.: There, legal features such as "close-company apportionments" that could have an impact on the breakdown of large shareholders were considered. In his view some of the tax rules had changed in the last years, involving increased large shareholder structures.

One discussant suggested with respect to the different kind of tax rules to distinguish between different types: "progressivity changes" which might lead to diffusion and "exit taxes" such as capital gains taxes which in turn could possibly lead to lock-in effects. Changes of these rules might prompt people to sell their shares. Only these types of tax changes could lead to changes in ownership structures. By contrast, for example, heavy corporate taxation would as such not lead to changes in corporate ownership structures.

The tax-favored treatment of private-equity was given as an example of a tax rule that changes ownership structures. One participant doubted that changes in ownership structures were always relevant for corporate governance. In terms of other interesting examples for tax-driven shareholder structures, the introduction of REITs in Germany and the importance of hybrid-ownership structure were mentioned. The M&A trend was mentioned as having the effect of dispersing ownership. The last aspect of the discussion was the taxation of derivates in contrast to direct interest in corporations and its effects.

Ault concluded by stressing that corporate governance had to focus more on tax aspects because many ownership structures were influenced by tax rules and the corporate governance structure was thus related to the taxation of the company and its shareholders.

Part 3:

The Influence of Corporate Governance on Tax Strategy and Compliance

Corporate Social Responsibility and Strategic Tax Behavior

*Reuven S. Avi-Yonah**

> The imposition of taxes and the expenditure of tax proceeds are governmental functions … The whole justification for permitting the corporate executive to be selected by the stockholders is that the executive is an agent serving the interests of his principal. This justification disappears when the corporate executive imposes taxes and spends the proceeds for "social" purposes.
>
> Milton Friedman[1]

1. Introduction

Should corporations pay tax?

The usual understanding of this question relates to the debate on whether there should be a corporate tax. Many observers have recently criticized the corporate tax, and some have defended it, but that is not the focus of this article.[2] Instead, I will assume that the state wants to tax corporations, for whatever reason (a safe assumption, at least in the short to medium run). Given this assumption, I will address two questions. First, from the perspective of the corporation, should the corporation cooperate and pay the corporate tax, or should it engage in "strategic" tax behavior designed to minimize or eliminate its corporate tax burden? Second, from the perspective of the state, should the state use the corporate tax just to raise revenue, or should it also try to use it as a regulatory tool to steer corporate behavior in directions that it deems beneficial to society?

Both of these questions are related to the voluminous debate around corporate social responsibility (CSR).[3] From the perspective of the corporation, if engaging in

---

* The author would like to thank David Hasen, Bob Kuttner, Sagit Leviner, Wolfgang Schön, Dganit Sivan, Pekka Timmonen, and participants in workshops at Georgetown Law Center, the Interdisciplinary Center, Herzelya, and the Max Planck Institute for Intellectual Property, Competition and Tax Law.

1 FRIEDMAN, The Social Responsibility of Business Is To Increase Its Profits, NY Times SM17 (Sept. 13, 1970).

2 For my view on this debate, as well as a review of the extensive literature, *see* AVI-YONAH, Corporations, Society and the State: A Defense of the Corporate Tax, 90 Va. L. Rev. 1193 (2004).

3 For a review of this debate *see* AVI-YONAH, The Cyclical Transformations of the Corporate Form: A Historical Perspective on Corporate Social Responsibility, 30 Del. J. Corp. L. 767 (2005), and for previous literature *see*, *e.g.*, JENSEN, Value Maximization, Stakeholder Theory, and the Corporate Objective Function, 12 Bus. Ethics Q. 235 (2002); *see* also JENSEN/MECKLING, The Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure, 3 J. Fin. Econ. 305 (1976). For different perspectives on CSR in general *see* also PHILIPS, Reappraising the Real Entity Theory of the Corporation, 21 Fla. St. U. L. Rev. 1061 (1994)

CSR is a legitimate corporate function, then corporations can also be expected to pay taxes to bolster society as part of their assumption of CSR. If, on the other hand, CSR is illegitimate, there is a question whether corporations should try to minimize their tax payments as part of avoiding CSR and maximizing the profits of their shareholders. From the perspective of the state, using tax as a tool to bolster CSR activity by corporations is arguably acceptable only if CSR is a legitimate corporate function.

The answer to these questions thus depends on our view of CSR. That view, in turn, depends on our view of the corporation. Historically, three views of the corporation have emerged and rotated in cyclical fashion.[4] The first is the view that the corporation is primarily a creature of the state (the "artificial entity" view). The second is that the corporation is an entity separate from both the state and from its shareholders (the "real entity" view). The third is that the corporation is merely an aggregate of its individual members or shareholders (the "aggregate" or "nexus of contracts" view).[5]

Each of these three views has different implications for the issue of tax and CSR. Under the artificial entity view, the corporation owes its existence to the state and is granted certain privileges in order to be able to fulfill functions that the state would like to achieve. Thus, engaging in some forms of CSR is part of the corporation's mission, and paying corporate tax is one way of fulfilling the corporation's CSR obligations. The state is fully justified in both imposing taxes on the corporation and in using the corporate tax as a regulatory device to steer corporate CSR activity.

Under the real entity view, the corporation is similar to an individual citizen in its rights and obligations. Just like an individual citizen does not have a legal requirement to aid her follow citizens but is praised if she does so, so the corporation may not be required to engage in CSR, but corporate management should be encouraged if they do so. As for taxes, just like an individual citizen, a corporation is legally required to pay taxes, and is expected not to engage in over-aggressive tax planning to minimize its tax obligations. The state may not require the corporation to engage in CSR, but is justified in encouraging corporations to do so and steering their efforts through the tax system.

The most interesting debate is under the aggregate or "nexus of contracts" view of the corporation, which is the dominant view among contemporary corporate scholars.[6] Under this view CSR is an illegitimate attempt by managers to tax shareholders without their consent, and leads to managers being unaccountable to the shareholders that elected them. If so, management can be argued also to have a responsibility to maximize shareholder profits by minimizing corporate taxes as

---

WELLS, The Cycles of Corporate Social Responsibility: An Historical Retrospective for the Twenty-first Century, 51 Kansas L. Rev. 77 (2002); ALLEN, Our Schizophrenic Conception of the Business Corporation, 14 Cardozo L. Rev. 261 (1992); WILLIAMS, Corporate Social Responsibility in an Era of Economic Globalization, 35 UC Davis L. Rev. 705 (2002); CHEN/HANSON, The Illusion of Law: The Legitimating Schemas of Modern Policy and Corporate Law, 103 Mich. L. Rev. 1 (2004).

[4] *See* AVI-YONAH, Cyclical Transformations, *supra* note 3.

[5] *See* AVI-YONAH, *id.*, and the literature cited therein.

much as possible, and the state has no business in encouraging corporations to engage in illegitimate CSR through the tax system.

This article will argue that both of these views, when taken to their extreme, are misguided. First, if corporations are not permitted to engage in CSR, then all social

---

[6] *See*, *e.g.*, ARROW, Social Responsibility and Economic Efficiency, 21 Pub. Policy 303, 303-07 (1973); HAYEK, The Corporation in a Democratic Society, in Whose Interest Ought It and Will It Be Run, in: ANSHEN/BACH (eds.), Management and Corporations, 99 (1960); FRIEDMAN, *supra* note 1. The classic case affirming this "shareholder primacy" doctrine is *Dodge v. Ford Motor Co.*, 204 Mich. 459, 507, 170 N.W. 688 (1919). *See* also the classic debate between Berle and Dodd (BERLE, Corporate Powers as Powers in Trust, 44 Harv. L. Rev. 1049 (1931); DODD, For Whom Are Corporate Managers Trustees, 45 Harv. Law Rev. 1145 (1932); BERLE, For Whom Are Corporate Managers Trustees: A Note, 45 Harv. Law Rev. 1365 (1932)). The shareholder primacy doctrine has become a mainstay of modern corporate law. *See*, *e.g.*, HANSMANN/KRAAKMAN, The End of History for Corporate Law, 89 Geo. L.J. 439, 441, 449-451 (2001) (shareholder primacy likely to dominate future development of corporate law); EASTERBROOK/FISCHEL, the Economic Structure of Corporate Law 12 (1991) (stating that shareholders, as residual claimants, have implicitly contracted for promise that firm will maximize profits in long run); MANNE/WALLICH, The Modern Corporation and Social Responsibility (1972) (noting that social responsibility of corporations is shareholder wealth maximizing); BLACK/KRAAKMAN, A Self-Enforcing Model of Corporate Law, 109 Harv. L. Rev. 1911 (1996) (arguing that principal goal of corporate law is to maximize shareholder wealth); *see* also BRADLEY/SCHIPANI/SUNDARAM/WALSH, The Purposes and Accountability of the Corporation in Contemporary Society: Corporate Governance at a Crossroads, 62 Law & Contemp. Probs. 9 (1999); ROMANO, The Political Economy of Takeover Statutes, 73 Va. L. Rev. 111, 113 (1987) (asserting that core goal of corporate law is to maximize equity share prices); GREENWOOD, Fictional Shareholders: For Whom Are Corporate Managers Trustees, Revisited, 69 S. Cal. L. Rev. 1021, 1023 (1996) ("[A]ll but the communitarians agree that virtually the sole task of corporate law is to ensure that managers act as agents for the shareholder owners."); *cf.* COFFEE, Unstable Coalitions: Corporate Governance As a Multi-Player Game, 78 Geo. L.J. 1495 (1990) (discussing role of stakeholders in firm); BEBCHUK/FRIED, Pay Without Performance (2004) (discussing need to align managerial incentives with shareholder interests). For arguments on the other side *see* WILLIAMS, Corporate Social Responsibility in an Era of Economic Globalization, *supra* note 3 (it is debatable whether HANSMANN/KRAAKMAN's statement about shareholders' control of the corporation is accurate in the United States. In fact, one of the striking features of American corporate law is how little real control shareholders have, given that they are the "owners" of the corporation); BLAIR/STOUT, A Team Production Theory of Corporate Law, 85 Va. L. Rev. 247, 310 (1999) (where shareholders are widely dispersed, shareholders' voting rights are practically meaningless, given collective action problems, shareholders' rational apathy, and the power top managers exercise in nominating the candidates for the board and in otherwise shaping the voting agenda); MITCHELL, A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes, 70 Tex. L. Rev. 579, 630-43 (1992) (arguing that courts should modify corporate law to grant stakeholders standing to sue directors when the former are harmed by corporate action); O'CONNOR, The Human Capital Era: Reconceptualizing Corporate Law to Facilitate Labor-Management Cooperation, 78 Cornell L. Rev. 899, 936-65 (1993) (arguing that corporate law should be changed to encourage employee representation on the board and standing to sue); MILLON, Theories of the Corporation, 1990 Duke L.J. 201, 261-62 (praising case law that reaffirms directors' discretion to consider nonshareholder interests). *See* generally MITCHELL (ed.), Progressive Corporate Law (1995) (surveying recent nontraditional approaches to corporate legal scholarship); Developments in the Law – Corporations and Society, 117 Harv. L. Rev. 2176-2177 (2004).

responsibility functions devolve on the state. Both taxing and spending become, to use Milton Friedman's language, purely governmental functions. But if corporate managers are required to minimize tax payments as much as possible, that could mean that the state is left without adequate resources to fulfill its governmental function. Thus, the aggregate view of the corporation, taken to its logical extreme, is self-defeating, because it could mean that neither corporations nor the government can fulfill their responsibilities to society. That is not an acceptable outcome.

Second, even if from the perspective of management CSR is an illegitimate tax on shareholders, the government could still legitimately try to encourage corporations to engage in CSR by giving tax incentives. Assuming that some CSR activities are better performed by the private sector than by the government, it seems acceptable for the government to refrain from collecting certain amounts of tax in order to incentivize the private sector to engage in those activities. This is just as legitimate as the government taxing and then using is procurement muscle (paid for by the taxes) to encourage corporations to engage in CSR, as many governments have recently done.[7]

The following discussion is divided into four parts. Part 2 of the article briefly summarizes the development of the three views of the corporation. Part 3 applies these three views to the question whether corporations should seek to minimize their corporate tax. Part 4 applies the same three views to the question whether the state should use tax as a vehicle for encouraging and steering corporate CSR. Part 5 concludes.

2. The Three Views of the Corporation: A Historical Perspective[8]

Historically, the corporation evolved from its origins in Roman law in a series of four major transformations. First, the concept of the corporation as a separate legal person from its owners or members had to be developed, and this development was only completed with the work of the civil law Commentators in the fourteenth century. By the end of the Middle Ages, the membership corporation, *i.e.*, a corporation with several members who chose others to succeed them, had legal personality (the capacity to own property, sue and be sued, and even bear criminal responsibility) and unlimited life, was well established in both civil and common law jurisdictions. The next important step was the shift from non-profit membership corporations to for-profit business corporations, which took place in England and the U.S. in the end of the eighteenth and beginning of the nineteenth century. The third transformation was the shift from closely-held corporations to corporations whose shares are widely held and publicly traded, and with it the rise of limited liability and freedom to incorporate, which took place by the end of the nineteenth century and the beginning of the twentieth. Finally, the last major transformation was from corporations

---

[7] MCCRUDDEN, Corporate Social Responsibility and European public Procurement, in: MCBARNET/VOICULESCU/CAMPBELL (eds.), The New Corporate Accountability: Corporate Social Responsibility and the Law (forthcoming, 2007).

[8] This part is based on AVI-YONAH, Cyclical Transformations, *supra* note 3.

doing business in one country to multinational enterprises whose operations span the globe, which began after World War II and is still going on today.

Each of these four transformations (as well as a smaller, more temporary one which occurred in the U.S. in the 1980s with the advent of hostile takeovers) was accompanied by changes in the legal conception of the corporation. What is remarkable, however, is that throughout all these changes spanning two millennia, the same three theories of the corporation can be discerned. Those theories are the aggregate theory, which views the corporation as an aggregate of its members or shareholders; the artificial entity theory, which views the corporation as a creature of the state; and the real entity theory, which views the corporation as neither the sum of its owners nor an extension of the state, but as a separate entity controlled by its managers.[9]

Each of these theories has different implications for the legitimacy of CSR, as indicated in the following table:

Table 1: Theories of the Corporation and CSR

Theory Type of CSR	**Aggregate**	**Artificial**	**Real**
For long-run benefit of shareholders	Yes	Yes	Yes
Not for shareholders, Corporation responsible	No	Yes	Yes
Not for shareholders, Corporation not responsible	No	No	Yes

The first type of CSR involves activities that can clearly and demonstrably benefit shareholders in the long run. For example, actions that prevent environmental disasters or comply with legal and ethical rules can have a significant positive effect in preventing disastrous corporate calamities, even if they cost money in the short run. Thus, even proponents of the aggregate theory, the currently dominant theory of the corporation in academic circles, would support this type of CSR.

The second type of CSR involves activities that are designed to mitigate social harms the corporation was responsible for, even when there is no direct legal responsibility, and when no benefit to the shareholders can be shown. Under the aggregate theory, such activities should not be permitted because they do not benefit shareholders. But under the artificial entity theory, since it emphasizes the benefits of corporate existence derived from the state, an implicit contract can be inferred that the corporation will help the state in mitigating harms that it causes even in the absence of legal responsibility. Otherwise, the state will have to bear this burden imposed by the corporation it created.

Finally, the third type of CSR involves activities like AIDS prevention, for which the corporation is not responsible and which in most cases do not benefit its share-

[9] These three theories are the standard ones in the literature. *See*, *e.g.*, MILLON, *supra* note 6. For a full exposition of these developments *see* AVI-YONAH, Cyclical Transformations, *supra* note 3.

holders, even in the long run. This type of CSR would not be permitted under the aggregate or artificial entity theories. But under the real entity theory, since the corporation is regarded as a person just like individuals, it is permitted to act philanthropically just like individuals are, and should in fact be praised to the extent it does so.[10] Thus, under the real theory, even CSR activities that have nothing to do with benefiting shareholders or with direct corporate responsibility are permitted.

The aggregate or nexus of contracts theory has been dominant in U.S. academic circles in recent years, but less so elsewhere. To understand why, a comparative perspective is needed. Political economists distinguish among three types of advanced capitalist societies. Under the "varieties of capitalism" framework, economies can be differentiated by their comparative institutional advantages. In general, economies can be characterized as either liberal (market economies, such as the U.S. and the U.K.), corporatist (organized market economies that rely on tightly integrated private and networked associations to resolve significant dilemmas of economic integration, such as Germany and Japan), or statist (depending on hierarchical solutions in resolving coordination problems, such as France).[11]

The varieties of capitalism framework suggest that firms in each of the three models of economic governance will distinguish themselves in different fields. In liberal market economies, the advantages of a flexible regulatory structure benefits industries targeting low costs and those operating in sectors characterized by radical innovation (*e.g.*, software, bio technology). In corporatist economies, high levels of business coordination benefit sectors that rely on long-term contracts, and firms specialize in high quality, scale intensive and specialized supplier industries (autos, machine tools, chemicals). Statist economies favor large scale-intensive industries that have long time horizons or require major capital investment (autos, transport).[12]

There is an obvious correlation between the three varieties of capitalism described by political economists and the three historical theories of the firm outlined above. The liberal model of the U.K. and the U.S., with its emphasis on arm's length relationships and public trading, best first the aggregate theory of the firm. The statist, hierarchical model of France, with its emphasis on the relationship between the firm and the state, best fits the artificial entity model. And the German and Japanese style corporatist model best fits the real entity theory.

This relationship can also explain why in Europe CSR is much less controversial than in the U.S. Practically every EU government (including even the U.K.) has programs designed to foster CSR.[13] These kind of programs are hard to imagine in the U.S. context given the widespread hostility to CSR.

---

[10] WHITE, From Expectation to Experience: Essays on Law & Legal Education (1999).

[11] HALL/SOSKICE (eds.), Varieties of Capitalism: The Institutional Foundations of Comparative Advantage (2001).

[12] FIORETOS, Varieties of Capitalism, Institutional Change, and Multilateralism in Post-War Europe, 11-12 (2004).

[13] EUROPEAN COMMISSION, Corporate Social Responsibility: National Public Policy in the European Union (2004).

Fundamentally, therefore, the debate around CSR is linked to another widespread debate in corporate law: Whether corporate law is destined to "converge" on the U.S. model of publicly traded corporations with dispersed share ownership, or whether other models (such as the German and Japanese models) are viable. The aggregate, nexus of contracts theory is closely linked to the U.S. corporate governance model, while other models are much more open to CSR. Recent literature has given rise to doubts about the convergence hypothesis, but this debate will no doubt continue.[14]

As I have shown elsewhere, however, even in the U.S. context the aggregate theory has not always been dominant.[15] In fact, throughout most of the history described above, the real entity theory was the dominant one, and it can be argued that in practice most corporations are still operating on the basis of the real theory, not the aggregate one. Thus, CSR, which as we have seen is most easy to justify in all its forms on the basis of the real theory of the corporation, is likely to remain practiced for the future. The debate on CSR should therefore in my opinion shift from whether CSR is acceptable to how to make it more accountable and effective in obtaining social goals – but that is an issue for another day.[16]

3. Implications of the Three Views for CSR and the Corporate Tax

What are the implications of the three views of the corporation summarized above for the question with which we began, *i.e.*, whether corporations should pay the corporate tax (assuming that a corporate tax is imposed)?

This is not just a theoretical question, because in fact corporations have significant leeway about whether they should pay the tax imposed on them. In the U.S., revenues from the corporate income tax amounted to about a quarter of all federal tax revenues in 1965; today the tax accounts for less than 10% of revenues and that number is declining.[17] The major reason in recent years for this decline is the growth of a corporate tax shelter industry, in which some of America's best minds scour the Code for ways to reduce corporate tax liabilities by various transactions and then sell these transactions for high fees to corporate clients.[18] Estimates of the revenue loss

---

[14] ROE, A Political Theory of American Corporate Finance, 91 Colum. L. Rev. 10 (1991); BEBCHUK/ROE, A Theory of Path Dependence in Corporate Ownership and Governance, 52 Stan. L. Rev. 127 (1999); WEST, The Puzzling Divergence of Corporate Law: Evidence and Explanations from Japan and the United States, 150 U. Pa. L. Rev. 527 (2001).

[15] AVI-YONAH, Cyclical Transformations, *supra* note 3.

[16] *See* WALSH/AVI-YONAH, The Unfettered Corporation: Corporate Social Responsibility and the Coming Crisis of Corporate Control (forthcoming).

[17] Corporate tax rates were higher before 1986, but the base was narrower, so that the 1986 tax reform act (which reduced the rate from 46% to the current 35%) actually raised taxes on corporations. However, the effective tax rates today are close to what they were before 1986. *See* YIN, Getting Serious about Corporate Tax Shelters, 54 SMU L. Rev. 209 (2001).

[18] *See*, *e.g.*, BANKMAN, The New Market in Corporate Tax Shelters, 83 Tax Notes 1775 (1999); WEISBACH, The Failure of Disclosure as an Approach to Shelters, 54 SMU L. Rev. 73 (2001); YIN, *id.*

vary, but there is a consensus that it is significant and that the IRS has so far not been able to stop it with the weapons at hand.[19]

The decline in corporate tax revenues is even more pronounced on a world-wide basis, and especially among developing countries that have traditionally relied on the corporate tax for a much higher percentage of total revenues than OECD member countries.[20] There are two likely reasons for this overall decline. The first is an increase in aggressive tax behavior among corporations, especially in the case of developing countries that lack the resources to effectively counter such strategic tax planning behavior, such as abusive transfer pricing. The second is tax competition among countries to attract corporate investments, which has grown significantly in the last two decades.[21] This competition enables companies like Intel to pay no tax at all on its non-U.S. income. The most recent manifestation of this trend has been inversion transactions, in which U.S.-based corporations nominally move their headquarters to a tax haven like Bermuda. This type of transaction can result in a dramatic decrease in worldwide effective tax rates for the inverting corporation.[22]

In what follows, we will discuss the implications of each of the three views of the corporation for the attitude that the corporation should take to paying the corporate tax.

3.1 The Artificial Entity View

From the artificial entity view the corporation is a creature of the state. The state creates it and bestows various legal advantages on it, such as legal personality and limited liability. The state also creates the conditions for the corporation to operate in the market by providing defense and a property rights regime, as well as building infrastructure and educating workers.

The implication of this view for CSR, as noted above, is that the corporation is obligated not to impose additional burdens on the state that created it. Thus, to the extent the corporation's own activities result in additional burdens (*e.g.*, by creating pollution), the corporation is obligated to remedy that situation.

---

[19] The litigation record is mixed, *see ACM Partnership v. Comm'r*, 157 F.3d 231 (3rd Cir. 1998); *Compaq v. Comm'r*, 277 F.3d 778 (5th Cir. 2001); *UPS v. Comm'r*, 254 F.3d 1014 (11th Cir. 2001).

[20] In developing countries the corporate tax can amount to as much as 25% of total tax revenues, *see* SHOME (ed.), World Bank, Tax Policy Handbook, 165 (1995). The average from 1990 to 2001 was 17%, as opposed to 7% in developed countries: KEEN/SIMONE, Is Tax Competition Harming Developing Countries More Than Developed? 34 Tax Notes Int'l 1317 (2004). Keen and Simone show that from 1990 to 2001 corporate tax rates have declined in both developed and developing countries. However, while in developed countries this decline in the rates was matched by a broadening of the tax base, so that no decline in revenues can be observed, in developing countries the same period witnessed a decline of corporate tax revenues by about 20 percent on average.

[21] AVI-YONAH, Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State, 113 Harv. L. Rev. 1573 (2000); ROIN, Competition and Evasion: Another Perspective on International Tax Competition, 89 Geo. L.J. 543 (2001).

[22] AVI-YONAH, For Haven's Sake: Reflections on Inversion Transactions, 95 Tax Notes 1793 (2002).

It is less clear that the artificial entity view requires or permits corporations to engage in CSR that is unrelated to their activities. While historically the state created corporations "imbued with a public purpose", developments since the mid-19th century (such as general incorporation and the decline of *ultra vires*) have led to the view that the corporation fulfills its purpose sufficiently in engaging in its normal for profit activities, and should not be required to do more.

However, precisely that limitation also has implications for the corporate tax. To the extent the corporation is free to pursue purely for profit activities, as long as those do not impose a burden on the state, the state is left with the obligation to carry to weight of social responsibility on its own. For example, if there is a health crisis that the corporation did not contribute to creating, such as AIDS, the state and not the corporation has the obligation to address it. But this means that the state needs resources, and a major way of obtaining these resources is to impose taxes, including the corporate tax.

I would therefore argue that under the artificial entity view corporations have an affirmative obligation not to engage in aggressive tax planning designed to reduce their tax burden. The state created the corporation and the conditions for its operation in the market. In return, the state may legitimately expect corporations not to impose additional burdens on it. But since the state and not the corporation bears the burden of most social obligations under this model, the state can also expect the corporation to contribute its fair share to the ability of the state to fulfill its obligations to its citizens. This means that when the corporation engages in aggressive tax planning such as corporate tax shelters or abusive transfer pricing, it is breaching an implicit bargain with the state that created it, gave it legal rights, and created the conditions for it to make those same profits it is attempting to shield from tax.

Of course, this begs the question of how to distinguish abusive tax evasion from legitimate tax avoidance. But while this is a hard question to answer from the government's perspective, or in a court of law, it is less unclear from the corporation's perspective. Most corporate tax managers know very well when a transaction is tax motivated as opposed to having a non-tax business reason. Thus, a corporation can be legitimately expected to police its own behavior in this regard, without worrying too much about where the line should be drawn.[23]

3.2 The Real Entity View

Under the real entity view, the corporation is similar to an individual. It is an entity made up of people (corporate managers and employees) that is separate from both the state and from its shareholders.[24] The implication for CSR is that our view of CSR activities that are unrelated to the corporation, but are beneficial to society at large, should be the same as our view of such behavior by individuals: It should not be legally required, but is praiseworthy and should be encouraged when it happens. This is the view most management takes of CSR, and judging by their advertising, the view of the general public as well.

[23] The exception would be tax competition, which can be argued represents legitimate business planning from the corporation's perspective.

What are the implications of the real view for corporate strategic tax behavior? Judge Learned Hand famously stated in 1935 that there is "not even a patriotic duty" for citizens to pay their taxes; instead, it is the state's obligation to force them to do so. But even if that statement could be taken literally in 1935 (and there are grounds to doubt that Hand meant it seriously), it certainly cannot be applied in the post-World War II environment, in which the obligation to pay the income tax was shifted from the rich to the middle class.[25] While much of the success of the U.S. in collecting the income tax stems from its sophisticated use of withholding and information reporting, it is by no means true that nobody pays taxes voluntarily. If that were the case, the estimates for compliance in the absence of withholding or information reporting would be far below 70%. The U.S. tax system could not work unless the majority of its citizens were trying to abide by the law, not evade it.

The importance of voluntary compliance can also be demonstrated by the contrast between the U.S. and countries in which there is no tax-paying "culture". The U.S. is far more successful in collecting the taxes due than countries like Italy or than most developing countries, where the citizens indeed follow Hand's dictum (or even regard it as their patriotic duty *not* to pay taxes). The reason for the U.S.' relative success, even in an era of sharp cutbacks in IRS audit and enforcement activity, is that most U.S. citizens do regard it as their duty to try to comply with the tax law. That is also the reason why the U.S. can depend on most residents filing a tax return and self-assessing their tax liability every April 15, even though the refund they typically get is without interest and means that they have been giving the government an interest-free loan.

In general, the modern literature on tax enforcement assumes that there exists an "enforcement pyramid".[26] At the bottom are the majority of citizens whose inclination is to try to comply with the tax law. As you go up the pyramid, the appetite for

---

[24] As one sociologist has stated, "[t]he recurrent problem in sociology is to conceive of corporate organization, and to study it, in ways that do not anthropomorphize it and do not reduce it to the behavior of individuals or of human aggregates." SWANSON, The Tasks of Sociology, 192 Science 665 (1976). A whole branch of economic sociology centers on the study of organizations, and there are numerous books devoted to the topic. *See*, *e.g.*, THOMPSON, Organizations in Action: Social Science Bases of Administrative Theory (1967, reissued 2003); SCOTT, Organizations: Rational, Natural, and Open Systems (5th ed. 2003); PFEFFER/SALANCIK, The External Control of Organizations: A Resource Dependence Perspective (1978, reissued 2003); POWELL/DIMAGGIO (eds.), The New Institutionalism in Organizational Analysis (1991); SMELSER/SWEDBERG (eds.), The Handbook of Economic Sociology (1994), especially Part II, Section C, The Sociology of Firms, Organizations, and Industry. Most of these books revolve around the study of large corporations, since these are the dominant forms of organization in this society.

[25] Hand's statement was dicta in the context of the most famous case shutting down an avenue of tax avoidance, *Gregory v. Helvering*. As Assaf Likhovski has shown, this statement (and the whole opinion) should be understood against the background of the contemporary hearings into tax evasion by rich and famous Americans such as Andrew Mellon. It seems to me that if pressed even Hand would acknowledge that the tax system could not work if everybody tried as hard as Mellon did to avoid paying their taxes. LIKHOVSKI, The Story of Gregory: How Are Tax Avoidance Cases Decided, in: BANK/STARK (eds.), Business Tax Stories 89 (2005).

[26] BRAITHWAITE, Restorative Justice and Responsive Regulation (2003).

avoidance increases and the number of citizens decreases, and the type of enforcement changes from cooperation and the provision of information to increasingly harsher enforcement measures. Where the pyramid is reversed and most citizens do not cooperate, enforcement fails. In that way tax law is no different than other laws: A modern state cannot exist unless most citizens could be expected to comply with the law most of the time.

From that perspective, if the real view of the corporation is the correct one, the implication is that the corporation should behave like an ordinary citizen: It should try to comply with the tax law to the best of its ability. Thus, it is legitimate for corporations to try to minimize taxes paid on ordinary business transactions, but it is not legitimate to engage deliberately in strategic tax behavior designed solely to minimize its taxes. As stated above, while this line is difficult for the government or a court to draw from the outside, it is not so hard to discern from the perspective of the corporation.

Strangely from today's perspective, this was in fact the attitude that most corporations took to tax compliance before the 1990s. The tax function was not viewed as a profit center, and while corporations tried to minimize tax costs, large publicly held corporations did not engage in tax shelters (and were in fact quite conservative in tax matters). It was part of the corporation's general responsibility to society to pay its taxes, just like it is part of an individual's responsibility, and under the real view CSR is generally legitimate even if there is no connection between the uses of the funds and the corporation's own activities.

This attitude changed by the mid 1990s, and today major corporations like General Electric or Colgate Palmolive have lost important tax shelter cases.[27] Presumably, this shift in attitude was accompanied by a shift in the corporation's view of itself, as the aggregate view came to dominate the discussion and shareholder profit maximization became the sole legitimate goal of corporate activity. To this view, which poses the hardest challenge to CSR, we can now turn.

3.3 The Aggregate View

How does strategic tax behavior appear from the aggregate perspective on the corporation? From this point of view, the sole legitimate function of the corporation is shareholder profit maximization, and any CSR activity that is not related to long-term profit maximization is an illegitimate "tax" imposed by management on the shareholders, without the accompanying democratic accountability.

It is easy to see how this view can lead to strategic tax behavior. If tax is considered a cost like any other cost imposed on the corporation, it behooves the management to try to minimize this cost, or even turn it into a profit. Thus, the goal of shareholder profit maximization can naturally lead to corporations trying to minimize taxes and thus enhance earnings per share.

In the early 1990s, two factors led an increasing number of corporations to adopt this view. First, management compensation was linked to earnings per share via

---

[27] *ACM*, *supra* note 19; *Coltec v. U.S.*, 454 F.3d 1340 (Fed. Cir. 2006).

stock options, and although this led to abuses in some cases (even leading to corporations like Enron paying additional taxes on fictitious earnings), in most cases the mechanism worked properly, inducing management to focus exclusively on increasing earnings per share. Second, consolidation in the accounting field led the "Big Four" accounting firms to try to move beyond their traditional audit functions to devising tax strategies to be sold to individual corporate clients.

Increasing competition among corporations and increasing pressure on top management to deliver higher EPS explains the rest. Once some firms adopted aggressive tax strategies and saw their effective global tax rate plunge and their EPS increase, management in other firms came under pressure to deliver similar results. It became commonplace for the CEO and CFO, who never bothered to look at a lowly cost center like taxes before, to summon the Tax Director and require an explanation why their global effective tax rate was several percentage points higher than the competition. The Tax Director, who was already under pressure from the accounting firms to try out novel tax strategies, usually succumbed. Thus a significant number of conservative firms came to adopt aggressive tax strategies. The rhetoric of shareholder profit maximization came to provide a convenient cover and rationalization for this activity.

A good example of the spread of this type of strategic tax behavior is the saga of inversion transactions. Before 1997, most corporate managers assumed that shareholders would not tolerate a publicly traded U.S. corporation reincorporating in Bermuda, despite the fact that such transactions could significantly reduce the overall effective tax rate. However, after Tyco inverted in 1997 and its stock price went up, there was increased pressure on competitors, resulting in about 15 more inversions. This wave only stopped after September 11, 2001, when public outcry against "unpatriotic" corporations and ensuing changes to the tax law blocked the phenomenon, at least temporarily. The inversions were defended in the name of shareholder profit maximization, even though as Desai has shown they may also have made it easier to fudge corporate accounts and harm shareholders.[28]

What is wrong with reducing taxes as a way of maximizing shareholder returns? The basic problem is that under the aggregate view most CSR activities are illegitimate. This necessarily means that they devolve upon the state, which is supposed to use its legitimate taxing function (unlike the illegitimate tax imposed by management upon the shareholders if the corporation engages in CSR) to raise money to fulfill these obligations.[29] But if all corporations engage in strategic tax behavior, the state may not be able to raise sufficient money to fulfill its exclusive social responsibility functions.

---

[28] DESAI, Earnings Management and Corporate Tax Shelters (2006).

[29] In developed countries, the state may delegate some of its social responsibility to the non-profit sector. But this is no solution, since under the aggregate view for-profit corporations are prohibited from donating funds to non-profits as well, unless it can be shown that such contributions enhance shareholder returns (which is doubtful). Moreover, the non-profit sector is weak or non-existent in developing countries, where the CSR issue is most acute.

It will immediately be argued that this scenario is unrealistic: since in OECD member countries the corporate tax amounts to less than 10% of total tax revenue, the state can replace the lost revenue from corporate tax avoidance by raising other taxes. But even if one sets aside issues of distribution and fairness (lowering taxes on capital usually means higher taxes on labor), this answer is inadequate for three reasons. First, there may be political constraints to raising other taxes; especially in the U.S. context it seems glib to say that politicians could respond to a decline in the corporate tax by raising individual tax rates. Second, individual tax rates may already be set so high that it becomes highly inefficient and potentially counter-productive to raise them further. If individual rates are set very high, there will be an impact on both the labor/leisure trade-off and on the willingness of individuals to pay taxes, on which the system depends. Finally, in many non-OECD countries, as well as in some OECD members like Japan, the corporate tax amounts to a far higher percentage of total revenues. It has been shown that tax competition, which is itself a form of strategic tax behavior, has resulted in significant declines in tax revenues in developing countries, which have not been offset by tax increases elsewhere.[30]

It can also be argued that strategic tax behavior by corporations is positive in situations where the government is ineffective or corrupt, and therefore the funds can be put to better use in the private sector. This is precisely the reason that under the real view CSR is acceptable, because in many situations corporations are better situated than the government to address social problems. But this argument cannot be made under the aggregate view, because under that view almost all CSR is illegitimate and solving social problems is the exclusive responsibility of the government.

Thus, it seems to me that there is an internal contradiction in Friedman's argument, which the corporate tax shelter wave of the 1990s has brought out. If the sole function of corporations is profit maximization, it seems to follow that corporations should maximize profits by minimizing their taxes. But if all corporations avoid paying taxes, the result can be inadequate revenue for the government to fulfill those obligations that under the aggregate view it bears the sole responsibility for. The result would be that neither corporations nor the government can address social problems, and I do not think even Friedman would regard that outcome as desirable.

I would thus argue that even under the extreme version of the aggregate view, corporations do have an affirmative obligation to pay their taxes, so as to enable the state to carry out those functions that they are barred from pursuing since they are unrelated to the goal of shareholder profit maximization. This, in fact, can be seen as another justification of imposing tax on the corporation: Rather than bear any social responsibility, the corporation can by paying its taxes shift that responsibility to the state, where it belongs.

Thus, strategic tax behavior seems to be inconsistent with *any* view of the corporation. Under the artificial entity view, it undermines the constitutive relationship between the corporation and the state. Under the real view, it runs contrary to the nor-

---

[30] KEEN/SIMONE, *supra* note 20.

mal obligation of citizens to comply with the law even in the absence of effective enforcement. And under the aggregate view, it is different from other forms of shareholder profit maximization in that it weakens the ability of the state to carry out those functions that the corporation is barred from pursuing. It would thus seem that whatever view management takes of its relationship to the shareholders, to society and to the state, it is never justified in pursuing tax strategies that have as their only goal minimizing the corporation's tax payments to the government.

4. The Corporate Tax and CSR from the State's Perspective

From the state's perspective, is the state justified in using the corporate tax as a device to induce corporations to engage in CSR? It seems clear that a major function of the corporate tax is to regulate corporate behavior and steer it in directions that the state deems beneficial.[31] But is this function justified?

As Weisbach and Nussim have shown, government faces a choice in the forms of regulation it imposes.[32] It can regulate directly, or it can subsidize certain activities directly, or it can subsidize indirectly via the tax system. The choice between these options depends on which is the most effective way of achieving the government's goal.

Moreover, from the government's perspective, it is clear that it can choose to perform certain activities itself, or to delegate those activities to the private sector. If the most effective way of performing social responsibilities is in the private sector, that is the option the government can pursue. But in a market economy the government rarely imposes social responsibilities on private actors, and none of the views of the corporation set out above suggest that the government should impose a legal obligation on corporations to engage in CSR. The corporate tax is in general a legitimate tool for the government to incentivize private, for-profit corporations to assume certain social responsibilities.

The same conclusion can be drawn from the three perspectives on the corporation. From the artificial entity point of view, the state creates corporations precisely because it does not wish to perform certain functions itself. Those corporations are "imbued with a public purpose" and while the state cannot take them over, it can legitimately attempt to influence their behavior via the tax system. This is true even if the resulting CSR behavior would not be legitimate for the corporation to undertake on its own (because it is unrelated to its own activities): the state is still free from its perspective to try to encourage such corporate activity.

From the real entity perspective, the state can regulate corporate behavior like it regulates individual behavior, and that includes using tax expenditures. Since all forms of CSR are legitimate under the real entity view, this is the easiest case to make in justifying this form of regulation.

---

31 AVI-YONAH, Corporations, Society and the State: A Defense of the Corporate Tax, *supra* note 2.

32 WEISBACH/NUSSIM, The Integration of Tax and Spending Programs, 113 Yale L.J. 955 (2004).

Finally, from the aggregate perspective, one needs again to distinguish between what CSR functions the corporation may legitimately undertake (only those that clearly result in increased shareholder profits), and those CSR activities that the state can try to incentivize corporations to undertake. The latter are broader in scope than the former. In fact, from the aggregate perspective, the state's use of tax as a regulatory tool can be seen as an attempt to align its interests with those of the shareholders by promising an increased profit (resulting from lower taxes) to shareholders from those corporations engaging in CSR activities. Given the widespread acceptance of the aggregate view from the 1990s onward, this is presumably why governments have increasingly resorted to tax incentives (as well as procurement) as a way of encouraging corporations to engage in behavior that has positive externalities, like protecting the environment.

5. Conclusion

From the corporation's perspective, it thus seems that whatever our view of the nature of the corporation, it should not be permitted to engage in strategic behavior that is designed solely to minimize its taxes. From an artificial entity perspective such behavior undermines the special bond between the state and the corporations it created. From the real entity perspective such behavior is as unacceptable as it would be if all individual citizens engaged in it. And from an aggregate perspective strategic tax behavior does not leave the state adequate revenues to fulfill the increased obligations imposed on it by forbidding corporations to engage in CSR.

From the state's perspective, it likewise appears legitimate under all three views of the corporation to use the corporate tax to steer corporate behavior in the direction of CSR. This is true even for CSR functions that the corporation may not undertake on its own, because the state can still try to encourage corporations to undertake such activities, even though it cannot force them to do so.

The problem is that as long as any CSR activity that is not related to shareholder profit maximization is deemed illegitimate if undertaken without government incentives, it seems unlikely that the government can provide sufficient incentives to align its goals with those of the shareholders. Recent experience has shown that such incentives frequently fail: For example, the temporary amnesty for repatriating corporate profits with a minimal tax rate offered for 2005 failed to induce corporations to create more jobs. Moreover, such incentives cost the government money which it could use to fulfill other social responsibilities.

Overall, while regulating corporate behavior via the tax system is a legitimate government function and a major justification for taxing corporations, it seems unlikely to lead to an ideal division of labor in addressing social problems. From the perspective of adequately addressing problems such as global warming or AIDS, it would seem that the ideal world is one in which responsibility is divided as seems best for each problem and each set of actors between the government, nonprofits, and the private sector. The government should be able to levy sufficient taxes to fulfill its share, and can also try to use both taxing and spending to induce private enti-

ties to address those problems. But for the best outcome, it seems crucial to leave corporations free like private individuals to attempt to address problems not of their own making, even if no shareholder benefit ensues. Adopting the real view of corporations, which also strikes me as the most realistic view, seems to be the best way towards this goal.[33]

[33] This still leaves unanswered the question of how to hold corporations accountable for CSR behavior. *See* WALSH/AVI-YONAH, *supra* note 16.

Corporate Social Responsibility and Strategic Tax Behavior – Comment on the paper by Reuven S. Avi-Yonah

Pekka Timonen

Professor Avi-Yonah addresses two questions:

> "First, from the perspective of the corporation, should the corporation cooperate and pay the corporate tax, or should it engage in 'strategic' tax behavior designed to minimize or eliminate its corporate tax burden?
>
> Second, from the perspective of the state, should the state use the corporate tax just to raise revenue, or should it also try to use it as a regulatory tool to steer corporate behavior in directions that it deems beneficial to society?"

This comment is only directed towards the first question – which really is an important and highly topical question in global commercial environment.[1]

This became an issue for states and their treasuries as soon as it became possible for companies to exploit as well regulatory and tax competition between nation states as different regulatory structures of tax legislations and it has become even more relevant as it has become evident that the "world is flat"[2] and it is possible to place either operations or at least organizations in whichever part of the world you like. However, it might be useful to test if we have any common understanding about the "strategic" tax behavior or if we are able to make a distinction between acceptable and unacceptable tax strategies. This is however outside the scope of this comment so I won't even try.[3]

I am not quite sure, whether we should agree with professor Avi-Yonah when he states that "if engaging in CSR is a legitimate corporate function, then corporations can also be expected to pay taxes to bolster society as part of their assumption of CSR." It is by no means self-evident that paying taxes is an elementary part of the CSR and even less self-evident that companies should voluntarily pay anything they are not obliged to pay. Therefore, I do find – despite this skepticism – it justified to

---

[1] Due to this there is no need to raise questions connected to the second question, *e.g.* concerning distributive taxation or a need to find some welfarist approach or other possible justifications for the use of taxes. A comprehensive overview of the welfarist approach is KAPLOW/SHAVELL, Fairness versus Welfare (2002).

[2] The concept is from FRIEDMAN, The World Is Flat (2005).

[3] As an example it may be noted that some Finnish companies have subsidiaries in the Netherlands with their only task to own real estates or other commercial premises in Finland. These premises are leased to the parent company or to some other subsidiary within the group. The economic rationale behind this is that Dutch taxation has had much more favorable treatment for profits from real estate sales. This is not considered an aggressive tax planning but a routine arrangement to save company and its shareholders from taxes.

say "that the answer depends on our view of CSR" but I still have some doubts if this view really "depends on our view of the corporation".

I hope I am not too cynical when I ask if corporate social responsibility really is justification for companies to be "happy taxpayers" (which is quite a rare phenomenon in commercial community). Besides that I must say that as much I appreciate professor Avi-Yonah's analysis of the three competing (or sometimes completing) views of the corporation they do not get much attention on the management floor or in the boardroom where the relevant decisions are made. Sometimes it is even questionable if the CSR gets enough attention there but my understanding is that companies do not really see taxation as a CSR issue. Instead, taxes are recognized merely as a standard cost related to profits, the specialty of which is that it is sometimes avoidable or at least possible to reduce by tax planning.[4]

This being so, the question for management and for board members is, why should we give shareholders money to the state if we have a legal way to operate without doing so and if we can minimize the tax burden without taking too much risk. From the boardroom point of view this is far from being a simple "transfer value from the state to our shareholders"-scheme as the board faces a question of acceptable ways to make profit and risks related to them. There are several types of risks (litigation, reputation, financial and criminal sanctions, *etc.*) connected to aggressive tax planning and every board has to balance the pros and cons when adopting strategic tax decisions. A workable starting point for this discussion is: if you are not ready to disclose it and make it absolutely transparent you usually shouldn't use it. If tax designing seems to require exemptions from standard financial reporting the company is quite certainly on the grey area and it should just step back and accept taxes as a standard cost.

1. Our Understanding of CSR

Even though corporate social responsibility as such has been a subject of discussion from early 1960s only,[5] the phenomenon as its self is much older. As soon as large industrial companies begun to emerge, they took some concern for the living conditions of their staff. Although we may have doubts if this really was concern for the welfare of the staff or concern for the availability of the staff, it appeared in forms which are common for genuine social responsibility. Companies or their owners built houses, schools and hospitals, hired teachers and nurses and so on. Sometimes this was based on pure economic rationales as it was the only way to guarantee the availability of the workers, sometimes it was real paternalism of socially-aware or

[4] Tax liabilities are in most cases among the three or four largest groups of operational costs of companies and all tax-related information is hence essential for shareholders, creditors and investors to understand the performance of the company. This being so, the disclosure and transparency of tax-arrangements are essential from the corporate governance point of view but this does not as itself justify any CSR-related obligation *e.g.* to avoid aggressive tax planning.

[5] *See* FRIEDMAN, Freedom and Capitalism (1962). Paradoxically enough from our present viewpoint, Friedman only recognized one social responsibility for the corporations: to generate profits for the benefit of shareholders.

religious industrialists but whatever the reasons, they caused action easily recognizable as social responsibility.[6]

Social responsibility as its current form, responsible behavior instead of pure wealth maximization, only emerged from 1970s or 1980s. When analyzing the business community understanding by CSR Vincent Commenne[7] has found six different levels:

- At the first level, being responsible means respecting the laws of the country where the company operates and providing jobs. The rules are formulated by the government and followed by the company.
- At the second level, which Commenne characterizes as being "marginally higher up the scale", some amount of charity is added but otherwise there's no real difference to level 1.
- At the third level, companies adopt a negative criteria which means that they are not doing real harm, *i.e.* do not pollute too much, do not exploit the natural resources too much, do not product harmful products or at least do not try to hide the harmful effects of those.
- At the fourth level, companies commit themselves to positive actions *e.g.* by integrating environmental management to their line operations or by recruiting underprivileged employees.
- At the fifth level, companies adopt global responsibility by using higher than demanded standards for working conditions, wages, pollution and so on. One typical example in Western Europe is to have a social audit or some similar mechanism for the production chain which starts from developing countries to guarantee *e.g.* the non-use of child labor or the minimum standards of working conditions.
- At the sixth level there are no "normal" commercial companies but only those created to practice societal responsibility in partnership or at least in common understanding with NGO's or other societal actors.

The "official" European definition is somewhere near the fourth level as the European Commission defines CSR as "a concept whereby companies integrate social and environmental concerns in their business operations and in their interaction with their stakeholders on a voluntary basis".[8] This is far from enough for the NGO's, which tend to claim for much more far-reaching commitments as well as regulatory European approach on CSR. The minimum standard acceptable for these NGO's is that companies must respect international human rights treaties, International Labour Organization's conventions, international environmental agreements and national laws. The real concern is on conditions in the developing countries as these minimum standards are usually less demanding than the legislative obligations in

---

[6] *See* in general COMMENNE, Economic Actors' Participation in Social and Environmental Responsibility (2006).

[7] COMMENNE, *id.*, at 64-66.

[8] EUROPEAN COMMISSION, Corporate Social Responsibility: Encouraging best behaviour, June 15, 2006 (*see* http://ec.europa.eu/enterprise/library/ee_online/art11_en.htm).

the European Union or in other industrial societies. Saying this I am aware of national tensions in many industrialized countries as well as national or local criticism against job reductions, factory closings, *etc.* In these discussions we hear loud and demanding arguments saying that those are against company social responsibility but I consider these as national or local politics which should be kept separate from real and global corporate social responsibility.

All this means, that the commitments of the business community and the expectations of the NGO's are far from being common or even having common ground. The European Commission and many European governments are willing to follow the attitudes of the business community as their main concern is on the economic growth and on the competitiveness of European or national companies. But this is not the issue in this context and I only brought this up to show that taxation is not a "traditional" CSR issue and being a good taxpayer is not recognized as a CSR action in the current discussion of the CSR. This means that it is not only companies that do not recognize taxation as a CSR issue but that this has been the attitude of governments and NGO's as well.

2. From Social Responsibility to a Happy Taxpayer?

As CSR is tightly related to moral arguments, it is easy to say that the companies should follow their CSR-obligations but this does not by definition mean that companies are obliged to follow those obligations. If such an obligation exists, it is moral, not legal. Besides that, the main focus of the social responsibility in the global business environment is clearly on reaching some minimum common standards. Following those standards is most often supposed to mean that companies accept the responsibility in improving working conditions, stopping pollution, promoting better education and in general promoting sustainable development in developing countries.

It is pretty easy to say that these goals are generally accepted and get their justification from this acceptance. It might even be legitimate (although probably impossible to give any water-tight proof) to say that due to improved customer satisfaction or decreased risk of customer reactions responsible behavior will in the long run increase profits despite the fact that such behavior most certainly means immediate costs and therefore decreases short-term profits. This, in fact, means similarity or at least likeness with investment decisions as the expectation of future profits exists. For managements and boards this is essential as their primary task is to create value for shareholders. As I see it, the value creation is not and needs not to be synonymous with maximization of short-term profits but the target should be set to enlightened and long-term value maximization as defined by Jensen and as adopted into the new Companies Act of the U.K.[9] If the management and the board work for enlightened value maximization they don't only have a permission but do have an obligation to

---

[9] U.K. Company Law Reform Bill, Explanatory Notes (2005), ch 324, Guidance (2005), ch 10 and 62. The concept originates from JENSEN, Value Maximization, Stakeholder Theory, and the Corporate Objective Function, 14/3 Journal of Applied Corporate Finance 8, 9 (2001), who stresses the importance of stakeholders for the value maximization.

take stakeholders into account as this is elementary for the maximization of the shareholder value.

However, it is not acceptable to try to misuse this acceptance by expanding the use of the label "CSR" to other areas without some justification. If we try to build such justification we must firstly keep in mind that paying taxes has not been recognized as a primary CSR-obligation and I am not sure if it is even a secondary one. Secondly it should be noted that tax planning or strategic tax behavior are normally considered problematic by the state only (the one losing cash flows from taxes) and other stakeholders seldom react to it. Thirdly this means that it is extremely difficult to claim that a company is promoting the enlightened value maximization by voluntarily paying taxes as it is quite difficult to see the connection between short-term cost and expected long-term profit. Instead, taxes are treated as standard costs which companies should minimize whenever that is possible by legal means.

Therefore, and although it is self-evident that every government is keen to collect taxes whenever that is doable, my conclusion is that taxation should not be discussed as a CSR issue nor as engaged to the enlightened value maximization. For companies, taxes are primarily costs and most often nothing more than costs. For shareholders, more costs means less profit and less added value for their investments. For other stakeholders (except the state) taxation is neutral unless it has effects on their specific stakes. From the management and boardroom point of view there should be some added justification to claim that "it is never justified in pursuing tax strategies that have as their only goal minimizing the corporation's tax payments to the government". Otherwise, and if this is a moral argument only, the managements and the boards are allowed to use every legal way to reduce the costs. There is no "shall" but "should" only and it is quite often a weak argument.

It is very easy to agree with professor Avi-Yonah's conclusion as he says that "it seems crucial to leave corporations free like private individuals to attempt to address problems not of their own making". Still, and while agreeing with this it is essential to keep in mind that corporations are not private individuals but organizations managed by individuals. Those individuals (managers and board members) are trustees for shareholders primarily and have to listen to them and respect their opinion. Despite exemptions the general message from the global investor community is clear enough: make profit and create value. Otherwise you should expect to be sacked and substituted by somebody willing and capable of doing that. That is basically the rationale for decisions which aim at reducing the tax burden and it is without doubt a tough task to create a moral argument (be it named as social responsibility or something else) to overweight that rationale in boardroom discussions. To make the international investor community convinced of that rationale would be a real challenge.

Tax Risk Management and Board Responsibility

*Bernd Erle**

1. Introduction

Is the board responsible for tax? This question might have caused interesting discussions among board members a few years ago. Statements such as "It's a CFO issue" and "tax is under control" might quite possibly have been among the responses. Taxation gives rise to complex, multi-faceted problems in every country in the world, that can only be dealt with by tax specialists. This argument used to be met with some sympathy, especially by members of the public who were familiar with the complexities of filing their own income tax returns every year. But the question remained: how can an issue that might encourage a corporate reorganization or influence the payment of dividends to shareholders, or which might affect a merger or take-over, possibly stay out of the boardroom?

Particularly in the wake of corporate scandals like Enron and WorldCom, or the collapse of the new economy in Germany it has become clear that there is a need for the board to set up a transparent governance system throughout its company. Legislative requirements as regards internal control systems have increased significantly, as well as other initiatives from governmental and non-governmental bodies.

Stakeholders are showing increasing interest in obtaining comprehensive information on how tax risk management and corporate conduct are implemented and supervised. Financial key performance indicators used to be the most important measures for the performance of companies and therefore "the lower the tax charge the better" was the simple rule. Now concepts of sustainability and the management of long-term value added are assuming increased importance. The value of tax avoidance strategies is increasingly in doubt especially when taking the potential damage to reputation into account. Stakeholders demand sufficient long-term information on how tax risks are being controlled, the tax risk management system is implemented and the corporate conduct is supervised.

In theory there is no doubt that tax risk management is part of the corporate governance system and therefore it is the responsibility of the whole board.

From every theory arise a number of practical questions. Are the board members aware of their responsibility for tax risk management? What impact does tax risk management have on corporate structures, processes and transactions? Tax issues are complex, multi-faceted and subject to ongoing change. What qualifications do the board need to actually understand and govern tax risks? What exactly does the board need to do to implement a tax risk management system? What communication and documentation requirements need to be fulfilled? What kind of future developments need to be considered?

* The author wishes to thank his assistant, Ms. Michaela Peisger, for her valuable contribution.

This paper will address most of the issues raised, mainly from a practitioner's point of view. The study starts with a short look at the developments that have given rise to the increasing importance of tax risk management for the board. Following this analysis the key results of a recent KPMG survey of the views of board members on tax risk management are outlined. The third part will show the challenges of tax risk management and introduce practical solutions. In chapter four the paper focuses on the responsibilities of the board for managing tax risks.

Where do we go from here? The final chapter considers what the future might look like with regard to tax risk management and the board's role in this area.

2. The Changing Landscape – Why has Tax Risk Management Become Increasingly Important?

2.1 Tax is in the News

"Non-compliance a growing problem",[1] "Tax: Multinationals' low bill in poor nations under fire",[2] "Managers under pressure to give tax its due – as rules and scandals proliferate, the issue of how to manage tax has become far more urgent",[3] "Cut tax or lose business",[4] "HSBC says tax regime may force it to move",[5] "IFRS brings tax out of the back room – TAXING MATTERS – a company's tax policy, traditionally a mere technical issue, is increasingly viewed as a strategic matter".[6]

Major business headlines deal with non-compliance of companies, tax as a significant cost factor for business and increasing regulation on the disclosure of tax information.

Primary goal for the board is to achieve excellent financial results. Tax is a significant cost factor for companies. That implies that minimizing tax will increase profitability. But besides the obvious tax payments there are other costs that are harder to measure but that need to be taken into account.

There is a strong interrelation between the success of a business and its reputation which significantly depends on the general perception of the company. The public interest in corporate social responsibility of businesses (CSR) is growing. Paying the taxes legally required in any country where the company operates is considered an important part of being socially responsible. CSR is no longer the concern only of non-government organizations. It has been raised to the agenda of international organizations like the United Nations and the Organisation for Economic Co-operation and Development (OECD). "Business practices rooted in universal values can bring social and economical gain".[7]

---

1 Financial Times, October 13, 2006.
2 The Guardian, September 18, 2006.
3 Financial Times, August 19, 2005.
4 The Times, October 10, 2006.
5 Financial Times, October 6, 2006.
6 Financial Times, July 4, 2005.
7 BAN KI-MOON, Secretary General of the United Nations.

Stakeholders are enquiring more into the values that underlie a business's actions. Companies that move to tax shelters without obvious business reasons risk reputational damage in addition to the possibility of legal actions. In 2004 Swatch, the Swiss watchmaker, featured in the newspapers over its transfer pricing arrangements, while U.S. clothing group Tommy Hilfiger could find itself in court over the commissions paid to a non-U.S. subsidiary.[8]

Stakeholders' demand for ethical behavior is increasing significantly and tax is one area where businesses have to show value-based behavior. Socially responsible investors have been active in the U.S. at companies such as Pepsi and Raytheon, and have demanded curbs on tax havens used by Tyco and others.[9] In the U.K. Henderson Global Investors encourages all companies to consider whether tax matters are among the principal risks and uncertainties facing the company, or are included in the main trends and factors which are likely to affect the company's future development, performance and position.[10]

Tax has become an ethical and reputational issue and the board is responsible to ensure awareness of tax issues throughout the organization.

2.2 Relevance of Tax for Business Performance and Financial Statements

Certainly the board is primarily accountable for the financial performance of a business. And it should not be forgotten that, as Josef Ackermann stated, financial success is important because the more a company earns the more taxes it is able to pay.[11]

Taxes are important figures on the face of the balance sheet and the income statement of a company. They have strong implications for the year end results as well as the profitability and the ability to pay dividends. Tax considerations can influence the decisions on major business transactions such as mergers, acquisitions and disposals of companies. Thus if something goes wrong this does not only affect the balance sheet but may also affect the share price significantly. In February 2006 Google announced reduced earnings due to a higher than expected tax charge. Market value fell by 20 billion dollars.

An analysis of companies listed on the Dax-30 Index in Germany shows that the deferred tax assets can easily amount to forty percent of the equity of a business. This means that if the tax asset is impaired almost half of the equity may be wiped out.

Due to the importance of tax effects on business performance and financial statements the board will be accountable for implementing processes that ensure the quality of tax figures reported. This implies specifically that tax provisions and liabilities must be calculated accurately and the correct valuation of deferred tax assets in the balance sheet must be ensured. The board must therefore bridge the gap

[8] ETHICAL COMPANY, 25 (December 2004).

[9] *Id.*

[10] HENDERSON GLOBAL INVESTORS, Responsible Tax (October 2005).

[11] "Wir wollen Deutschland nicht verlassen", Süddeutsche Zeitung, March 10, 2007, 25.

between being profitable and not taking tax risks that could have negative impacts on the business performance and the financial statements. But tax in many cases has a long-term perspective. So the implication go far beyond the financial statement of one year.

2.3 Compliance and Reporting an Ongoing Challenge

The trend of globalization has developed further as emerging markets offer new business opportunities. An international survey among 250 chief financial officers of successful global companies shows that the majority sees foreign expansion as one of their top priorities.[12] However, globalization has become a "two-way street" where emerging economies show increasing amounts of foreign direct investment. At the same time, there are significant flows of investment into emerging markets to take advantage of low costs and access to new markets.[13] Multinational companies now have to take into account different local regulations, customs and stakeholder expectations as well as market demands.

In addition the complexity of tax laws at national and international level has increased significantly and is subject to ongoing changes. Furthermore, tax law often inter-relates with other legal issues. Uncertainties with regard to interpretations of legal regulations are also not uncommon. To ensure full compliance with all legal requirements has become a challenge for almost every corporate governance system. As the OECD Principles state: "Corporate governance requirements and practices are typically influenced by an array of legal domains, such as company law, securities regulations, accounting and auditing standards, insolvency law, contract law, labor law and tax law. Under these circumstances, there is a risk that the variety of legal influences might cause unintentional overlaps and even conflicts, which may frustrate the ability to pursue key corporate governance objectives".[14]

Global markets and the free flow of capital made it possible to control the jurisdiction in which profits arise which is a challenge for tax authorities. As a result the enforcement processes through civil and criminal actions have been strengthened in many countries and on an international level.

Reporting and documentation requirements have been enhanced to address the problems of information asymmetries resulting from the principal-agent conflict – between shareholders and the management – and in the light of corporate scandals like Enron and WorldCom. Most notably the Sarbanes-Oxley Act (SOX) was introduced in the United States which required a significant effort from companies in documenting their internal control systems. The Financial Accounting Standards Board (FASB) Interpretation No. 48 (FIN 48) also intensifies the focus on accounting and disclosures for uncertainties in tax positions in the financial statements.[15]

---

[12] KPMG, Emerging Markets, 1 (January 2007).

[13] UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT, World Investment Report 2006 (*see* www.unctad.org).

[14] OECD Principles of Corporate Governance (2004), Annotations I.C.

[15] FASB Interpretation No. 48, Accounting for Uncertainties in Income Taxes, an Interpretation of FASB Statement No. 109.

In the light of these developments tax cannot stay in the splendid isolation in which its technical nature has historically placed it. The management of tax risk has become even more important in the light of recent changes. The public, shareholders and legislators expect board members to address these effects through the corporate governance system of a business.

3. Tax is in the Boardroom – What is the Perspective of the Board?

3.1 Awareness

The OECD states: "What is clear is that the recent spate of corporate scandals, the success of a number of tax administrations in challenging aggressive tax schemes and the general change in attitudes towards tax planning, will all combine to produce a greater awareness in the Boardroom of the importance of tax issues".[16]

KPMG has undertaken surveys and asked board members for their views on the relevance of tax issues for the board over recent years. The directors of many companies acknowledge the need to change their attitudes towards tax. There is a general understanding that tax cannot be managed independently from the main business and can have a significant influence on decisions as regards the transactions undertaken.[17]

Survey results from 2006 show that 72% of the respondents consider tax and its risks to be boardroom issues (an increase of 11% over a two year period). There is awareness that a reduction in taxes can increase the value of a company. They also consider that the most significant areas where tax has an impact are changes in capital structures, intra-group funding arrangements, transfer pricing and similar transactions.[18]

The issue has therefore become more important in recent years. But this does not mean that changes follow at the same speed. Various major critical issues remain. Many tax departments are isolated so that their presence is not felt throughout the business. There is a lack of general understanding and awareness of tax issues. Tax considerations are not integrated into the main business processes. Tax may be considered on central projects, but is often ignored in routine day-to-day transactions. The performance measures for management are mainly based on pre-tax figures such as earnings before interest and tax (EBIT).

The results of the survey show that only 14% of the companies included in the research had board-approved tax objectives. Regular formal reviews of the tax department by internal audit were carried out in only 22% of the companies. Only 10% of the tax departments felt that they were widely understood outside the tax function.[19]

---

[16] OECD FORUM ON TAX ADMINISTRATION, Good Corporate Governance: the Tax Dimension (September 2006).
[17] KPMG's Wired Tax survey 2004.
[18] KPMG's Wired Tax survey 2004 and 2006.
[19] *Id.*

The reasons for the contradiction between the awareness of the board and the lack of implementation are many. It is mainly caused by the increasing complexity of tax law as well as increasing reporting requirements that leave less time to consider strategic issues and debate the big picture. A lack of expert staff makes change even more difficult. Finally there is a lack of understanding on how the world's tax authorities are changing their approaches.

3.2 Tax Risk Attitudes versus Actual Behavior

When informally asked about their risk appetites the majority of the board members questioned would designate themselves "conservative". Only very few would see themselves as "very conservative", meaning that they would do nothing to provoke the tax authorities. The majority require a legal opinion comfort of more than 50% on their tax planning. Companies are mainly willing to defend their tax planning in court, but none of the board members questioned think a reputational risk is acceptable. The research suggests also that attitudes have shifted towards the risk-averse end of the spectrum.[20]

Surprisingly there is a gap between tax risk attitudes and actual behavior as the results of legal proceedings from tax authorities often show. Since that is the case the board members are facing significant problems due to the fact that the company's behavior does not reflect their attitudes and might trigger inquiries by tax authorities.

Tax authorities have shifted to a risk-oriented approach to identify non-compliant taxpayers and look especially at questions like: Is a clear direction from the board given as regards tax matters? Does the audit committee request information on tax issues and is adequate supervision in place? Have there been compliance issues in the past? Is there extraordinary pressure from investors to deliver results and are directors or management under pressure to achieve personal goals?[21]

A key challenge is to ensure that the risk attitude of the board is reflected in the company's actual behavior and in the mindset of everybody involved. There cannot be two policies: one for the board and one for the tax department.

3.3 Managing Tax Risks – What is the Challenge for the Board?

Tax risks include the risk of overpaying taxes or of paying less tax than legally required. Reputational damage resulting from such errors can incur additional costs which are hard to measure. Errors in assessing the tax effects of transactions can lead to wrong business decisions. For many businesses tax is a cost factor that can be important for its competitiveness. To summaries: tax risks mainly consist of compliance risks, transactional risks, and operational and reputational risks.[22] These are good reasons for the board to be involved in tax risk management.

---

[20] *Id.*
[21] KPMG, Tax in the Boardroom, A Discussion Paper (2004).
[22] KPMG, Tax in the Boardroom, A Discussion Paper, Appendix II (2004).

The goal for the board is to implement a tax risk management process that has the right balance between risk and opportunity. The business processes need to ensure that taxes are not overpaid but that legal obligations are fulfilled.

Going forward, organizations will need a dual focus: (1) sustaining an ongoing assessment process for compliance and (2) balancing risk and controls while identifying and pursuing process improvement opportunities to better the business.[23]

The question of how to implement a tax risk management system that ensures this objective is met will be addressed in the following chapter.

4. Tax Risk Management in Practice

4.1 Defining a Tax Philosophy and Setting a Framework

The board has to set the general standards for tax issues by defining a global tax philosophy and setting a framework for the governance of tax issues throughout the business. The tax philosophy on a practical level is the code of conduct for tax issues.[24] A code of conduct is intended to establish the ethical norms of the company and to set standards for ethical behavior when dealing with those inside and outside the firm.[25] So the tax philosophy as code of conduct with regard to tax issues states the overall position of the company towards tax.

The OECD Guidelines for Multinational Companies indicate what can be addressed: "It is important that enterprises contribute to the public finances of host countries by making timely payment of their tax liabilities. In particular, enterprises should comply with the tax laws and regulations in all countries in which they operate and should exert every effort to act in accordance with both the letter and spirit of those laws and regulations. This would include such measures as providing to the relevant authorities the information necessary for the correct determination of taxes to be assessed in connection with their operations and conforming transfer pricing practices to the arm's length principle".[26]

The tax philosophy needs to be embedded in the overall goals of the business. As the code of conduct it must not only be a set of rules for good behavior but must be part of company's culture and become a factor in everyday business dealings.[27] Establishing a position requires the board to decide on the focus areas for tax management. Is tax mainly seen as a normal cost factor that needs to be minimized as a duty to shareholders or is its payment a social obligation and a duty to the local community. Most companies take a position closer to the idea that "tax is a cost factor" and therefore a decision needs to be made on how aggressive tax management

---

[23] KPMG, The Compliance Journey Balancing Risk and Controls with Business Improvement (2004).

[24] KPMG, Tax in the Boardroom, A Discussion Paper, 6 (2004).

[25] BANKS, Corporate Governance – Financial Responsibility, Ethics and Controls, 47 (2004).

[26] OECD, Guidelines for Multinational Enterprises, 27 (2000) (*see* www.oecd.org/dataoecd/56/36/1922428.pdf).

[27] BANKS, *supra* note 25, *id.*

should be and what level of risk is acceptable for the company. Furthermore short-term and long-term effects have to be balanced properly.

The tax risk management system will be derived from the tax philosophy. It is embedded in a framework which is outlined below.

The aspects of the framework are at the same time practice indicators on the operation of the tax risk management system.[28]

Once the framework and the policies are defined it is important to give guidance to the staff on how they should be implemented.[29]

4.2 Components of the Tax Risk Management Framework

4.2.1 Strategy

Tax risk strategy is derived from and aligned with the tax philosophy as well as the business strategy. Tax strategy should reflect where in the spectrum of positions the company wants to place itself. Businesses are not limited to compliance with tax regulations, but can claim leadership through engaging in discussions about the tax policy development with legislators.[30]

It can be left to the tax department to develop an action plan and deal with risk areas, but the tax strategy should be understood and approved by the board and communicated within the business.

Policies around key strategies and risks need to be documented and communicated. This is not only a requirement of SOX 404[31] but also sends an important message to stakeholders of the company. It will also help align the tax behavior of managers throughout the organization.[32]

---

[28] KPMG, Tax in the Boardroom, A Discussion Paper, 11 (2004).
[29] HENDERSON GLOBAL INVESTORS, *supra* note 10, at 61.
[30] KPMG, Tax in the Boardroom, A Discussion Paper, 7 (2004).
[31] Sarbanes-Oxley Act of 2002, section 404.
[32] SALZBERGER, Corporate Governance – Begriff und Aufgaben, 167 (2005).

4.2.2 Risk Management and Control

Tax should be an integral part of the internal control and the risk management system of a business. Hence the same rules apply for tax risks as apply for recognition and control of general business risks. Publishing the tax philosophy and tax strategy is important as is a control environment that ensures that deviations from rules are dealt with. Only then does a control environment actually exercise control. Establishing the control environment is normally the duty of the board.

Effective control also implies that the tax department is subject to independent reviews from internal audit. To review the tax processes professionals need to have adequate knowledge and experience in tax. The review should address compliance with strategy and policies as well as the quality of advice provided by tax staff to other functions.[33]

4.2.3 Profile, Relationships and Communication

The profile of the tax department should be one of a business partner across the various business functions with clear contact points. The tax department has a role as both an external and an internal contact point and therefore needs to be aware who its stakeholders are (*e.g.* the tax authorities, financial market, legislators) are. Communication from the tax department needs to be in line with the established tax philosophy and tax strategy of the business. External and internal relationship management is a key success factor. Furthermore, it is important that the tax department goals and strategic drivers are understood by the business as a whole and that there is awareness of tax issues throughout the business.

The tax department should have a clear reporting line to the board. Boards need to be informed about issues that could have material impact on the business. Frequency and method of reporting can vary but should include a regular annual report on the state of the company's tax affairs. It is important to ensure that the board receives adequate data in a digestible form. Reporting should embrace all taxes and include all tax systems at group and business unit levels.[34]

4.2.4 Processes and Technology

Processes and controls in a tax department should be documented not only to comply with SOX and other corporate governance regulations but to allow regular evaluation and improvement. The tax technology system should be part of the accounting system of a business since significant information for the taxation process will be obtained from it.

4.2.5 Staff

The tax team needs to understand the business model a company acts upon. This includes being aware of their role in achieving the business strategy. The mindset of the tax department should be one of a service provider to internal clients. Within the

---

[33] KPMG, Tax in the Boardroom, A Discussion Paper, Appendix III (2004).
[34] *Id.*

department clear roles around tax management and adequate support to internal clients will have to be defined.

The success of a tax department depends to a great extent on the appropriate qualification of the staff. The complexity and speed of change in tax regulations demands ongoing training and specialization.[35]

4.2.6 Compliance

Compliance can only be assured if tax issues are identified and dealt with in a timely way. This will only be achieved by awareness of tax issues throughout the business. A close link between the compliance process and other tax functions (*e.g.* planning) is important. One of the department's goals will be to manage compliance efficiently to ensure that tax processes are cost effective and also that no overpayment of taxes takes place.[36]

4.2.7 Accounting

The accounting system is the basis for sufficient and accurate information for the tax department. Accounting principles need to be understood by the tax department, just as the accounting department should be competent to identify potential tax issues.[37]

4.2.8 Planning

The planning process should ensure that the tax department gets involved at the strategic level at an early stage of projects. Tax planning can only be effective if there is access to management information and decision makers of the business. Procedures need to be aligned with risk policies. Furthermore it is essential to establish processes to monitor the implementation and post-implementation stages.[38]

4.2.9 Coverage

Tax issues need to be on the agenda of the board. The tax department has to cover all taxes adequately. If there is no operational control over certain taxes the tax department should at least be able to exercise oversight and ensure that any necessary action is taken by the appropriate party or engage specialist help as necessary. Any taxes not dealt with within the tax department need to be clearly designated as the responsibility of another department, *i.e.* wage tax dealt in the HR-department.

Processes to raise awareness of tax issues throughout the business should be implemented.[39]

---

[35] *Id.*
[36] *Id.*
[37] *Id.*
[38] *Id.*
[39] *Id.*

5. Board Responsibility

5.1 International Focus on Board Responsibility for Tax Risk Management

The OECD has stressed the importance of board involvement in tax strategies of multinational companies: "Encouraging management and audit committees of large enterprises (*e.g.* CEOs and boards of directors) to take greater interest in, and responsibility for, their tax strategies".[40]

There is a clear expectation that the OECD will extend its guidelines on corporate tax governance in the near future. The main responsibility for determining the global business strategy on tax and ensuring that the system of internal controls is effective in facilitating the application of this strategy is seen to rest with the board.

International reporting requirements have been extended with the introduction of SOX 404 and corporate governance guidelines in various countries. The standard FIN 48 under U.S. GAAP intensifies the focus on accounting and disclosures for uncertainty in income taxes. The extension of reporting obligations is accompanied by an increasing interest by stakeholders in risks resulting from tax issues.

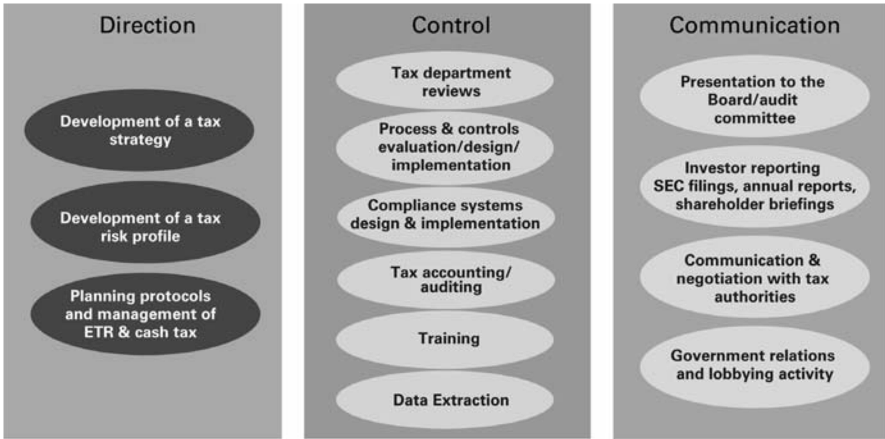
So, to summarize, there are two very important challenges for the board. One is to ensure the creation of an internal corporate environment that is handling all tax matters appropriately and in line with the tax strategy. The second is adequate external communication addressing the requirements of international reporting standards as well as the information needs of external stakeholders.

5.2 Decisions to Make and Questions to Ask

The board is responsible for the strategic direction of the company, the control environment and the implementation of the internal control system as well as communication with stakeholders. Each organization will need to develop its own particular way of managing tax. There is no "one size fits all" answer because each business has its own drivers and constraints. The following illustration outlines factors with regard to direction and control that need to be considered. Additional influences come from the external environment such as customers, investors and competitors. It is important that the board delivers clarity around its direction and control of tax.

---

[40] OECD, Final Seoul Declaration (September 2006).



5.2.1 Direction

The tax philosophy has to be determined by the board, documented, communicated and implemented. It should be derived from and aligned with the overall management strategy. One of the aspects that need to be taken into account is the general risk appetite of the board which will be reflected in the tax risk attitude chosen. As the surveys have shown the majority of board members would take a conservative view.

There is a spectrum of approaches towards tax that the board can adopt as the following illustration outlines.

The board needs to decide whether the business should: be a *leader* by progressively adding value through tax-driven business process and transaction design; take *advantage* by devising and implementing progressive tax planning; or *add value* by exploring opportunities including those above the profit line. *Maintenance* includes the enhancement of commercial decisions already made and *compliance* requires fulfilling legal and statutory obligations.

When determining the direction the board will also have to consider internal and external business-specific factors. The internal factors mainly result from business goals and strategy reflected in the core business processes which include the procurement process, the provision of services or production and the sales process. As an example the decision as to the jurisdiction in which a production site is located will determine the amount of labor taxes, transfer pricing requirements and customs duties.

In addition external factors such as market development, position of competitors, expectations of customers and investors, as well as differences in national tax systems, will have an influence on the tax direction of a business.

A final check of the areas outlined in the following illustration will cover most significant questions.

For multinational businesses *compliance* is not a question but an obligation. Aspects to consider on *tax management* are the cost compared to the gains from tax savings achieved and tax risks avoided. *Planning and accounting* should take into consideration effects on the profit and loss account and the balance sheet. This includes the deferred taxes shown in the financial statements, that also need to be managed. *Controls and reviews* will involve ensuring that the risk attitude of the board is reflected in processes and transactions. The *effective tax rate* is an important factor for a company to increase value and stay competitive in the market and with regard to attracting investors.

5.2.2 Control

It is the responsibility of the board to ensure a control environment where there is a common awareness of potential tax issues throughout the company. An effective risk management system includes, essentially, controls that identify risks, analyze the impact and define measures to manage risk.[41]

Control over tax issues is mainly executed through the tax department. The tax department is responsible for the implementation of the tax strategy and for provid-

[41] DÖRNER/HORVATH/KAGERMANN, Praxis des Risikomanagements, 109 (2000).

ing adequate information to the board, but it is also part of the internal control system and needs to be reviewed by internal audit. Adequate staff and ongoing training are critical success factors to watch over.

To obtain an overview of the state of control the board can check on questions such as the following: Does the board receive sufficient data and in a digestible form? Has the company appropriate reporting lines and access to the tax function? Are responsibilities defined and authority delegated as appropriate? Is the tax department set up in such a way as to provide appropriate resources to implement the strategy? Is the quantity and quality of staff appropriate? Are the appropriate controls in place? Are independent reviews of the tax function carried out? As with any risk management system, effective tax risk management requires that tax risks are identified, that they are analyzed with regard to their impact, and that measures are defined to manage them.

5.2.3 Communication

The right communication on tax issues is a significant factor for the reputation of a company and therefore for the success of the business. In practice a reluctance to disclose information on tax issues and tax risks in the annual report can still be found. This is often because tax authorities have access to such information as well. There is a general concern that through the report critical areas could be identified which then might be subject to inspections by tax authorities. As a result statements on tax issues often remain generic and too unspecific. However, communication of this sort is likely to trigger insecurity and distrust and not to achieve its aim since tax authorities are focusing more and more on a risk-oriented approach.

The main question that arises, therefore, is how to establish a system of communication that informs stakeholders adequately and gives comfort to tax authorities as well. The right message to investors, authorities and legislators is the key. One vehicle to convey this is the annual report of the company. This gives the opportunity to state the overall tax philosophy and strategy of the business. It should also outline the internal control process for tax risks and include information on tax department structure and training. A commitment to compliance with legal requirements is a significant statement to establish confidence among stakeholders. Also important for investors is the message that within legal boundaries the company seeks tax efficiency in the corporate structure, the supply chain and acquisitions and disposals.[42]

Besides the question of what to communicate the company also needs to address the questions of who to communicate to, and how. It is the responsibility of the board to implement processes that identify, and establish relations, with stakeholders who have a specific interest in tax issues of the company. This naturally includes the tax authorities. An international business whose tax strategy is to be a leader will, for example, engage actively in communication with legislators and international standard setters such as the OECD. If the main focus of the tax strategy is on compliance and maintenance the relationship management will concentrate on local tax authorities.

---

[42] KPMG GLOBAL TAX, The Governance of Tax, A Discussion Paper, 15 (2006).

Good and consistent communication can only be achieved if the information reported has substance. Unsupported general statements are likely to have an adverse effect on the company if there are grounds to challenge them at a later stage. What the company communicates has to reflect its policies and organizational culture as well as its relative appetite for risk and opportunity.

6. Future Developments

Stakeholders do not always have the same interests when it comes to taxes. Companies will need to balance the demands of reducing tax to become more competitive and at the same time being good citizens and thus paying taxes. Tax may be expected to pose an increasing reputational issue because of growing awareness of its ethical dimensions. The expectation on companies to apply the concept of corporate social responsibility is gaining more and more importance.

The OECD has announced that the Corporate Governance Guidelines will be expanded. There will be a greater attention to the linkage between tax and good governance. Furthermore the OECD produces statistics of international comparisons, engages in monitoring and encourages the exchange of information between national tax authorities.[43] Legislators are beginning to work globally on solutions for tax problems. The OECD has established the "Forum on Tax Administration", as a panel of national tax administrators. Regulators such as stock exchange supervisors will extend the focus on internal control systems.[44] In the U.S. the Public Company Accounting Oversight Board (PCAOB) was created by the SOX and is already focusing on audit of internal control systems to protect the interests of investors and the public.[45]

International co-operation and information sharing between tax authorities will increase significantly over the coming years. A joint international tax shelter information centre taskforce was set in place by Australia, Canada, the U.K. and the U.S. in 2004.[46] The Committee on Fiscal Affairs of the OECD is working to improve exchange of information both from a legal and a practical perspective.[47] The establishment of the "Leeds Castle Group" which will be an extension of the IRS was agreed in 2006 and nine countries have already joined. The main goal is to discuss compliance challenges. For the first time China, India and South Korea are included in such discussions.[48]

From an investor's perspective there is a demand for increases in the value of the company through sustainable tax rate reductions, and for "no surprises". Long-term

---

[43] OECD (2007) (*see* www.oecd.org/topic).

[44] INTERNAL REVENUE SERVICE, U.S. Department of the Treasury (*see* www.irs.gov/newsroom/article).

[45] PCAOB, 2003-2006 (*see* www.pcaobus.org/).

[46] INTERNAL REVENUE SERVICE, U.S. Department of the Treasury, May 3, 2004 (*see* www.irs.gov/newsroom/article).

[47] OECD (2007) (*see* www.oecd.org/topic).

[48] INTERNAL REVENUE SERVICE, U.S. Department of the Treasury, IRS News Release IR-2006-120, August 1, 2006 (*see* www.irs.gov/newsroom/article).

after-tax performance indicators give a clear indication of the effectiveness of tax risk management. Consequently, after-tax goals are greatly to be preferred as performance measures for management.

The change in the role of tax from an internal domain of the tax department to the external domain of stakeholders will continue and the challenges for the board will increase. The changing environment will require tax risk management to move towards a tax governance system.

Tax governance will have to cover the tax philosophy, tax strategy, internal policies and processes with regard to tax risks, and external communication on all tax issues. The board will be held accountable for setting a direction, implementing a tax governance system and of course for value enhancement through tax reduction.

7. Conclusion

The board is responsible for tax risk management and will be held accountable for it by the stakeholders of the company. Challenges in the global capital markets result in increasing expectations from stakeholders and in tightening regulation on corporate governance with a strong focus on internal controls. Furthermore, companies are more and more relying on their reputation of behaving in a socially responsible way as a factor contributing to their success. These developments will cause a shift from the board being in charge of tax risk management to a responsibility for tax governance as more widely conceived.

Increasing requirements and challenges will cause ongoing changes for business with regard to tax risk management and governance. The vision of an effective tax governance system is to continually minimize the effective tax rate and add sustainable value to the company. From a long-term perspective this is the best strategy for all stakeholders since only a company that remains competitive and successful in the market can pay taxes and contribute to society.

Report on the Discussion

Christian Kersting

1. Presentation by Reuven S. Avi-Yonah and Comment by Pekka Timonen (Chair: Wolfgang Schön)

Schön opened the discussion by stressing the fact that the problematic cases of corporate social responsibility were not cases in which the company showing corporate social responsibility benefits from positive reputation effects or other effects affecting positively its long-term profitability. The problematic cases were the ones in which there was no consideration accruing to the company in return for its display of corporate social responsibility. Other commentators agreed and one pointed out that the expression should not offer managers an excuse to do things which they wanted to do anyway but could otherwise not justify. *Schön* continued by enumerating three possibilities of dealing with these cases. Firstly, one could assume an obligation of the board to minimize tax. Secondly, one could assume that the board is not bound to be a "happy taxpayer" who refrains from minimizing tax but that it may act this way. Thirdly, one could assume that the ethical argument not to engage in the minimization of tax is so strong that the board is quasi-legally obliged to refrain from it. One participant asked whether the obligation to maximize taxes should not be added as the fourth alternative. He explained that by posing this provocative question he wanted to emphasize the difficulty of drawing the line between legitimate and unwanted aggressive tax planning. Another participant suggested replacing the expression "happy taxpayer" which was used during one of the presentations with "responsible taxpayer" which he considered to be more appropriate.

A major part of the discussion then dealt with the question of the legality of tax shelters. Whereas some participants saw them as legal instruments of questionable legitimacy, another one pointed out that the assumption that tax shelters were legal under U.S. law rested on a technical interpretation of the statute which disregarded legal doctrines that were underlying the statute, *e.g.* the substance over form doctrine. The same participant went on to explain the reasons for the tax shelter activities in the 1990s. He explained that in the late 1980s tax advisors only looked at the literal interpretation of the statutes. In addition, computerization facilitated the development of tax shelter strategies. Then, a strategy of mass marketing emerged. Tax advisors were told to sell shelters not by talking to the tax director of a company who might have raised concerns but to talk to the CFO instead. Finally, during that period the funding of the Internal Revenue Service went down and at the same time self-policing in the industry stopped. This meant a considerable cutback on enforcement.

Another participant was critical of the opinion that the legality of a tax shelter not only depended on the letter of the law but also on underlying legal doctrines and asked whether it could legitimately be required of a taxpayer to follow the intentions

of the lawmakers, if they did not express themselves clearly. He pointed to a need for guidance as to what is legal and suggested to have special rules only for wholly artificial constructions. As regards guidance on the interpretation of the tax statute, it was replied that in the U.S. there were already many interpretations by the tax authorities that could serve as guidelines. Also in response to this it was pointed out that the substance over form doctrine was about interpreting speech in a sensible way and not about an attempt to find out the real intentions of the lawmakers.

The discussion then left the question of how to draw the line between legal and illegal conduct and concentrated on the question of whether the legitimacy of legal conduct could be called into question, *i.e.* whether there was room for corporate social responsibility in the fiscal context at all. There was consensus that there was such a place for corporate social responsibility; the question that was controversially debated was, as *Timonen* put it, whether this responsibility extended beyond the respect for the law.

Some commentators agreed that one could argue that legal tax shelters were ethically acceptable, but they nevertheless thought that it could not be said that tax was only about black letter law and not at all about morality. One of them wanted to enlist the help of the tax advisors who should form the first line of defense against aggressive tax planning and considered their integrity to be of special importance in ensuring compliance with tax laws. *Avi-Yonah* agreed that it would be useful to have tax advisors as the first line of defense but voiced doubts as to the practicality of it. Tax advisors were under great pressure from their clients so that they could not be relied on as a first line of defense. In this context it was mentioned that tax advisors used to be remunerated according to the amount of taxes saved. This was generally seen as problematic, even by the participants who did not think that corporate social responsibility meant more than respecting the law.

Another participant also thought that corporate social responsibility related to tax and pointed to several open questions: Must corporate social responsibility be exercised throughout the corporation or can it be centralized in the head office? Is there a common understanding of the concept of corporate social responsibility throughout the world? To what extent does corporate social responsibility extend to the environment, does it extend to people the company does business with? With respect to the last question he pointed out that professional service providers in the past seemed to have lost view of the fact that their responsibility extended beyond their clients.

There was, however, relatively strong opposition to the idea of corporate social responsibility going beyond the mere respect for the law. One commentator argued that the tax law should be changed in order to curb aggressive tax planning, the possibility of which was a failure in legal design. Shifting responsibility to the board he only thought to be the second best solution. He therefore considered the board to be under a strong obligation to minimize taxes unless they had good reasons not to do so. In that case, the reasons for not minimizing taxes would have to be disclosed. Another commentator also resented the ethical approach and thought that it was just as well that the taxpayer was always a little bit faster than the tax authorities. The only pertinent question was whether a tax planning strategy was legal or not. As long as no doctrine like the substance over form doctrine or a doctrine dealing with abuse

of law applied, a tax planning strategy should be accepted. In reply to this, *Avi-Yonah* opined that the line had to be drawn where wholly artificial transactions were concerned, driven only by tax considerations. He thought that a balancing act was required of the managers. They were responsible for striking the right balance between the company's responsibility as a taxpayer and its responsibility towards its shareholders. *Timonen* explained that he could agree to tax compliance as requiring disclosure and transparency. He asked, however, what social responsibility really meant, especially to whom it was owed, and pointed out that this notion would always mean a loss of responsibility *vis-à-vis* the shareholders.

Another participant also questioned the validity of the idea of corporate social responsibility. He pointed out that financial analysts would not accept this concept. A company having a higher effective tax rate than its competitors could not compensate for that by arguing that it was voluntarily paying higher taxes, owing to its corporate social responsibility. Somebody else also put the idea of corporate social responsibility to the test by asking three questions: Is it moral to pay taxes to an immoral government? Is it moral to lobby for tax exemptions? Is it moral to accept a high tax rate and to compensate this by cutting wages? *Avi-Yonah* replied that it was relevant what the government did with the money but also pointed out that according to Milton Friedman, whom he had quoted in his presentation, it was only for the government to decide how money should be spent. As regards lobbying, he thought that this was different from tax evasion since the result was in the law and could only be achieved under public scrutiny.

Other commentators took an intermediary position and focused more on the relationship between the taxpayer and the tax authorities. One of them saw taxes and tax planning as just another function of a working business. The relationship with the tax authorities should be structured in such a way that the tax authority would have to enquire into the facts themselves which in turn would have to be stated truthfully by the company. As a test, with respect to the legitimacy of a tax strategy, he suggested for the board to ask itself whether it felt comfortable when the facts of the tax planning strategy came to light. In this context it was agreed that the responsibility for the collection of taxes rested both on the tax authorities and on the companies. A shared approach was considered necessary that did not place the burden only on the side of the companies but accepted that the tax authorities had to act responsibly as well, *e.g.* as regards speedy treatment of tax issues. One commentator took this aspect as an opportunity to pick up on a possibility of the U.S. Internal Revenue Service that had been mentioned before, the possibility to litigate the same questions in different circuits in order to achieve a desired outcome. He thought that this could hardly be called responsible conduct. Another participant went beyond the aspect of responsibility of tax authorities in order to stress the government's responsibility. She stressed that it was the government's responsibility to either litigate or legislate in order to get the law right. In this respect she considered tax breaks that were granted for desirable corporate behavior to be confusing because that suggested that taxes were an inherently bad thing.

Under corporate governance aspects it was discussed whether shareholders could sue the company if it paid too much in taxes and left tax saving opportunities

unused. *Schön* replied that there were no cases pertaining to this, but that liability was conceivable if the measures necessary to achieve the savings remained within the framework of the risk profile of the company. This was supported by another commentator. *Timonen*, however, thought that a shareholder's suit was not the right solution in case of management failure to minimize taxes. He considered it better to rely on the market for corporate control and reiterated that the board was under an obligation to seek the best tax advice.

Finally, it was pointed out that assets in a corporation have a dual status. On the one hand they were controlled by the management, whereas on the other hand they belonged to the shareholders who were the beneficial owners. With regard to this, another commentator pointed out that a concept of social responsibility had to be implemented to managers who, by doing so, spent other people's money. It was also mentioned that the concept of corporate social responsibility involved a prisoner's dilemma, because it was possible that everyone was better off, if all corporations behaved socially responsible. But there was always the possibility to cheat which would let the individual corporation be still better off.

2. Presentation by Bernd Erle and Comments by Theo J. Keijzer and Grant Kirkpatrick (Chair: Wolfgang Schön)

Schön opened the discussion by referring to the general perception that a certain amount of responsibility as regards taxation should be shifted from the tax department to the board. He wondered, though, how meaningful this would be given a tax strategy that was neither too aggressive nor too weak. He then put two further questions to the conference and asked who should take the responsibility in a major operation such as a merger and how centralized the tax strategy in a multinational corporation was. Taking up *Schön's* questions, one participant took the view that on the one hand it was nearly impossible to have the tax director explain the company's tax situation to the board in meaningful detail. On the other hand he thought, that as far as major operations such as a merger were concerned, the board should be informed about the tax risks involved. He finally referred to the question of how centralized the tax strategy should be and expressed the opinion that it should ideally be centralized. Another commentator supported the view that the tax strategy should be centralized and gave the example of a multinational corporation with 1,400 subsidiaries in which the tax department was the most centralized department. He also took the view that the tax policy was for the board to decide on and that it should neither be too aggressive nor too complacent. A further participant considered an integrated approach necessary, since tax should not be seen in isolation. He advocated an organizational structure in which the tax director reported to the board and in which the CFO was the former head of the tax department. *Erle* pointed out that "management of taxes" implied the introduction of the right organizational structure in which information is centralized. Another commentator raised the question whether board members should be educated to understand tax and pointed out that lectures on tax law were not a compulsory element of some MBA courses.

Another part of the discussion focused on the question whether incentive-based management remuneration should be based on an after-tax or a before-tax basis. *Timonen* was critical of basing incentives on after-tax results. He thought that this led to wrong incentives with the management focusing on short-term profits. In response to this, *Schön* pointed to the historic fact that incentive payments used to be linked to dividend payments, *i.e.* an after-tax factor, which nobody had considered to be problematic. One participant agreed with *Schön*. In his view, relying on an after-tax factor was not a horror scenario, especially since these factors were important in many cases. Another participant was more critical. He pointed out that incentive payments based on after-tax results would lead to the same incentive structure that was criticized with respect to tax advisors being remunerated, according to the amount of taxes saved. He suggested setting a tax rate to be achieved and to penalize rates that were too high as well as rates that were too low, a low rate being an indication of too aggressive tax planning. In response to this *Erle* thought it important to set the right goals as to the taking of risks in tax matters. *Kirkpatrick* concluded this part of the discussion by pointing to the need for the development of meaningful compensation statements within the corporate governance framework.

Part 4:

Tax Shelters, Business Behavior and Professional Responsibilities

Disclosure and Civil Penalty Rules in the U.S. Legal Response to Corporate Tax Shelters

Daniel Shaviro[*]

1. Introduction

Historians and sociologists frequently debate American exceptionalism, or the "view that America can be understood only by appreciating its singular origins and evolution."[1] In some areas, ranging from the death penalty[2] to the Bush Administration's embrace of torture and preemptive war, American exceptionalism has been emergent in recent years rather than a historical constant. In other areas, if the U.S. initially looks different from other economically advanced countries, it may simply have traveled down a common pathway first, without actually being exceptional at all.

Prominent recent scandals and debates in the U.S. regarding aggressive tax planning and breakdowns in corporate governance – the main topics at this conference – reflect, at most, the U.S. getting somewhere first. The U.S. had the Enron scandal; Europe the Parmalat scandal. In the U.S., then-Treasury Secretary Lawrence Summers said in 2000 that the "rapid growth of abusive corporate tax shelters" was "the most serious compliance issue threatening the American tax system today."[3] European tax authorities increasingly have similar concerns, albeit more focused on income-shifting within the European Union[4] than on the loss-creating transactions that have drawn the greatest attention from U.S. authorities.

Since the U.S. government response to corporate tax shelters has been unfolding for almost a decade by now, Europeans may naturally want to ask what lessons can be learned from the U.S. experience. Should U.S. responses be adopted more broadly? Could they be improved significantly?

In evaluating the U.S. legal response to corporate tax shelters, two types of issue arise. The first concerns the legal requirements for tax-reducing transactions to be treated as tax-effective. If a company has sufficient leeway under the law to create

---

* The author wishes to thank Philip Baker, Edward D. Kleinbard, Alexander Rust, Roman Seer, Michael Schler, and participants in the Munich Symposium on Tax and Corporate Governance for helpful comments on an earlier draft.

1 FRICKEY, American Exceptionalism in Federal Public Law, 119 Harv. L. Rev. 431, 433 (2005).

2 *See*, *e.g.*, STEIKER, Capital Punishment and American Exceptionalism, 81 Or. L. Rev. 97 (2002).

3 Treasury Secretary SUMMERS, "Tackling The Growth of Corporate Tax Shelters." Remarks to the Federal Bar Association, Washington, D.C., February 28, 2000.

4 In the U.S., states increasingly have similar concerns about income-shifting. *See* BANKMAN, State Tax Shelters and State Taxation of Capital (2006).

tax losses by simply shuffling paper and creating circular cash flows, then all the audit review and penalties in the world may not suffice to make it pay tax on its income.[5] Once the substantive rules that define permissible sheltering are in place, however, the issue shifts to one of compliance. How often do companies take reporting positions that would not be upheld if carefully scrutinized, how often are they caught, and what penalties do they face if caught?

This paper seeks modestly to advance inquiry into the compliance issues by reviewing and evaluating some of the main U.S. rules that address tax shelter reporting and penalties. I will argue that the disclosure rules do not impose unreasonable burdens. Moreover, while it is unclear how much audit benefit they actually offer the Internal Revenue Service (IRS), other than in directing auditors' attention to "listed transactions" that the IRS has publicly identified as problematic, they may more generally help the IRS in formulating responses to newly developed transactions. However, the effectiveness of the disclosure rules may be compromised by taxpayer over-disclosure, which might be designed either to avoid penalties for under-disclosure or to overwhelm the IRS with too much of a good thing. The expanded book-tax reconciliation reporting that must be furnished by corporate taxpayers on newly developed IRS Schedule M-3 likely does more to offer auditors a useful overview of the likely soft spots on a given tax return.

The penalty rules' main flaw, I will argue, is that they focus excessively on the taxpayer's state of mind regarding the likelihood of prevailing on audit, as a prerequisite for imposing civil penalties. *Mens rea* is, of course, an important element of any criminal offense that could send someone to jail. But there is little need for it in the context of a company facing the chance of, say, a 20 percent addition to the tax deficiency it will face if a given tax return position is rejected upon audit. Here, a penalty merely worsens the company's betting odds on taking a controversial tax return position – odds which may remain unduly favorable even with the risk of a penalty. Nothing should shock the conscience about such an adjustment to "audit lottery" payoffs. If we are uneasy about exposing the company to additional downside risk when it acts in apparent good faith, the answer is to permit insurance, rather than, in effect, to provide the insurance for free by simply not charging a penalty to begin with.[6]

Focusing on state of mind not only creates an escape hatch for over-aggressive taxpayers who take advantage of underlying legal uncertainty to claim good faith, but seriously distorts the role of tax lawyers. Taxpayers who might otherwise want

---

[5] *See*, *e.g.*, BANKMAN, The New Market in Corporate Tax Shelters, 83 Tax Notes 1775, 1777-1778 (1999), noting that, if a particular tax planning scheme (the high basis, low value shelter) "were respected (say, approved in a Revenue Ruling), it would reduce corporate taxable income to near zero. Each corporation would place profit- producing assets in a subsidiary and have that subsidiary purchase loss positions from a foreign taxpayer. The only limit on the use of the shelter would be the transaction costs involved in purchasing the loss position, and locating foreign persons who would be willing to serve as accommodation parties."

[6] On the recent growth of tax insurance in the U.S. marketplace and the policy issues raised thereby, *see* LOGUE, Tax Law Uncertainty and the Role of Tax Insurance, 25 Va. Tax Rev. 339 (2005).

objective legal advice devote themselves instead to shopping around for an opinion letter that is sufficiently encouraging about a particular tax return position's prospects if audited to serve as a "penalty shield."

The U.S. rules, having unwisely granted tax lawyers at least limited powers of priestly absolution, then go on to impose more burdensome regulatory oversight on the lawyers than would otherwise be necessary. A relatively trivial example of this regulatory blowback is the virus-like proliferation of Circular 230 notices on even the most casual communications from U.S. tax lawyers.[7] A second, perhaps more serious, instance of blowback is the tax rules creating incentives to assign opinion-writing duties for a given transaction to lawyers who lack reliable access to the underlying facts (but who ostensibly are freer to be "objective"), rather than to those who have such access.[8]

To explain the intuition that may underlie reliance on fault, suppose a corporate taxpayer's CFO and tax director reasonably believe that a given return position has a 90 percent chance of being found correct. If the position is subsequently held incorrect, wouldn't a 20 percent penalty be "unfair"? Perhaps it would, if we think of penalties as akin to bops on the snout administered to bad puppies by a dog trainer. If, however, we think instead in terms of properly aligning corporate taxpayers' incentives, a penalty in these circumstances may be entirely appropriate. Penalties need not have anything to do with wrongdoing; within limits, taxpayers are only to be expected to respond self-interestedly to uncertainty.

If all potentially erroneous return positions were subject to searching audit inquiry, there might be no need for penalties even where the tax return position had next to no chance of being correct. By definition, a searching inquiry means that the government gets a chance to exercise its judgment on each item, and thus to treat the tax return as little more than the opening bid in a negotiation. In these circumstances, aggressive return positions might do no more than delay full payment of ultimately determined tax liabilities, calling for interest charges but nothing more.[9]

Once we realize that not all taxpayer reporting positions are likely to receive a searching inquiry, however, the merits look different. Suppose a taxpayer who will not be audited is taking ten potentially controversial tax return positions, each of which has a 90 percent chance of being correct. On average, this taxpayer is likely to have, *ex post*, one error on the tax return in its own favor. The result is systematic

---

7 Thus, e-mails from U.S. tax lawyers discussing, say, dinner invitations or a recent baseball game typically include a disclaimer that says something like the following: "Any U.S. federal tax advice included in this communication was not intended or written to be used, and cannot be used, for the purpose of avoiding U.S. federal tax penalties." Similar legending festoons the paper products sent out by U.S. tax lawyers.

8 *See* U.S. Internal Revenue Code, section 6664(d)(3)(B).

9 If every transaction were closely scrutinized and there were penalties for under-payment, without matching rewards for over-payment, taxpayers would have reason to lean towards over-reporting their expected liability and requesting refunds. *See* SCOTCHMER/SLEMROD, Randomness in Tax Enforcement, 38 J. Pub. Econ. 17 (1989). Such an asymmetry may seem anomalous unless one relaxes the assumption that everything gets a searching inquiry, and views the procedural structure of the refund demand as likely to affect the review process.

under-taxation (relative to *ex post* “correct” outcomes) of transactions with absolutely certain tax consequences. Even if taxpayers draw the line far short of outright fraud, they end up having good reason to play the “audit lottery.”

Should we assume, however, that audit lottery problems are serious enough for no-fault penalties to be necessary? Recently expanded U.S. rules that mandate extensive information reporting with respect to potentially suspect transactions clearly are relevant here, as is the development of Schedule M-3. Yet, desirable though these disclosure rules may be, they do not guarantee that each disclosed transaction will end up getting a searching inquiry, especially given the staffing and salary levels at the scandalously under-funded IRS. Nor would taking a close look at everything be cost-efficient, even with adequate funding. Thus, while the optimal penalty level depends on the probability that controversial positions will get a close look, reporting, even for all such positions, does not by itself reduce the optimal penalty level to zero.

The remainder of this paper proceeds as follows. Section 2 discusses the underlying problems of defining and deterring tax shelters, which are critical to evaluating the disclosure and penalty issues. Section 3 describes and evaluates the U.S. tax rules concerning disclosure of suspected corporate tax shelters. Section 4 does the same for the U.S. tax rules concerning accuracy-related penalties. Section 5 provides a brief conclusion.

2. Defining and Deterring Corporate Tax Shelters

2.1 What is a Legally Impermissible Tax Shelter?

2.1.1 The Underlying Legal Uncertainty

Justice Potter Stewart of the U.S. Supreme Court famously remarked about pornography that, while he could not define it, “I know it when I see it.”[10] Legally impermissible tax sheltering prompts similar, and similarly unconvincing, assertions that the eye can confidently spot what the brain cannot crisply define.[11] In practice, uncertainty is pervasive if taxpayers choose to navigate near the line, although those whose tax planning is more conservative have less to worry about.

The contested and uncertain nature of identifying legally impermissible tax shelters is nicely illustrated by *Compaq v. Commissioner*,[12] in which the taxpayer tried to buy foreign tax credits from overseas investors who could not use them, by arranging to be the legal owner of Royal Dutch Petroleum stock solely for the moment when a previously declared dividend (subject to Dutch withholding tax) was formally being paid. The Tax Court held that the taxpayer’s position was not only legally unmeritorious, but subject to penalty on grounds of negligence. The

[10] *Jacobellis v. United States*, 378 U.S. 184, 197 (1964) (STEWART, concurring).

[11] *See*, *e.g.*, *Estate of Baron v. Commissioner*, 83 T.C. 542, 559, note 47 (1984)

[12] 113 T.C. 214 (1999), reversed, 277 F.3d 778 (5th Cir. 2001).

Fifth Circuit then reversed, finding the taxpayer's position not only non-negligent, but indeed legally correct.[13]

The uncertainty that bedevils taxpayers trying to predict how a transaction like that at issue in *Compaq* will fare if it is audited and litigated may be unfortunate, but in practice it is unavoidable. Or more precisely, avoiding it would lead to even worse consequences for the tax system, for two reasons. First, the tax law, at least under a transactional income tax as complicated as those in most OECD countries, cannot be administered effectively without requiring that transactions satisfy minimal economic substance and business purpose requirements if they are to be respected. Second, while precise black letter rules, specified in advance, may be used to implement these requirements in particular settings, they must be supplemented by general standards, applied in practice *ex post*, if tax avoidance is to be kept at acceptable levels. I next address each of these two points.

2.1.2 The Need for Economic Substance and Business Purpose Requirements

As Edward Kleinbard has noted, a typical income tax system, such as that in the U.S., "works by describing a finite number of idealized transactions and attaching to each a set of operative rules – what might be termed a set of tax cubbyholes. Tax professionals spend a modest amount of time learning to identify these tax cubbyholes and their consequences, and a great deal of time massaging reality to fit within the desired cubbyhole."[14]

While Kleinbard was mainly addressing the labels, such as debt or equity, that are given to particular financial instruments, his point applies more generally. Thus, consider the rule that gain or loss from an asset's change in value is ignored for income tax purposes until the occurrence of a realization event, such as a sale. In the idealized case of a pure sale, a taxpayer who previously had physical possession of a given asset, and bore one hundred percent of the upside and downside risk pertaining to its value, completely disposes of both possession and the risk. When this happens, we know beyond any doubt (barring the application of special rules to the contrary) that we have a taxable sale. In the real world of asset relationships, however, things are not always so simple. No matter who formally owns an asset, infinite

[13] As I have noted elsewhere, the Fifth Circuit's opinion in *Compaq* is legally suspect even if one agrees with it on policy grounds. *See* SHAVIRO/WEISBACH, The Fifth Circuit Gets It Wrong in Compaq v. Commissioner, 94 Tax Notes 511 (2002). In *Compaq*, the Fifth Circuit ignored its duty, in the exercise of appellate jurisdiction, to accept all findings of fact that were not clearly erroneous, and made fact findings of its own that were flatly contradicted by the case record. In addition, turning prior precedent on its head, the court treated steps that the parties took to insure that the transaction would lack economic substance as actually establishing such substance (on the view that it showed that they cared about the level of economic risk). *See* SHAVIRO/WEISBACH, *id.*, at 515-516. Yet, however shoddy the Fifth Circuit's performance, *Compaq* is not unique. The Eighth Circuit similarly mischaracterized a nearly identical transaction in *IES Industries, Inc. v. United States*, 253 F.3d 350 (2001), where it likewise reversed a lower court decision for the government.

[14] KLEINBARD, Equity Derivative Products: Financial Innovation's Newest Challenge to the Tax System, 69 Texas L. Rev. 1319, 1320 (1991).

gradations are possible in who uses and possesses it, and in who bears various upside and downside risks pertaining to it. Moreover, changes in any of these relationships may be substantially independent of changes in legal ownership.

Under these circumstances, if the transaction costs of independently manipulating economic relationships on the one hand and legal ownership on the other are low enough, and if realization depends purely on whether there has been a legal ownership change, then the occurrence of a taxable realization event is purely elective. Taxpayers, without regard to their preferences at any time regarding actual economic relationships to particular assets, can trigger realization whenever they like by inducing a legal ownership change, and can avoid realization whenever they like by avoiding any such change even if they are modifying economic relationships. This state of affairs would be equivalent to ignoring legal ownership changes and making the occurrence of a taxable sale explicitly elective, by permitting taxpayers to state on the face of their returns which assets they want to treat as having been sold.

Purely elective realization is an unacceptable state of affairs. For example, it creates inefficient tax biases in favor of long-lived assets that are affected by realization, as well as risky assets that are more likely to have large changes in value. In addition, it can lead to permanent exclusion for large swathes of income, along with unlimited loss generation to the extent not addressed by schedular rules (such as capital loss limitations) that restrict the types of income against which particular losses can be deducted. Thus, for a realization-based income tax to be feasible, one is virtually forced to make some sort of inquiry into whether or not, as a matter of economic substance, particular transactions "really" were sales (whether so classified by the taxpayer or not). This, in turn, requires inquiry into actual changes in underlying economic relationships to assets.

U.S. income tax law provides an instructive illustration. At one time, taxpayers with appreciated fungible financial assets, such as corporate stock, could get all of the economics of a sale (including the receipt of cash) without triggering tax on the gain, through a "short against the box" transaction, involving the short sale of an asset identical to that which one continued to hold.[15] The U.S. Congress eventually responded by enacting a provision treating such transactions as constructive sales.[16] In general, a constructive sale occurs when one takes a short position that is "substantially," even if not precisely, identical to one's appreciated long position.[17] It also occurs if one overly hedges one's position by other means, such as by acquiring too tight a "collar" (a combination of put and call options that transfer risks of gain and loss to counter-parties).[18]

Each of these two routes to constructive sales treatment involves a matter of degree. One can defeat the rule's application, therefore, by hedging one's long position with a short position that, while similar and highly correlated, falls just short of

---

[15] *See* KLEINBARD, *id.*, at 1357-1358.
[16] *See* Code section 1259.
[17] *See* Code section 1259(c)(1)(A) through (D).
[18] *See* Code section 1259(c)(1)(E).

being "substantially" identical.[19] Or one can acquire a collar that leaves just enough prospect of gain or loss via the spread between the put and call strike prices.[20]

By having such a rule, the tax law, while not eliminating formally driven realization elections, makes their exercise more costly. Avoiding a constructive sale of an appreciated asset may require retaining more economic risk with respect to a given asset than one would otherwise have preferred. Likewise, contriving a tax-effective sale of a loss asset may require departure from one's risk preferences.[21] There is no sensible reason for imposing these burdens on taxpayers, other than to make the implicit realization election costlier to exercise as a way of reducing the harm that would result from free electivity.[22] From this standpoint, however, "one might as well condition favorable tax consequences on whether the taxpayer's chief financial officer can execute 20 back-somersaults in the IRS National Office at midnight on April Fool's Day,"[23] given the risk requirement's lack of social value other than as a means of burdening electivity. This has come to be known in the U.S. tax policy literature as the "back-flips" view of anti-tax shelter rules.[24]

This basic tax law pattern – assessing the "reality" of a transaction, and thereby inducing taxpayers to massage the economics of what they are doing so as to achieve sufficient "reality" – is pervasive and fundamental. In *Compaq*, it arose via the inquiry into whether the taxpayer's acquisition of Royal Dutch Petroleum stock was a sham. *Compaq*-style transactions are now subject to a statutory requirement that the taxpayer hold the foreign stock (without excessive hedging) for at least 15 days.[25]

For a recent European example of the same phenomenon, consider the *Cadbury Schweppes*[26] case, in which the taxpayer had established two wholly owned finance subsidiaries in Ireland with no employees, no office, not even a telephone,[27] but, apparently, more than £34 million in annual profits that would otherwise have been fully taxable in the U.K. In this case, the European Court of Justice invalidated a U.K. tax rule that had been designed to impede income-shifting from the U.K. to

---

[19] As it happens, Code section 1259 also contains other escape hatches, such as a provision permitting the rule's application to be avoided where the taxpayer subsequently bears sufficient risk for 60 days. *See* Code section 1259(c)(3).

[20] The New York State Bar Association proposed that a 20 percent spread be sufficient to avoid constructive sale treatment with respect to a collar. Thus, for example, where stock is trading at $100 per share, one could acquire a put to sell it for $95 and write a call under which one was obligated to sell it for $115 without thereby engaging in a constructive sale. *See* NEW YORK STATE BAR ASSOCIATION TAX SECTION, Comments on H.R. 846 (May 21, 1997).

[21] *See*, *e.g.*, Code sections 1091 (disallowing losses on wash sales of securities, where one purchases substantially the same asset that one sold within a 30 day period) and 1092 (disallowing losses on straddles, where one retains a substantially identical offsetting position).

[22] *See* SHAVIRO, Economic Substance, Corporate Tax Shelters, and the *Compaq* Case, 88 Tax Notes 221, 222-223 (2000).

[23] SHAVIRO, *id.*, at 223.

[24] *See*, *e.g.*, KATZ, In Defense of Tax Shelters (2006).

[25] *See* Code section 901(k).

[26] ECJ, September 12, 2006, Case C-196/04, 2006 ECR I-7995 – *Cadbury Schweppes*.

[27] *See* SHEPPARD, Cadbury Schweppes: The ECJ Versus Tax Administration, 112 Tax Notes 480 (2006).

low-tax jurisdictions such as Ireland by making controlled foreign subsidiaries' profits automatically taxable in the U.K.[28] While rejecting any such *per se* rule, along with any general adverse reliance on taxpayers' motive to save taxes by shifting profits between European jurisdictions, the ECJ held that the U.K. could disregard "wholly artificial arrangements." It thus effectively permitted income-shifting at the price – perhaps a rather low price under the circumstances – of one's doing just enough in the low-tax jurisdiction to show that one had "genuinely established" a subsidiary that "actually carried out" services there, and that the transaction as a whole was not "devoid of economic purpose with regard to" the group's activities.[29]

Tax Notes columnist Lee Sheppard characterizes as follows the effects of the *Cadbury Schweppes* decision:

> "Our readers should rejoice in [Advocate General Philippe] Leger's opinion because it would make tax planning a whole lot more expensive. Imagine having to staff a finance subsidiary. What is the cost of office space in Dublin, anyway? And imagine having to answer a lengthy and messy factual inquiry on every audit. Yes, Leger imagined that a routine audit would feature that inquiry. The professional bills would be high, and it could all be blamed on the ECJ when an unhappy financial officer asked why the tax planning was costing so much. A professional specialty would develop for CFC regime exemption."[30]

2.1.3 The Need for Standards That Are Applied *Ex Post*

Burdening taxpayer electivity by requiring that tax-effective transactions have some minimum level of economic substance does not automatically create any special degree of legal uncertainty. Thus, the U.S. constructive sale rules are at least moderately well-specified, as is the 15-day rule for foreign stock ownership in *Compaq*-style transactions. Similarly, one could imagine the U.K. (subject to ECJ review) writing black letter rules for *Cadbury Schweppes*-style transactions – requiring, for example, specified levels of staffing and office space in the low-tax jurisdiction relative to the profit shift being claimed. Uncertainty does increase, however, if one relies on general legal standards of business purpose and economic substance that are applied *ex post*, rather than purely on precise black letter rules that have been specified *ex ante*.

There are many good reasons for so relying. For example, a standard can be briefer and less complex than all of the rules it implies because it can apply to multiple situations.[31] In addition, using standards reduces taxpayers' incentives to invest in continually finding new schemes that will pay off for a while until detected by the government and prospectively shut down through new rules. The use of broad economic substance-type standards has become increasingly common around the world, at least in specified subject areas, even in countries that resist enacting gen-

---

[28] *See* SHEPPARD, *id.*

[29] *See* the *Cadbury Schweppes* case, *supra* note 26.

[30] SHEPPARD, *supra* note 27. The subsequent Judgment of the Court in *Cadbury Schweppes* adopted the view of the Advocate General that the U.K. could only disregard "wholly artificial arrangements."

[31] *See* generally WEISBACH, Formalism in the Tax Law, 66 U. Chi. L. Rev. 660 (1999).

eral anti-avoidance rules (GAARs) that would apply across the board.[32] The consequences of such standards for tax planning have common features across countries even in the face of differences in the standards' breadth of application, precise details, and degrees of stringency.

2.1.4 The Worse, the Better: Tax Planning in Response to an Economic Substance Standard

The prior section showed that anti-tax shelter rules and standards often are, in effect, nothing more or less than "back-flip" requirements, inducing otherwise meaningless exertions from those who seek tax benefits. Unedifying though this may sound, the alternative of taxpayers' being able to make self-serving elections at zero cost would be even worse, and indeed would likely make a transactional income tax unfeasible. In this setting, much of what a tax lawyer does is to weigh the odds on whether a given transaction already has enough back-flips built into it, and to recommend additional ones if it does not. The client then decides whether to engage in the transaction, and how many back-flips to engage in if it does.

Lawyers therefore may advance compliance by making bad transactions worse, in the sense of adding to the social waste (in the form of undesired economic consequences) associated with particular tax maneuvers. If a given transaction clearly does work, even if it ought not to, lawyers are ethically blameless for bringing it to their clients' attention, and clients are blameless when they do the transactions. Bad behavior consists, not in doing "bad" transactions or making them socially worse, but in treating transactions as lawful when they are not, in reliance on the audit lottery.[33] It is entirely an issue of *malum prohibitum*, not *malum in se*. Where the law does not require back-flips, lawyers have no moral duty to insist on them.

Given pervasive legal uncertainty about the application of economic substance standards to particular cases, however, it is a mistake to think primarily in terms of deliberately wrong behavior. Likelihood of correctness is a continuum from zero to one hundred percent. Even without second-order uncertainty (*e.g.*, concerning whether a transaction is actually 49 percent or 51 percent likely to be respected), it is hard to see why we should take a discontinuous view of gradually changing probabilities, such as by penalizing only those whose *ex ante* chances of correctness were too low. Consider again the taxpayer who does ten transactions, each with a 90 percent chance of being correct, and who therefore has on average the same number of *ex post* errors as a taxpayer who does one transaction with zero chance of being cor-

[32] According to AULT/ARNOLD, Comparative Income Taxation: A Structural Analysis (2nd ed. 2004), general anti-avoidance standards of one sort or another are used in Australia, Canada, France, Germany, the Netherlands, and Sweden, in addition to the United States. Japan and the United Kingdom, which have been more resistant to a GAAR-type approach, have been relying more on economic substance-type rules in recent years, at least in particular areas. *See* AULT/ARNOLD, *id.*, at 17, 33, 50, 70, 86, 99, 112, and 132.

[33] Other ethical violations by tax lawyers may involve failing to make required disclosures and otherwise concealing or trying to misrepresent transactions that the government authorities might otherwise scrutinize more closely.

rect. We give taxpayers the wrong incentives if we do not address the 90 percent transactions as well as those with a zero percent chance of correctness.

2.2 Disclosure and "Back-Flip" Rules

Tax transaction disclosure rules are commonly thought of as posing a tradeoff between (a) the benefit of giving government auditors more information so that they can identify "bad" transactions, and (b) the cost of imposing greater burdens on taxpayers when they engage in "good" transactions. Obviously, the tradeoff would not exist if the disclosure rules could be precisely tailored so that only "bad" transactions were subject to disclosure, in which case taxpayers simply would not do the transactions to begin with unless planning to defy the disclosure requirements as well as the substantive law. It is well understood, however, that no feasible set of disclosure rules could be tailored so accurately, thus requiring in practice that we choose between degrees of over-inclusiveness and under-inclusiveness.

This analysis must be modified once we factor in the "back-flip"-requiring character of economic substance rules, along with the unavoidably probabilistic nature of whether a given transaction will be classified *ex post* as legally permissible. In particular, the following implications emerge:

- Effective disclosure is vital given the audit lottery, and not just for transactions that are highly likely to be struck down but even those for that have a good chance of being upheld. Even for the latter transactions, an IRS opportunity to engage in serious review, and taxpayer anticipation of such review, may have desirable incentive effects when taxpayers are choosing between transactions (*e.g.*, between the definitely permissible and the probably permissible).
- The fact that a transaction has good *ex ante* chances of being upheld, and/or is determined *ex post* to be permissible, does not necessarily mean that we should regret burdening taxpayers who engage in it with a disclosure requirement. Again, while back-flips are wasteful if we hold constant the taxpayer's choice of transactions, they can change transaction choices in potentially desirable ways.
- Disclosure requirements can be tailored to impede the efficient (but socially undesirable) functioning of the tax shelter market. Along these lines, commentators have noted that making tax planning strategies legally patentable might be undesirable if the risk of having one's innovation "stolen" without compensation helps to reduce over-production (from the social standpoint) of such strategies.[34] Disclosure rules might similarly be tailored to impede the functioning of the tax shelter market by making it harder for innovators to protect their intellectual property, such as by causing confidentiality agreements to trigger disclosure.

---

[34] *See*, *e.g.*, BURK/MCDONNELL, Tax Investment Strategies, Business Method Patents, and the Firm (2006).

2.3 Penalties and Taxpayer Incentives

Economic models of behavior have become ever more prominent in policy discussion in recent decades. Thus, Gary Becker founded the modern criminal deterrence literature when he proposed setting criminal penalties to equal the social harm caused by the crime, multiplied by one over the probability of detection.[35] His proposal effectively equated optimal penalty levels with Pigovian taxation[36] (modified to add uncertainty of detection), as well as to the principle that a due care requirement in tort law should equate marginal cost to marginal benefit.[37] Subsequent writers added administrative cost to the analysis, with the implication that higher penalties should be used to "pay" under the Becker formula for a reduced probability of detection so that the state could economize on enforcement.[38] It was noted as well that risk aversion or a norm of proportionality might set an upper bound on permissible penalties. Thus, we might be uncomfortable with imposing the death penalty on one out of every million jaywalkers even if this permitted us to satisfy the Becker formula at the lowest possible administrative cost.

The analysis of tax evasion, defined as taking a reporting position that has a zero percent chance of being correct, has followed similar principles. Thus, tax evaders are modeled as making risky investments that pay off in the form of reduced taxes unless the evasion is detected, corrected, and penalized.[39] Such analysis suggests that penalties, as in the Becker model, should be set high enough to eliminate any expected net benefit given the taxpayer's degree of risk aversion. Thus, in the simple case of a risk-neutral taxpayer evading $1 million of taxes with a 20 percent probability of being caught, a penalty of 400 percent, or an extra $4 million in the event of a $1 million correction, would leave both the taxpayer and a risk-neutral government indifferent between evasion and compliance.

These models clearly are less than perfect in their assumptions regarding human behavior – albeit perhaps best suited to the corporate setting, where financial officers may actually approach tax planning as identical in principle to managing inventory costs.[40] The models fail to explain "pathological honesty," or taxpayers' decisions not to cheat even when it seems that they "should" from a purely financial standpoint, given the odds and the risk aversion that they exhibit in other settings.[41] Given

---

[35] BECKER, Crime and Punishment: An Economic Approach, 76 J Pol Econ 169 (1968).

[36] Pigovian taxation seeks to address externalities by requiring, for example, a polluter to pay tax equal to the value of the harm it has caused. For a discussion of such taxes, *see*, *e.g.*, POSNER, Economic Analysis of Law, 391 (6th ed. 2003).

[37] *See*, *e.g.*, POSNER, *id.*, at 167-171.

[38] POLINSKY/SHAVELL, The Optimal Use of Fines and Imprisonment, 24 J Pub Econ 89 (1984).

[39] *See* ALLINGHAM/SANDMO, Income Tax Evasion: A Theoretical Analysis, 1 J. Pub. Econ. 323 (1972); YITZHAKI, A Note on Income Tax Evasion: A Theoretical Analysis, 3 J. Pub. Econ. 201 (1974).

[40] *See* KLEINBARD, Corporate Tax Shelters and Corporate Tax Management, 51 Tax Executive 231 (1999).

[41] *See* SLEMROD, Trust in Public Finance, Nat'l Bureau of Econ. Research, Working Paper No. 9187 (2002).

the benefit to any given taxpayer when others comply, the decision whether to do so involves a prisoner's dilemma, and people appear to respond to cues about whether others are cooperating or defecting even if their own actions are not being observed.[42] Yet these departures from pure financial rationality can add to as well as detract from the social payoff to raising expected penalties that were previously too low. A norm of evasion or hyper-aggressiveness may potentially flip over into one of play-it-safe compliance if people discern that cheaters are now being punished or that the odds have suddenly changed for the worse.

Adapting the tax evasion model to deal with *ex ante* legal uncertainty about permissible transactions is straightforward. Again, taxpayers face two big decisions in evaluating potential tax shelter transactions, which can usefully be separated for analytical purposes here even though in practice they may be considered jointly. The first is whether to engage in a transaction that might *ex post* be ruled an improper tax shelter, and the second is how many back-flips to build into it so that its chances of being upheld (if detected) will be better.

Turning clearcut tax evasion into acting with, say, a 50 percent chance of being upheld upon close scrutiny does not change the structure of the basic analysis. Suppose we return to our example of the $1 million tax evader whose behavior is detected 20 percent of the time, with the added proviso that if detected his transaction has a 50 percent chance of being upheld. Assuming risk neutrality, everyone's incentives are the same as if he had a zero percent chance of being correct but was under-reporting only $500,000 instead of $1 million. So the 400 percent penalty if he is detected and loses remains optimal, although the average stakes have been cut in half. Suppose he takes an aggressive stance ten times, and is right (whether or not detected) five of these times. In the five cases where he is right there is nothing more to say. In the five where he is wrong, he pays $1 million too little on four occasions and pays a $4 million penalty when caught, giving him the right incentive structure even though we might think of a 50 percent correctness bet as having been made in tolerably good faith.

One argument for a lower penalty for "good faith" taxpayers might be that they should not be required to bear the downside risk of a penalty if they are taking a defensible stance that merely happens *ex post* to be rejected by the decision-maker. This might well be a compelling line of argument if one were contemplating, say, jail time for taking good faith but *ex post* erroneous positions. However, a mere financial penalty on top of a corrected tax liability does not raise similar concerns, in particular if it is insurable. As it happens, transaction-specific tax liability insurance that covers penalties has been on the rise in the U.S. in recent years,[43] and the IRS has decided against generally requiring disclosure of insured transactions.[44] While one might conceivably object normatively to such insurance as likely to make companies more willing to take erroneous positions, the insurers have self-interested reasons to

---

[42] *See*, *e.g.*, KAHAN, Reciprocity, Collective Action, and Community Policing, 90 Calif. L. Rev. 1513, 1516 (2002).
[43] *See* LOGUE, *supra* note 6, at 389.
[44] *See* LOGUE, *id.*, at 401-405.

monitor this behavior (which constitutes moral hazard from their perspective) and to build it into their pricing. Insured parties end up bearing their average costs in any economically sustainable insurance market. Insurers would thus be expected to price the coverage for a given transaction based on the company's own analysis of the risk (albeit taking account of the audit lottery). They might also conceivably at some point begin to experience-rate particular taxpayers or the transactions associated with particular promoters.

Even if one is skeptical about allowing penalty insurance, such skepticism cannot reasonably be combined with a view that penalties should be limited to bad faith situations so that those acting in good faith will not face penalty risk. Such a stance would amount to demanding that taxpayers be given for free the same insurance that they are not being allowed to purchase. It should come as no surprise that U.S. tax lawyers actually use the term "penalty insurance" to describe the legal opinions that taxpayers commonly obtain to avoid penalties by showing good faith.[45]

Now consider the question of how many back-flips to add to a transaction, so that the taxpayer has a better chance of showing economic substance in the event of detection. As David Weisbach notes,[46] Richard Craswell and John E. Calfee have analyzed a similar problem in the setting where it is unclear how much care is needed to avoid, say, a negligence penalty under tort law.[47] The big difference is that, in the tort setting, excessive and inadequate care levels lead directly to expected social loss. In the tax shelter setting, where back-flips represent, not due care but rather a burden on taxpayer electivity, the tradeoff lies between raising and lowering the burden threshold. Wasteful though inducing extra back-flips may be, in some instances it reduces social waste by causing the taxpayer to abandon a contemplated tax planning transaction. Likewise, while reducing the number of back-flips reduces social waste if the taxpayer goes forward anyway, it increases the likelihood that the taxpayer will do so, and thus that there will be some waste. Still, the tradeoff is analogous to that in the Craswell and Calfee model if we posit that the economic substance standard, absent uncertainty, would have set the friction level just right.

Craswell and Calfee show that uncertainty can either raise or lower levels of care. However, "if the uncertainty created by the legal system is distributed normally about the optimal level of compliance, and if the uncertainty is not too large – two seemingly plausible assumptions – then the result under normal damage rules will be too much deterrence [reflecting parties' risk aversion] rather than too little."[48] This, in turn, could lead to excessive back-flips, from a social welfare standpoint, if the requirement had otherwise been set at the optimal level. However, when cases such as *Compaq* regularly, if unpredictably, come out for the taxpayer, it seems unlikely the back-flips requirement is currently set too high. If set too low and if the Craswell-

---

[45] *See* LOGUE, *id.*, at 346.

[46] *See* WEISBACH, An Economic Analysis of Anti-Tax Avoidance Doctrines, 4 Am. Law & Econ. Rev. 88, 106 (2002).

[47] CRASWELL/CALFEE, Deterrence and Uncertain Legal Standards, 2 J. Law Econ. & Org. 279 (1986).

[48] CRASWELL/CALFEE, *id.*, at 299.

Calfee base-case scenario does indeed apply,[49] then the uncertainty may conceivably move the back-flips requirement closer to its optimal level.

2.4 Institutional Issues in Penalty Design

While treating bad faith as a penalty prerequisite is dubious enough in theory, it begins to look even worse when we consider its institutional effects. These relate both to tax practitioners and to IRS audits of major corporations.

2.4.1 Tax Practice

As we will see in section 4, the requisite good faith for avoiding penalties may depend in certain settings on whether the taxpayer can demonstrate reliance on a sufficiently sanguine opinion of counsel. Tax lawyers therefore have at least a limited power to grant penalty protection. In effect, they can sell absolution for a fee, at the risk of incurring reputational costs if their analysis is ultimately rejected by a court.

Taxpayers' incentive to pay for penalty protection, and even to shop around for it if necessary, leads to waste – in effect, to extra back-flips. While this reduces the incentive to play the audit lottery, the prospect of paying a penalty notwithstanding good faith would have the same deterrent effect, and would involve transferring resources to the government rather than wasting them.

Comparing this genre of "penalty insurance" to the use of actual insurance does not make the practice look any better. Insurers get a fee for lowering the variance in their customers' expected outcomes, but without reducing expected costs. Moreover, while insurance worsens incentives at the margin by creating moral hazard, insurers have an incentive to monitor and address this problem.

The incentive to shop around for penalty protection does more than waste resources, however. It also undermines the use of tax lawyers to provide objective legal advice. Taxpayers have reason actually to want to know their likelihood of success if audited. This may be outweighed, however, by the expected cash payoff to having in hand a sufficiently sanguine opinion if one is audited and loses.

Tax practitioners are often quite unenthusiastic about offering "penalty insurance" opinions, which expose them to reputational risk, but may face strong internal pressures to issue the opinions. The underlying dynamic reflects the economics of big-firm tax practice. Tax departments in major law firms typically have very low "leverage" (*i.e.*, ratio of associates to partners), reflecting the need for a high level of expertise in tax practice. Since leverage is crucial to per-partner profitability, tax lawyers cannot easily "pull their weight" in large firms through their billings alone, even if they charge high hourly rates and are constantly in demand. They need, therefore, to show their value as facilitators for the transactions being handled by other departments. Withhold a penalty shield opinion and the client may take its business

[49] CRASWELL/CALFEE, *id.*, emphasize, however, that "we can say very little about how to tell when those assumptions [*i.e.*, those underlying the base-case scenario] are likely to be satisfied."

elsewhere, to another firm that is just as capable of doing the lucrative transactional work and has tax partners who are not quite so cautious or scrupulous. The end result may be to undermine scrupulous tax lawyers' internal standing in their firms, which can affect not just their compensation but their prestige and influence. Accordingly, when a big-firm tax lawyer declines to write a sufficiently sanguine opinion, the consequences may go beyond simply losing the fee that would have been paid for that opinion.

As we will see in section 4, the tax rules for penalty shield opinions address this problem in certain settings, through rules that deny penalty protection to opinions provided by a firm that is too heavily involved in the underlying transaction.[50] The client may therefore have no choice but to shop around for a favorable opinion elsewhere. This creates problems of its own, so far as the opinion's likely credibility is concerned, for the same reason that expert witnesses at a trial are commonly disparaged as "guns for hire". In addition, if the opinion-writer is acting in good faith, he or she may face an irremediable informational disadvantage relative to that of the disqualified advisors, who likely would have had better access to the actual facts and understandings. The lawyers implementing a transaction are likely to respond both more fully and more candidly when the request for background information about it comes from in-house.

A final problem with allowing tax opinions to function as penalty shields goes to the regulatory blowback. As noted in section 1, much of the regulatory apparatus that recently has been directed by the IRS at tax lawyers, such as the disclaimers required under Circular 230, responds to the tax law's having unwisely granted the power of absolution. Some of these rigors could possibly be eased, with no harm to anyone, if good faith were no longer relevant to the imposition of regular civil penalties.

2.4.2 IRS Audits

A second institutional factor that worsens the impact of a bad-faith standard for penalties concerns IRS auditors. Major U.S. companies are typically audited all the time, with respect to all taxable years although, inevitably, not all potentially controversial issues. IRS auditors have long-term assignments to particular companies, permitting the auditors to develop particularized expertise. In these assignments, the auditors develop long-term relationships with taxpayer personnel who are assigned to the audit process. Inevitably, these relationships work better for everyone if they mix the cooperative with the purely adversarial, and involve tit-for-tat elements with regard to the ratio between these two approaches. Counter-parties therefore become in a sense a constituency to one whom seeks to demonstrate good faith even amidst the expectation of bargaining conflict.

In this setting, I am told, IRS auditors often are reluctant to assert penalties that depend on asserting bad faith. The problem is not the financial consequences of a penalty; taxpayers understand and expect that the auditors will seek more money for the government where they have a plausible legal basis for doing so. Rather, the problem lies in the need to assert bad faith and thereby effectively declare war.

---

[50] *See* Code section 6664(d)(3)(B).

Accordingly, auditors are unduly inhibited from seeking penalties by the associated declarative element of needing to impugn the taxpayer's integrity.

2.5 If Not Bad Faith, Then What?

If taxpayers are strictly liable for taking what prove to be erroneous positions on their returns, a question arises whether absolutely all positive adjustments to tax liability should be penalized. That is one possibility, given the potential audit lottery aspects of any position on the return, but it is subject to a couple of caveats. First, where a tax return position is certain to be seriously scrutinized, the audit lottery justifications for a penalty cease to apply. Merely reporting something, however, does not necessarily mean that it is guaranteed to get a hard look, especially if a lot of things are reported, if auditing resources are limited, and if the reporting is not sufficiently informative about why the auditor might want to pay close attention. Second, the asymmetry of charging an understatement penalty, without offering rewards for over-reporting tax liability, can be thought of as an information-forcing device. It helps the government to identify areas that merit a close look. However, over-use of this technique may tend to blunt its impact. One would not learn much of anything, for example, if taxpayers had to wait until audit before claiming run-of-the-mill business deductions. Thus, some limitation on penalties for understatement may be desirable, even without any reliance on good faith.

Many different approaches are possible. Among the possible filters, some of which the U.S. income tax law currently uses, are (1) the adequacy of taxpayer disclosure, whether affirmatively required or not, (2) the magnitude of the taxpayer's under-statement of liability, absolutely or as a percentage of liability, and (3) whether the transaction, even if potentially legally defensible, has a significant tax avoidance aspect.

3. Tax Shelter Disclosure Rules

3.1 Transactions Subject to Disclosure

Under Code section 6011, the IRS has broad authority to set reporting requirements for taxpayers, ranging from basic tax return filing to disclosure for suspected tax shelters. For corporate taxpayers that engage in possibly questionable transactions, the most important disclosure requirement may be that relating to the differences between reported taxable and financial accounting income. Since 2004, companies with at least $10 million in assets have been required to file Schedule M-3, reconciling the two measures in much greater detail than was previously necessary.[51] What makes the information on Schedule M-3 so useful is the evident importance to officials in publicly traded companies of combining high book income with low taxable income. Differences between the two therefore provide a vital roadmap to the potentially most questionable parts of the tax return.

---

[51] *See* Rev. Proc. 2004-45, 2004-2 C.B. 140.

Otherwise, the IRS has exercised its authority under Code section 6011 to establish six categories of reportable transactions.[52] The categories, along with a brief assessment of each, are as follows:

3.1.1 Listed Transactions

This category covers any transaction that is the same as or substantially similar to any type of transaction that the IRS has identified in any published guidance as a tax avoidance transaction.[53] If a given transaction becomes a listed transaction after the filing of the tax return for the year in which it occurred, but before the statute of limitations has become applicable to that year, the taxpayer must attach a disclosure statement to the next tax return that it files.[54] Thus, taxpayers must continue to monitor IRS listings of tax avoidance transactions as to all open years, in addition to making judgments about whether a given transaction with unique features is "substantially similar" to any that have been listed.

One could certainly criticize the ongoing burden that this rule places on taxpayers, especially given the strict liability penalties, discussed below, for noncompliance. I would argue, however, that such criticism is misguided, for the following reasons:

- Whether or not the IRS is correct that every listed transaction it identifies (including all "substantially similar" versions) is impermissible under present law (*i.e.*, would lose in court if litigated), it would have to be radically and surprisingly wrong if it did not consistently succeed in identifying transactions that have at least some significant chance of losing on economic substance, business purpose, or similar grounds. As discussed above, burdening such transactions may have desirable incentive effects even if we recognize that some of them will be upheld.
- Listed transactions are likely to have the highest payoff in terms of actual close scrutiny. IRS auditors with limited time and resources will not necessarily pay close attention to every single disclosure statement that they receive. However, when they are informed that a given transaction is one that the IRS has listed as a tax avoidance transaction, one would expect close scrutiny to follow as a matter of course.
- The IRS inevitably lags behind the tax bar in learning what new types of transactions are being used to promote aggressive tax planning. It cannot always reasonably be expected to respond within the same year that a new transaction emerges or first becomes popular. Effectively grandfathering transactions, so far as disclosure is concerned, if they were completed before the year in which the IRS first listed them creates incentives to keep on developing new aggressive transactions that can be adopted widely before the IRS catches on.

---

[52] The categories were most recently modified on November 2, 2006, when the IRS issued new proposed regulations reflecting recent statutory changes.

[53] Prop. Regs. § 1.6011-4(b)(2).

[54] Prop. Regs. § 1.6011-4(e)(2)(i).

In practice, the big problem posed for taxpayers by the listed transactions rule is that of how broadly to interpret the concept of substantial similarity. For example, even clearly permissible transactions may exploit the same gaps, anomalies, and inconsistencies in the tax law as listed transactions, even allowing for big differences in economic substance and business purpose. The safest way to respond to the uncertainty, if one wants to minimize the risk of penalties, is to lean decidedly in the direction of over-disclosure. Here the problem for the IRS is that disclosing everything may effectively become equivalent to disclosing nothing. Indeed, taxpayers have little downside (the costs of the extra paperwork aside) to engaging in strategic over-disclosure, motivated not just by over-scrupulousness but by the aim of burying the really important disclosures in a blizzard of irrelevant filings. The seemingly logical government response of penalizing over-disclosure (thus creating symmetry between it and under-disclosure) is unlikely to be adopted, and might in any event prove too much of a distracting and costly detour from litigating issues of substance.

Over-disclosure not only impedes the ability of the IRS to identify the most pertinent items, but also may dilute the effect of the disclosure rules in burdening legally questionable transactions relative to those that are certain to be upheld. So far as transaction choice is concerned, burdening all of the taxpayer's options may be no better than burdening none of them, potentially converting the extra back-flips into pure waste.

3.1.2 Confidential Transactions

Disclosure is required for transactions that were offered to the taxpayer under conditions of confidentiality and for which the taxpayer paid a minimum fee ($250,000 if the taxpayer is a corporation).[55] Conditions of confidentiality exist where "the advisor who is paid the minimum fee places a limitation on disclosure by the taxpayer of the tax treatment of the transaction and the limitation on disclosure protects the confidentiality of that advisor's tax strategies."[56] Such conditions may exist even if the limitation is not legally binding,[57] a detail that rightly recognizes the importance of expectations and informal norms when the parties have ongoing interactions and broader business reputations to worry about.

This disclosure requirement has two separate virtues. First, it may serve as a useful filter for identifying suspect transactions, since those with confidentiality requirements may be unusually likely to involve aggressive tax planning that the IRS would want to review. Second, taxpayers have an incentive to over-invest, from a social standpoint, in lawful as well as unlawful tax planning.[58] Impeding the functioning of the tax planning market by making it harder for innovators to protect their intellectual property may therefore have social benefits by reducing investment in this realm of activity. This, of course, is simply an inverted form of the argument for

[55] Prop. Regs. § 1.6011-4(b)(3).
[56] Prop. Regs. § 1.6011-4(b)(3)(ii).
[57] *Id.*
[58] *See*, *e.g.*, WEISBACH, Ten Truths About Tax Shelters, 55 Tax L. Rev. 215, 222 (2002).

patent protection and protection of trade secrets, based on viewing the affected innovations as socially costly rather than beneficial.

3.1.3 Transactions with Contractual Protection

This category covers transactions in which the fees paid by the taxpayer are contingent (including through a right to total or partial refund) on whether all of the intended tax consequences are sustained.[59] Once again, such protection is likely to be a good filter for transactions that the IRS either might want to audit in a given case or to consider identifying as a newly listed transaction. After all, absent significant legal uncertainty, taxpayers have less reason to value this type of coverage, which effectively constitutes insurance, albeit offered by an advisor relying on its knowledge about the transaction and its own good judgment, rather than by an insurance company relying on the law of large numbers.[60] Taxpayers that forego contractual protection so that they will not have to disclose the transaction in effect face an extra back-flip if they are risk-averse and do not simply go to an insurance company for the same protection.

3.1.4 Loss Transactions

Disclosure is required for transactions that result in losses by a corporate taxpayer of at least $10 million in any single taxable year or $20 million in any combination of taxable years.[61] Again, the rationale is that transactions producing such large losses are likely to be ones that the IRS has reason to want to know about, either for purposes of a given audit or more generally.

3.1.5 Transactions of Interest

This category is a new one, having been added on November 2, 2006, when the Treasury issued proposed regulations modifying the previously existing regulations. Like listed transactions, transactions of interest are those specifically identified as such by the IRS, along with substantially similar transactions.[62] However, the IRS does not purport to be certain of the abusive character of transactions of interest. The preamble that accompanied publication of the new proposed regulations describes a transaction of interest as one "that the IRS and Treasury Department believe has a potential for tax avoidance or evasion, but for which the IRS and Treasury Depart-

---

[59] Prop. Regs. § 1.6011-4(b)(4)(i).

[60] Contractual protection might not denote likely aggressiveness in cases where it serves to ensure that the counterparty will not create a "foot-fault" by botching compliance with detailed technical preconditions for the receipt of a tax benefit.

[61] Prop. Regs. § 1.6011-4(b)(5). The relevant losses are those that allowable under Code section 165, concerning losses sustained during a given taxable year, as distinct from Code section 162, concerning ordinary and necessary business expenses. The relevant losses are measured without regard to offsetting gains and without regard to whether they are currently allowable to the taxpayer. *See* Prop. Regs. § 1.6011-4(b)(5)(iii).

[62] Prop. Regs. § 1.6011-4(b)(6). This category replaces that of transactions with a significant book-tax difference, eliminated in the proposed regulations by reason of the overlap with reporting on Schedule M-3.

ment lack enough information to determine" whether it in fact involves either of these ills. Once such information is available, a given transaction may either become a full-fledged listed transaction or else simply be removed from the transactions of interest list and thus made non-reportable.[63] While holding this intermediate status, transactions of interest do not trigger the further adverse consequences that, as we will see below, attach to listed transactions. They do, however, similarly require updating of one's disclosures for prior taxable years that remain open, when new items are added to the list.[64]

For two reasons, this new category may prove important and valuable notwithstanding the usual twin dangers of over-disclosure and under-disclosure. First, it offers the IRS information that, even if not used extensively in particular audits, may help it in formulating broader regulatory responses to new transactions. Second, as with listed transactions, the prospect that a deal not currently required to be disclosed may subsequently become so may serve as a socially valuable deterrent when taxpayers are contemplating in questionable newly designed transactions.

3.1.6 Transactions Involving a Brief Asset Holding Period

Disclosure is required for transactions in which the taxpayer claimed a tax credit (other than a foreign tax credit) exceeding $250,000 with respect to an asset that the taxpayer held for 45 days or less.[65] This requirement is a natural complement to that concerning loss transactions, since credits and losses are the two main routes to sheltering the tax that otherwise would be due on other income and gains.

3.2 Possible Additions to the List of Reportable Transactions

While this is not the place for a detailed inquiry into how the disclosure requirements in the U.S. rules could be expanded, several main possibilities come to mind. In particular:

– Disclosure could be required for transactions as to which the taxpayer has third-party insurance coverage. The original proposed regulations concerning tax shelter disclosure applied to such transactions, covering insured transactions under the same rubric as that for contingent fee arrangements,[66] but the insurance industry persuaded the IRS to retreat on the grounds that there is insufficient reason to

---

[63] *See* Treasury Department, AJCA Modifications to the Section 6011 Regulations, 71 Fed. Reg. 64488 (November 2, 2006).

[64] Prop. Regs. § 1.6011-4(e)(2)(i).

[65] Prop. Regs. § 1.6011-4(b)(7). Until their modification on November 2, 2006, this disclosure requirement applied to foreign tax credits as well as other tax credits, and thus to transactions such as that in *Compaq*. Foreign tax credit transactions were removed from the list by reason of the amendment of the foreign tax credit rules to require a 15-day holding period. *See* Code section 901(k) and (l); Treasury Department, AJCA Modifications to the Section 6011 Regulations, 71 Fed. Reg. 64488 (November 2, 2006).

[66] *See* Regs. § 1.6011-4T(b)(4) (2002).

infer abuse from the purchase of insurance.[67] While the merits here can reasonably be debated,[68] a back-flips view of burdening under-audited transactions that have uncertain tax consequences might support the earlier IRS position.

- Tax shelter transactions often involve tax-indifferent counterparties, who are useful for absorbing taxable income that may accompany the taxpayer's reporting of a loss. At least in cases where the taxpayer could reasonably be expected to know that the counterparty is tax-indifferent (*e.g.*, because it is a tax-exempt organization or a foreign taxpayer, or because the transaction structure required finding such a counterparty), arguably a reporting requirement would be useful. Given the variety of transactions in which tax-exempt parties participate, however, some further filtering devices might be needed here to avoid self-defeating overbreadth.
- Disclosure could be required for tax planning strategies that have patent protection, whether or not they are covered by the disclosure rule pertaining to confidential transactions.[69] While patents are public documents, the IRS may have difficulty finding important planning information that they contain without the aid of taxpayer disclosure.

3.3 Penalties for Failure to Meet Disclosure Requirements

In 2004, Congress enacted Code section 6707A, imposing penalties on taxpayers that fail to disclose reportable transactions. For corporations, the penalty is $200,000 per listed transaction, and otherwise $50,000 per reportable transaction.[70] Other than with respect to listed transactions, the IRS can elect to rescind a given penalty if doing so would "promote compliance … and effective tax administration."[71] Such rescission would then be reportable to Congress,[72] likely deterring IRS exercise of its rescission authority.[73] The penalty gives especial teeth to the requirement that listed transactions and transactions of interest, along with their "substantially similar" variants, be disclosed even if they only obtained this status in a subsequent taxable year. If one regards the disclosure rules as important and beneficial, it is difficult to argue with penalizing noncompliance.

---

[67] *See* LOGUE, *supra* note 6, at 404. In proposed regulations issued on November 2, 2006, the IRS provided that the provision of "tax result protection that insures some or all of the tax benefits of a reportable transaction" may cause one to be subject to the material advisor disclosure rules, described below. Prop. Regs. § 301.6111-3(b)(2)(ii)(A).

[68] See LOGUE, *supra* note 6, at 404-405.

[69] The confidential transactions rule applies if the advisor "places a limitation on disclosure by the taxpayer." Prop. Regs. § 1.6011-4(b)(3)(ii). In the case of patent protection, arguably the taxpayer is merely subject to the same legal limitation as all other parties, rather than being specifically placed under such a limitation by the advisor.

[70] Code section 6707A(b).

[71] Code section 6707A(d).

[72] *See* H.R. Rep. No. 755, 108th Cong., 2nd Sess. 599 (2004).

[73] *See* EDLAVITCH/MASTERSON, Practical Guide for Compliance with Circular 230 and the Reportable Transaction Disclosure Framework Post-AJCA, 46 Tax Management Memorandum No. 9 (2005).

3.4 Disclosure Requirements Pertaining to Material Advisors

Under Code section 6111, each material advisor with respect to any reportable transaction must file an information return with the IRS that provides information identifying and describing both the transaction and its expected tax benefits. For purposes of this rule, a material advisor is any person who both (a) provides "any material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, insuring, or carrying out any reportable transaction,"[74] and (b) receives a fee of at least $250,000 in the case of a corporate taxpayer,[75] an amount that is reduced to $50,000 for listed transactions.[76] Material advisors also are required to retain investor lists with respect to reportable transactions that are open to inspection by the IRS.[77] Failure to supply required customer lists within 20 business days of an IRS request for them leads to penalties of $20,000 per day unless excused by the IRS on grounds of reasonable cause.[78]

These rules are potentially burdensome on tax advisors, and some have questioned the extent to which the IRS actually makes commensurate use of the potentially voluminous information thus reported to it or required to be retained for possible inspection. The rules' main virtue may relate to taxpayers who are considering whether to comply (or how hard to try to comply) with their own reporting requirements. One is less likely to get away with non-disclosure if reporting or record retention by one's advisors increases the chance of IRS detection. The value of the rules therefore depends not only on how much direct use the IRS makes of the information retained by tax advisors, but also on the effects on taxpayer disclosure. One also can make "back-flip" arguments in favor of the requirement if, as one would expect, material advisors effectively pass on these costs to taxpayers engaging in transactions that have uncertain legal merits.

4. Accuracy-Related Penalties

Even with disclosure that will not always result in a searching inquiry, government tax authorities need significant penalties in order to address taxpayer incentives to play the audit lottery with respect to legally uncertain transactions. I argued in section 2 that the penalties should apply even in cases where the taxpayer reasonably believed that there was a significant chance that a transaction would be upheld, and all the more so if the inquiry into such reasonable belief simply means that one has to shop around for a sufficiently sanguine tax opinion.

The U.S. rules at one time very clearly placed strong reliance on ostensible good faith. The extent to which they continue to do so today is unclear, due to ambiguities in recently enacted rules. These ambiguities relate in particular to the phrase "a significant purpose of tax avoidance or evasion," which the rules crucially rely on at

[74] Code section 6111(b)(1)(A)(i).
[75] Code section 6111(b)(1)(B)(ii).
[76] *See* IRS Notice 2004-80, 2004-50 I.R.B. 963.
[77] Code section 6112.
[78] Code section 6708.

several different points. This phrase plays a crucial role to both of the main statutory provisions imposing statutory-related penalties, Code sections 6662 and 6662A, which I discuss next.

4.1 Code Section 6662A Accuracy-Related Penalty With Respect to Reportable Transactions

Under Code section 6662A, "reportable transaction understatements" trigger a 20 percent penalty, raised to 30 percent if applicable disclosure requirements were not met.[79] For purposes of this rule, all understatements relating to listed transactions are treated as reportable transaction understatements.[80] However, for all other reportable transactions, the penalty under Code section 6662A does not apply unless "a significant purpose of such transaction is the avoidance or evasion of Federal income tax."[81]

This may initially sound like a good-faith-based prerequisite for application of the penalty. One should keep in mind, however, that it does not necessarily have anything to do with the likelihood that the transaction will be upheld, either by some putatively objective measure or in the belief of the taxpayer. Avoidance or evasion need only be a significant purpose, not the exclusive or even primary purpose served by a transaction. Innumerable clearly permissible transactions may involve a significant purpose of legal tax avoidance. An example might be engaging in a tax-free corporate reorganization.

Importantly, while "evasion" seems to require violating the law, "avoidance' can in common usage mean as little as legally reducing one's tax liability through an expressly permitted planning move (*e.g.*, paying workers tax-free fringe benefits in lieu of cash salary). Commentators on the U.S. rules have therefore speculated that a significant purpose of avoidance might exist whenever taxpayers seek to avoid the most highly-taxed route to a given business objective, and indeed whenever they seek tax advice at the transactional planning stage.[82] Under this view, the requirement might always be met unless the tax consequences at issue were bordering on trivial.

While logically defensible, this interpretation of the "significant purpose" requirement is far from being clearly correct. If intended, it might more straightforwardly have been implemented by having the requirement refer simply to significant tax consequences. "Tax avoidance" is not an entirely neutral-sounding way of referring to a goal of paying less rather than more tax. Pairing it with the word "evasion" arguably strengthens the inference that it is meant to sound condemnatory.

The IRS and Treasury Department have not as yet directly addressed the proper interpretation of the significant purpose requirement. It seems clear, however, that they do not in fact regard it as coextensive with the existence of significant tax

---

[79] Code section 6662A(a) and (c).
[80] Code section 6662A(b)(2)(A).
[81] Code section 6662A(b)(2)(B).
[82] *See*, *e.g.*, GIESSELMAN, A Significant Problem Defining a "Significant Purpose" and the Significant Difficulties That Result, 111 Tax Notes 1119 (2006).

stakes. Thus, recall the statement in the preamble to the recently issued proposed regulations that transactions of interest have a "potential for tax avoidance or evasion" but are not yet clearly identifiable by the government as tax avoidance transactions. This professed lack of full information seems more likely to denote uncertainty about the legal merits of the taxpayer's position than about whether significant tax dollars are involved.

Under the view of penalties that I have advanced in this paper, the rule would be a better one if "a significant purpose" were interpreted to require nothing more than significant tax stakes. However, such a reading is clearly somewhat tone-deaf from the standpoint of statutory interpretation, and does not seem to be what the IRS has in mind. Pending more definite guidance, however, some taxpayers may treat it as a mandate to disclose just about everything, whether out of an abundance of caution or affirmatively to hamper IRS review of the really pertinent disclosures.

4.2 Code Section 6662 Accuracy-Related Penalty on Underpayments

For tax underpayments not involving "reportable transaction understatements" to which Code section 6662A applies, the operative accuracy-related penalty provision is Code section 6662. This provision likewise attaches a 20 percent penalty, triggered by negligence or disregard of rules or regulations and also by "[a]ny substantial understatement of income tax."[83] Negligence and disregard raise state of mind issues, although to some extent the existence of contrary authority might be discerned objectively. The question of whether "substantial understatement" turns on state of mind issues is subject to the same interpretive uncertainties as those described above.

"Substantial understatements" that trigger the penalty are subject to a quantitative threshold. For corporate taxpayers, the penalty does not apply unless the amount of the understatement for the taxable year either (i) exceeds $10 million, or (ii) is more than 10 percent of the amount the taxpayer was supposed to pay and also is more than $10,000.[84] In determining the amount of the relevant underpayment, however, the effect of transactions subject to the Code section 6662A penalty is ignored, to prevent overlap. Also ignored are underpayments that result from what I will call "substantial authority items" and "adequate disclosure items".[85] Each of these two items requires further elucidation.

<u>Substantial Authority Items</u> – These are items as to which the taxpayer had "substantial authority" for the position it took.[86] While this seems to put us back in the realm of using a tax opinion to show good faith, and indeed of not even requiring anything close to a "more likely than not" opinion, the exception's reach is modified

---

[83] Code section 6662(b)(1) and (2). Penalties under Code section 6662 also apply to substantial valuation misstatements, substantial overstatements of pension liabilities, and substantial estate and gift tax valuation understatements. Code section 6662(b)(3) through (5).

[84] Code section 6662(d)(1)(B).

[85] Code section 6662(d)(2)(B).

[86] Code section 6662(d)(2)(B)(i).

by a rule treating it as inapplicable to "any item attributable to a tax shelter".[87] A "tax shelter," in turn, is defined as any plan or arrangement that had as a "significant purpose … the avoidance or evasion of federal income tax."[88] Once again, good faith is irrelevant if we interpret this as simply requiring significant tax stakes, but that interpretation arguably is hard to square with the tenor of the language – and of using the term "tax shelter" – which imply that something at least borderline improper is going on.

Adequate Disclosure Items – These are items as to which the relevant facts affecting their proper tax treatment were adequately disclosed, and as to which there was a reasonable basis for the taxpayer's position.[89] Once again, however, the exception does not apply to a "tax shelter", defined in terms of a significant purpose of tax avoidance or evasion.[90]

Accordingly, for Code section 6662, as for Code section 6662A, the standard for imposing a penalty approaches strict liability if one interprets the "significant purpose" requirement as mandating little more than that there actually were significant tax stakes. This might be discerned by comparing the actual reported tax treatment to the least favorable one that had any possibility of applying either to the actual transaction or to an alternative transaction that could have been engaged in to serve the same substantive business ends. Such a reading, while in my view the best one from the standpoint of giving desirable incentive effects to the penalty rules, is considerably more open to criticism from the standpoint of proper statutory interpretation. I would therefore advise tax policymakers from other countries, if examining and considering generally adopting something like the U.S. rules, to avoid using limiting phrases that go beyond requiring significant tax stakes.

4.3 Remaining Role of "Penalty Shield" Opinions

Under Code section 6662, "penalty shield" opinions retain an important role if (as seems highly likely) the "significant purpose" language does not effectively create strict liability whenever there are significant tax stakes. In particular, a tax opinion may help provide the basis for a claim of substantial authority, and may directly establish that a relying taxpayer had a reasonable basis for its position with respect to an adequate disclosure item. Such an opinion is not given this effect, however, if it comes from a "disqualified tax advisor", defined as any of the following:[91]

1) A material advisor who participates in the organization, management, promotion, or sale of the transaction or is related to one who so participates. A material advisor does not become a disqualified participant merely by reason of rendering an

---

87 Code section 6662(d)(2)(C)(i). Any such reliance on a legal opinion would, however, be further limited by rules in Circular 230 that are outside the scope of this paper.

88 Code section 6662(d)(2)(C)(ii).

89 Code section 6662(d)(2)(B)(ii). For corporate taxpayers engaged in multiple-party financing transactions, there is an additional requirement that the tax treatment clearly reflect the income of the corporation. *Id.*

90 Code section 6662(d)(2)(C)(ii).

91 Code section 6664(d)(3)(B).

opinion regarding the tax consequences of the transaction. However, if this involves suggesting modifications to the transaction that are "material" and that "assist the taxpayer in obtaining the anticipated tax benefits", the advisor is disqualified.[92]

Given this rule, tax lawyers for the law firm that is implementing a given transaction are highly unlikely to be able to issue an effective penalty shield opinion. As discussed previously, while this mitigates the conflict of interest problem that such a tax lawyer would otherwise face, it also is likely to diminish the quality of the information that is available to the opinion writer.

2) Anyone who is compensated directly or indirectly by a material advisor with respect to the transaction.
3) Anyone who has a contingent fee arrangement that depends on the transaction's intended tax benefits being sustained.
4) Anyone who has a "disqualifying financial interest" with respect to the transaction, such as an agreement or understanding, whether oral or written, that the advisor is expected to render a favorable opinion with respect to a reportable transaction.[93] This rule presumably does not bar sufficiently careful taxpayers from delicately probing a potential opinion writer's view of a given transaction before deciding whether to request an opinion.

Even when not written by disqualified tax advisors, opinions fail to offer penalty shield protection if they are based on unreasonable factual or legal assumptions, unreasonably rely on the taxpayer's representations, or do not identify and consider all relevant facts.[94] This recently enacted requirement potentially makes getting a penalty shield opinion much less of a *pro forma* exercise than taxpayers, in some cases, had previously assumed. It thus adds to the back-flip character of the rules in addition to pushing penalty shield opinions to be more credible.

5. Conclusion

In controlling tax shelters, once the substantive rules for identifying permissible transactions are in place, much depends on the effectiveness of disclosure and penalty rules. Well-targeted disclosure rules are vital to avoiding too low a probability of detection. Penalties are needed to ensure that taxpayers have appropriate incentives given the inevitability of legal uncertainty and of the audit lottery in terms of issues that get thorough review (even with extensive disclosure).

Taxpayers sometimes complain about the burden from disclosure requirements, and about being penalized for taking in good faith positions that were determined *ex post* to be incorrect. As for disclosure burdens, while increasing them may be socially wasteful if transaction choice remains the same, the "back-flips" character of economic substance rules suggests a possibility of decreasing overall waste if transactions of uncertain legal merit are discouraged relative to those that are clearly

[92] IRS Notice 2005-12, 2005-1 C.B. 494.
[93] *See id.*
[94] Code section 6664(d)(3)(ii).

permissible. No-fault penalties should not even be controversial once we understand that taxpayers can hardly be expected to refrain from responding strategically to legal uncertainty. We need not condemn such taxpayers or such responses in order to be concerned about the incentive effects of legal uncertainty when audit review is potentially so incomplete. Insurance can be permitted if we are concerned about imposing downside risk on parties that believe their tax return positions have a decent chance of being correct.

The U.S. disclosure rules' main problem lies in the inherent difficulty of addressing the twin perils of under-disclosure and over-disclosure with respect to transactions that might or might not be deemed "substantially similar" to listed transactions and transactions of interest. Under-disclosure occurs if taxpayers can dodge reporting requirements by relying on relatively trivial variations between transactions. Over-disclosure occurs if so much is being reported to the IRS that it cannot use the reports to focus its audit efforts effectively, and if the back-flips effect of requiring disclosure is being overly diluted by its extension to transactions that approach legal certainty of correctness. Reporting about book-tax differences under Schedule M-3 does not suffer from this conundrum, making it inherently a more powerful tool even if we are confident that the disclosure rules provide some added value.

The main problem with the U.S. rules concerning accuracy-related penalties is that they continue to rely unduly on fault, all too often meaning in practice that one need only shop around for a penalty shield opinion in order to be assured of a positive expected return when one plays the audit lottery. The demand for penalty shield opinions interferes with the market for providing sound legal advice, and has led the IRS to impose burdensome rules on U.S. tax lawyers (such as Circular 230) that might not otherwise be necessary. The disqualified tax advisor rules, while salutary insofar as they address the conflict of interest problem faced by the tax lawyers in a firm that is doing the transaction work on a given deal, may tend to make the opinions obtained less well-informed and thus less credible. The weakness of the normative case for penalty shield protection suggests that other countries should consider applying strict liability for *ex post* legal error, without regard to the objectively or subjectively determined reasonableness of the taxpayer's position, if they otherwise follow the general outlines of the substantial understatement penalty in U.S. tax law.

Disclosure and Civil Penalty Rules in the U.S. Legal Response to Corporate Tax Shelters – Comment on the paper by Daniel Shaviro

Philip Baker

Professor Shaviro's excellent and thought-provoking paper points, in my view, to a clear conclusion for other countries contemplating introducing a scheme of tax shelter disclosures. The conclusion is that the U.S. scheme has grown exceptionally out of circumstances in that country, and that it would be unwise, if not unlawful in some countries, to try to replant that scheme outside the United States. Put more strongly: tax shelter disclosure is an unwelcome export from the United States, and should be sent back where it came from as quickly as possible.

I would probably do great injustice to Daniel Shaviro's paper if I tried to summarize it. However, in essence, he argues that substantial understatement penalties should be imposed on a strict liability basis, restricted only by the requirement that there should be significant tax at stake. He argues that the good faith of the taxpayer in taking a tax position which is subsequently proved to be wrong should be irrelevant. As a corollary, the fact that a taxpayer acted on the basis of a legal opinion should be irrelevant. The substantial understatement penalty should be fixed at a sufficiently high level as to ensure that the taxpayer who makes the understatement obtains no overall advantage from doing so. If tax filing is seen simply as a summation of the percentage chances of success on taking various tax positions, the overall economic result once penalties are factored in would deter the taxpayer from taking a position with even a 90% chance of success: the downside of being found to have understated income – even in good faith – would take away any economic advantages achieved. If strict liability were regarded as somewhat harsh, then Professor Shaviro would allow insurance against tax penalties so that the insurance market effectively prices out any potential advantages from an understatement of income.

Without going further in to the reasoning in Professor Shaviro's paper, there is one specific point on which I find myself in disagreement with the analysis. This is the example of a taxpayer who enters into ten tax schemes, or takes ten tax positions, each with a 90% chance of success. The analysis assumes that, in those circumstances, on average one of those ten schemes would fail, be proved to have involved a substantial understatement, and the penalty for that understatement would (I think it is implicit in what is said) be sufficiently high as to deter the taxpayer from participation in any of those ten schemes.

With respect, I do not think that this analysis is correct. The probability of different tax positions being correct is an independent probability: there is no lesser likelihood of a scheme being correct if it is one of a large number of schemes or positions being taken. It is like the rolling of a dice: if a dice has rolled the number "6"

on 99 consecutive occasions, the probability of it rolling 6 on the 100th occasion is still 1/6 (unless these unlikely events have proved that the dice is actually loaded).

If a taxpayer takes ten tax positions, all of which are 90% likely to be correct, then assuming that the standard of proof in tax cases is a balance of probabilities (which we would assume translates into a greater than 50% chance of success), the taxpayer ought to be successful on all ten occasions.

This is, in fact, closer to the reality, rather than a hypothetical scenario. Given the uncertainty over the proof of facts, and possible disagreement over the meaning of tax legislation, it is unlikely that any taxpayer could ever be 100% certain of every single tax position he takes. 90% is virtual certainty, but making an entirely reasonable allowance for the vicissitudes of the tax audit and litigation process.

On Professor Shaviro's view, a substantial understatement penalty would be imposed on the taxpayer who, though in good faith assuming a 90% probability of success, was found ultimately to have taken an incorrect tax position.

I should like to turn now from Professor Shaviro's paper and address some more general comments on tax shelter disclosure.

What is generally absent from the discourse about tax shelter disclosure is any discussion of some very fundamental legal concepts which fulfil a crucial role in European legal systems, but which are perhaps absent in the United States.[1]

I have seen no discussion in the discourse on tax avoidance disclosure of the concept of proportionality, particularly in terms of the penalty and the mischief against which it is addressed. Proportionality is a strong principle in the constitutional traditions of many European countries, in European Community law, and in the jurisprudence of the European Court of Human Rights. To take an extreme example: executing the senior tax counsel of corporate taxpayers for having engaged in a tax shelter would be highly effective; we do not do so, however, because it would be a disproportionate response. How does one justify, however, a strict liability, substantial understatement penalty (and here the adjective "substantial" qualifies the penalty and not just the understatement) on grounds of proportionality. I return to this when I ask: what is the mischief against which tax shelter disclosure is really targeted?

I have seen no discussion in the context of tax shelter disclosure of any right to take legal advice, and the restraints which tax shelter disclosure places on that right. The draftsmen of human rights instruments, such as the European Convention on Human Rights and the International Covenant on Civil and Political Rights, took it as so axiomatic that there was a right to legal counsel (which no state would deny) that they did not expressly guarantee that right. That does not, of course, mean that the right to legal counsel was undervalued: in many areas – such as the recognition of legal professional privilege or the right of prisoners to consult their lawyers in private – human rights tribunals have explicitly recognized the right to take legal advice.

---

[1] In fact, the discussion of Professor Shaviro's paper in Munich tended to confirm that some of these concepts are given different weight in the United States.

Tax shelter disclosure, however, severely restricts this right. If a prisoner facing a criminal trial is entitled to consult with his lawyer in circumstances where the discussions are completely privileged from disclosure, why is an in-house tax counsel obliged to disclose the results of a discussion on tax law, if the result of that discussion is to identify a potential tax shelter. One point which emerged from the discussions at the Munich conference was that legal professional privilege, while recognized, is not automatically guaranteed in the U.S. legal system: this differs from the position in European legal systems (so far as they were represented).

The discussion of tax shelter disclosure fails to consider issues of confidentiality, which is again guaranteed in international human rights instruments.[2] Confidentiality is, of course, a qualified right which can be overridden if there is sufficient public interest to outweigh the taxpayer's right to confidentiality, if the interference it is shown to be necessary in a democratic society, and it is in accordance with law. Whether tax shelter disclosure is necessary in a democratic society is again a question that turns on the mischief to which tax shelter disclosure is directed.

Finally, there is no discussion within the discourse on tax shelter disclosure of questions of legal certainty in the scope of the legislation. If a penalty (often substantial) is imposed for failure to disclose a tax shelter, then it is incumbent on a state to define with precision the circumstances where disclosure is required. However, tax shelter disclosure works most effectively for the revenue authority where vague terms are used, such as a requirement to disclosing schemes which are "similar" to existing or listed schemes.

These fundamental legal principles mean that the environment outside the United States is not the same as that in which tax shelter disclosure developed in that country. Governments who consider that the introduction of tax shelter disclosure may be advantageous, should consider very carefully whether they would be acting unconstitutionally or unlawfully in going down this route.

The United Kingdom has followed the route of tax shelter disclosure. Limited legislation in 2004[3] has been more broadly extended since summer 2006.[4] On several occasions since 2004 public statements have been made to the effect that legislation to close particular loopholes has been prompted by the disclosure of a particular tax avoidance scheme. One assumes, however, that if tax avoidance disclosure had not been introduced, these schemes would have eventually been identified, and legislation would have been introduced, but perhaps four or five years down the line. That legislation might have been retrospective in its effect. The threat of potentially retrospective legislation might have had just as strong an impact on whether taxpayers would have bought into these schemes or not.

Which takes us to examine the questions: what are the real costs and benefits of tax shelter disclosure? I think that Professor Shaviro would agree that the advantages for the revenue authorities are actually rather limited. On the one hand, there is a tim-

[2] By Article 8 of the European Convention on Human Rights, for example.

[3] Part 7 of the Finance Act 2004.

[4] *See* the Tax Avoidance Schemes (Prescribed Descriptions of Arrangements) Regulations 2006, SI No. 1542.

ing advantage in the ability to identify loopholes in the legislation which have led to tax shelters at an earlier stage, and legislate against those loopholes early. However, this is only a timing advantage: if one assumes that the loophole would eventually have been identified, and that legislation to close the loophole could have been introduced retrospectively, then early legislation has no long-term impact.

The second advantage is that, because taxpayers are required to highlight any tax shelters in which they are engaged, it is more likely that the shelters will be picked up in an audit. The corollary is that less resources need to be allocated to the audit function since the taxpayer already does part of the work of the audit agent. Two comments to this: does the potential saving in resources for the revenue authority justify interfering with fundamental legal rights? Secondly, is there a danger that, if audit agents focus only on disclosed tax shelters, non-disclosable matters may pass under the radar?

At the end of the day, one has to be aware of the possible long-term impact that tax shelter disclosure may have. If, as Professor Shaviro suggests, there should be a strict liability penalty for even good faith understatement of a tax position where substantial tax is at stake, then one has to see what will be the impact on taxpayer behavior. One possibility is that taxpayers will never take a position where there is even the slightest possibility that this differs from the view taken by the revenue authority or the slightest possibility that the position may be found to be incorrect. Given the uncertainties over tax law and findings of fact, this effectively pushes us into a near-totalitarian society where taxpayers do exactly and only what the revenue authorities tell them to. This assumes that there is (perhaps with hindsight) only one possible view a taxpayer might take of his liability.

By showing us the logical extension of tax shelter disclosure, I consider that Professor Shaviro is doing us a great service. He implicitly warns us where the introduction of tax shelter disclosure may ultimately lead.

Tax Shelter Disclosure and Civil Penalty Rules – Comment on the paper by Daniel Shaviro

Roman Seer

1. Self-Assessment System versus State Assessment System

The U.S. income and corporate tax system is procedurally based on self-assessment – as far as I can see: from its beginning in 1913. The taxpayers are obliged to compute and assess the owed tax against themselves. Their responsibility covers not only the tax-relevant facts, but also the application of law. Tax procedure including tax collection seems to be extensively socialized, like an act of self-regulation by society.

The continental Europe approaches this public affair traditionally from a different point of view. Taxation is still a state act. The state tax authorities are fully responsible for tax assessments by using an inquisitorial system. However, the taxpayers have to comply by delivering some evidence. Of course, they have to file tax returns in which the tax-relevant items are to be declared. But they are not responsible for the assessment of the concrete tax amount they have to pay. Only the state tax administration will assess the tax in a tax notice which is qualified as a formal administrative act. The tax authorities are responsible for applying the law to the reported and inspected or, moreover, examined facts.

At first sight, we recognize a fundamental difference between both systems. On closer inspection, however, the gap appears to be less big. For the tax return decision, as to which tax base items have to be recognized, a continental European taxpayer must apply the tax law to the facts, too. Tax relevance of facts always carries an issue of applying law. From this point of view a continental European taxpayer is also responsible for both, the diligent recording of facts *and* the correct application of law.

On the other hand, no self-assessment system will be sufficient without state act means. A voluntarily complying taxpayer is still a rare animal that could be listed as an endangered species by the World Wide Fund. No tax declaration system can exist without a – structural – verification system. Therefore, modern tax authorities use different risk management systems to check tax returns. Auditing is one very important classic instrument. In the U.S., levy surcharges on tax in cases of non-compliance – especially by civil penalties – constitute another important sanction measure, less common in continental Europe.

However, if the likelihood to be drawn in the so-called audit lottery is declining, the lack of verification can not be compensated by higher civil penalties. Firstly, drastic penalties may somehow deter taxpayers from cheating on tax authorities, but not proportionally to the decreasing number of audits. Secondly, the likelihood to be charged by civil penalties is in the same way declining as the auditing rate. Thirdly,

the unlucky person whose odd is drawn in the auditing lottery will be treated harshly while many other non-compliant taxpayers remain undiscovered and uncharged. Civil penalties which levy a multiple of the true tax amount are not acceptable from the point of legal protection in the single case. Despite its character as civil penalty the addition to tax will fall under Art. 6 of the Convention for the Protection of Human Rights and Fundamental Freedoms. Art. 6 § 2 of this convention will be violated by heavy penalties which are assessed automatically without any effective possibility of exculpation.

2. Criterion of Sphere Responsibility

In my opinion, we must differentiate using the criterion of sphere responsibility. As a state body the tax authorities are responsible for the statutory tax law, regulations, rulings, advice and precedents (leading cases) of state courts. A taxpayer can rely on these issues. If the taxpayer files a tax return confiding in these sources, no sanctions, especially no civil penalties, should be imposed *ex post*.

On the other hand, facts and transactions realized by the taxpayer, are located in his/her influence sphere. In general, the taxpayer has to provide the tax authorities with the facts which are relevant under the law, regulations, rulings and judicial precedents. If the taxpayer does not consider these facts when computing the taxable income, the consequence shall be sanctions like civil penalties.

The problematic grey area affects the extensive range of cases in which it is unclear if or how far the facts or transactions realized by the taxpayer are relevant for the concrete tax and where no substantial authority leads the tax treatment. On the one hand, the facts and transactions are rooted in the sphere which is under the influence of the taxpayer. Therefore, he or she is responsible to disclose the facts which are otherwise hidden in his books. On the other hand, the taxpayer should not be forced to file the tax return pro fiscus. The solution for this conflict is the disclosure statement which protects him/her against civil penalties and enables the tax authority to examine the taxpayer's opinion. This seems to be an adequate balance between the legal protection of the taxpayer on the one hand and the budgetary interests of the tax authority on the other hand. The taxpayer is able to argue for his position. The tax authority can attend to the public interests. If there is no way for a compromise the Tax Court has to decide as the neutral public instance.

I agree with Daniel Shaviro that the "reasonable cause and good faith"-exception clause is less appropriate. It encourages taxpayers to go shopping for opinions as "penalty shields". I think the taxpayer does not act "in good faith" if a tax advisor denies a request because he or she is seriously in doubt of supporting the taxpayer's position by writing an expertise. In the single case it is not easy to decide if there has been a reasonable cause *and* whether the taxpayer has acted in good faith. The alternative is still a disclosure statement as the prerequisite for hindering civil penalties.

Furthermore, Daniel Shaviro pointed out the dilemma between over- and underdisclosures. Indeed, disclosing everything may effectively become equivalent to disclosing nothing. However, the need of disclosures has its origin in the sphere of the tax authority. It is the task of the tax administration as a state body to examine the tax

obligations. If taxpayers disclose transactions and other facts, they provide the tax authorities with information. Only excessive strategies of overwhelming the Revenue Service with disclosures can be indicated for penalizing. Besides these abusive strategies you will find the mistakes not in the disclosure procedure but in the uncertainty and complexity of modern tax law, accompanied by a declining percentage of auditing which is caused by reduced staffs of tax agents.

3. Tax Shelter Category

The other important question is indeed to define the category of tax shelters. In contrast to Daniel Shaviro's appointment I can not say "I know it when I see it." For example, if a company uses a tax benefit which is granted and intended by the legislator to trigger economic growth, does this already constitute a tax shelter? Or: if a national income tax law, following consequently the realization principle, allows over generations increasing hidden reserves, does this represent a tax shelter?

Under German tax law we found also some diffuse categories like "Loss-Contribution-Companies" or "Tax-Deferral-Models". These new provisions bear a great deal of uncertainty. Thus, I am very reluctant to copy the U.S. tax shelter regime. On the other hand, the general anti-avoidance rules (GAARs) are also not very meaningful. For example, Art. 42 German Abgabenordnung tries to prevent the misuse of legal instruments contrary to the intention of the law. Due to the interpretation of this provision in a "substance over form"-sense, an economic substance test has paved its way into the jurisdiction. This can be a tool to deal with the phenomenon of Controlled Foreign Companies which Daniel Shaviro has mentioned using the example of the *Cadbury Schweppes* case. The European Court of Justice has unfortunately remained elusive as to when an arrangement may be considered only wholly artificial and intended to escape the national tax which is normally payable. What is the minimum level for controlled companies for carrying on genuine economic activities in the host Member State? This must be put in more concrete terms in order to be applicable.

Opinion Standards for Tax Practitioners Under U.S. Department of the Treasury Circular 230

Michael J. Desmond

1. Background

Practitioners[1] who appear before the Internal Revenue Service (IRS) are subject to the practice standards published in Treasury Department Circular 230.[2] These standards cover "matters connected with a presentation to the Internal Revenue Service … relating to a taxpayer's rights, privileges, or liabilities under laws or regulations administered by the Internal Revenue Service."[3] The Circular 230 standards apply to a broad range of practitioner conduct, including matters such as practitioner due diligence, conflicts of interest, fees, and the provision of tax advice. Circular 230 also contains sanction provisions that apply when the practice standards are violated and procedural rules governing disciplinary proceedings. The rules set forth in Circular 230 are administered and enforced by the Director of the Office of Professional Responsibility.

Under the U.S. tax system, practitioners – attorneys and accountants in particular – are largely self-governing professionals not subject to active oversight by any regulatory agency. This system of self-governance has generally served the tax system well, and plays an integral part in the self-reporting regime that has consistently achieved a compliance rate in the United States of nearly 85 percent. Nevertheless, at various times the self-regulating nature of the practitioner community has broken down, leading to abusive practices by a small number of individual practitioners whose actions have threatened to erode public confidence in the U.S. tax system. In response, on several occasions, the Treasury Department and IRS have tightened the Circular 230 standards addressing the provision of tax advice by practitioners.

---

1 "Practitioners" are defined by Circular 230 to include attorneys, certified public accountants, enrolled agents and enrolled actuaries. Treasury Department Circular 230 (31 C.F.R. 330) (hereinafter "Circular 230"), §§ 10.2(d) and 10.3.

2 Statutory authority to promulgate the regulations published in Circular 230 is provided by 31 U.S.C. § 330.

3 In section 822(b) of the American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1587, Congress confirmed that the Treasury Department has authority to regulate under Circular 230 the rendering of written tax advice, amending 31 U.S.C. § 330 to provide:

> "Nothing in this section or in any other provision of law shall be construed to limit the authority of the Secretary of the Treasury to impose standards applicable to the rendering of written advice with respect to any entity, transaction plan or arrangement, or other plan or arrangement, which is of a type which the Secretary determines as having a potential for tax avoidance or evasion."

The focus of this paper is on the advice standards set forth in Circular 230 and the evolution of those standards over the past three decades. In particular, this paper will discuss amendments to the advice standards made to respond to the growth of abusive tax practices in the early 1980s and late 1990s. The advice standards are, however, only one part of a multi-faceted effort by the Treasury Department and the IRS to address abusive tax transactions. The Treasury Department and the IRS have also actively worked to improve transparency with respect to potentially abusive tax transactions, recognizing that disclosure and early notification to the IRS regarding aggressive tax planning plays a critical role in addressing problematic tax shelters at an early stage. To advance this goal, Congress recently amended the tax shelter disclosure and related penalty provisions in the Internal Revenue Code (26 U.S.C. ("the Code")),[4] and the Treasury Department and IRS have been active in issuing regulations under these statutory provisions.[5]

2. 1984 Modifications to Circular 230 to Address Tax Shelters

Circular 230 has, for many years, contained a general due diligence rule that covers a wide range of practitioner conduct, including oral and written tax advice.[6] However, the general rule does not give specific guidance on what due diligence means in the context of tax advice rendered with respect to potentially abusive transactions. In 1984, culminating what at the time was a multi-year process, the Treasury Department and IRS finalized a set of tax shelter standards in Circular 230 that tightened the rules about written tax advice in the context of abusive transactions, building on the existing general due diligence standards.[7] Enactment of these standards (the

---

4 In October 2004, President Bush signed the American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 (the Jobs Act). The Jobs Act made a number of amendments to the statutory provisions requiring disclosure of potentially abusive tax transactions, including Code sections 6111 and 6112. The Jobs Act also enacted new Code section 6707A, which imposes a penalty on taxpayers who fail to properly report a transaction to the IRS in accordance with rules promulgated under Code section 6011. The Jobs Act also enacted a new accuracy related penalty in Code section 6662A, which applies to deficiencies in tax arising from transactions required to be reported under the section 6011 regulations.

5 Most recently, on November 2, 2006, the Treasury Department and IRS published several sets of proposed (and, in some respects, temporary) regulations updating the "reportable transaction" regulations published under Code sections 6011, 6111 and 6112. *See* 71 Federal Register (F.R.) 64456 (temporary regulations relating to letter ruling requests to the IRS with respect to reportable transactions); 71 F.R. 64488 (proposed regulations relating to the categories of reportable transactions taxpayers are required to disclose to the IRS); 71 F.R. 64496 (proposed regulations relating to material advisor obligations to register reportable transactions with the IRS); 71 F.R. 64501 (proposed regulations relating to material advisor obligations to maintain "lists" with respect to reportable transactions).

6 Circular 230, § 10.22 (diligence as to accuracy). Section 10.22 provides, in relevant part, that "[a] practitioner must exercise due diligence … [i]n determining the correctness of oral or written representations made by the practitioner to clients with reference to any matter administered by the Internal Revenue Service."

7 Regulations Governing the Practice of Attorneys, Certified Public Accountants, Enrolled Agents, and Enrolled Actuaries Before the Internal Revenue Service, 31 C.F.R. Part 10, 49 F.R. 6719-01 (Feb. 23, 1984).

"1984 Tax Shelter Standards") was driven by the proliferation of marketed, individual tax shelters in the late 1970s and early 1980s. The 1984 Tax Shelter Standards were patterned after American Bar Association (ABA) Formal Opinion 346 (1982) (which was put forth in response to a 1980 Treasury Department proposal), and were directed at the types of marketed tax shelters prevalent at that time, typically involving wealthy individuals claiming passive losses generated by investments in limited partnerships. More specifically, the 1984 Tax Shelter Standards were targeted to marketed shelter opinions intended to be included or described in tax shelter offering materials that were prepared for the purpose of soliciting investments in transactions designed to produce significant tax benefits. The 1984 Tax Shelter Standards adopted the following definition of the potentially abusive transactions to which they were directed (with certain enumerated exceptions, such as tax-exempt bonds):

> "A 'tax shelter,' as the term is used in this section, is an investment which has as a significant and intended feature for Federal income or excise tax purposes either of the following attributes: (i) Deductions in excess of income from the investment being available in any year to reduce income from other sources in that year, or (ii) credits in excess of the tax attributable to the income from the investment being available in any year to offset taxes on income from other sources in that year. . . . Whether an investment is intended to have tax shelter features depends on the objective facts and circumstances of each case. Significant weight will be given to the features described in the offering materials to determine whether the investment is a tax shelter."[8]

The 1984 Tax Shelter Standards required that, for opinions rendered with respect to a tax shelter (as defined), the practitioner rendering the opinion had to (1) make an inquiry as to all relevant facts, (2) be satisfied that the material facts were accurately and completely described in the offering materials, and (3) assure that any representations as to future activities were clearly identified, reasonable, and complete. The 1984 Tax Shelter Standards also required that the practitioner relate the law to the actual facts of the transaction and, when addressing issues based on future activities, clearly identify what facts were assumed. In addition, the practitioner was obligated to ascertain that all material Federal tax issues had been considered and that any material issues raising the reasonable possibility of a challenge by the IRS were fully and fairly addressed. Finally, the 1984 Tax Shelter Standards required that the practitioner, where possible, render an opinion as to whether it was "more likely than not" that an investor would prevail on the merits of each material tax issue if there was a reasonable possibility of challenge by the IRS.

The 1984 Tax Shelter Standards responded to the proliferation of individual, marketed shelters because tax opinions rendered with respect to those shelters (often provided to the marketer of the transaction, rather than the taxpayer directly) gave investors comfort that their tax-structured investments would be sustained if challenged by the IRS or, if not sustained on their merits, would not be subject to penalties. In part, this comfort derived from the facts and circumstances-based "reasonable cause" defense that could be asserted by the investor in response to an IRS

---

[8] 49 F.R. 6723.

assertion of penalties.[9] Although this comfort was often misplaced, in rendering opinions with respect to marketed transactions, practitioners played a key role in facilitating the proliferation of abusive transactions.

When the 1984 Tax Shelter Standards were published, many commentators were critical of the definition of tax shelters subject to the heightened opinion standards, arguing that it was too broad, caught too many non-abusive transactions, and should be amended to cover only the narrower set of transactions subject to accuracy-related penalties under former Code section 6661. However, because the 1984 standards were general in nature and did not dictate specific elements that had to be included in written tax advice, they had only an indirect immediate impact on practitioners.

Soon after promulgation of the 1984 Tax Shelter Standards, Congress stepped in to address the broader problem of marketed, individual shelters by enacting the passive activity loss rules in Code section 469.[10] The passive activity loss rules were successful in making the abusive transactions then prevalent economically unfeasible, regardless of whether their promised tax benefits were sustained. As a result, for the next decade, marketed tax shelters fell out of fashion and the pressure to use Circular 230 to address the problem of abusive tax transactions abated.

3. The "Technical Tax Shelter" Problem of the 1990s

After a 10-year hiatus, the tax shelter phenomenon returned to prominence in the late 1990s, driven in part by rising financial markets, which created demand for new and aggressive ways to shelter income from tax. Combined with a shift away from the individual shelters of the 1980s toward complex shelters marketed by sophisticated law firms and accounting firms, there arose an unacceptable and growing level of tax avoidance behavior.[11] A small number of unscrupulous practitioners played a key role in facilitating the tax shelters that emerged in the 1990s, with their written opinions on complex aspects of the tax law often being sold to taxpayers as providing a risk-free defense to any assertion of penalties by the IRS. Absent a strong penalty deterrent (or the perception of a strong penalty deterrent), many taxpayers saw little disincentive to investing in abusive transactions.

Unlike the individual tax shelters of the early 1980s (which were often premised on accelerated depreciation deductions generated by limited partnerships), the tax shelters utilized by corporations and high net worth individuals in the 1990s (sometimes referred to as "technical tax shelters") took numerous forms. Irrespective of their form, the technical tax shelters were not classified as tax shelters under the outmoded definition of the term found in the 1984 Tax Shelter Standards. Because these

---

9 *See* 26 U.S.C. (Code) § 6664.

10 Congress enacted section 469 as part of the Tax Reform Act of 1986, Pub. L. No. 99-514, § 501(a), 100 Stat. 2085.

11 The pervasive nature of the tax shelter problem in the late 1990s was reflected in the popular press. Illustrative of the problem was a 1998 cover story in Forbes magazine was devoted to the "thriving industry of hustling corporate tax shelters." NOVACK/SAUNDERS, "The Hustling of X Rated Shelters", Forbes, December 14, 1998, 198, 203.

technical tax shelters took a variety of forms and exploited anomalies in and among a variety of Code provisions, there was no single proposal that could adequately address them. Thus, the technical tax shelters presented a far different set of challenges than the shelters of the 1980s.

4. Modification of Circular 230's Opinion Standards to Address Technical Tax Shelters

In the late 1990s, the Treasury Department and the IRS began to consider again whether the advice standards of Circular 230 should be tightened to address potentially abusive tax transactions. In doing so, the Treasury Department and the IRS have continued to struggle, as they did in the early 1980s, with ways to focus the advice standards on transactions that present significant potential for abuse, without sweeping too broadly and adversely impacting appropriate tax advice.

The effort to properly target the advice standards has been complicated by a number of factors. The complex and highly technical nature of the tax law does not easily lend itself to a broad ethical rule, but separate rules for different types of abusive transaction are not feasible. An ethical rule that provides only broad and undefined standards, however, provides little comfort to those seeking to comply with the rule, who may not know where lines should be drawn. The uncertainty created by a broad rule is highlighted by the fact that while many abusive tax transactions fail on technical grounds, others can be effectively challenged only on case-specific applications of common law doctrines such as "economic substance," "business purpose," "substance-over-form," and "step transaction." These doctrines often have a taxpayer-specific, subjective element to them, the abuse of which is difficult to target *ex ante* through a set of ethical rules like Circular 230.

More fundamentally, the effort to target tax advice under an ethical rule is made difficult by competing values in tax administration that make it important to craft an ethical rule that is appropriately targeted. Taxpayers have the right to conduct their affairs in a manner that minimizes their tax liability. In doing so, taxpayers must often turn to practitioners for advice and assurance that their transactions and return reporting positions will survive scrutiny by the IRS. When the government establishes an ethical rule governing tax advice, the government indirectly imposes costs and burdens on taxpayers who need that advice. When the costs imposed by the ethical rule fall on advice that would be sustained notwithstanding an IRS challenge, those costs function as a regulatory burden that should be offset by the benefits produced by the ethical rule's effect (prophylactic or remedial) upon "bad" advice. In addition, if tax advisors decline to give "good" advice because of the costs imposed by the ethical rule (hence frustrating those taxpayers who would otherwise enter into the transaction involved), then the government has indirectly obtained a tax result through the ethical rule to which it might not be entitled under the substantive tax law.

4.1 May 2000 Advance Notice Suggesting Changes to Circular 230

On May 5, 2000, an advance notice of proposed rulemaking (the "May 2000 Advance Notice") was published by the Treasury Department and the IRS, announcing a broad review of the Circular 230 regulations.[12] The May 2000 Advance Notice began a multi-year process of considering how Circular 230 could be used effectively to target potentially abusive tax transactions and address through the practitioner ethics rules the technical tax shelters of the 1990s.[13]

The Treasury Department and the IRS received a number of comments in response to the May 2000 Advance Notice. With respect to the tax shelter opinion standards in Circular 230, commentators recommended that new standards be promulgated covering opinions rendered for the purpose of establishing a reasonable cause and good faith defense to the accuracy-related penalties under section 6662 of the Code ("reasonable cause opinions"). These commentators suggested that standards for such opinions impose factual due diligence requirements that would restrict the reliance on hypothetical facts or factual assumptions. Some commentators also suggested that reliance on factual assumptions regarding the business purpose or noneconomic consequences of a transaction be treated as inherently unreasonable. Comments also were received on whether and to what extent reliance in an opinion on taxpayer representations or certifications should be permitted and the conditions under which a practitioner may rely on the opinions of other practitioners.

Several commentators recommended that new opinion standards impose requirements with respect to the legal analysis contained in reasonable cause opinions, particularly that such opinions contain no unreasonable legal assumptions, address all material tax issues, evaluate relevant legal authorities and consider applicable judicial doctrines and statutory and regulatory anti-abuse rules.

Comments also were received as to whether a reasonable cause opinion should unambiguously opine on a comfort level of "more likely than not" or higher, and should state that it is issued to establish a reasonable cause defense for the taxpayer. One commentator suggested that the opinion standards provide that satisfaction of the standards would meet a practitioner's obligations under Circular 230, but would not determine the persuasiveness of, and the taxpayer's good faith reliance on, the opinion. Commentators also suggested that standards be promulgated for written advice used for "marketing" purposes.

---

[12] 65 F.R. 30375 (May 11, 2000).

[13] While working on revisions to Circular 230, Congress, the Treasury Department and the IRS have also focused on changes to substantive tax provisions to address areas of abuse. *See*, *e.g.*, Community Renewal Tax Relief Act of 2000, Pub. L. No. 106-554 , § 309 (enacting Code section 358(h), which provides a statutory definition of the term "liability" designed to address the contingent liability abusive tax transaction identified as a "listed" transaction in Notice 2001-17, 2001-1 C.B. 730).

4.2 January 2001 Proposed Regulations

Taking the comments received in response to the May 2000 Advance Notice into account, on January 12, 2001, the Treasury Department and the IRS published proposed regulations (the "January 2001 Proposed Regulations") addressing numerous aspects of Circular 230, including opinion standards with respect to tax shelters.[14] The January 2001 Proposed Regulations included provisions dealing with: (1) tax shelter opinions rendered at a "more likely than not" level of confidence and tax shelter opinions used to facilitate the marketing of transactions to third parties; (2) requirements for tax shelter opinions; and (3) procedures to ensure compliance with the new tax shelter advice standards.

4.2.1 Tax Shelter Opinions

Two sections of the January 2001 Proposed Regulations provided standards governing tax shelter opinions. New proposed § 10.35 applied to all tax shelter opinions that concluded that the Federal tax treatment of a tax shelter item or items is more likely than not (or a higher opinion level) the proper treatment ("more likely than not opinions"). The proposed regulations also revised § 10.33 to apply to all tax shelter opinions not governed by § 10.35 that a practitioner knows or has reason to believe will be used or referred to by persons other than the practitioner to promote, market or recommend a tax shelter ("marketed opinions").

Under the proposed regulations, the definition of a "tax shelter" conformed to the definition then found in Code section 6662(d)(2)(C)(iii), subject to carve outs for tax-exempt bond and qualified retirement plan opinions. That definition included a broad range of transactions "a significant purpose" of which is tax avoidance or evasion.[15]

4.2.2 Requirements for Tax Shelter Opinions

If a transaction met the broad definition of tax shelter and an opinion with respect to that transaction was a more likely than not opinion or a marketed opinion, the 2001 Proposed Regulations mandated practitioner compliance with a detailed set of rules regarding reliance on factual representations, statements, findings or agreements. The proposed regulations also provided that a practitioner need not conduct an audit or independent verification of a factual representation, but that reliance would not be permitted on factual representations that the practitioner knows or has reason to believe are unreasonable, incorrect, incomplete, inconsistent or implausible. In

[14] 66 F.R. 3276 (Jan. 12, 2001).

[15] Code section 6662(d)(2)(C)(iii) has since been renumbered section 6662(d)(2)(C)(ii). That statute broadly defined a "tax shelter" to include: "(I) a partnership or other entity, (II) any investment plan or arrangement, or (III) any other plan or arrangement, if a *significant purpose* of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax." *Id.* (emphasis added). Prior to 1997, the statute defined "tax shelter" by reference to a narrower category of transactions with a "principal purpose" of tax avoidance or evasion. *See* Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788, § 1028(c) (substituting "a significant purpose" for "the principal purpose").

addition, the proposed regulations contained specific rules regarding the treatment in an opinion of "material Federal tax issues," defined to include issues involving the reasonable possibility of a successful challenge by the Internal Revenue Service. Finally, the proposed regulations included rules requiring the practitioner to articulate the conclusion reached in an opinion, the reasons why that opinion was reached, and the consequences of the opinion, particularly with respect to the impact on potential defenses to penalties that might be asserted by the IRS.

4.2.3 Procedures to Ensure Compliance

Section 10.36 of the January 2001 Proposed Regulations included provisions designed to ensure that the new tax shelter opinion standards were adhered to. Section 10.36 provided that a practitioner who is a member of, associated with, or employed by a firm must take reasonable steps, consistent with his or her authority and responsibility for the firm's practice advising clients regarding matters arising under the Federal tax laws, to make certain that the firm has adequate procedures in place to ensure compliance with the new opinion standards.

4.3 2002 Final Non-Shelter Regulations

Following publication of the January 2001 Proposed Regulations, on July 26, 2002, the Treasury Department and the IRS published a comprehensive set of final regulations (the "2002 Final Non-Shelter Regulations") adopting, with changes, the proposed regulations, but carving out those aspects of the regulations dealing with tax shelter opinions.[16] Based on the large number of comments received on the tax shelter provisions of the January 2001 Proposed Regulations, and the significance of and difficulty in addressing the issue, the July 2002 Final Non-Shelter Regulations noted that the Treasury Department would propose further amendments to Circular 230 specifically addressing tax shelter opinions.

4.4 December 2003 Re-Proposed Shelter Regulations

Responding to comments regarding tax shelter opinion standards provided in connection with both the May 2000 Advance Notice and the January 2001 Proposed Regulations, on December 30, 2003, the Treasury Department and the IRS published re-proposed regulations (the "December 2003 Re-Proposed Regulations"), focused specifically on tax shelter opinion standards.[17]

The standards for tax shelter opinions set forth in the December 2003 Re-Proposed Regulations differed from the January 2001 Proposed Regulations in several important respects. First, § 10.33 was amended to prescribe best practices for all tax advisors. Second, the re-proposed regulations combined and modified the standards applicable to more likely than not and marketed tax shelter opinions, which had been separately stated in §§ 10.33 and 10.35 of the January 2001 Proposed Regulations.

---

[16] 67 F.R. 48760 (July 26, 2002).
[17] 68 F.R. 75186 (Dec. 30, 2003).

Third, the re-proposed regulations added new disclosure requirements applicable to more likely than not and marketed tax shelter opinions.

Many commentators expressed concern with the definition of a "tax shelter" in the January 2001 Proposed Regulations, suggesting that it was too broad in application. Responding to these comments, the re-proposed regulations retained the broad definition (applying to transactions with a significant purpose of tax avoidance or evasion), but created additional exceptions, including an exception for preliminary advice expected to be followed by a more detailed written opinion and a provision allowing "limited scope" opinions that explicitly addressed fewer than all significant Federal tax issues raised by a transaction. The re-proposed regulations also generally retained the detailed requirements set forth in the January 2001 Proposed Regulations applicable to more likely than not and marketed tax shelter opinions.

The re-proposed regulations added provisions requiring practitioners to make specific disclosures regarding more likely than not and marketed tax shelter opinions. These included: (1) disclosures regarding the relationship, if any, between a practitioner and a person promoting or marketing a tax shelter; (2) disclosure that a marketed opinion may not be sufficient for a taxpayer to use for the purpose of avoiding penalties; (3) in a limited scope opinion, disclosure that additional issues may exist that could affect the Federal tax treatment of the tax shelter; and (4) disclosures if the opinion fails to reach a conclusion at a confidence level of at least more likely than not with respect to one or more material Federal tax issues addressed by the opinion.

4.5 December 2004 Final "Covered Opinion" Regulations

In December 2004, the Treasury Department and IRS finalized the December 2003 Re-Proposed Regulations, with changes based on comments received.[18] The final regulations published in December 2004 (the "Final Covered Opinion Regulations") took effect in June 2005 and are (with several revisions made in May 2005),[19] the ethical rules currently in effect governing the rendering of written tax advice with respect to potentially abusive transactions.

Responding to comments, the Final Covered Opinion Regulations narrow the category of transactions to which detailed opinion standards and disclosure requirements apply by replacing the tax shelter trigger (which captured a broad range of transactions with a significant purpose of tax avoidance or evasion) with three "cov-

[18] 69 F.R. 75839.

[19] On April 19, 2005, the Treasury Department and IRS published revisions to the Final Covered Opinion Regulations to carve out from their application (1) written advice provided after a transaction was reported on a tax return (post-return advice), (2) written advice provided by a practitioner in the context of an employee-employer relationship, if the advice related to the tax liability of the employer (in-house counsel advice), and (3) negative written advice. 70 F.R. 28824. The technical corrections also revised the form of disclosure that was required for written advice subject to the heightened covered opinion standards and added a definition of "the principal purpose" to remove from the scope of the covered opinion standards written advice with respect to transactions claiming tax benefits consistent with a particular statute and with Congressional intent. *Id.*

ered opinion" filters that each incorporate elements of potentially abusive transactions. Under the final regulations, the detailed opinion standards apply to written advice falling into any of the following three filters:

1. Listed Transactions;[20]
2. Principal Purpose Transactions; and
3. Significant Purpose Transactions that involve:
   a. a reliance opinion (*i.e.*, an opinion reaching a "more likely than not" conclusion with respect to a "significant Federal tax issue");
   b. a marketed opinion;
   c. a confidentiality provision; or
   d. a contractual protection provision.

Consistent with the December 2003 Re-Proposed Regulations, the Final Covered Opinion Regulations exclude from the definition of covered opinions certain transactions that do not present a significant potential for abuse. In addition, in certain circumstances, the final regulations permit an "opt out" if appropriate reference is made to the fact that the written advice cannot be used for purposes of penalty protection. Under the Final Covered Opinion Regulations, written advice that triggers one of the three filters is subject to detailed opinion requirements and disclosures similar to those set forth in the December 2003 Re-Proposed Regulations.

For all written advice that does not trigger one of the three covered opinion filters (regardless of its connection to a potentially abusive transaction), § 10.37 of the Final Covered Opinion Regulations has a default rule imposing general opinion standards. These general standards mirror in many respects the covered opinion rules, but without the detailed documentation requirement for elements of the written advice that are mandated for covered opinions.

5. Next Steps: The Ongoing Role of Circular 230 in Addressing Potentially Abusive Transactions

Since publication of the Final Covered Opinion standards in December 2004, the Treasury Department and the IRS have received numerous comments on the regulations, most of them critical of the scope of the new standards. In particular, commentators have noted the complex nature of the covered opinion filters, which often require a detailed analysis of a transaction in order to determine whether the covered opinion standards apply to begin with. In addition, commentators have noted that a literal reading of the covered opinion filters could subject a broad range of written material to the covered opinion standards in situations that present little potential for abuse. These include disclosures mandated by Federal securities laws, written statements to employee plan participants regarding tax aspects of their benefits, and

[20] Under Treas. Reg. (26 C.F.R.) § 1.6011-4(b)(2), "listed transactions" include transactions that are the same as or substantially similar to one of the types of transactions that the IRS has determined to be tax avoidance transactions and identified in published guidance as listed transactions.

solicitations by charitable organizations that reference the Federal tax law. Commentators have also been critical of the "mass legending" that has resulted from the provision that permits a practitioner to "opt out" of the covered opinion standards by including a statement that written advice cannot be used for penalty protection purposes.

While some changes to the covered opinion standards may be appropriate in order to ensure that the opinion standards are properly targeted, any modifications will have to take into account the positive effect that the standards have had over the past two years. In particular, the covered opinion standards have had the intended effect of causing practitioners to conduct a more critical examination of their written tax advice, including questioning more closely the basis for taxpayer representations of fact and the basis for assumptions that are an integral part of any written tax advice. Practitioners and taxpayers have, since publication of the Final Covered Opinion Regulations, also focused more directly on the role that tax advice plays in providing a potential defense to penalties.

Opinion Standards for Tax Practitioners Under U.S. Department of the Treasury Circular 230 – Comment on the paper by Michael J. Desmond

Tobias Beuchert

1. The Underlying Problem Addressed by Circular 230

For a full understanding, Circular 230 has to be viewed in the context of the U.S. civil penalties system and its good faith exemption. Because this is where the problems that Circular 230 attempts to address with its advice standards arose.

Admittedly, Europe, too, has its good share of tax opinions that fail to meet ordinary quality standards and of off-the-shelf tax opinions that do not evaluate the pertinent factual aspects of the taxpayer concerned. The reasons for this are manifold: Overly positive tax opinions are used to enhance the marketing of certain tax shelters; they are formulated as a backing for a discussion with tax authorities about the correct treatment of a transaction under substantive law; sometimes they are even meant to be a safeguard against the accusation of tax evasion.

However, it seems that the problem with tax opinions in the United States is decidedly more serious. This is because the civil penalties system and its good faith exemption give an important additional incentive to abuse a tax opinion as a basis for defense instead of a source of objective legal advice to the taxpayer.

It is agreed that civil penalties systems have much allure in the tax shelter context. But whenever policymakers ponder their implementation, they will be prompted to consider a good-faith exemption as the most obvious tool to not unduly burden the taxpayer with the insecurity that goes along with ever more complicated tax law, and consequently they will have to bear in mind what unintended incentives this exemption creates for inadequate tax opinions.

2. The Adequacy of the Solution Offered by Circular 230 in its Current Form

It is fair to say that the 2004 revision of Circular 230 has not received a warm welcome by the U.S. tax practice. This is probably not surprising, given the fact that Circular 230 poses considerable additional burden and risk on tax practitioners. However, the sheer amount of specific criticism is remarkable: It includes the allegation that Circular 230 has resulted in nothing more but a profusion of disclaimers in tax advisors' e-mails and other written correspondence, thereby leaving taxpayers in total confusion.[1] It is contended that Circular 230 is insufficiently aligned with the

---

[1] RABY/RABY, Accuracy-Related Penalties and Circular 230 Caveats, 110 Tax Notes 239, 241 (2006).

civil penalties system.[2] Others argue that it infringes the First Amendment of the United States Constitution.[3] Some commentators claim that the revision of Circular 230 has created by far the biggest current problem for a nonshelter tax practice.[4] The list of complaints could be extended for much longer.

Some of the complaints may be misguided or exaggerated. Others appear to be more valid. I would like to expound only on the following two aspects, of which I have the impression that they crystallize general aspects that go beyond the discussion of Circular 230 itself.

2.1 Circular 230's Overreach

Given the fact that the cause for the current problem was taxpayers trying to claim the good faith exemption under the civil penalties system based on inadequate tax opinions and advisors issuing tax opinions accordingly, it appears that the most obvious solution to the problem would have been just simply to concretize and tighten the requisites for tax opinions in the civil penalties system itself. The disqualified opinions rules[5] that complement the disqualified tax advisors rules mentioned by Prof. Shaviro would have been the ideal place to do exactly that.

The U.S. Treasury decided otherwise and opted for Circular 230 as the place to tackle the problem. And they did not content themselves with tightening the requirements for a defense to penalties. Rather, Circular 230 seems to pursue a three-fold objective. And, even more importantly, these different aims result also in three parallel mechanisms:

First, as just said, the threshold for civil penalties' good faith exemption is being raised by detailed minimum requirements for tax opinions. The second aim appears to be improving consumer, *i.e.* taxpayer, protection. In particular, the opt-out and disclaimer system, according to which, whenever a written tax advice does not fulfill all requirements of Circular 230, a disclaimer stating that this advice will not be sufficient basis for good faith exemption has to be included, cannot be explained but with the aim to inform and protect the taxpayer. The third objective apparently is to directly tackle the tax shelter market from the (opinions) supply side. This is highlighted by the virtual prohibition of some kinds of tax opinions altogether, like limited scope opinions or informal written tax advice in relation with transactions with the principal purpose of tax avoidance. Michael Desmond hinted at this third approach by noting that the government could indirectly through the ethical rule obtain a tax result to which it might not be entitled under substantive law.

---

[2] BERG, Practitioners' Reaction Indicates Need for Clearer Circ. 230 Rules, 108 Tax Notes 245, 245 (2005).

[3] SCHENK, The Circular 230 Amendments: Time to Throw Them Out and Start Over, 110 Tax Notes 1311, 1315 *et seq.* (2006); BLATTMACHR/GANS/ZEYDEL/BENTLEY, Circular 230 Redux: Questions of Validity and Compliance Strategies, 107 Tax Notes 1533, 1534 *et seq.* (2005).

[4] SCHLER, Effects of Anti-Tax-Shelter Rules on Nonshelter Tax Practice, 109 Tax Notes 915, 918 (2005).

[5] *See* U.S. Internal Revenue Code, section 6664(d)(3)(B)(iii).

In my opinion, it is the coexistence of these three aims and mechanisms that has caused the biggest troubles. For two reasons: First, it is my impression that this coexistence is the actual basis for the enormous complexity that is noted by so many commentators; above all, because the three different mechanisms are by no means distinctly stated but rather largely interwoven within the very same section 10.35. Second, these three different approaches even tend to conflict with one another. For example, the opt-out system has resulted in a profusion of disclaimers. Because, to play safe, many advisors put them just simply on all tax advice, including advice that is not even covered by Circular 230 or that, conversely, fulfills all requirements stated by Circular 230. This results not merely in confusion amongst taxpayers, but also blurs the line regarding the good faith exemption. For is a taxpayer still acting in good faith relying on an opinion that – incorrectly – tells him he must not rely?[6] Another conflict is caused between the restriction on various kinds of advice, such as informal written advice in certain circumstances, and the aim to better protect the taxpayer. Is oral advice preferable from a consumer protection viewpoint to a short notice via e-mail?

Short, the revision of Circular 230 in this respect somehow appears to be a telling example of rules that attain less than possible by striving for too much at a time.

2.2 Circular 230 in the Light of Over- and Under-Inclusion

As Michael Desmond pointed out, the more recent modifications of Circular 230, above all its section 10.35, which is at the very center of all criticism directed against Circular 230, are targeted at the tax shelter problem. So what one consequently would expect when looking at the rules, is a definition of "tax shelter". However, this one will not find. Whereas the proposed shelter regulations of 2001 and 2003 contained such a definition, all one will find in the current version as of 2004 is a definition of "covered opinion", specifying the scope of application. This is not only a question of wording; rather, the decision against the heading "tax shelter opinion" appears to be deliberate and in conformity with the content of section 10.35. Because, when looking at what kind of opinions are covered, one will notice that it will, for example, be sufficient that the transaction concerned has a significant purpose of tax avoidance and that the opinion concludes on a more-likely-than-not confidence level. Both will be true for many transactions and opinions that have nothing to do at all with tax shelters.

Is Circular 230 therefore unduly over-inclusive, pretendedly aiming at tax shelters but apparently encompassing also many nonshelter situations? This is one of the points of criticism voiced most often in the discussion on Circular 230.[7]

But the answer to this question is by far not as easy as it may seem. Because it leads to the question of what a tax shelter actually is and how to design anti-shelter measures.

---

6 *See* RABY/RABY, *supra* note 1, at 241, and SCHENK, *supra* note 3, at 1313.

7 SCHENK, *id.*; NEW YORK STATE BAR ASSOCIATION TAX SECTION, Recommendations for Improving the Circular 230 Regulations, 107 Tax Notes 91, 91 (2005); SCHLER, *supra* note 4, at 919.

While studying the literature on tax shelters and on the various international approaches to tackle them, I have gained the impression that not only is there no universal definition of what a tax shelter actually is, but also that such a universal tax shelter definition cannot even reasonably be expected to be construed. Admittedly, we know common traits of tax shelters, like little or no economic substance or business justification, conflict with the legislator's deliberations or the objective purpose of the law, high complexity, and exploitation of asymmetries or abnormalities in the tax system. But common traits do not as yet constitute a precise and comprehensive definition. Just to mention two problems: Unfortunately, many abnormalities in the tax system are actually intended by the legislator; if so, the fact that the taxpayer strives to secure such a benefit for sole tax purposes obviously does not result in a tax shelter. Other undesirable transactions that from a policy viewpoint are clearly abusive, like many double-dip transactions, are founded on the interplay of different unrelated set of rules in one tax system or even more than one tax systems, so that there is no distinct common purpose the transaction could conflict with.

What is the consequence of this observation? I think it entails three things:

First, I reckon that we should accept that there never will be a perfect and universally applicable definition of a "tax shelter" and that we are rather dealing with a slightly vague and elusive policy concept instead of a definite legal term.

Second, in each specific anti-shelter measure, be it construed by way of legal precedent, statute or regulation, there still will be a specific and distinct concept of tax shelter – implied or expressly defined. The acknowledgement that we cannot define a tax shelter in a universally applicable way is thus not *per se* a reason to fret about uncertainty and ambiguity in tax law. This is due to the fact that it, of course, does not relieve from the obligation to accurately design this specific anti-shelter measure and to strive for a most suitable concept of tax shelter in the specific case at issue.

Third, the specific anti-shelter measure will, by way of necessity, be either under- or over-inclusive compared with the elusive general concept of a tax shelter, which it will never fully match. We have to accept that over-inclusion of a tax shelter measure is not *per se* a valid basis for criticism. In some situations over-inclusion might not be harmful or might even be desirable, whereas in other situations it can hardly be justified, so that, there, the aim can only be the least under-inclusive legal design.

I would like to give two examples:

The world's general anti-avoidance rules are an apparent example of under-inclusive tax shelter measures. Whether codified or not, they usually stress the lack of business purpose or substance and the lack of conformity with the legislator's deliberations or the objective purpose of the law.

However, there are many transactions that are actual tax shelter transactions, but that cannot be treated as such under the general anti-avoidance rules, because, for example in the case of substance requirements, – to use Prof. Shaviro's words – the taxpayer performs some extra back-flips to meet these just.

The German Federal Tax Court has recently issued a ruling that tellingly highlights the innate limitations of general anti-avoidance rules.[8] A classic prearranged tax avoidance transaction was at issue that had as its sole aim the obtention of a tax advantage, and that was uniformly implemented by numerous taxpayers. The transaction was based on a combination of, first, the acquisition of a share in a corporation at a price much exceeding the real value of the share and, second, a one-time dividend distribution of this corporation to the new shareholder almost equaling the inflated share price. As a result, it was possible to mobilize imputation credits under the imputation system, which was prevailing in Germany's corporate taxation before 2001. The Court – perfectly in line with its own precedents and case law in other tax systems – noted that the fact alone that a transaction was tax-driven would not result in it being disregarded as long as there was no abuse of tax law. The Court could not discern such an abuse of law, that is a conflict with the law's purpose. Rather, each step of the transaction was in conformity with the purpose of the respective specific tax rule; and the Court declined to disregard the different steps based on a step transactions approach, because the transaction was effected by different parties to the transaction that, though acting following a common plan, were not legally obliged to act accordingly.

These problems demonstrate that, without even having to take recourse to concepts of judicial self-restraint or textualism, general anti-avoidance rules will always be distinctly under-inclusive.

The situation with tax shelter disclosure rules is converse. They capture much more than actually abusive transactions. The recently proposed addition to the U.S. rules, the category of transactions of interest, largely highlights this fact.[9] Likewise, the U.K. hallmarks do not only address actual tax shelters, but also transactions with nothing but a certain potential for abuse. Tax shelter disclosure rules thus are openly over-inclusive. It is even the declared and legitimate aim of tax shelter disclosure rules to bring to tax authorities' attention transactions that could be, but need not be tax shelters.

The evaluation of Circular 230 in this context is complex. The prohibition of certain kinds of tax advice is adequately restricted to situations with a strong tax shelter potential, encompassing listed transactions, transactions with the principal purpose of tax avoidance and marketed opinions only. The U.S. Treasury occurs to have been aware that an over-inclusion in this context would have been especially difficult to justify.

However, the areas of application for the other two mechanisms, *i.e.* raising the threshold for the tax opinion-based exemption from civil penalties and consumer protection by way of disclaimers, are clearly over-inclusive. A justification is not

---

8 German Federal Tax Court, June 28, 2006, I R 97/05, 2006 DStR 1938 – *Rücklagenmanagement*; confirming a lower tax court's decision (Tax Court of Münster, August 19, 2005, 9 K 5138/02, 2006 EFG 205), but dissenting from another lower tax court's decision (Tax Court of the State of Hesse, March 2, 2005, 4 K 2223/02 *et al.*, 2005 EFG 1587); digressing also from a Decree of Non-Application by the German Federal Ministry of Finance (BMF, December 7, 2000, IV A 2 – S 2810 – 4/00, 2001 BStBl. I 47).

9 Proposed Treasury Regulations § 1.6011-4(b)(6), November 2, 2006, 71 FR 64488.

apparent. Because nonshelter transactions, being sustained under substantive law (that tends to be under-inclusive), will never be threatened by civil penalties anyhow. Why then should they, too, be subject to the tightened requirements of Circular 230? And why should a taxpayer be informed about the ability of a tax opinion to serve as a basis for good faith in situations outside the realms of tax shelters, that is without a manifest risk of civil penalties? Requiring advisors to include disclaimers also in opinions on transactions with only a remote tax shelter potential not only burdens them without any visible advantage for the taxpayers or the fisc. The omnipresence of disclaimers also much impairs the positive impact such a disclaimer could have on taxpayers in actual tax shelter transactions. In this respect, the makers of Circular 230, as usually having had to choose between over- and under-inclusion, should better have preferred under-inclusion.[10]

[10] The NEW YORK STATE BAR ASSOCIATION TAX SECTION also favoured this restricted opt-out approach; *see supra* note 7, at 93 and 96.

Opinion Standards for Tax Practitioners Under U.S. Department of the Treasury Circular 230 – Comment on the paper by Michael J. Desmond

*Paul Morton**

Very early in his eminently clear and thought provoking paper, the author notes that tax practitioners are largely self-governing in the U.S.; a system which has served the U.S. well. Similar remarks have been made in the U.K. by Her Majesty's Revenue & Customs and government Ministers. Although international experience varies between regulated environments such as that in Germany and wholly unregulated states such as The Netherlands it is fair to say that the generally accepted parameters of professional behavior and the quality of tax education is determined in every case by the profession itself. There are therefore limits as to what can be achieved through regulation and the ultimate prize is to win the hearts and minds of the overwhelming majority of tax practitioners.

It becomes evident early on in almost any discussion of tax shelters or tax avoidance that the quality of the debate is easily debased by a lack of definition. The author quotes the definition of a potentially abusive transaction in the 1984 Tax Shelter Standards which notes that "whether an investment is intended to have tax shelter features depends on the objective facts and circumstances of each case". By implication, a general definition is impractical. A report on "Tax Avoidance" by the U.K. Tax Law Rewrite Committee in November 1997 noted that "we think it impossible to define the expression 'tax avoidance' in any truly satisfactory manner". The absence of definition in this area is troubling. Most observers would agree that since tax is an imposition on the taxpayer by the state it should only be exigible where there is a clear and unambiguous obligation to pay according to the laws promulgated by the legislature. This approach respects principles of certainty, predictability and fairness which are ancient principles of law. Adam Smith described such principles in his 1785 publication the "Wealth of Nations" which pre-dated the world's first income tax by some fourteen years.

The lack of definition is perhaps not surprising given that quite similar cases with subtle differences in facts and circumstances may call for different conclusions. Authorities and practitioners tend to have different views. In fact practitioners can by no means agree among themselves and there can be wide differences of opinion among officials within the same tax authority. The Courts tend to be unpredictable to varying degrees so it is tempting to conclude that the question of defining tax avoidance or tax shelters is too difficult to be worth attempting.

---

* The views offered in this response are personal and do not necessarily represent those of the Confédération Fiscale Européenne or of Reed Elsevier. Notice: This document was not intended or written to be used, and it cannot be used, for the purpose of avoiding U.S. federal, state or local tax penalties.

However, although it may not be for us to finish this particular task it must certainly be attempted. Interestingly, there is no self-evident definition of "income" which in a sense leaves every corporate and individual income tax in the world without a proper foundation. Centuries of argument and debate have left us now with quite a good set of principles and definitions as to what is income both for financial reporting and for tax purposes. We must therefore undertake further international research and discussion on the meaning of "tax shelter" and "tax avoidance" in the hope of developing underlying principles which might even lead to the adoption of international standards as has been done so effectively in relation to transfer pricing in the form of the OECD Guidelines.

The author refers to the "technical" tax shelter problem. "A small number of unscrupulous practitioners played a key role in facilitating the tax shelters that emerged in the 1990s, with their written opinions on complex aspects of the tax law often being sold to taxpayers as providing a risk-free defense to any assertion of penalties by the IRS."

It is interesting to reflect on the position which, say, a large corporate taxpayer finds itself when approached by an adviser with a technical tax shelter proposal. Perhaps the company will need to weigh two key considerations. On the one hand it needs to remain competitive and to provide the maximum possible return to the shareholder. Indeed, if it fails in this regard the consequences could be serious for all stakeholders in the company whether they be employees, suppliers, customers, shareholders or, of course, the state which relies on the tax revenues. On the other hand, the company will be exercising principles of sound governance, behaving in a responsible manner, perhaps with an eye to specific aspects of corporate social responsibility. It will be considering its reputation with fiscal authorities and also with other stakeholders including the general public.

A large company will certainly wish to avoid adverse publicity whether it arises through leaks of information, disclosures arising from legal proceedings, its financial statements and regulatory disclosures or other sources. Any company subject to the Sarbanes Oxley requirements will certainly wish to avoid having to disclose a material weakness in its internal controls and such a disclosure might be obligatory following a large and unanticipated reversal of a tax shelter strategy. Disclosures have been more frequent in the tax accounting area than in any other area of financial reporting and there is evidence that the share price falls following a disclosure. There are reports of tax directors and their advisers falling out with the companies concerned when disclosures are required.

The author then notes that "the effort to properly target the advice standards has been complicated by a number of factors. The complex and highly technical nature of the tax law does not easily lend itself to a broad ethical rule, but separate rules for different types of abusive transaction are not feasible. An ethical rule that provides only broad and undefined standards, however, provides little comfort to those seeking to comply with the rule, who may not know where lines should be drawn …"

He continues "more fundamentally, the effort to target tax advice under an ethical rule is made difficult by competing values in tax administration that make it important to craft an ethical rule that is appropriately targeted. Taxpayers have the right to

conduct their affairs in a manner that minimizes their tax liability. In doing so, taxpayers must often turn to practitioners for advice and assurance that their transactions and return reporting positions will survive scrutiny by the IRS. When the government establishes an ethical rule governing tax advice, the government indirectly imposes costs and burdens on taxpayers who need that advice. When the costs imposed by the ethical rule fall on advice that would be sustained notwithstanding an IRS challenge, those costs function as a regulatory burden that should be offset by the benefits produced by the ethical rule's effect (prophylactic or remedial) upon "bad" advice. In addition, if tax advisors decline to give "good" advice because of the costs imposed by the ethical rule (hence frustrating those taxpayers who would otherwise enter into the transaction involved), then the government has indirectly obtained a tax result through the ethical rule to which it might not be entitled under the substantive tax law."

The respondent strongly agrees with all of these comments which have been very well made. It has been said by some tax officials that uncertainty and vagueness are better than bright lines in this area because a bright line would only encourage companies to approach it more closely than they will the vague boundaries of a minefield. This is probably true but it is not the best solution to this problem because of the burden it places on the more responsible taxpayers.

Before considering the difficult question as to whether or not ethics are really relevant in this context it is perhaps appropriate for a brief digression on the question of cost. Tax advice is already costly for large corporates, for small and medium sized enterprises and for individuals. Clearly the tax profession calls for deep knowledge, intelligence, excellent communication skills, forensic skills, numeracy and other desirable qualities which command a certain premium. However, the issue is compounded by the burden of other regulation in areas such as money laundering, auditor independence, regulatory aspects of Sarbanes Oxley, the extreme complexity of financial reporting requirements and the ever increasing complexity of tax law and practice. In a recent case, the respondent attempted to secure professional tax advice for a particular class of individuals in relation to the tax treatment of certain items of their remuneration as employees. Once the cost to a professional adviser of complying with money laundering checks and then preparing properly to provide the advice through ascertaining the full facts and applying the law in a manner analogous to that required by Circular 230 had been taken into account it was impossible to construct an arrangement in which the fee was less than the worst-case tax cost. Fortunately, the individuals concerned could probably rely on free advice from the fiscal authority in question.

Returning to the question of ethics it is immediately apparent that, once again, there are no clear answers. Most observers would agree that tax fraud involves dishonest behavior to some degree and is clearly unethical and the very large majority of tax advisers and practitioners regard such behavior as repugnant. Most observers would also agree that it is simply impossible to bring any consideration of ethics to bear on a purely technical question. Where there is a considerable range of views is whether ethics are applicable to the more complex questions. Without much further debate and reflection it is difficult to draw conclusions. The Courts in the U.K. have

suggested that there is no underlying "spirit" behind the tax legislation to which one might apply an ethical standard. Perhaps an important observation, however, is that much damage can be, and has been, done to the necessary good relationship between fiscal authorities and tax practitioners and taxpayers by an inappropriate use of arguments based on ethics. Certainly, tax authorities should be cautious before accusing professionals of unethical conduct. Equally, one would expect a professional to take great care to behave ethically at all times. The marketing of an aggressive tax shelter to an unknowing and innocent taxpayer hardly seems to be on the right side of the ethical line.

Returning briefly to the position of a large corporate taxpayer there is no doubt that it has a general obligation to maximize the return to shareholders. The tax contribution to achieving this goal is to minimize tax liabilities and costs. However, importantly, shareholders, in most cases, place more importance on sustainability and predictability than on short-term gains so a short-term tax strategy which ultimately increases the tax burden through damaged relationships and wasted management time will not be appreciated. Increasingly, investors are looking for both the pre-tax and post-tax earnings to be competitive and the chief financial officer or finance director must be able to explain the tax position of the company to the investors in a transparent manner. What is not clear yet is whether investors are looking for a "responsible" tax rate although they would expect to see a rate which was neither unrealistically low nor consistently higher than the competition.

An example of a tax rate that, in hindsight, was wholly beyond any acceptable explanation is contained in the excellent report: "Written Testimony of the Staff of the Joint Committee on Taxation on the Report of Investigation of Enron Corporation and Related Entities regarding Federal Tax and Compensation Issues and Policy Recommendations".[1] It states that "Enron reported financial statement net income of $2.3 billion, but tax losses of $3 billion for 1996 through 1999".[2] Later it explains that "… from 1995 until Enron filed for bankruptcy, Enron achieved more than $2 billion in tax and financial accounting benefits and paid approximately $88 million in fees paid to advisers and promoters".[3]

Two interesting studies into the attitudes and behaviors of large companies in the U.K. were published by Henderson Global Investors in 2005 and 2006. The first was entitled "Tax, risk and corporate governance".[4] It found, for example, that only one third of companies stated that the board had adopted a documented tax policy for the company. Interestingly, only one third of companies considered their willingness to take on tax risk as being medium or higher. Nearly half felt that they were conservative although nearly one quarter did not respond. An even higher proportion, nearly three quarters, stated that their risk of being challenged in relation to the use of tax havens was low. Perhaps it would be interesting to ask whether this is because they were not employing tax havens or, as seems more likely, their use of tax havens was

---

[1] *See* www.house.gov/jct/x-10-03.pdf.

[2] *Id.*, at 5.

[3] *Id.*, at 7.

[4] *See* www.henderson.com/global_includes/pdf/sri/tax_paper.pdf.

regarded as appropriate and robust. Of particular relevance here, 62% of companies considered that the risk of being challenged in relation to tax avoidance schemes was low, 12% medium and only two companies in the 350 surveyed considered that the risk was high.

While the debate on ethics is hardly advanced and the relevance of the wider aspects of corporate social responsibility is subject to serious debate there is little doubt that tax is now seen as a matter of governance by most companies and an area where responsibility needs to be exercised. Most corporates would accept limitations on their behavior which go beyond the strict requirements of the law. They will refrain from egregious transactions so as not to damage important relationships with officials or to provoke a disproportionate reaction from the legislature. Interestingly, there is a public case for responsibility in this area which precisely mirrors the internal considerations for a company. These were very clearly articulated in the U.S. Treasury White Paper on corporate tax shelters which was published in July 1999. Irresponsible corporate tax activities lead to disrespect for the tax system by corporates and pressure to follow the pack, disrespect by other taxpayers who perceive unfairness, complexity and the uneconomic use of resources. The general public expects the tax burden to be shared "fairly". On the other hand individuals rely on corporates to deliver a satisfactory return in order to meet their expectations of their pension funds, insurance schemes and savings in general.

In conclusion, Circular 230 has clearly been effective and is to be broadly welcomed as an important tool in leveling the playing field for the more responsible companies and individuals. The cost implications need to be close monitored and it is not at all self-evident that the same model would be appropriate in other countries where other approaches have been successfully trialed, such as the new disclosure regime in the U.K. There has not been time here to compare and contrast the various approaches.

Above all, there is an urgent need for more research and discussion on important definitions such as that for "tax shelter" and "tax avoidance" and agreement at international level of the principles and guidelines to be applied.

Shelters, Schemes, and Abusive Transactions: Why Today's Thoughtful U.S. Tax Advisors Should Tell Their Clients to "Just Say No"

Donald L. Korb[*]

1. History of Tax Shelters

1.1 Tax Planning Over the Ages

Tax advisors have been figuring out ways to reduce taxpayers' tax liability forever. In Ancient Rome, farmers of small farms would obtain relief from taxes by transferring their lands to the nearest military chief or large landowner and rid themselves of tax obligations. The peasant farmer was better off. Tied to the land anyway, he could live in the same house, farm the same land, and use the same animals. Only the tax picture had changed; the Roman tax man would now have to deal with the small farmer's master, who had the wherewithal to handle the Roman tax man.[1]

During the Middle Ages in Syria, Egypt and other areas of the Islamic world, the land tax could be avoided by newly conquered native populations if they became Moslems – unfortunately for the tax collectors, mass conversions of native populations to Islam drained off a large percentage of their tax revenue.[2]

In the 1600s, landlords in Russia developed an interesting tax avoidance scheme. A new landlord would pay off a peasant's debt and refinance the peasant on his own land. Poll taxes were based on a census, which was conducted every five years. Before the census was taken, new serfs would not be taxed since they were not on the census rolls. The Russian government eventually had to pass a law preventing this practice.[3]

In Charleston, South Carolina during the first half of the 19th century, real estate taxes were based not on the value of the house or other structure situated on a lot but on the footage of the portion of the lot directly next to the street. Tax planning led to houses being built on deep lots which were very narrow where they fronted the street. Thus, a typical house built during that time might be 10 foot wide but 80 or even 100 feet deep – many of these houses still exist today.

And the search for shelter continues.[4]

---

* This article was originally presented at the University of Cambridge, Cambridge, England, December 14, 2005. As revised to update through February 15, 2007 (thanks to Rebecca Asta, Andrew Keyso and Beverly Katz). This material was designed for informational purposes only. Under no circumstances should the contents be used or cited as authority for setting or sustaining a technical position.

1 ADAMS, For Good and Evil: The Impact of Taxes on the Course of Civilization, 113-114 (1994).

2 *Id.*, at 132.

3 *Id.*, at 169.

4 *See* "The Search for a Safe Tax Shelter", Wall Street Journal, October 13, 2005.

1.2 Tax Shelters: Legitimate Tax Planning vs. Tax Avoidance

As Judge Learned Hand said in *Helvering v. Gregory*:[5]

> "We agree with the Board and the taxpayer that a transaction, otherwise within an exception of the tax law, does not lose its immunity, because it is actuated by a desire to avoid, or, if one choose, to evade, taxation. Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes."

Professor Michael Graetz of the Yale Law School says that a tax shelter is "a deal done by very smart people, that absent tax considerations, would be very stupid." Additionally, he has often said like pornography, a tax shelter is something that people know when they see it. The term "tax shelter" is difficult to define and whether a tax shelter is "abusive" depends upon who is watching.

The Taxpayer Relief Act of 1997 defined a "tax shelter" as any partnership, entity, plan or arrangement "if a significant purpose of such partnership, entity, plan or arrangement is the avoidance or evasion of Federal income tax."[6]

"The Role of Professional Firms in the U.S. Tax Shelter Industry"[7] notes on page 1 that while no single standard exists "to determine the line between legitimate 'tax planning' and 'abusive tax shelters,' the latter can be characterized as transactions in which a significant purpose is the avoidance or evasion of Federal, state or local tax in a manner not intended by law."

Tax shelters can be grouped into three broad categories: legitimate tax shelters, gray area tax shelters, and abusive tax shelters. Professors Graetz and Deborah Schenk (of the New York University Law School) define the two categories as follows in (a) and (c)[8] – I have added a third category in (b):

a. Legitimate tax shelters usually involve tax-favored investments clearly sanctioned by the tax laws, typically where tax benefits have been enacted expressly as incentives for particular activities (for example, oil exploration and real estate).
b. Gray area tax shelters: In other cases, the result sought by taxpayers may be available under current law, but the tax preference is in fact unintended. Corporate owned life insurance is a good example. These are the tax shelters that reside in the hazy, middle ground between legitimate tax shelters and abusive tax shelters.
c. Abusive tax shelters, on the other hand, typically involve transactions that, if the facts were known, would not be upheld in court. These investments enable taxpayers to take a reporting position for claiming deductions or credit that, while not ultimately allowable, may produce significant tax savings either because the return will not be examined by the IRS, or, if it is examined and the claimed

---

[5] 69 F.2d 809, 811 (2nd Cir. 1934), aff'd, 293 U.S. 465 (1935).
[6] *See* Section 6662(d)(2)(C).
[7] PERMANENT SUBCOMMITTEE ON INVESTIGATIONS OF THE COMMITTEE ON HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS, The Role of Professional Firms in the U.S. Tax Shelter Industry, S. Rept. No. 109-54 (2005).
[8] GRAETZ/SCHENK, Federal Income Taxation, Principles and Policies, 387 (4th ed. 2001).

deduction is disallowed, the tax will be deferred at a low interest cost. Abusive tax shelter investments are entered into primarily, if not exclusively, to reduce federal income tax liability. Often they yield negligible returns (and sometimes negative returns) before tax, but offer significant after-tax returns.

Today's tax shelter problem is not new in the history of the income tax. Here are three historical examples among many:

a. In the 1930s, the Roosevelt Administration focused on the prosecution of tax evaders and the closing of loopholes used by tax avoiders. The culmination of that effort was the Revenue Act of 1937 which increased taxation of personal holding companies, limited deductions for corporate yachts and country estates, restricted deductions for losses from sales or exchanges of property, reduced incentives for the creation of multiple trusts, and eliminated favors for nonresident taxpayers.[9]
b. In January 1969, the outgoing Secretary of Treasury revealed that in 1967 there were 21 millionaires who paid no tax at all. The result of that revelation was the enactment in 1969 of a minimum tax designed to make sure that those receiving tax preferences pay some minimum level of tax.[10]
c. In the 1970s and the early 1980s, there was a significant individual tax shelter syndication industry which promoted all sorts of tax shelters to individuals, and not just to wealthy individuals, but to middle class taxpayers as well. Included were tax shelters involving such things as cattle breeding, master recordings, equipment leasing, movie production and distribution, oil well drilling ventures, development of orchards and vineyards, and rental real estate.[11]

2. The Zenith of the Individual Tax Shelter: The Mid-1970s Through the Mid-1980s

2.1 Common Individual Tax Sheltering Techniques

The tax shelters aimed at individual taxpayers relied on five basic techniques to reduce tax liability.[12]

Income shifting involves structuring transactions to ensure that income, deductions, or credits are allocated among taxpayers in the manner that produces the lowest net tax liability. Generally, this means that deductions and credits are allocated to those in the highest brackets or to those who have offsetting income. Conversely, income is allocated to those in the lowest brackets or to those with expiring losses.

---

9 *See* BROWNLEE, Federal Taxation in America: A Short History, 79-80 (1996).

10 *See* ZELIGER, Taxing America: Wilbur Mills, Congress, and the State, 1945-1975, 21 (1998); STERN, The Rape of the Taxpayer, 67-68 (1974).

11 *See* STERN, *id.*, at 164-205; and CARSON, The Golden Egg, The Personal Income Tax: Where It Came From and How It Grew, 182-188 (1977).

12 *See* GRAETZ/SCHENK, *supra* note 8, at 388-390; and KLEIN/BANKMAN/SHAVIRO, Federal Income Taxation, 622 (12th ed. 2000).

Exemption involves receipt of economic income that is not subject to tax. Exemptions under current law include, for example, the exclusion of interest on state and local bonds and interest, dividends, and other amounts earned on individual retirement accounts and qualified employer pensions.

Deferral consists of pushing income into the future by incurring costs that are currently deductible and receiving the corresponding return from the investment in some future year. The tax advantage arises from the use of the funds that would otherwise be paid in taxes for the period of deferral.

Conversion of ordinary income into tax-preferred income is typically achieved where the investment generates both deductions against ordinary income and income that will be taxed at lower rates for example, as long-term capital gains.

Leverage is the use of borrowed funds to increase the size of deductible expenditures. The *Crane* rule, discussed below, may allow the taxpayer to obtain deductions based not only on a cash investment but also on indebtedness incurred incident to the investment. For example, a taxpayer who is subject to income tax at a 40 percent rate makes a tax shelter investment of $100,000 – $10,000 of his own funds and $90,000 in borrowed funds. If the investment produces a $30,000 tax loss in the first year, the taxpayer may save $12,000 in taxes on a $10,000 cash investment.

Leverage in combination with exemption, conversion or deferral is often labeled *tax arbitrage*. Tax arbitrage involves incurring expenses that are deductible in order to generate income that is tax-favored, thus creating a tax loss in excess of any economic loss. In illustration, suppose that you borrow to hold municipal bonds. If not for Sec. 265, the transaction might generate deductible interest expense on the one hand and excludable income on the other. The tax loss it generated would therefore exceed any real economic loss. While Sec. 265 blocks this particular tax arbitrage transaction (assuming the interest expense is indeed allocated to the bonds for tax purposes), the basic idea of pairing deductible expense against tax-favored income can be implemented in a variety of ways.

2.2 The Basic Building Blocks of Individual Tax Shelters

2.2.1 Many Business Activities Combined in Single Tax Return

In general, an individual files a tax return which combines all of his business activities for the year. Since it is a single return, money lost on one activity could be subtracted from money gained on another, and the net results would be the individual's taxable income for the year. Pre-1986, this simple truism provided one of the fundamental building blocks for tax shelters. If the individual's return were bifurcated – *e.g.*, losses incurred in real estate could not be taken against salary earned as an executive – tax shelters would be limited. The concept of a high-income taxpayer engaging in activities which produce tax losses against which he or she offsets his or her high income was central to the individual taxpayer tax shelter market prior to the passage in 1986 of the passive loss rule contained in Sec. 469 (although certain types of taxpayers – those in the real property business – can still take advantage to some extent of this building block).

2.2.2 The Limited Partnership

This was the ideal, tax-transparent vehicle for constructing a tax shelter because of the limited liability it afforded to investors and the ability to pass the tax losses generated through to the partners.

2.2.3 Increase of Basis by Nonrecourse Financing

Prior to the enactment of the at-risk rule in Sec. 465 (which, in any event, did not apply to real estate), a taxpayer's basis was not necessarily restricted to the amount invested in his or her limited partnership share. If the limited partnership purchased property subject to a purchase money mortgage (or a mortgage to a third party), even though the loan was secured only by the property itself (be it apartment building, movie, railroad rolling stock, *etc.*), the partner's basis would be increased by his or her share of the loan if certain technical requirements were met.

This result applies the rule articulated by the Supreme Court in *Crane v. Commissioner.*[13] In *Crane*, which did not involve a partnership, the Supreme Court held that when property subject to a nonrecourse debt is inherited, the heir includes in her basis the amount of that nonrecourse debt.

An example will illustrate the effect of employing the *Crane* approach: A limited partner pays $50,000 for his 10% share of a partnership. The partnership arranges a $2.5 million loan to finance construction of an apartment building, the loan secured only by the building. If various technical requirements of partnership tax law are met, the limited partner would be entitled to increase his basis in the partnership by $250,000, to a total basis of $300,000, although he or she had only contributed $50,000. Such 80 or 90 percent nonrecourse debt financing was common in limited partnerships in the individual taxpayer tax shelter field.

2.2.4 Early Deductions

Based on the previous building blocks, we have a high income limited partner who, although he or she has only contributed $50,000 in the partnership, has a basis that has been "artificially" increased to $300,000. Thus he or she has a tremendous potential for incurring tax losses. The final step is a lot of deductions early in the life of the investment which would create a substantial net operating loss for the partnership, these losses to be then passed through to the partners. In certain kinds of businesses, large early deductions are available – whether by government policy to encourage that business, or by happenstance. It is these businesses, then, that were typically the subject matter of the individual taxpayer limited partnership tax shelter.

2.2.5 Winding Up

After the project has operated for several years, the shelter effect begins to wane – largely because, as indicated in the preceding discussion, many of the key deductions have their greatest effect in the early years of the project. Thus, there comes a time when it is attractive to the investor to sell out his or her interest and reinvest his

---

[13] 331 U.S. 1 (1947).

or her funds in another shelter or some other project. It is upon this sale of his interest that a tax may be incurred. This is because *Crane* also held that when property is sold subject to a nonrecourse indebtedness, the taxpayer has an amount realized in the amount of the nonrecourse indebtedness. This will often give rise to a gain which has been subjected to varying treatment over the years and has depended also on the type of property involved. Historically, however, taxpayers have received the favorable capital gains treatment on selling out.

2.3 Government's Response Through 1986

2.3.1 Judicial Response: Some of the Significant Court Cases

2.3.1.1 Knetsch v. United States[14]

Transaction in which taxpayer borrowed money at 3.5% to buy bonds that paid interest at 2.5% held to lack economic substance where taxpayer could realize no economic benefit from the transaction apart from anticipated tax benefits resulting from deductions for prepaid interest. (Government prevailed.)

2.3.1.2 Estate of Franklin v. Commissioner[15]

Transaction in which taxpayer entered into a purported sale-leaseback involving overvalued property held not to constitute a true sale; depreciation and interest on nonrecourse mortgage disallowed. (Government prevailed.)

2.3.1.3 Frank Lyon Co. v. United States[16]

Sale-leaseback transaction respected for tax purposes notwithstanding that the terms of the purported lease effectively limited the taxpayer-lessor's financial interest to its investment plus compensation for the time value of money; Supreme Court found that the transaction had economic substance and tax considerations were "not at the nub of the business plan". (Taxpayer prevailed.)

2.3.1.4 Hilton v. Commissioner[17]

Purported sale-leaseback transaction in which there could be no possibility for economic gain from the inception of the transaction held distinguishable from *Frank Lyon Co.* in that there was lacking a "genuine multi-party transaction with economic substance compelled by business realities and imbued with tax-independent considerations". (Government prevailed.)

2.3.1.5 Rice's Toyota World v. Commissioner[18]

Where facts surrounding the taxpayer's purported purchase of computer equipment in a sale-leaseback transaction indicated that residual value of the equipment was

[14] 364 U.S. 361 (1960).
[15] 544 F.2d 1045 (9th Cir. 1976).
[16] 435 U.S. 561 (1978).
[17] 74 T.C. 305, aff'd, 671 F.2d 316 (9th Cir. 1982).
[18] 81 T.C. 184 (1983), aff'd in part and rev'd in part, 752 F.2d 89 (4th Cir. 1985).

insufficient to generate a profit, equipment was overvalued, and transaction was financed with nonrecourse debt, the court concluded that the taxpayer "subjectively lacked business purpose and the transaction objectively lacked economic substance". (Government prevailed.)

2.3.2 Congressional Response

While judicial responses to tax shelters helped knock out some of the most egregious deals, they were widely perceived as falling short of an adequate response to the tax shelter boom of the 1970s and early 1980s. One problem was that taxpayers could satisfy the judicial standard (to the extent there was a judicial standard) by simply folding in enough actual or at least apparent nontax content when engaging in transactions that were mainly designed to generate tax losses. A second problem was that uncertainty concerning how the courts would evaluate a given transaction encouraged taxpayers who knew they were unlikely to be audited by the IRS to take aggressive "reporting positions" on their tax returns, by acting under the undisclosed assumption that a questionable transaction actually was legitimate under the judicial standard.

Beginning in the mid-1970s and continuing into the mid-1980s, Congress responded with a number of statutory provisions designed to defeat or discourage tax sheltering activity. One response was to make various deduction rules less favorable across the board – that is, without regard to whether a given taxpayer was engaged in aggressive sheltering. Examples include the introduction of the at-risk rule, new limits on interest deductions, elimination of retroactive allocations of losses by partnerships, *etc.* by the Tax Reform Act of 1976; expansion of the at-risk rule by the Revenue Act of 1978; and prohibition against disguised sales by partners with partnerships and more tightening of the at-risk rule by the Tax Reform Act of 1984.

In addition, Congressional concern with tax shelters led to the adoption of a new set of administrative and enforcement tools in the Tax Equity and Fiscal Responsibility Act of 1982 and the Tax Reform Act of 1984. These provisions included partnership audit rules; penalties on promoters, organizers and sellers of tax shelters; a new "no-fault" substantial understatement penalty; tax shelter registration requirements; authorization of injunctive actions against promoters; and valuation overstatement penalties.

2.3.3 Rules Aimed at the Tax Practitioner

During the heyday of the syndicated individual taxpayer tax shelter industry, tax shelter opinions played a key role in the tax shelter market. The opinions, paid for by the shelter promoter, provided information to the prospective purchasers and in many cases provided protection against penalties. In some cases, the tax benefits might be uncertain or overstated by the promoters of the tax shelter. It was common for such opinions to be narrowly drafted and to ignore whether the tax benefits would stand up to scrutiny in court.

In an effort to self-police lawyers who provided such opinions, the American Bar Association adopted Formal Opinion 346 (Revised)[19] in January 1982 which addressed the concerns of false opinions, assumed fact opinions, and reasonable basis opinions. Opinion 346 tried to establish general ethical guidelines for participation by lawyers in tax shelter offerings.

In 1984, the Treasury Department adopted a rule on tax-shelter opinions that requires the tax lawyer to opine on each material issue raised by the tax shelter and make inquiry as to all the facts that are relevant to its tax consequences. That rule[20] was set forth in what is known as Circular 230. A lawyer who violates these regulations may be barred from practice before the IRS if the violation was "willful, reckless" or the result of "gross incompetence" or was "part of a pattern of providing tax shelter opinions" that are in violation.

Notwithstanding ABA Formal Opinion 346 and the Treasury rules described above, promoters continued to find tax practitioners willing to provide favorable opinions on tax shelters that most tax lawyers believed had little chance of surviving judicial challenge.

2.3.4 Tax Reform Act of 1986

However, administrative and judicial efforts and various statutory provisions, including new penalties and compliance measures enacted in 1976, 1978, 1982 and 1984, failed to stem the tide of individual taxpayer tax shelters. Consequently, Congress responded in the Tax Reform Act of 1986 with an extremely broad-based attack that limited the deduction of losses from "passive activities." It was this change contained in Sec. 469 which basically wiped out the syndicated individual taxpayer tax shelter business as it existed prior to 1986. This section was intended primarily to preclude taxpayers from using losses derived from tax shelter investments to reduce taxes on earned income and on investment income, such as interest and dividends. The passive loss rules are very complex, but they have been enormously successful in shutting down tax shelters marketed to individuals.

3. Corporate Tax Shelters

3.1 A New Phenomenon[21]

The Tax Reform Act of 1986 was supposed to remove tax considerations from economic decision making. Tax sheltering was supposed to disappear. In fact, it did for a while. But the widespread use of computers and the exotica of modern corporate finance coupled with the desire of the Big 6 public accounting firms, investment

---

[19] 68 A.B.A.J. 471 (1982).

[20] 31 C.F.R. § 10.33.

[21] For an interesting perspective on this new phenomenon, *see* "Tax Shelter Hustlers: Respectable Accountants Are Peddling Dicey Corporate Tax Loopholes", Forbes Magazine, December 14, 1998; "How to Cheat on Your Taxes", Forbes Magazine, March 5, 2001; "Gaming the Tax System, Tax Shelters Gone Awry", Business Week Magazine, March 31, 2003; and "Helter Shelter", American Lawyer, December 2003; "Leaky Shelters", Forbes Magazine, April 15, 2005.

bankers and some law firms to generate revenues, not based on the traditional billable hours, but instead based on contingency or premium fees, led to a new phenomenon, commonly called Corporate Tax Shelters.[22]

In turn, emboldened by the perceived weakness of the IRS in discovering these new forms of tax shelters, a whole new breed of tax shelter promoters emerged to peddle questionable tax shelter schemes – that oftentimes were unsolicited by any client – to corporations and to individuals who became newly wealthy during the booming economy of the 1990s.

The hallmark of the new tax shelters was to develop a transaction which involved exploitation of not-well-known imperfections in specialized parts of the tax law to produce results that everyone knows would not have been intended if they had been foreseen, and which are likely to be corrected soon after they are discovered. Often they involved modern, sophisticated financial products, and they frequently involved participation by foreigners not subject to U.S. taxation. Rather than providing tax planning advice to individual clients based on their particular circumstances, these transactions were developed in a way that made them easy to replicate and promote to a variety of clients and non-clients alike.

Most of these new tax shelters were not publicly syndicated, partly to keep them secret from competitors, but largely to keep them secret from the IRS as long as possible. Indeed until about four years ago, many of these schemes were shown to prospective customers subject to confidentiality agreements committing the prospects not to reveal anything about the tax shelter to anyone else. Sometimes the prospect was not even permitted to share the deal with his or her lawyer in order to obtain legal advice unless the lawyer subscribed to the confidentiality agreement too.

3.2 Indicia of the New Style Corporate Tax Shelters

a. Generation of losses for tax purposes but not for book purposes.
b. Exclusion of income.
c. Presence of tax indifferent party.
d. Presence of tax transparent entity (why? to take advantage of the check the box regulations[23]).
e. Life insurance somewhere in the transaction (*e.g.*, COLI – based on the tax free inside buildup and the tax free nature of the proceeds paid on death).
f. Convoluted structure of the transaction (virtually all of them).
g. Gap between U.S. tax law and tax law of foreign jurisdiction.

---

[22] Although the new tax shelters were sold primarily to corporations, there were some tax shelters which were marketable to individuals. For example, *see* the BOSS and Son of BOSS transactions which are discussed below, 3.3.2.3.

[23] Treas. Reg. § 301.7701-3.

3.3 Examples of the New Style of Tax Shelters

In general, *see* the list of tax shelters that the IRS has identified to be abusive. They are identified as "Listed Transactions."[24]

3.3.1 Some Corporate Examples

3.3.1.1 Contingent Installment Note Sales: The ACM Case

This transaction involved an intricate plan designed to create losses where the offsetting gains would escape U.S. taxation. Colgate-Palmolive Company had reported a sizeable capital gain in 1988 (approximately $105 million) from its sale of a subsidiary. Colgate wanted to avoid or minimize paying Federal income tax on that gain. The transaction was designed for that purpose, *i.e.*, to avoid ever paying tax on a realized gain. The transaction involved the formation of a partnership with a foreign bank and utilization of special ratable basis recovery rules under the Sec. 453 regulations in connection with the purchase and sale of short-term securities.[25]

3.3.1.2 Dividend Stripping: The Compaq and IES Cases

This transaction involved a variation of what is commonly referred to as a "dividend strip" transaction. In such a transaction, a corporate purchaser acquires dividend-paying stock of a corporation immediately before the corporation declares a dividend. The purchase price reflects the value of the expected dividend (because the corporate purchaser is entitled to the dividend). Immediately following the declaration of the dividend, the corporate purchaser sells the dividend-paying stock for less than its purchase price (because the subsequent purchaser buys the stock "ex dividend," or without entitlement to the declared dividend). Though the corporate purchaser has ordinary income from the dividend and a capital loss from the stock sale, the tax consequences from the dividend income typically are offset by other aspects of the transaction and tax benefits can be created. In the *Compaq* case, the tax benefit was the availability of foreign tax credits.[26]

3.3.1.3 COLI Cases

These cases considered whether corporations were entitled to deduct interest expenses and program administrative fees associated with a leveraged corporate-owned life insurance ("COLI") program. Under a typical COLI program, the taxpayer would purchase life insurance policies on thousands of its employees. In order

---

[24] For the current list, *see* 3.5.1.2 below.

[25] *ACM Partnership v. Commissioner*, 157 F.3d 231 (3rd Cir. 1998), *cert*. denied 526 U.S. 1017 (1999), aff'd in part and rev'd in part 73 T.C. Memo 1997-115. Also *see Boca Investerings Partnership v. United States*, 314 F.3d 625 (D.C. Cir. 2003), *cert*. denied 540 U.S. 826 (2003), rev'd 167 F. Supp.2d 298 (D.D.C. 2001).

[26] *Compaq Computer Corp. v. Commissioner*, 277 F.3d 778 (5th Cir. 2001), rev'd 113 T.C. 214 (1999). *See also IES Industries v. United States*, 253 F.3d 350 (8th Cir. 2001), rev'd in part and aff'd in part, 1999 U.S. Dist. LEXIS 22610 (N.D. Iowa 1999). It should be noted that in CCA 200620022, 2006 WL 1370916, the IRS denied the benefit of substantial foreign tax credits relating to a multi-step transaction that lacked economic substance.

to help fund the premiums required under the policies, the taxpayer would systematically borrow against the cash surrender value of such policies. The net pre-tax profit or loss of the program consisted of the cash surrender value of the policies plus any death benefits received, reduced by (1) the annual premiums paid, (2) the accrued interest on the policy loans, and (3) administration fees. It was not unusual for the sales projections relating to a typical COLI program to show that the taxpayer would sustain a pre-tax loss (but an after-tax profit) for every year the plan remained in effect (sometimes such program would last 60 years or more). For example, the cumulative projections over the life of the COLI program that was the subject of the *Winn-Dixie* case indicated that the taxpayer would sustain an aggregate pre-tax loss of approximately $682 million but would also receive an aggregate after-tax profit in excess of $2 billion. The difference between the pre-tax and after-tax effects was attributable to the income tax savings that would result from deducting the interest and, to a lesser extent, the administrative fees.[27]

3.3.1.4 Lease Strips

Here a domestic corporation was inserted into an existing leveraged lease circle of payments as temporary owner of a leasehold interest so it can have the tax benefit of prepaid rent deductions. Prior to the domestic corporation joining the partnership, however, some of the rent was prepaid to a foreign taxpayer, who is exempt from U.S. tax. Thus, the rent deductions, but not the associated rental income, flowed through to the domestic corporation.[28]

3.3.1.5 Intermediary Transactions

These transactions generally involved a shareholder who desired to sell stock of a target corporation, an intermediary corporation, and a buyer who desired to purchase the assets, but not the stock, of the target. The shareholder purported to sell the stock of the target to the intermediary. The target then purported to sell some or all of its assets to the buyer. The buyer claimed a basis in the target assets equal to its purchase price. Under one version of this transaction, the target was included as a member of the affiliated group that included the intermediary, which filed a consolidated return, and the group reported losses (or credits) to offset the gain (or tax) resulting from the target's sale of assets. In an alternative form of the transaction, the

[27] *See Winn-Dixie Stores, Inc. v. Commissioner*, 113 T.C. 254 (1999), aff'd 254 F.3d 1313 (11th Cir. 2001), *cert.* denied 535 U.S. 986 (2002); *In re CM Holdings, Inc.*, 254 B.R. 578 (D. Del. 2000), aff'd, 301 F.3d 96 (3rd Cir. 2002); *American Electric Power Co. v. United States*, 136 F. Supp.2d 762 (S.D. Ohio 2001), aff'd 326 F.3d 737 (6th Cir. 2003), *cert.* denied 124 S.Ct. 1043 (2004); and *Dow Chemical Co. v. United States*, 250 F. Supp.2d 748 (E.D. Mich. 2003), modified by 278 F.Supp.2d 844 (E.D. Mich. 2003), rev'd, 435 F.3d 594 (6th Cir. 2006), petition for *cert*. pending, No. 06-478, 75 U.S.L.W. 3207 (filed October 2006). The Government won all of these cases.

[28] *Andantech L.L.C. v. Commissioner*, 331 F.3d 972 (DC Cir. 2003), aff'd in part and remanding T.C. Memo 2002-97; *TIFD III-E Inc. v. United States*, 342 F.Supp.2d 94 (D.Conn. 2004), rev'd, 459 F.3d 220 (2d Cir. 2006); Notice 2003-55, 2003-34 I.R.B. 395 (modifying and superseding Notice 95- 53, 1995-2 C.B. 334) (identified as "listed transactions" on February 28, 2000).

intermediary could be an entity that was not subject to tax and that liquidated the target with no reported gain on the sale of the target's assets.[29]

3.3.1.6 Contingent Liability

In these cases, a parent corporation contributed $X+1 million cash and $X million contingent liabilities into a subsidiary, in exchange for preferred stock. The parent reported the transaction as a Sec. 351 exchange and took a basis in the preferred stock of $X+1 million even though the value of the preferred stock was approximately $1 million ($X+1 million of cash less $X of liabilities). Soon there after, the parent sold the preferred stock for $1 million and claimed a $X million loss on the sale, equal to the excess of its claimed basis over the sales proceeds.[30]

3.3.2 Some Individual Examples

3.3.2.1 Compensatory Option Sale

Here an individual (generally an employee) was granted a nonstatutory compensatory stock option, then transferred it to a related person (could be a family limited partnership or other entity where the individual and family members own substantial interests). The related person paid an amount based on the value of the option, generally in a long-term (*e.g.*, 30-year) balloon note. The related person would have little or no liquidity. The taxpayer's intended goal was to treat the options as sold in an arm's length transaction under Treas. Reg. Sec. 1.83-7, closing the transaction so that the taxpayer does not recognize compensation income when the option is recognized. Further, because the related person is paying the note over time (*e.g.*, 30 years), the taxpayer was attempting to defer compensation income on the sale portion over the note period.[31]

3.3.2.2 Life Insurance

One example of a tax shelter which used life insurance to avoid the gift, estate, and generation – skipping transfer taxes, relied on a 1996 private letter ruling.[32] This particular tax sheltering technique was predicated on the purchase of life insurance at highly inflated rates. The designers of the shelter took advantage of the rule that the payment of a premium on a life insurance policy on which the taxpayer retains no control is a taxable gift.

---

[29] *Nicole Rose Corp. v. Commissioner*, 320 F.3d 282 (2d Cir. 2003); Notice 2001-16, 2001-9 I.R.B. 1.

[30] *Coltec Industries, Inc. v. United States*, 62 Fed.Cl. 716 (2004), vacated and remanded, 454 F.3d 1340 (Fed. Cir. 2006), petition for *cert.* pending, No. 06-659, 75 U.S.L.W. 3267 (filed November 8, 2006); *Black & Decker Corp. v. United States*, 340 F.Supp.2d 621 (D.Md. 2004), aff'd in part, rev'd in part, 436 F.3d 431 (4th Cir. 2006). In 2000 Congress added language to Section 358(h) effectively shutting down the shelter. Community Renewal Tax Relief Act of 2000, P.L. 106-554, § 309(c) (2000); Notice 2001-17, 2001-9 I.R.B. 730.

[31] *See* Announcement 2005-19, 2005-11 I.R.B. 744.

[32] PLR 9636033 (September 6, 1996).

Under this technique, the payer of the premium payment reduced the amount of gift tax that would normally be imposed on the premium payment by reporting as a taxable gift *only* the *lowest* price charged by the insurance company of the policy (rather than the higher premium that was actually paid). The insurance company invested the difference between the lowest price charged and the actual premium paid by the life insurance policy. The return on that investment (which, as so-called "inside buildup," goes tax free) was used to fund future premiums on the policy. Then, when the proceeds of the life insurance policy were paid at the insured's death, they were not included in the insured's gross estate for estate tax purposes and could be recovered by the heir free of income tax.

Consequently, the use of this technique allowed the person purchasing the life insurance policy to transfer a substantial sum of money at a minimal (or no) gift tax cost and at no estate tax cost whatever – what a country![33]

3.3.2.3 Boss (Bond and Option Strategy)/Son of Boss

In one variation of this transaction, the taxpayer borrowed at a premium and subsequently a partnership assumes that indebtedness. The terms of the loan agreement provided for an inflated stated rate of interest and a stated principal amount that was less than the issue price of the note (the issue price of the note was the amount of cash received by the taxpayer). In some cases, to mitigate interest rate risk, the partnership entered into an interest rate swap with the lender. The taxpayer claimed that the basis in the taxpayer's partnership interest was reduced under Sec. 752 only for the stated principal amount of the indebtedness. Subsequently, the taxpayer claimed a loss on the disposition of the partnership interest even though the taxpayer had incurred no corresponding economic loss. In other variations, the inflated partnership basis was transferred to partnership assets through a distribution in liquidation of the partnership. In variations involving the transfer of the inflated basis to partnership assets, the tax shelter could either result in the generation of a loss on the subsequent sale of the distributed assets or the elimination of built in gain in the distributed assets.[34]

3.3.2.4 Offshore Payment Cards/Financial Arrangements

The approach was to underreport U.S. income tax liability through the use of (1) financial arrangements that relied on offshore payment cards (including credit, debit, or charge cards) issued by banks in foreign jurisdictions or (2) offshore financial arrangements (including arrangements with foreign banks, financial institutions, corporations, partnerships, trusts, or other entities).

In a typical case, U.S. taxpayers stashed money in offshore financial accounts, without disclosing it to the IRS. They had access to the money through anonymous

---

[33] *See* "Both Still Certain, but Taxes May Be Subject to a Loophole", New York Times, July 28, 2002; and more ominously for tax practitioners: "Wealthy Family Suing Lawyer Over Tax Plan", New York Times, July 10, 2003.

[34] *See* Chief Counsel Notice CC-2003-030 (November 20, 2003) and Announcement 2004-46, 2004-21 I.R.B. 964.

credit or debit cards that they could give to merchants or use in automated teller machines.

Note that this one crosses the line from tax avoidance to tax fraud/evasion.

3.4 Judicial Response

3.4.1 Judicial Doctrines Applicable to Tax Shelters[35]

3.4.1.1 Sham Transaction Doctrine

Sham transactions are those in which the economic activity that is purported to give rise to the desired tax benefits does not actually occur. The transactions have been referred to as "facades" or mere "fictions"[36] and, in their most egregious form, one may question whether the transactions might be characterized as fraudulent.

At a minimum, the sham transaction doctrine can be said to apply to a "sham in fact." For example, where a taxpayer purported to buy Treasury notes for a small down payment and a financing secured by the Treasury notes in order to generate favorable tax benefits, but neither the purchase nor the loan actually occurred, the court applied the sham transaction doctrine to deny the tax benefits.[37]

Note that although many of the cases raising this doctrine deal with individual tax shelters, it also has been applied in the corporate context.[38]

Although the sham transaction doctrine generally applies when the purported activity giving rise to the tax benefits does not actually occur, in certain circumstances, a transaction may be found to constitute a sham even when the purported activity does occur. For example, if a transaction is entered into to generate loss for the taxpayer, and the taxpayer actually has risk with respect to the transaction, but that risk has been eliminated through a guarantee by a broker that the broker will bear the market risk and that the only consequences to the taxpayer will be the desired tax benefits, such transaction may be found to be a "sham in substance." In general, *see* the COLI cases[39] for a good discussion of sham in substance vs. sham in fact.

Finally, it should be noted that the delineation between this doctrine (particularly as applied to shams "in substance") and the "economic substance" and the "business purpose" doctrines (both discussed below) is not always clear. Some courts find that if transactions lack economic substance and business purpose, they are "shams" notwithstanding that the purported activity did actually occur.[40]

---

[35] The following discussion of the judicial doctrines applicable to tax shelters, including the information in the footnotes, has been taken in large part from STAFF OF THE JOINT COMMITTEE ON TAXATION, Appendix II to JCX-82-99: Description of Analysis of Present-Law Tax Rules and Recent Proposals Relating to Corporate Tax Shelters, JCX-84-99 (1999).

[36] *See e.g.*, *Knetsch v. United States*, 364 U.S. 361 (1960), disallowing deductions for prepaid interest on a nonrecourse, riskless loan to purchase deferred annuity savings bonds.

[37] *See Goodstein v. Commissioner*, 267 F.2d 127 (1st Cir. 1959).

[38] *See. e.g.*, *ACM Partnership v. Commissioner*, *supra* note 25; *ASA Investerings v. Commissioner*, 76 T.C.M. 325 (1998).

[39] Particularly *American Electric Power*, 136 F.Supp 2d at 779-780, and *Dow Chemical*, 250 F. Supp. 2d at 799-811.

[40] *See e.g.*, *United States v. Wexler*, 31 F.3d 117 (3rd Cir. 1994).

3.4.1.2 Economic Substance Doctrine

The courts generally will deny claimed tax benefits where the transaction giving rise to those benefits lacks economic substance independent of tax considerations – notwithstanding that the purported activity did actually occur. The Tax Court recently described the doctrine as follows:

> "The tax law … requires that the intended transactions have economic substance separate and distinct from economic benefit achieved solely by tax reduction. The doctrine of economic substance becomes applicable, and a judicial remedy is warranted, where a taxpayer seeks to claim tax benefits, unintended by Congress, by means of transactions that serve no economic purpose other than tax savings."[41]

The seminal authority most often credited for laying the foundation of the economic substance doctrine is the Supreme Court and Second Circuit decisions in *Gregory v. Helvering*.[42] In *Gregory*, a transitory subsidiary was established to effectuate, utilizing the corporate reorganization provisions of the Code, a tax advantaged distribution from a corporation to its shareholder of appreciated corporate securities that the corporation (and its shareholder) intended to sell. Although the court found that the transaction satisfied the literal definition of a tax-free reorganization, the Second Circuit held (and the Supreme Court affirmed) that satisfying the literal definition was not enough.

> "[T]he underlying presupposition is plain that the readjustment shall be undertaken for reasons germane to the conduct of the venture in hand, not as an ephemeral incident, egregious to its prosecution. To dodge the shareholder's taxes is not one of the transactions contemplated as corporate "reorganizations."[43]

Since the time of *Gregory*, several cases have denied tax benefits on the grounds that the subject transactions lacked economic substance.[44] The economic substance doctrine can apply even when a taxpayer exposes itself to risk of loss and where there is some profit potential (*i.e.*, where the transactions are real) if the facts suggest that the economic risks and profit potential were insignificant when compared to the tax benefits.[45] In other words, the doctrine suggests a balancing of the risks and profit

---

[41] *ACM Partnership v. Commissioner*, *supra* note 25, at 2245.

[42] *Supra* note 5.

[43] *Gregory v. Helvering*, 69 F.2d at 811.

[44] *See, e.g., Knetsch v. United States*, 364 U.S. 361 (1960); *Goldstein v. Commissioner*, 364 F.2d 734 (2d Cir. 1966), holding that an unprofitable, leveraged acquisition of T-bills, and accompanying prepaid interest deduction, lacks economic substance; *Sheldon v. Commissioner*, 94 T.C. 738 (1990), holding that a marginally profitable, leveraged acquisition of T-bills, and accompanying prepaid interest deduction, lacks economic substance, and imposing penalties; *Santa Monica Pictures, LLC v. Commissioner*, 89 T.C.M. 1157 (2005), holding that a purported joint venture lacked economic substance and was motivated by a desire to shift tax losses among the participants; gross valuation misstatement penalty imposed; *CMA Consolidated, Inc. v. Commissioner*, 89 T.C.M. 701 (2005), holding that a lease strip transaction lacked economic substance and imposing the gross valuation misstatement penalty; *Ginsburg v. Commissioner*, 35 T.C.M. 860 (1976), holding that a leveraged cattle-breeding program lacks economic substance.

[45] *See Goldstein v. Commissioner*, 364 F.2d 734, 739-40 (2d Cir. 1966), disallowing deduction even though taxpayer has a possibility of small gain or loss by owning T-bills; *Sheldon v. Commissioner*, 94 T.C. 738, 768 (1990), stating, "potential for gain … is infinitesimally nominal and vastly insignificant when considered in comparison with the claimed deductions".

potential as compared to the tax benefits in order to determine whether the transactions had "purpose, substance or utility apart from their anticipated tax consequences."[46]

3.4.1.3 Business Purpose Doctrine

Another doctrine that overlays and is often considered together with (if not part and parcel of) the sham transaction and economic substance doctrines is the business purpose doctrine. Although numerous authorities apply this doctrine in the context of individuals or partnerships, as the discussion above with respect to the *ACM* case makes clear, the doctrine equally applies in the corporate context. Additionally, the doctrine is not limited to cases where the relevant statutory provisions by their terms require a business purpose or profit potential.[47]

In its common application, the courts use business purpose (in combination with economic substance, as discussed above) as part of a two-prong test for determining whether a transaction should be disregarded for tax purposes: (a) the taxpayer was motivated by no business purpose other than obtaining tax benefits in entering the transaction, and (b) the transaction lacks economic substance.[48] In essence, a transaction will only be respected for tax purposes if it has "economic substance which 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."[49]

The business purpose test is a subjective inquiry into the motives of the taxpayer – that is, whether the taxpayer intended the transaction to serve some useful nontax purpose.[50]

Finally, where appropriate, the court may bifurcate a transaction in which independent activities with nontax objectives have been combined with an unrelated transaction having only tax-avoidance objectives in order to establish a business purpose for the overall transaction.[51] Thus, a taxpayer cannot utilize an unrelated business objective to hide the lack of business purpose with respect to the particular tax-motivated activities.

---

[46] *See Goldstein*, *id.*, at 740. Even this articulation of the economic substance doctrine will fall short in its application to some sets of facts. For example, taxpayers motivated solely by tax considerations have been permitted by the courts to time their recognition of accrued economic losses, notwithstanding that the IRS attacked such tax-motivated transactions as lacking economic substance. *See, e.g.*, *Cottage Savings v. Commissioner*, 499 U.S. 554 (1991), allowing losses, pursuant to section 1001(a), on exchanges of substantially identical mortgages; *Doyle v. Commissioner*, 286 F.2d 654 (7th Cir. 1961). In *Doyle*, the IRS argued that the taxpayer's use of a straddle to recognize loss on its stock without taking itself out of its ownership in the stock lacked economic substance; held: the transactions were at arm's length and, therefore, *bona fide* so that the losses were allowed under Section 165.

[47] *ACM*, *supra* note 25, at 253; *Goldstein*, *id.*, at 736; *Wexler*, *supra* note 40, at 122.

[48] *Rice's Toyota World*, *supra* note 18, at 91.

[49] *Frank Lyon Co.*, *supra* note 16, at 561.

[50] *See e.g.*, *Rice's Toyota World*, *supra* note 18, at 89; *ACM*, *supra* note 25 at 231; *Peerless Indus. v. Commissioner*, 1994-1 U.S.T.C. ¶ 50,043 (E.D. Pa. 1994).

[51] *ACM*, *supra* note 25, at 256 n. 48.

3.4.1.4 Substance Over Form Doctrine

The concept of the substance over form doctrine is that the tax results of an arrangement are better determined based on the underlying substance rather than an evaluation of the mere formal steps by which the arrangement was undertaken. For instance, two transactions that achieve the same underlying result should not be taxed differently simply because they are achieved through different legal steps. The Supreme Court has found that a "given result at the end of a straight path is not made a different result because reached by following a devious path."[52] However, many areas of income tax law are very formalistic and, therefore, it is often difficult for taxpayers and the courts to determine whether application of the doctrine is appropriate.

While tax cases have been decided both ways, the IRS generally has the ability to recharacterize a transaction according to its underlying substance. Taxpayers, however, are usually bound to abide by their chosen legal form.[53] In *National Alfalfa Dehydrating & Mill Co.*, the Supreme Court ruled as follows:

> "This Court has observed repeatedly that, while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not, [citations omitted], and may not enjoy the benefit of some other route he might have chosen to follow but did not."[54]

3.4.1.5 Step Transaction Doctrine

A business transaction often does not have a sharply defined beginning or ending. One step in a transactional sequence often bears a strong relationship to that which came before it and that which follows it. For analytical purposes, however, it is often necessary to examine a transaction as an organic whole. To that end, the IRS and courts often fuse formally separate transactional steps to determine the tax consequences of the overall transaction. This step transaction doctrine is as pervasive in corporate tax law as it has iterations. More than one iteration may be appropriately applied to a single set of circumstances; however, the satisfaction of only one of the tests is sufficient for a court to disregard transitory or unnecessary steps.[55]

---

[52] *Minnesota Tea Co. v. Helvering*, 302 U.S. 609, 613 (1938).

[53] *Commissioner v. Danielson*, 378 F.2d 771 (3d Cir. 1967), *cert.* denied 389 U.S. 858 (1967).

[54] *Commissioner v. National Alfalfa Dehydrating & Mill Co.*, 417 U.S. 134, 149 (1974). *See also Higgens v. Smith*, 308 U.S. 473, 477 (1940).

[55] For the various iterations of the test, *see Penrod v. Commissioner*, 88 T.C. 1415 (1987); *King Enterprises, Inc. v. United States*, 418 F.2d 511 (Ct. Cl. 1969); *Commissioner v. Gordon*, 391 U.S. 83 (1968); and *McDonalds Restaurants of Ill. v. Commissioner*, 688 F.2d 520 (7th Cir. 1982).

3.4.2 Significant Court Cases

3.4.2.1 Contingent Installment Note Sales

a. *ACM Partnership v. Commissioner*:[56] Transaction comprised of selling notes on contingent installment basis held to lack economic substance. (Government prevailed.)
b. *ASA Investerings Partnership v. Commissioner*:[57] Partnership formed for purpose of selling notes on contingent installment basis held to lack business purpose and was therefore ignored. (Government prevailed.)
c. *Saba Partnership v. Commissioner*:[58] Transaction comprised of selling notes on contingent installment basis held to lack economic substance. (Government prevailed.)
d. *Boca Investerings Partnership v. United States*:[59] Partnership formed for purpose of selling notes on contingent installment basis held to lack business purpose and was therefore ignored. (Government prevailed at USCA; Taxpayer prevailed at USDC (that the transaction lacked economic substance).)

3.4.2.2 Lease Strips

a. *Andantech L.L.C. v. Commissioner:*[60] Partnership formed for lease strip transaction held to lack business purpose and was ignored. (Government prevailed.)
b. *TIFD III-E Inc. v. United States*:[61] In the so-called "Castle Harbour" case, the Circuit Court recast the transaction to reflect the true interests of the parties, *i.e.*, a loan transaction rather than a partnership transaction. (Government prevailed.)
c. *CMA Consolidated Inc. & Subs., Inc. v. Commissioner*:[62] CMA's lease strip lacked economic substance. (Government prevailed.)
d. *Transcapital Leasing Associates v. U.S.A.*:[63] The lease transactions where a sham entered into solely for tax avoidance purposes. (Government prevailed.)

3.4.2.3 Intermediary Transactions and Inflated Basis Resulting from Lease Strips

a. *Nicole Rose v. Commissioner*:[64] Intermediary transaction held not to have economic substance. (Government prevailed.)

---

[56] 157 F.3d 231 (3d Cir. 1998), *cert.* denied 526 U.S. 1017 (1999), aff'd in part and rev'd in part T.C. Memo 1997-115.
[57] 201 F.3d 505 (D.C. Cir. 2000), *cert.* denied 531 U.S. 871 (2000), aff'd. T.C. Memo 1998-305.
[58] T.C. Memo 2003-31, on remand from 273 F.3d 1135 (D.C. Cir. 2001), rev'd. T.C. Memo 1999-359.
[59] 314 F.3d 625 (D.C. Cir. 2003), *cert.* denied 540 U.S. 826 (2003), rev'd. 167 F.Supp.2d 298 (D.D.C. 2001).
[60] 331 F.3d 972 (D.C. Cir. 2003) aff'd. in part and remanding T.C. Memo 2002-97.
[61] 459 F.3d 220 (2d Cir. 2006), rev'd 342 F. Supp. 2d 94 (D. Conn. 2004).
[62] T.C. Memo. 2005-16.
[63] 97 A.F.T.R.2d (RIA) 2006-1916 (W.D. Tex. 2006).
[64] 320 F.3d 282 (2d Cir. 2003), aff'd. per curiam 117 T.C. 328 (2001).

b. *Long Term Capital Holdings, L.P. v. United States*:[65] Sale of assets with inflated basis, due to prior lease strip transaction, held not to have economic substance. Forty-percent penalty applied to taxpayer's understatement. (Government prevailed.)

3.4.2.4 Corporate Owned Life Insurance (COLI)

a. *Winn-Dixie Stores, Inc. v. Commissioner*:[66] Corporate owned life insurance scheme held to lack economic substance. (Government prevailed.)
b. *IRS v. CM Holdings, Inc.*:[67] Corporate owned life insurance scheme held to lack economic substance. (Government prevailed.)
c. *American Electric Power v. United States*:[68] Corporate owned life insurance scheme held to lack economic substance and penalties applied. (Government prevailed.)
d. *Dow Chemical Co. and Subsidiaries v. United States*:[69] Corporate owned life insurance scheme did not have economic substance. (Government prevailed.)

3.4.2.5 Contingent Liability

a. *Black and Decker v. United States*:[70] Contingent liability transaction; remanded to District Court for determination of economic substance; and *Black and Decker v. United States*:[71] Liabilities assumed in a contingent liability transaction held not to be "money received" in a Sec. 351 transaction.
b. *Coltec Industries, Inc. v. United States*:[72] Notwithstanding finding that the transaction satisfied all statutory requirements, the Circuit Court still disallowed the results of the transaction on basis that it lacked economic substance. (Government prevailed.)
c. Hercules settlement news release:[73] IRS announced resolution of a dispute with Hercules Incorporated over a listed tax shelter transaction, whereby Hercules will pay a tax liability of approximately $30 million and a 20 percent accuracy-related penalty of approximately $6 million.

---

[65] 330 F.Supp. 2d 122 (D. Conn., 2004), aff'd 2005 WL 2365336 (2nd Cir. 2005), not selected for publication in the Federal Reporter, NO. 04-5687.

[66] 254 F.3d 1313 (11th Cir. 2001), *cert*. denied, 535 U.S. 986 (2002), aff'd 113 T.C. 254 (1999).

[67] 301 F.3d 96 (3d Cir. 2002), aff'd. 254 B.R. 578 (D. Del. October 16, 2000).

[68] 326 F.3d 737 (6th Cir. 2003), *cert*. denied, 124 S.Ct. 1043 (2004), aff'd. 136 F.Supp.2d. 762 (S.D. Ohio 2001).

[69] 435 F.3d 594 (6th Cir. 2006), rev'd 250 F. Supp. 2d 748, modified by 278 F. Supp. 2d 844 (E.D. Mich. 2003), petition for *cert*. pending, No. 06-478, 75 U.S.L.W. 3207, filed October 8, 2006.

[70] 436 F.3d 431 (4th Cir. 2006), rev'd 340 F.Supp.2d 621 (D. Md. 2004).

[71] No. Civ. WDQ-02-2070 (D. Md., slip op. August 3, 2004).

[72] 454 F.3d 1340 (Fed. Cir. 2006), rev'd 62 Fed. Cl. 716 (2004), petition for *cert*. pending, No. 06-659, 75 U.S.L.W. 3267, filed November 8, 2006.

[73] 2004 Tax Notes Today 243-4, December 16, 2004.

3.4.2.6 Dividend Stripping

a. *Compaq Computer Corp. and Subsidiaries v. Commissioner*:[74] Purchase and sale of American depository receipts held to have economic substance. (Taxpayer prevailed.)
b. *IES Industries, Inc. v. U.S.*:[75] Purchase and sale of American depository receipts held to have economic substance and business purpose. (Taxpayer prevailed.)

3.4.2.7 Son of Boss

a. *Salina Partnership v. Commissioner*:[76] Obligation from short sale is a Sec. 752 liability. (Government prevailed.)
b. *A.D. Global v. U.S.A.*[77] (Government prevailed).
c. *Schumacher Trading Partners II v. U.S.*[78] (Government prevailed.)
d. *Grapevine v. U.S.A.*[79] (Government prevailed).
e. *Klamath v. U.S.A.*:[80] Holding that the loan transactions lacked economic substance. No penalties were awarded due to court finding that taxpayer reasonably relied on its qualified tax professionals. (Government prevailed.)
f. *Colm Producer v. USA*:[81] Short sale obligation is a Sec. 752 liability. (Government prevailed.)
g. *Soward v. Commissioner*:[82] Statutory notice dismissed as invalid because it raises affected items before partnership level proceeding has been completed. (Government prevailed.)
h. *Curr-Spec Partners v. Commissioner.*[83] (Government prevailed).

3.4.2.8 Other Cases

a. *Santa Monica Pictures, LLC et al. v. Commissioner*:[84] Taxpayer's loss is disallowed and 40-percent penalty applied to taxpayer's understatement. (Government prevailed.)
b. *UPS v. Commissioner*:[85] Reinsurance transaction. (Taxpayer prevailed).

---

[74] 277 F.3d 778 (5th Cir. 2001), rev'd. 113 T.C. 214 (1999).
[75] 253 F.3d 350 (8th Cir. 2001), rev'd in part and aff'd in part 1999 U.S. Dist. LEXIS 22610, 6445 (N.D. Iowa 1999).
[76] T.C. Memo 2000-352.
[77] 68 Fed. Cl. 663 (Fed. Cir. 2005) (partial summary judgment; statute of limitations is open). Taxpayer appeal pending, 167 Fed. Appx. 171 (Fed. Cir. January 9, 2006).
[78] 72 Fed. Cl. 95 (2006) (summary judgment; statute of limitations is open).
[79] 71 Fed. Cl. 324 (Fed. Cir. 2006) (partial summary judgment; statute of limitations is open).
[80] 2007 Tax Notes Today 22-9 (E.D. Tex. 2007).
[81] 460 F.Supp.2d 713, 2006 WL 3228527, 98 A.F.T.R.2d 2006-7494 (N.D.Tex. October 2006) (Summary judgment).
[82] TC Memo 2006-262.
[83] TC Memo 2006-266 (summary judgment granted; statute of limitations open).
[84] T.C. Memo. 2005-104.
[85] 254 F.3d 1014 (11th Cir. 2001).

3.5 Administrative Response

3.5.1 Internal Revenue Service

3.5.1.1 Office of Tax Shelter Analysis

The IRS has established an Office of Tax Shelter Analysis ("OTSA") which serves as a clearinghouse for information that comes to the attention of the Service relating to potentially improper tax shelter activity.[86] The IRS website encourages persons wishing to submit information to the Office of Tax Shelter Analysis relating to tax shelter transactions and activities to do so by mail, telephone, fax, or e-mail.

3.5.1.2 Listed Transactions

In general *see* the list of tax shelters that the IRS has determined to be abusive. They are identified as "listed transactions" and as discussed below, such listed transactions require disclosure by participating corporations, individuals, partnerships and trusts, in accordance with Treasury Regulation § 1.6011-4. Listed transactions, with citations of published guidance, regulations or court cases are accessible from the following list[87] which can be found on the IRS website:[88]

a. Notice 2005-13 – SILO transactions.
b. Notice 2004-31 – Intercompany financing through partnerships.
c. Notice 2004-30 – Transfer of the incidence of taxation from S corporations to exempt entities.
d. Notice 2004-20 – Abusive foreign tax credit intermediary transaction.
e. Transactions that are the same as, or substantially similar to, those described in Situation 2 of Rev. Rul. 2004-20 – employer deducts contributions to a qualified pension plan for premiums on life insurance contracts that provide for death benefits in excess of the participant's death benefit, where under the terms of the plan, the balance of the death benefit proceeds revert to the plan as a return on investment.
f. Rev. Rul. 2004-4 – ESOP owned S-corporation in which profits are segregated in a QSUB so that rank-and-file employees do not benefit from participation in the ESOP.
g. Notice 2004-8 – Transactions designed to avoid the contribution limitations for Roth IRAs.
h. Notice 2003-81 – Transactions in which a taxpayer claims a loss upon the assignment of a Sec. 1256 contract to a charity but fails to report the recognition of gain when the taxpayer's obligation under an offsetting non-Sec. 1256 contract terminates.
i. Notice 2003-77 – Transactions using contested liability trusts to accelerate deductions for contested liabilities under Sec. 461(f).

---

[86] *See* IRS Announcement 2000-12, 2000-12 I.R.B. 835; "Inside OTSA: A Bird's Eye View of Shelter Central at the IRS", 2003 Tax Notes Today 174-2, September 9, 2003.

[87] *See* IRS Notice 2004-67, 2004-41 I.R.B. 600.

[88] http://www.irs.gov/businesses/corporations.

j. Notice 2003-55 – Accounting for Lease Strips and Other Stripping Transactions.
    i. Revenue Ruling 2003-96 – Reallocation of income and deductions among unrelated parties to a lease strip.
    ii. Notice 95-53 – Lease Strips – Modified and superseded by Notice 2003-55 above.
k. Notice 2003-47 – Transfers of Compensatory Stock Options to Related Persons.
l. Notice 2003-24 – Certain Trust Arrangements Seeking to Qualify for Exception for Collectively Bargained Welfare Benefit Funds under Sec. 419A(f)(5).
m. Notice 2003-22 – Offshore Deferred Compensation Arrangements.
n. Revenue Ruling 2003-6 – Abuses Associated with S Corp ESOPs.
o. Notice 2002-69 – Lease-In/Lease-out LILO Transactions.
p. Notice 2002-50 – Partnership Straddle Tax Shelter.
r. Notice 2002-35 – Notional Principal Contracts.
   Revenue Ruling 2002-30 – Notional Principal Contracts.
s. Notice 2002-21 – Inflated Basis "CARDS" Transactions.
t. Notice 2001-45 – Sec. 302 Basis-Shifting Transactions.
u. Notice 2001-17 – Sec. 351 Contingent Liability.
v. Notice 2001-16 – Intermediary Transactions.
   Coordinated Issue Paper – Intermediary Transactions.
w. Notice 2000-61 – Guam Trust.
x. Notice 2000-60 – Stock Compensation Transactions.
y. Notice 2000-44 – Inflated Partnership Basis Transactions (Son of Boss).
    i. TD 9062 – Assumption of Partner Liabilities. Treas. Reg. Sec. 1.752-7T.
    ii. TD 9207 – Assumption of Partner Liabilities. Treas. Reg. Sec. 1.752-7.
    iii. CCN 2003-20 – Chief Counsel Guidance.
z. Revenue Ruling 2000-12 – Debt Straddles.
aa. Treas. Reg. Sec. 1.7701(l)-3 – Fast Pay or Step-Down Preferred Transactions.
bb. Notice 99-59 – BOSS Transactions.
cc. Treas. Reg. Sec. 1.643(a)-8 – Certain Distributions from Charitable Remainder Trusts.
dd. Transactions substantially similar to those at issue in *ASA Investering Partnership* and *ACM*.
ee. Notice 95-34 – Certain Trusts Purported to be Multiple Employer Welfare Funds Exempted from the Lists of Sec. 419 and 419A.
ff. Revenue Ruling 90-105 – Certain Accelerated Deductions for Contributions to a Qualified Cash or Deferred Arrangement or Matching Contributions to a Defined Contribution Plan.

De-listed Listed Transactions:
a. Notice 2002-70 – Certain Reinsurance Arrangements.[89]
b. Notice 2004-64 – Modification of exemption from tax for small property and casualty insurance companies.
c. Notice 2004-65 – Producer owned reinsurance companies (PORC).

[89] *See* Notice 2004-65.

Note that the IRS has designated an IRS Lead Executive for each of these listed transactions as well as a Technical Contact for each one. *See* the IRS website for the names and telephone numbers of these individuals.

Finally, the IRS LMSB Division has been using a standard Information Document Report (IDR) for all LMSB examinations beginning after April 23, 2002. This IDR, developed by the OTSA and LMSB Counsel, requests information concerning listed transactions.[90]

3.5.1.3 Disclosure Regulations[91]

Beginning in the late-1990s, the Treasury Department came to the conclusion that disclosure by taxpayers, and by those who organized and marketed the abusive tax shelters, is the most effective way to stop them. As I and others have said, "sunshine is the best disinfectant."

Consequently, in order to identify tax-advantaged products which have been sold to individual and corporate taxpayers, Treasury issued Regulations which require taxpayers to identify certain "reportable transactions" which have the potential for tax avoidance. If such a "reportable transaction" exists, the taxpayer must report the transaction on IRS Form 8886 which form is attached to its tax return, and must also send a copy of the IRS Form 8886 to the IRS Office of Tax Shelter Analysis in the IRS National Office. In general.[92]

The first kind of reportable transaction which has the potential for tax-avoidance are the "Listed Transactions."[93] Periodically, the Treasury or IRS will issue regulations, rulings or announcements which will "list" a specific type of transaction that has tax avoidance potential. A listed transaction also includes transactions which are "substantially similar" to the listed transactions.[94]

The term "substantially similar" is broadly constructed in favor of disclosure:

> "[A]ny transaction that is expected to obtain the same or similar types of tax consequences and that is either [(1)] factually similar or [(2)] based on the same or similar tax strategy."[95]

The second kind of reportable transaction which has a potential for tax avoidance are transactions which have one or more of the following attributes:[96]

---

[90] *See* IRS Announcement 2002-2, 2002-2 I.R.B. 304. IRS Announcement 2002-2, subject to certain conditions, gave taxpayers the ability to disclose participation in listed transactions through April 23, 2002. If full disclosure was made, the taxpayer received waiver of the accuracy-related penalties. The IRS has said that 1,206 taxpayers took advantage of this Disclosure Initiative to disclose 1,664 questionable transactions (*See* "Tax Shelter Settlement Program Raises Questions", 2002 Tax Notes Today 184-5, September 23, 2002.)

[91] Treas. Reg. Section 1.6011-4.

[92] *See* Treas. Reg. Section 1.6011-4.

[93] Treas. Reg. Section 1.6011-4(b)(2).

[94] For the current list of listed transactions, *see* 3.5.1.2 above. *See* 3.6.7.1 below for a discussion of proposed regulations issued on November 2, 2006, creating a new category of reportable transactions entitled "transactions of interest."

[95] Treas. Reg. Section 1.6011-4(c)(4).

[96] *See* Treas. Reg. Section 1.6011-4(b)(3)-(b)(7).

a. Disclosure of the tax treatment or tax structure of the transaction is limited in any way (a “confidential transaction”);
b. Fees to service providers are contingent, or partially or fully refundable, depending on whether the intended tax consequences of the transaction are sustained (“contractual protection”);
c. Deductible losses meeting certain threshold amounts; generally, $10 million in a single year or $20 million in any combination of years for C corporations, and $2 million in a single year or $4 million in any combination of years for S corporations, individuals, partnerships and trusts (with some exceptions);
d. A $10 million difference between the “book” and “tax” treatment of items of income, gain, expense or loss in any year (this attribute applies only to SEC reporting taxpayers and taxpayers with significant assets); or
e. A transaction generating tax credits exceeding $250,000 and the asset(s) giving rise to the tax credits will be held by the taxpayer for 45 days or less.

3.5.1.4 Material Advisor Disclosure and List Maintenance Regulations

3.5.1.4.1 Disclosure of Reportable Transactions

The American Jobs Creation Act (AJCA), enacted in October 2004, replaced the “tax shelter registration” rules of former Sec. 6111 with rules requiring material advisors to disclose reportable transactions to the IRS.[97]

The IRS and the Treasury Department are revising regulations under Sec. 6111 to reflect the statutory revisions.[98]

3.5.1.4.2 List Maintenance Regulations

Former Sec. 6112 required organizers and sellers of potentially abusive tax shelters to maintain a list of shelter buyers. The AJCA broadens Sec. 6112 by requiring material advisors to maintain lists identifying persons with respect to whom the advisor acted as a material advisor on a reportable transaction.

The IRS and the Treasury Department are revising regulations under Sec. 6112 to reflect the amendments.[99]

3.5.1.5 Penalty Regulations: Penalty for Failure to Disclose Reportable Transactions

Recent legislation imposes a penalty for failure to disclose a reportable transaction (including a listed transaction).[100] The IRS and Treasury intend to draft regulations that interpret Sec. 6707A.[101]

---

[97] *See* 3.6.5 below.
[98] *See* 3.6.6 for interim guidance pending publication of regulations. *See* 3.6.7.2 below for a discussion of proposed regulations issued on November 2, 2006.
[99] *See* 3.6.6 below for interim guidance pending publication of regulations. *See* 3.6.7.3 below for a discussion of proposed regulations issued on November 2, 2006.
[100] *See* the discussion of Section 6707A below, 3.6.2.
[101] *See* 3.6.2.5 below for interim guidance pending publication of regulations.

3.5.1.5.1 Good Faith/Reasonable Cause Defense

In December 2003, IRS and Treasury finalized amendments to regulations under Sec. 6664 that affect the "reasonable cause and good faith" defense to the accuracy-related penalty provided by Sec. 6664(c). These regulations provide that a taxpayer may not rely on an opinion or advice of a tax practitioner that a regulation is invalid to establish that the taxpayer acted with reasonable cause and good faith unless the taxpayer adequately discloses the position that the regulation in question is invalid.

The final regulations further provide that if any portion of an underpayment of tax is attributable to a reportable transaction,[102] then failure by the taxpayer to disclose the transaction in accordance with Treas. Reg. Sec. 1.6011-4 is a strong indication that the taxpayer did not act in good faith with respect to the portion of the underpayment attributable to the reportable transaction.

The regulations also amend existing regulations under Sec. 6662(b)(1), relating to negligence or disregard of rules or regulations, so that the defenses provided by those regulations are not available for reportable transactions not properly disclosed.

Taxpayers may have difficulty avoiding penalties based on reliance on the advice of a tax advisor in cases where business purpose or economic substance are held to be lacking. For example, in *Long Term Capital Holdings, L.P. v. United States*,[103] the Second Circuit affirmed the imposition of a 40 percent gross valuation misstatement penalty under Sec. 6662(h) in a case involving a lease-stripping transaction that was held to lack economic substance. Although the taxpayer had obtained advice on the transaction from its tax advisor, the court concluded that the reasonable cause exception in Sec. 6664(c)(1) did not shield the taxpayer from the penalty. In seeking a tax opinion on the transaction, the taxpayer directed its advisor to assume a valid business purpose and a profit motive for the lease-stripping transaction. The court found that taxpayer knew these assumptions to be false and that it was unreasonable for the tax advisor to rely on these assumptions when a reasonably diligent review would have revealed them to be false.[104]

Reliance on advice that is too good to be true does not constitute reasonable reliance.[105] Taxpayer's reliance on promoter of trust product and accountant referred to by promoter was not reasonable were trust scheme eliminated all of their self-employment tax liabilities and almost all of their income tax liabilities. Tax benefits of this magnitude should have caused taxpayer to question the validity of the scheme.

---

[102] As defined in Treas. Reg. Section 1.6011-4(b).

[103] 2005 WL 2365336 (2nd Cir. 2005), aff'd 330 F.Supp. 2d 122 (D.Conn. 2004).

[104] *See* also *Santa Monica Pictures, LLC et al. v. Commissioner*, 2005-104 T.C. Memo, taxpayer failed to meet the reasonable cause exception for reliance on the advice of a tax advisor where the tax advisors' opinions were based on business purpose assumptions that the taxpayer knew were unreasonable. But *see Klamath v. U.S.A.*, 2007 Tax Notes Today 22-9 (E.D. Tex. 2007), finding that taxpayer's reliance on comprehensive opinions of counsel was reasonable under the facts of that case.

[105] *Rogers v. CIR*, T.C. Memo 2005-248 (October 2005).

3.5.1.5.2 Proposed Penalty Regulations

In December 2002, Treasury issued proposed regulations under Sec. 6662 and 6664 that will prohibit taxpayers from relying on advice or an opinion from a tax practitioner to establish a good faith and reasonable cause defense to the penalty under Sec. 6664(c) in cases where the taxpayer did not properly disclose a reportable transaction or a position that a regulation is invalid.

The proposed regulations also modify the Treasury Regulations under Sec. 6662(b)(1), relating to negligence or disregard of rules or regulations, so that the defenses provided by those regulations are not available for reportable transactions not properly disclosed. The proposed regulations state that they will apply, when finalized, to transactions entered into on or after January 1, 2003.

3.5.1.6 Settlement Initiatives

Another tool used by the IRS in its battle against corporate and individual tax shelters is the global settlement initiative.

3.5.1.6.1 Settlement Initiatives of 2002

On October 4, 2002, the IRS announced three initiatives designed to resolve tax disputes as to three tax avoidance transactions, two of which have been listed as reportable tax avoidance transactions. The three transactions are:

a. COLI (IRS Announcement 2002-96, 2002-43 I.R.B. 1),
b. Sec. 302/318 basis shifting (IRS Announcement 2002-97, 2002-43 I.R.B. 752), and
c. Sec. 351 contingent liability transactions (Rev. Proc. 2002-67, 2002-43 I.R.B. 733).

As a result of these initiatives, the IRS has claimed that 92% of the 488 taxpayers involved in basis shifting transactions have accepted the settlement terms,[106] all but 5-10 of the COLI cases have been settled,[107] and that while more than 50 percent of the eligible taxpayers had applied for the contingent liability settlement option, only 11 taxpayers had requested the fast-track option.[108]

3.5.1.6.2 Son-of-BOSS Settlement Initiative[109]

This initiative has collected more than $3.7 billion and the final tally from the program is expected to reach roughly $4 billion. The settlement offer has been accepted by 1,200 taxpayers; 750 taxpayers have declined to participate and will be pursued through audits and litigation. Son-of-BOSS tax shelter promoters are barred from participating in the settlement initiative.[110]

---

[106] "Chief Counsel Sees Work on Guidance and Shelters Pay Off ", 2003 Tax Notes Today 47-2, March 10, 2003.
[107] "Inside OTSA: A Bird's Eye View of Shelter Central at the IRS ", 2003 Tax Notes Today 174-2, September 9, 2003.
[108] *Id.*
[109] Announcement 2004-46, 2004-21 I.R.B. 964.
[110] "IRS Hails Executive Comp Initiative; Son-of-BOSS Numbers Updated", 2005 Tax Notes Today 132-1, July 12, 2005; "Settlement Initiative for Son-of-Boss Investors was Successful, TIGTA says", 2006 Tax Notes Today 65-40, April 5, 2006.

3.5.1.6.3 Executive Stock Option Settlement Initiative[111]

Eighty executives have accepted the settlement terms, requiring participants to include 100 percent of their stock option compensation in income, along with applicable interest, income and employment taxes, and a 10 percent penalty. The remaining 15 executives who settled their cases did so during audits. The agreements could yield upwards of $500 million in income adjustments to the executives' tax liabilities. Nineteen executives opted not to participate and are either under audit or facing other pending criminal tax investigations.[112]

3.5.1.6.4 SC2 Settlement Initiative

The settlement offer requires a taxpayer to unwind the SC2 transaction entirely. The S corporation is considered terminated on the date of transfer of stock to the exempt party, and S corporation income is allocated as if there had been no transfer of stock to the exempt party. The taxpayer is not be allowed a charitable contribution deduction for the contribution of nonvoting stock.[113]

3.5.1.6.5 Settlement Offer of October 2005[114]

On October 27, 2005, the IRS announced a sweeping settlement offer covering 21 transactions designed to provide a "quick, quiet, and cost-effective" way for taxpayers to settle transactions the Service considered abusive.[115]

The transactions covered by this settlement initiative are divided into three categories, two covering shelters the IRS has already identified as abusive and listed as such, and a third covering five kinds of transactions regarded as suspicious.

Category 1

a. Tax Avoidance Using Offsetting Foreign Currently Contacts (Notice 2003-81);
b. Lease Strips (Notice 2003-55);
c. Common Trust Fund Straddle Tax Shelter (Notice 2003-54);
d. Tax Avoidance Using Inflated Basis (Notice 2002-21);
e. Intermediary Transactions (Notice 2001-16); and
f. Distributions of Encumbered Property (Notice 99-59).

Category 2

a. Rev. Rul. 2004-20, Situation 2 (including the non-listed Situation 1 and Rev. Rul. 2004-21);
b. ESOP-owned S Corp (Rev. Rul. 2004-44);
c. Abusive Roth IRA Transactions (Notice 2004-8);

---

[111] Announcement 2005-19, 2005-11 I.R.B. 744.

[112] "IRS Hails Executive Comp Initiative; Son-of-BOSS Numbers Updated", 2005 Tax Notes Today 132-1, July 12, 2005.

[113] "IRS Makes Settlement Offer to SC2 Investors ", 2005 Tax Notes Today 66-1, April 7, 2005.

[114] *See* "I.R.S. Offers Carrot to Tax Shelter Users", New York Times, October 28, 2005; "Confess and Pay Less, IRS Says Initiative Targets Participants in Abusive Tax Shelters", Washington Post, October 28, 2005; BNA Daily Tax Report, October 28, 2005.

[115] Announcement 2005-80, 2005-46 I.R.B. 1; *see* "IRS Makes Settlement Offer on Abusive Transactions", 2005 Tax Notes Today 208-1, October 28, 2005.

d. Contested Liabilities (Notice 2003-77);
e. Welfare Benefit Funds Under Sec. 419A(f)(5)(Notice 2003-24);
f. ESOPs Holding Stock in an S Corp (Rev. Rul. 2003-6);
g. Stock Compensation (Notice 2000-60);
h. Debt Straddles (Rev. Rul. 2000-12);
i. Distributions by Charitable Remainder Trusts (Treas. Reg. § 1.643(a)-8); and
j. Certain Trust Arrangements Using Exemptions From Sec. 419 (Notice 95-34).

Category 3
In the third category are five additional transactions. While not "listed transactions" subject to disclosure rules, they are abuses that have been flagged by the IRS over the past several years.
a. Reimbursements for Employee Parking (Rev. Rul. 2004-98);
b. Certain Abusive Conservation Easements (Notice 2004-41);
c. Certain Abusive Donations of Patents and Other Intellectual Property; (Notice 2004-7);
d. Reimbursements of Employees' Medical Expenses (Rev. Rul. 2002-3); and
e. Management S Corp/ESOP Transactions.

To participate in the program, a taxpayer has to concede all the tax benefits from the shelter and pay interest on the unpaid taxes. Taxpayers are allowed, however, to deduct transaction costs of the shelter, including fees paid to promoters.

The taxpayers also has to pay a portion of the penalties that would normally have been assessed in these types of cases where a tax benefit is disallowed by the IRS. These penalties in most cases are 20 percent of the tax, but in some cases are 40 percent. In 15 of the 21 shelters (Categories 2 and 3 above), the taxpayer has to pay a quarter of the normal penalty. In the remaining six (Category 1 above), which the IRS regards as more abusive, the penalty is half.

Note that taxpayers can escape penalties if they either disclosed the transaction to the IRS earlier, or if they relied on an opinion from an independent advisor that the deal was legitimate.

3.5.1.7 Tax Accrual Workpapers

In the past (at least since 1981), the IRS had a policy of requesting tax accrual workpapers only in "unusual circumstances."[116] This policy remained in place even after the IRS won the *Arthur Young* case in the Supreme Court (where the court held that tax accrual workpapers (prepared by auditors) were not protected from an IRS summons under an asserted accountant-client privilege or accountant work-product privilege).[117] However, in 2002, in connection with its increased efforts to crack down on abusive tax shelter transactions, the IRS updated its procedures for seeking tax accrual workpapers by issuing IRS Announcement 2002-63, 2002-27 I.R.B. 72. These updated procedures are now incorporated into the Internal Revenue Manual.[118]

---

[116] *See* IRS News Release IR 81-49, May 5, 1981, and I.R.M. 4024.5, May 14, 1981.
[117] *See United States v. Arthur Young & Co.*, 465 U.S. 805 (1984).
[118] *See* IRM. §4.10.20 (rev. January 15, 2005).

Under the new procedures, for tax returns filed on or after July 1, 2002, if a taxpayer discloses a "listed transaction," the IRS will routinely request tax accrual workpapers – but only for that listed transaction. More importantly, however, the IRS will routinely request all tax accrual workpapers when any of the following circumstances exist:

a. The taxpayer does not disclose the listed transaction on the return.
b. The taxpayer claims tax benefits on the return from two or more investments in listed transactions, regardless of disclosure.
c. There are reported financial irregularities (*e.g.*, restatement of earnings) in connection with the examination of a return claiming tax benefits from a disclosed listed transaction.

For returns filed before July 1, 2002, the IRS will – in appropriate circumstances – request tax accrual workpapers pertaining only to a listed transaction in situations where the taxpayer failed to comply with an obligation to disclose the listed transaction.

In July 2005, the IRS posted to its website a list of "Tax Accrual Workpapers Frequently Asked Questions." These questions and answers provide further insight into how the IRS intends to apply the tax accrual workpaper policy described in Announcement 2002-63.[119] For corporate tax executives, IRS Announcement 2002-63 has served as the catalyst for developing new strategies to protect the corporation's most sensitive tax contingency material. Faced with this type of exposure, tax executives have three courses of action:

> First, corporation management can take appropriate steps to ensure that the corporation does not engage in listed transactions, or in transactions that are substantially similar to listed transactions.
>
> Second, if the corporation has engaged in only one listed transaction, then disclosure of that transaction to the IRS should be seriously considered. Such a disclosure will limit the request for tax accrual workpapers to only that listed transaction, and will also permit the corporation to rely on advice of its tax advisers to avoid accuracy-related penalties.
>
> Finally, tax executives must develop policies and procedures that will enable the corporation to be in the best position possible to assert the attorney-client privilege, the federally authorized tax practitioner privilege, and/or the work product doctrine with respect to its most sensitive tax contingency material – such as underlying legal memoranda.

Recent developments on the disclosure of tax accrual workpapers include *U.S. v. Roxworthy*,[120] defining documents prepared "in anticipation of litigation" as "prepared or obtained because of the prospect of litigation" and found that the work-product doctrine protected the two memoranda at issue.[121]

---

[119] *See* the link to "Abusive Tax Shelters and Transactions" on the IRS website to www.irs.gov/businesses/corporations.
[120] 457 F.3d 590 (6th Cir. 2006).

3.5.1.8 Circular 230 Amendments

Circular 230 provides regulations governing practice before the Internal Revenue Service. As the preamble to the December 20, 2004, regulations provides "The tax system is best served when the public has confidence in the honesty and integrity of the professionals providing tax advice."[122]

3.5.1.8.1 American Jobs Creation Act of 2004

The American Jobs Creation Act of 2004 ("AJCA") amended Sec. 330 of title 31 as follows: AJCA clarifies that the Secretary of the Treasury may impose standards for written advice relating to a matter that is identified as having a potential for tax avoidance or evasion.[123]

Sec. 882 of the AJCA also authorizes the Treasury Department and the Service to impose a monetary penalty against practitioners that violate any provision of Circular 230.[124]

3.5.1.8.2 December 2004 Final Regulations

The December 2004 final regulations provided rules in the following areas:

a. Sec. 10.33 – Best practices for tax advisors:
   Under Sec. 10.33, best practices include the following:
   i. "Communicating clearly with the client regarding the terms of the engagement";[125]
   ii. "Establishing the facts, determining which facts are relevant, evaluating the reasonableness of any assumptions or representations, relating the applicable law (including potentially applicable judicial doctrines) to the relevant facts, and arriving at a conclusion supported by the law and the facts";[126]
   iii. "Advising the client regarding the import of the conclusions reached, including, for example, whether a taxpayer may avoid accuracy-related penalties under the Internal Revenue Code if a taxpayer acts in reliance on the advice";[127] and
   iv. "Acting fairly and with integrity in practice before the Internal Revenue Service".[128]

   Under Sec. 10.33(b), tax advisors with responsibility for overseeing certain practices should take reasonable steps to ensure that the firm's procedures for

[121] *See U.S. v. Textron, Inc.*, 2006 Tax Notes Today 84-19 (D.R.I. April 2006), a currently pending summons enforcement action seeking the production of tax accrual workpapers. *See also* CALLAHAN/ERNEY/GAWLIK, Tax Accrual Workpapers: IRS Efforts to Obtain Them, Corporate Strategies to Protect Them, 55 Tax Executive 364 (2003); PUGH, United States v. Roxworthy: What Does It Mean to Taxpayers?, 58 Tax Executive 378 (2006).

[122] T.D. 9165, 69 Fed. Reg. 75839, 75840 (December 20, 2004).

[123] *Id.*; *see also* P.L. 108-357, Sec. 882.

[124] *Id.*; *see also* P.L. 108-357, Sec. 882.

[125] §10.33(a)(1).

[126] §10.33(a)(2).

[127] §10.33(a)(3).

[128] §10.33(a)(4).

all members, associates, and employees are consistent with the best practices in Sec. 10.33(a).

b. Sec. 10.35 – Requirements for covered opinions:

A practitioner who provides a covered opinion "shall comply" with the standards of practice in Sec. 10.35.[129] A "covered opinion" is written advice (including electronic communications) by a practitioner concerning one or more Federal tax issues arising from:[130]

i. A listed transaction (within the meaning of Treas. Reg. Sec. 1.6011-4(b)(2));[131]

ii. "Any partnership or other entity, any investment plan or any other plan or arrangement, the principal purpose of which is the avoidance or evasion of any tax imposed by the Internal Revenue Code";[132] or

iii. "Any partnership or other entity, any investment plan or arrangement, a significant purpose of which is the avoidance or evasion of any tax imposed by the Internal Revenue Code if the written advice –

(1) Is a reliance opinion;

(2) Is a marketed opinion;

(3) Is subject to conditions of confidentiality; or

(4) Is subject to contractual protection."[133]

A covered opinion does not include:

i. "Written advice provided to a client during the course of an engagement if the practitioner is reasonably expected to provide subsequent written advice to the client that satisfies the requirements of this Sec.";[134] or

ii. Written advice (other than advice described in Sec. 10.33(b)(2)(i)(A) or (B)) "that:

(1) Concerns the qualification of a qualified plan;

(2) Is a state or local bond opinion; or

(3) Is included in documents required to be filed with the Securities and Exchange Commission."[135]

The requirements for a covered opinion relate to the following:[136]

i. Factual matters;

ii. Relate law to facts;

iii. Evaluation of significant Federal tax issues; and

iv. Overall conclusions.

On the competence of practitioners to provide opinions and on the possibility of practitioners relying on the opinions of others the regulations provide:

---

[129] §10.35(a).

[130] §10.35(b)(2)(i).

[131] §10.35(b)(2)(i)(A).

[132] §10.35(b)(2)(i)(B).

[133] §10.35(b)(2)(i)(C).

[134] §10.35(b)(2)(ii)(A).

[135] §10.35(b)(2)(ii)(B).

[136] §10.35(c).

> "The practitioner must be knowledgeable in all aspects of Federal tax law relevant to the opinion being rendered, except that the practitioner may rely on the opinion of another practitioner with respect to one or more significant Federal tax issues, unless the practitioner knows or should know that the opinion of the other practitioner should not be relied on."[137]

The following disclosures are required:

i. Relationship between promoter and practitioner;[138]
ii. Information related to marketed opinions;[139]
iii. Information related to limited scope opinions;[140] and
iv. Information related to opinions that fail to reach a more likely than not conclusion.[141]

An opinion that meets the requirements of this Sec. satisfies the practitioner's responsibilities under Sec. 10.35, but the persuasiveness of the opinion with regard to the tax issues in question and the taxpayer's good faith reliance on the opinion is determined separately under applicable provisions of the law and regulations.[142]

c. Sec. 10.36 – Procedures to ensure compliance:
Any practitioner who has principal authority and responsibility for overseeing certain practices must take reasonable steps to ensure that the firm has adequate procedures in effect for all members, associates, and employees for purposes of complying with Sec. 10.35.[143] Any such practitioners will be subject to discipline for failing to comply with the requirements of Sec. 10.36 in certain circumstances.[144]

d. Sec. 10.37 – Requirements for other written advice:
Sec. 10.37 provides the requirements for other written advice, including the following:

> "A practitioner must not give written advice (including electronic communications) concerning one or more Federal tax issues if the practitioner bases the written advice on unreasonable factual assumptions (including assumptions about future events), unreasonably relies upon representations, statements, findings or agreements of the taxpayer or any other person, does not consider all relevant facts that the practitioner knows or should know, or, in evaluating a Federal tax issue, takes into account the possibility that a tax return will not be audited, or that an issue will be resolved through settlement if raised."[145]

e. Sec. 10.38 – Establishment of advisory committees.
f. Sec. 10.52 – Violation of regulations.

---

[137] §10.35(d)(1).
[138] §10.35(e)(1).
[139] §10.35(e)(2).
[140] §10.35(e)(3).
[141] §10.35(e)(4).
[142] §10.35(f).
[143] §10.36(a).
[144] §10.36(a).
[145] §10.37(a).

A practitioner can be censured, suspended or disbarred from practice before the IRS for any of the following:

i. "Willfully violating any of the regulations (other than Sec. 10.33) contained in this part";[146] or
ii. "Recklessly or through gross incompetence (within the meaning of Sec. 10.51(l)) violating Sec. 10.34, 10.35, 10.36 or 10.37."[147]

3.5.1.8.3 Clarifying Regulations

Clarifying regulations were issued in May 2005.[148] These regulations:

a. Provide that written advice prepared and provided to a taxpayer after the return is filed generally is excluded from the covered opinion requirements;
b. Provide that advice provided by a taxpayer's in-house counsel generally is excluded from the covered opinion requirements;
c. Provide that negative advice generally is excluded from the covered opinion requirements;
d. Clarify the definition of "prominently disclosed" under Sec. 10.35(b)(8) of Circular 230; and
e. Clarify the definition of "principal purpose" under Sec. 10.35(b)(10) of Circular 230.

3.5.1.8.4 Notice 2007-21

Notice 2007-21, published on February 2, 2007, provides guidance to practitioners, employers, firms, and other entities that may be subject to monetary penalties under 31 U.S.C. Sec. 330 regarding the amount of penalties that may be imposed.

3.5.1.9 Big 4 Accounting Firms/Other Promoters

On June 27, 2002, the IRS announced that it reached agreement with PricewaterhouseCoopers to resolve tax shelter registration and list maintenance issues. According to the news release, PwC agreed to make a "substantial payment" to the IRS to resolve issues in connection with advice rendered to clients dating back to 1995.[149] Under the agreement, PwC agreed to provide to the IRS certain client information in response to summonses. It also agreed to work with the IRS to develop processes to ensure ongoing compliance with the shelter registration and investor list maintenance requirements.[150]

On July 2, 2003, Ernst & Young LLP agreed to pay the IRS $15 million to settle an audit looking at E&Y's marketing of tax shelters.[151] In addition to the nondeductible payment, E&Y agreed to work with the IRS to ensure ongoing compliance with the registration and list maintenance requirements for the tax shelters it sold.

---

[146] §10.52(a)(1).
[147] §10.52(a)(2).
[148] T.D. 9201, May 18, 2005.
[149] IR-2002-82.
[150] A similar case was settled with Merrill Lynch in 2001. *See* IR-2001-74.
[151] *See* IR-2003-84.

This is just the tip of the iceberg. *See* "Inside OTSA: A Bird's Eye View of Shelter Central at the IRS"[152] where the following is detailed about IRS tax shelter promoter audits: In a June 2003 press release, the IRS announced that 78 of the summonses involving seven promoters had been referred to the Department of Justice for enforcement. On July 22, 2003, an IRS spokesperson told the WP that 129 people in LMSB are working on cases involving promoters and that the IRS Chief Counsel's office has 72 more people working on tax shelters. On July 31, 2003, Treasury Assistant Secretary for Tax Policy Pamela F. Olson said that the IRS had underway nearly 100 promoter investigations and had issued over 270 summonses. By mid-August 2003, LMSB had 125 people working on 92 promoter entities under examinations and 98 promoter examinations open, and the Justice Department had filed summons enforcement actions against five promoters.

The law firm of Jenkens & Gilchrist was ordered to turn over investor lists identifying the firm's clients who participated in alleged abusive tax shelter transactions. On May 14, 2004, a U.S. District Court ordered Jenkens & Gilchrist to comply with John Doe summonses seeking identities and other information regarding tax shelters promoted by the law firm.[153]

Domenick DeGiorgio, an official with German bank Bayerische Hypo und Vereinsbank, was charged with conspiracy for his participation in BLIPS tax shelter transactions. Charges include tax shelter fraud conspiracy, unreported fee income conspiracy, wire fraud, and tax evasion.[154] A co-conspirator of DeGiorgio was charged with and pled guilty to the tax fraud scheme.[155]

In August 2005, Big 4 accounting firm KPMG LLP admitted to criminal wrongdoing and agreed to pay $456 million in fines, restitution and penalties as part of an agreement to defer prosecution of the firm. *See* IR-2005-83. Separately, 19 individuals were indicted on charges in connection with tax shelters sold by KPMG.[156]

The government alleged that from 1996 through 2003, KPMG, as well as the indicted individual defendants, conspired to defraud the IRS by designing, marketing, and implementing illegal tax shelters such as FLIP, OPIS, BLIPS, and SOS. In a deferred prosecution agreement, KPMG acknowledged that it assisted taxpayers in evading tax by developing, promoting, and implementing unregistered and fraudulent tax shelters. KPMG also admitted that its personnel took specific deliberate steps to conceal the existence of the shelters from the IRS by, among other things,

---

[152] 2003 Tax Notes Today 174-2, September 9, 2003.

[153] "Jenkens & Gilchrist Turns Over Investor Lists", 2004 Tax Notes Today 97-1, May 19, 2004.

[154] "Charges Filed Against German Bank Official In Blips Shelter Case", 2005 Tax Notes Today 155-20, August 12, 2005.

[155] "Information Filed against Businessman for Tax Shelter Conspiracy", 2006 Tax Notes Today 247-27, December 26, 2006; "California Man Pleads Guilty to Involvement in Fraudulent Tax Shelters", 2006 Tax Notes Today 247-74, December 21, 2006.

[156] *See* "8 Former Partners of KPMG Are Indicted", New York Times, October 30, 2005; "9 Charged Over Tax Shelters in KPMG Case", Washington Post, October 30, 2005; "Nine Are Charged In KPMG Case on Tax Shelters", Wall Street Journal, October 30, 2005; "Indictment Broadens in Shelters at KPMG", New York Times, October 18, 2005; "Ten More KPMG Executives Indicted Over Shelters", Wall Street Journal, October 18, 2005.

failing to register the shelters with the IRS as required by law, fraudulently concealing the shelter losses and income on tax returns, and attempting to hide the shelters using sham attorney-client privilege claims.

The $456 million penalty imposed on KPMG includes $100 million in civil fines for failure to register the tax shelters with the IRS, $128 million in criminal fines representing disgorgement of fees earned by KPMG on the four shelters that are the subject of the agreement, and $228 million in criminal restitution representing lost taxes to the IRS as a result of KPMG's intransigence in turning over documents and information to the IRS (leading to expired statutes of limitations).

In addition to the monetary penalties, the agreement requires permanent restrictions on KPMG's tax practice, including the termination of two practice areas: its private client tax practice and its compensation and benefits tax practice. The firm also agreed to permanently adhere to higher tax practice standards regarding the issuance of certain tax opinions and the preparation of tax returns. The firm agreed not to participate in marketing, implementing, or issuing opinions with respect to listed transactions, not to provide any tax services under any conditions of confidentiality, and not to become involved with any pre-packaged tax product. The agreement also restricts the firm from accepting fees not based on hourly rates.

The 19 indicted individuals include 16 former KPMG partners, 1 former KPMG senior tax manager, 1 former partner in the law firm Brown & Wood and 1 investment advisor. The indictment alleges that the individuals' participation in the fraud generated at least $11 billion in phony tax losses which cost the United States at least $2.5 billion in evaded tax.[157]

3.5.1.10 Offshore Voluntary Compliance Initiative

In January 2003, the IRS announced an initiative aimed at bringing taxpayers who used "offshore" payment cards or other offshore financial arrangements to hide their income back into compliance with the law.[158] Under the program, taxpayers could avoid civil fraud and information return penalties if they filed amended tax return between January 14, 2003 and April 15, 2003.[159] The IRS has accepted 94 percent of 1,300 applications received yielding more than $170 million in taxes, interest, and penalties.[160]

[157] *See* "Justice Department Brings Charges Against Nineteen Tax Professionals in KPMG Case", 200 BNA Daily Tax Report G-11, October 18, 2005; "Former KPMG Tax Partner Pleads Guilty to Tax Evasion, Conspiracy", Wall Street Journal, April 28, 2006; "Accountant Pleads Guilty in KPMG Shelter Case", Wall Street Journal, January 11, 2007; "5th Defendant Pleads Guilty in Shelter Case", Wall Street Journal, January 12, 2007.

[158] Discussed above, 3.3.2.4.

[159] *See* Rev. Proc 2003-11, offshore voluntary compliance initiative for individuals who have underreported their U.S. income tax liability through the use of offshore payment cards or financial arrangements.

[160] "IRS Offshore Compliance Initiative Collects $170 Million So Far, Official Says", 2004 Tax Notes Today 22-13, February 3, 2004.

3.5.2 Department of Justice Summons Enforcement Actions Against KPMG/BDO Seidman/Jenkens & Gilchrist

3.5.2.1 KPMG/BDO Seidman

In July 2002, the IRS filed summons enforcement actions against KPMG LLP and BDO Seidman LLP, two major accounting firms, seeking to obtain documents concerning transactions alleged to be abusive tax shelters.

In *United States v. KPMG LLP*,[161] after an *in camera* review of 30 documents, the court ordered KPMG to turn over to a magistrate judge 1,293 documents listed in KPMG's privilege log. The order instructed the magistrate to examine each document, evaluate the privilege asserted, and make a recommendation to the court.

The IRS issued nine summonses to KPMG between January 28, 2002, and May 3, 2002, asking for information on a wide variety of tax shelter transactions. Although KPMG produced several boxes of records, IRS claimed KPMG did not fully comply with its summonses.

KPMG claimed its documents were protected under the tax practitioner confidentiality privilege of Sec. 7525, the attorney-client privilege, the attorney work product privilege, and "its own privilege" which incorporates the latter two privileges. The court concluded that some documents may be protected under the attorney-client privilege, but generally did not find other privileges to apply.

In January, 2003, the special master appointed to examine KPMG's privilege log recommended that most of the documents be disclosed to the IRS.[162]

On October 16, the special master filed a second report with recommendations that partially support KPMG's claims that many documents the government sought in the promoter summons enforcement action should be protected by not only the attorney-client privilege, but the tax practitioner privilege as well.

Many of the same issues presented in the KPMG litigation, at least with respect to the scope of the Sec. 7525 privilege, are also found in *United States v. BDO Seidman LLP.*[163] Faced with the prospect of one privilege log of 86 pages covering 826 documents and another 42 pages covering 293 documents, the judge referred all of the documents in question to a magistrate for *in camera* inspection to evaluate claims of privilege.

In the same proceeding, two separate groups of John Doe clients of BDO Seidman sought to intervene. The district court initially denied the clients' attempts to intervene, and the intervenors appealed to the Seventh Circuit. The appeals court remanded the case to the district court to make more extensive findings of fact regarding the documents for which the intervenors claimed a privilege under Sec. 7525. In July 2003, the Seventh Circuit issued its opinion holding that the intervenors could not demonstrate a "colorable claim of privilege" in their identities under Sec. 7525.

---

[161] 237 F.Supp. 2d 35 (D.D.C. 2003).

[162] *See* "Special Master Recommends That KPMG Disclose Most Documents in Tax Shelter Promotion Inquiry", 2003 Tax Notes Today 52-18, March 18, 2003.

[163] 225 F. Supp. 2d 918 (N.D. Ill. 2002), aff'd 337 F.2d 802 (7th Cir. 2003).

In another summons enforcement case,[164] the district court relied on the BDO Seidman Seventh Circuit decision to order Arthur Anderson to reveal its clients' identities to the IRS.

Although BDO Seidman was forced to hand over thousands of documents to the government, it was successful in 2004 and 2005 in asserting the attorney-client privilege, Sec. 7525 privilege, and work product doctrine to prevent disclosure of certain other documents.[165]

3.5.2.2 Jenkens & Gilchrist

In June 2003, the IRS filed a summons enforcement action in district court in Illinois against Jenkens & Gilchrist, a major law firm, seeking the disclosure of the names of 600 clients who bought tax shelters, the IRS considers to be abusive.[166] In May 2004, the court ordered Jenkens & Gilchrist to comply with the summonses, and the firm immediately turned over to the government a list of tax shelter investor names.

3.5.2.3 Sidley, Austin, Brown & Wood

In October 2003, the IRS filed a second John Doe summons action, this time on Sidley, Austin, Brown & Wood LLP. In 2004, a district court granted the government's petition to enforce the summons and ordered the firm to deliver to the IRS the names of former clients who allegedly purchased abusive tax shelter products with the help of the firm. However, this order was stayed pending an appeal to the Seventh Circuit.

A John Doe summons differs from an administrative summons in that the statute of limitations for assessing tax deficiencies for the unknown parties – in this case, the investors – is automatically suspended beginning six months after the service of the summons while objections to the summons are resolved. The suspension preserves the status quo if questions about the right of the John Does to assert a privilege in their identity are litigated in a subsequent proceeding seeking enforcement of the John Doe summons.

The IRS sought from the law firm and its predecessor, Brown & Wood LLP, the names, addresses, and taxpayer identification numbers of all U.S. clients who participated in listed or potentially abusive transactions organized or sold by the firm's Chicago office during any part of the period from January 1, 1996, to October 15, 2003.

---

[164] *United States v. Arthur Anderson, LLP*, 2003-2 U.S.T.C. ¶ 50, 624 (N.D. Ill. 2003).

[165] *See* "BDO Seidman Court Breathes Life Into Accountant-Client Privilege", 2005 Tax Notes Today 64-2, April 5, 2005; "BDO Court Rules Attorney-Client Privilege Applies in Shelter Context", 2004 Tax Notes Today 129-1, July 6, 2004.

[166] *United States v. Jenkens & Gilchrist, P.C.*, N.D. Ill., No 03C5693 (August 14, 2003).

3.6 Congressional Response

3.6.1 The American Jobs Creation Act

In October 2004, Congress enacted the AJCA. The AJCA does much to strengthen the Government's hand in combating abusive shelters.

There are 193 provisions in the law, 178 of which require IRS actions. Note that 97% of the provisions in the AJCA were effective either before, on, or within 6 months of the date of enactment.[167] In part, this indicates that taxpayers (and their advisors) will have to be vigilant about monitoring the guidance published by the Internal Revenue Service. The Government's interpretation of these provisions will substantially affect the relationship between taxpayers and the Service and the relationship between taxpayers and their tax advisors.

Title VIII, Subtitle B of the AJCA contains 38 separate sections relating to tax shelter reforms, the most important of which are discussed below.[168]

3.6.2 Section 6707A

In general, Sec. 6707A imposes penalties for failures to disclose transactions that are reportable under Sec. 6011. Sec. 6011 (and its regulations) requires taxpayers that have participated in a reportable transaction to disclose certain information with their tax returns.

3.6.2.1 Reportable Transactions

There are six categories of reportable transactions, including transactions that are the same as, or substantially similar to, transactions that the Internal Revenue Service has determined to be tax avoidance transactions and are identified by notice, regulation, or other form of published guidance (*i.e.* "listed transactions").[169]

Disclosure of listed transactions is not limited to income tax transactions; listed transactions must also be disclosed under Treas. Reg. Sec. 20.6011-4 (estate tax); Treas. Reg. Sec. 31.6011-4 (gift tax); Treas. Reg. Sec. 31.6011-4 (employment tax); Treas. Reg. Sec. 53.6011-4 (foundation and similar excise taxes); Treas. Reg. Sec. 54.6011-4 (pension excise tax) and Treas. Reg. Sec. 56.6011-4 (public charity tax on excess lobbying expenditures).[170]

Notice 2006-6 informed taxpayers that the significant book-tax category of reportable transactions would no longer apply to transactions with a significant book-tax difference that otherwise would have to be disclosed by taxpayers on or after January 6, 2006.

Proposed Treas. Reg. Sec. 1.6011-4(b)(6) proposes "transactions of interest" as a new category of reportable transactions. A transaction of interest is a transaction that is the same as or substantially similar to one of the types of transactions that the

---

[167] KORB, The Case for Tax Reform, Remarks at the City Club of Cleveland, April 15, 2005.
[168] P.L. No. 108-357, Title VIII, Subtitle B, Parts I, II, and III.
[169] *See* Notice 2005-11, 2005-7 I.R.B. 493, citing Treas. Reg. Section 1.6011-4(b)(2).
[170] *Id.*

IRS has identified by notice, regulation, or other form of published guidance as a transaction of interest.

3.6.2.2 Amount of the Penalty

Under Sec. 6707A(b)(1), the amount of the penalty for failing disclose reportable transactions that are not listed transactions are $10,000 in the case of a natural person or $50,000 in any other case.

Under Sec. 6707A(b)(2), the amount of the penalty for failing to disclose a listed transaction is $100,000 in the case of a natural person or $200,000 in any other case.

Prior to the enactment of Sec. 6707A, there was no monetary penalty for the failure by a taxpayer to disclose a reportable transaction.[171]

3.6.2.3 Rescission

The penalty assessed under Sec. 6707A may only be rescinded on transactions other than listed transactions and only in certain circumstances under Sec. 6707A(d).

Under Sec. 6707A(d)(1), in order for the Commissioner to have the authority to rescind the Sec. 6707A penalty, the transaction must both be other than a listed transaction and the rescission of the penalty must promote compliance with the requirements of the Code and effective tax administration.

Under Sec. 6707A(d)(2), there is no judicial review of the Commissioner's determination whether to rescind the Sec. 6707A penalty.

Rev. Proc 2007-21, 2007-9 IRB 1, published on February 2, 2007, provides guidance for taxpayers and material advisers who seek rescission of a Sec. 6707 or 6707A disclosure penalty if the penalty relates to a reportable transaction other than a listed transaction. This revenue procedure describes the procedures for requesting rescission, including the deadline by which a person must request rescission; the information the person must provide in the rescission request; the factors that weigh in favor of and against granting rescission; and where the person must submit the rescission request.

3.6.2.4 Disclosure of Penalties to the SEC

Under Sec. 6707A(e), certain taxpayers also have to disclose the payment of certain penalties to the Securities and Exchange Commission ("SEC"). The penalties which trigger this new reporting obligation are the Sec. 6707A penalty for failure to disclose, the Sec. 6662A penalty for an understatement attributable to an undisclosed listed transaction or undisclosed reportable avoidance transaction; and the 40 percent penalty under Sec. 6662 for gross valuation misstatements if the 30 percent penalty under Sec. 6662A would have applied.

Note that the failure to make the disclosure to the SEC as just described is itself treated as a failure to include information with respect to a listed transaction for which the penalty under Sec. 6707A applies.

---

[171] *Id.*

Rev. Proc. 2005-51, published on August 15, 2005, describes the SEC report on which taxpayers must make the disclosures, the information that must be disclosed, and the deadlines by which persons must make the disclosure in order to avoid additional penalties. Specifically, a person who files SEC Form 10-K must disclose the requirement to pay the penalty in Item 3 (Legal Proceedings) on the Form 10-K filed with the SEC that relates to the fiscal year in which the Service sends the person notice and demand for payment of the penalty.

3.6.2.5 Notice 2005-11

On January 19, 2005, the Service issued Notice 2005-11 to provide interim guidance under Sec. 6707A. Notice 2005-11 provides guidance on the imposition of the Sec. 6707A penalty and the rescission authority under Sec. 6707A(d).

3.6.2.5.1 Imposition of the Section 6707A Penalty

The Sec. 6707A penalty is imposed with respect to each failure to disclose a reportable transaction within the time and in the form and manner provided under Sec. 6011. This penalty may be assessed either for a failure to attach a disclosure statement to an original or amended return or the failure to provide a copy of the disclosure statement to OTSA (if required).

The example provided in Notice 2005-11 illustrates that: (1) Only one penalty will be assessed when the taxpayer fails (with respect to the same transaction and the same taxable year) to file the disclosure statement with either the original return or with OTSA; and (2) If a taxpayer filed an amended return and fails to attach a disclosure statement when required, the penalty can be imposed at that point as well.

3.6.2.5.2 Rescission Authority

In determining whether to rescind the penalty under Sec. 6707A, the Commissioner (or his delegate) will take into account all of the facts and circumstances, including:

a. Whether the taxpayer has a history of complying with the tax laws;
b. Whether the violation results from an unintentional mistake of fact; and
c. Whether imposing the penalty would be against equity and good conscience.

The Commissioner's determination is not reviewable by IRS Appeals or any court.

Rev. Proc. 2007-21 provides greater detail on the factors that weigh in favor of and against granting rescission.

3.6.2.6 Effective Date

Sec. 6707A is effective for returns and statements the due date for which is after October 22, 2004 and which were not filed before that date.[172]

3.6.2.7 Understatement/Underpayment Not Necessary

The Sec. 6707A penalty is imposed regardless of whether the reportable transaction results in an underpayment or understatement and is assessed in addition to other

[172] *See* Sections 403(w) of P.L. No. 109-135 and 811(c) of P.L. No. 108-357.

potentially applicable penalties, including the accuracy-related penalties under Sec. 6662 and 6662A.[173]

3.6.3 Section 6662A

In general, Sec. 6662A provides that a 20-percent accuracy-related penalty may be imposed on any reportable transaction understatement.

A "reportable transaction understatement" means the sum of:

(A) The product of:
  (1)The amount of the increase (if any) in taxable income which results from a difference between the proper tax treatment of an item to which Sec. 6662A applies and the taxpayer's treatment of such item (as shown on the taxpayer's return); and
  (2)The highest rate of tax imposed by Sec. 1 (Sec. 11 for corporations); and
(B) The amount of decrease (if any) in the aggregate amount of credits determined under subtitle A which results from a difference between the taxpayer's treatment of an item to which Sec. 6662A applies (as shown on the taxpayer's return) and the proper tax treatment of such item.[174]

For purposes of determining whether there is a reportable transaction understatement, any reduction in the excess of deductions allowed for the year over gross income (*e.g.* decrease in net operating loss) and any reduction in the amount of capital losses which would be allowed for such year is treated as an increase in taxable income.

Sec. 6662A applies to any listed transaction and any reportable transaction (other than a listed transaction) if a significant purpose of such transaction is the avoidance or evasion of Federal income tax.[175] The Sec. 6662A penalty cannot be stacked with the Sec. 6662 accuracy-related penalty on underpayments or the Sec. 6663 fraud penalty. If either the 75% Sec. 6663 fraud penalty or the 40% Sec. 6662(h) gross valuation misstatement penalty apply, then the Sec. 6662A penalty will not be imposed.

The amount of the Sec. 6662A penalty is 30 percent, rather than 20 percent, if the taxpayer does not adequately disclose, in accordance with 6011 (and the regulations thereunder), the relevant facts affecting the tax treatment of the item giving rise to the understatement.[176] The reasonable cause and good faith defense is not available with respect to the 30 percent penalty.[177]

Under Sec. 6662A(e)(3), tax treatment on an amendment or supplement to a return of tax is not taken into account if the amendment or supplement is filed after the earlier of the date the taxpayer is first contacted by the Service regarding an examination of the return or any other date specified by the Secretary.

---

[173] *See* Section 6707A(f) and Notice 2005-11.
[174] Section 6662A(b)(1) and Notice 2005-12, 2005-7 I.R.B.
[175] Section 6662A(b)(2).
[176] Section 6662A(c), Section 6664(d)(2)(A), and Notice 2005-12.
[177] *Id.*

Except as provided in Sec. 6662A(c), where the 30% penalty applies because the taxpayer did not adequately disclose the reportable transaction, the Sec. 6662A accuracy-related penalty does not apply to any portion of a reportable transaction understatement if, pursuant to Sec. 6664(d), it is shown that there was reasonable cause and the taxpayer acted in good faith.[178]

The reasonable cause and good faith exception does not apply unless:

a. The relevant facts affecting the tax treatment of the item are adequately disclosed in accordance with Sec. 6011;
b. There is or was substantially authority for such treatment; and
c. The taxpayer reasonably believed that such treatment was more likely than not the proper treatment.[179]

Under Sec. 6664(d)(2), the requirement to adequately disclose under Sec. 6011 will be treated as satisfied even if the taxpayer did not in fact disclose if the Sec. 6707A penalty is rescinded.

Under Sec. 6664(d)(3)(B), the opinion of a tax advisor may not be relied upon to establish reasonable belief if either the tax advisor or the opinion is disqualified.

A tax advisor is a disqualified tax advisor if:

a. The advisor is a material advisor (within the meaning of Sec. 6111) and participates in the organization, management, promotion, or sale of the transaction, or is related to any person who so participates;
b. The advisor is compensated directly or indirectly by a material advisor with respect to the transaction;
c. The advisor has a fee arrangement with respect to the transaction which is contingent on all or part of the intended tax benefits from the transaction being sustained; or
d. By regulations, the advisor has a disqualifying financial interest in the transaction.

An opinion is a disqualified opinion if:

a. The opinion is based on unreasonable factual or legal assumptions (including assumptions about future events);
b. The opinion unreasonably relies on representations, statements, findings, or agreements of the taxpayer or any other person;
c. The opinion does not identify and consider all relevant facts; or
d. The opinion fails to meet other requirements prescribed by the Secretary.

3.6.4 Notice 2005-12

Notice 2005-12 provides interim guidance on implementing Sec. 6662A and the revisions to Sec. 6662 and 6664.

For purposes of determining whether the 30 percent penalty applies, the taxpayer will be treated as disclosing the relevant facts affecting the tax treatment of the item

[178] Notice 2005-12.
[179] Section 6664(d)(2).

under Sec. 6011 if the taxpayer filed a disclosure statement under Treas. Reg. Sec. 1.6011-4(d), is deemed to have satisfied its disclosure obligation under Rev. Proc. 2004-45, 2004-31 I.R.B. 140, or satisfies any other published guidance regarding disclosure under Sec. 6011.

For purposes of determining the amount of any reportable transaction understatement, the Service will not take into account amended returns filed after the dates specified in Treas. Reg. Sec. 1.6664-2(c)(3) which are dates after which a taxpayer may not file a "qualified amended return".

Notice 2005-12 also provides interim guidance on when a material advisor is a disqualified tax advisor under Sec. 6664(d)(3)(B). The notice describes certain activities that constitute the organization, management, promotion or sale of a transaction by a material advisor.

A material advisor participates in the "organization" of a transaction if the advisor:

a. devises, creates, investigates, or initiates the transaction or tax strategy;
b. devises the business or financial plans for the transaction or tax strategy;
c. carries out those plans through negotiations or transactions with others; or
d. performs acts related to the development or establishment of the transaction.

A material advisor participates in the "management" of a transaction if the material advisor is involved in the decision-making process regarding any business activity with respect to the transaction, including managing assets, directing business activity, or acting as a general partner of an entity involved in the transaction.

A material advisor participates in the "promotion or sale" of a transaction if they are involved in the marketing of the transaction, including soliciting taxpayer to enter into a transaction or tax strategy, placing an advertisement for the transaction; or instructing or advising others in the marketing of the transaction.

However, consistent with the legislative history, a tax advisor, including a material advisor, will not be treated as participating in one of the activities listed above if the advisor's only involvement in the transaction is rendering an opinion regarding the tax consequences of the transaction.

Notice 2005-12 also defines when a tax advisor will have a disqualified compensation arrangement. Under Sec. 6664(d)(3)(B)(ii), a disqualified compensation arrangement includes:

a. An arrangement by which the advisor is compensated directly or indirectly by a material advisor with respect to a transaction; or
b. A fee arrangement with respect to a transaction that is contingent on all or a part of the intended tax benefits from the transaction being sustained.

Until further guidance, a tax advisor is treated as a disqualified tax advisor if the tax advisor has a referral fee or fee-sharing arrangement by which the advisor is compensated directly or indirectly by a material advisor. This rule applies regardless of whether or not the tax advisor is a material advisor.

An arrangement is also a disqualified compensation arrangement if there is an agreement or understanding (oral or written) with a material advisor of a reportable

transaction pursuant to which the tax advisor is expected to render a favorable opinion regarding the tax treatment of the transaction to any person referred by the material advisor. However, if a material advisor merely recommends the tax advisor and there is no agreement or understanding that the tax advisor will render a favorable opinion, the tax advisor does not have a disqualifying compensation arrangement.

In interpreting when a fee is treated as “a fee that is contingent on all or part of the intended tax benefits from the transaction being sustained”, this includes arrangements that provide that:

a. a taxpayer has the right to a full or partial refund of fees if all or part of the tax consequences of the transaction are not sustained; or
b. the amount of the fee is contingent on the taxpayer’s realization of tax benefits from the transaction.

Notice 2005-12 also solicits comments on these issues. For taxpayers (and their advisors), this was an opportunity to help the Service create rules that, within the constraints of the statute, are rules that practitioners can live with. So far, no comments have been received.

3.6.5 Material Advisor Rules

Both before and after the AJCA, the determination of whether a tax advisor is a “material advisor” has an impact both on the tax advisor and on his or her clients. The AJCA made the following changes to the rules applicable to “material advisors”.

Sec. 6111(a) was amended to require each material advisor with respect to any reportable transaction to make a return (in such form as the Secretary may prescribe) setting forth:

a. information identifying and describing the transaction;
b. information describing any potential tax benefits expecting to result from the transaction; and
c. such other information as the Secretary may prescribe.

Sec. 6111(b) defines a material advisor. A material advisor means any person:

a. Who provides any material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, insuring, or carrying out any reportable transaction; and
b. Who directly or indirectly derives gross income in excess of the threshold amount (or such other amount as may be prescribed by the Secretary) for such advice or assistance. Under Sec. 6111(b)(1)(B), the threshold amounts are: $50,000 in the case of a reportable transaction substantially all of the tax benefits from which are provided to natural persons, and $250,000 in any other case.

Sec. 6111(c) provides certain regulatory authority:

a. That only one person shall be required to meet the Sec. 6111 requirements in cases in which two or more persons would otherwise be required to meet such requirements;

b. Exemptions from the requirements of the section; and
c. Such rules as may be necessary or appropriate to carry out the purposes of the Sec.

Sec. 6112 provides that each material advisor with respect to any reportable transaction is required to maintain a list:

a. Identifying each person with respect to whom such advisor acted as a material advisor with respect to such transaction; and
b. Containing such other information as the Secretary may by regulations require.

Sec. 6708 provides the penalty on a material advisor who fails to provide the list that is required to be maintained under Sec. 6112 in a certain period of time.

3.6.6 Interim Guidance

Since the enactment of AJCA, the Service has issued three notices providing interim guidance on these provisions: Notice 2004-80, Notice 2005-17 and Notice 2005-22.

3.6.6.1 Notice 2004-80[180]

Notice 2004-80 alerts taxpayers to the changes in Sec. 6111, 6112, and 6708, provides that the Service plans to issue regulations in this area, and provides certain interim guidance. The content of the interim guidance covers the following two general areas.

3.6.6.1.1 Disclosure by Material Advisors

The notice provides interim guidance for material advisors in the following areas:

a. Definition of a Reportable Transaction;
b. Definition of a Material Advisor;
c. Which form should by filed by the material advisor until the Form 8264 is revised; and
d. Due date of the return under Sec. 6111.

3.6.6.1.2 Maintenance of Lists by Material Advisors

As interim guidance, the rules of old Treas. Reg. Sec. 301.6112-1 (without regard to the provisions that related to registration under former Sec. 6111) apply to material advisors under the new Sec. 6112. For purposes of former Sec. 6112, old Treas. Reg. Sec. 301.6112-1 will continue to apply, even to periods expiring after October 22, 2004.

The notice also provides rules for determining the period after which the Sec. 6708 penalty will apply.

---

[180] 2004-50 I.R.B. 963.

3.6.6.2 Notice 2005-17

Notice 2005-17[181] provides an extension of the transition relief in Notice 2004-80 by providing that advisors that became material advisors after October 22, 2004, and on or before January 22, 2005, must file the return before March 1, 2005.

3.6.6.3 Notice 2005-22

Notice 2005-22[182] provides additional interim guidance to material advisors in the following areas:

a. How to complete of the Form 8264, as modified by Notice 2004-80.
b. When an advisor becomes a material advisor:
   Until further guidance, an advisor becomes a material advisor when all of the following events have occurred:
   i. The material advisor makes a tax statement;
   ii. The material advisor receives (or expects to receive) the minimum fees; and
   iii. The transaction is entered into by the taxpayer.
c. When the disclosure must be filed:
   Until further guidance, the filing obligation under Sec. 6111 is met if the Form 8264 is filled by the last day of the month that follows the end of the calendar quarter in which the advisor became a material advisor.
   Also, the relief in Notice 2005-17 is extended from March 31, 2005, to April 30, 2005.
   Once an advisor is a material advisor and files the Form 8264 with respect to the transaction, the material advisor is not required to file an additional Form 8264 for each additional taxpayer that subsequently enters into the same transaction or for separate transactions that are the same as, or substantially similar to, the transaction for which the material advisor has filed a Form 8264.
d. Whether the tolling provision under Treas. Reg. Sec. 1.6011-4(f) (with regard to whether the filing of a PLR request suspends the disclosure requirement) continues to apply. Temp. Reg. under Sec. 1.6011-4T(f), issued on November 2, 2006, eliminated the tolling provisions, providing that the potential obligation of the taxpayer to disclose the transaction under this section will not be suspended during the period that the ruling request is pending.
e. Whether Sec. 6112 (as amended) and Notice 2004-80 exclude persons who do not provide accounting advice (it does not). And
f. Additional effective date guidance for Notice 2004-80.

3.6.7 Proposed Regulations Under Sections 6011, 6111 and 6112

In addition to issuing the three notices, on November 2, 2006, the Internal Revenue Service issued proposed regulations under Sec. 6011, 6111 and 6112.[183]

---

[181] 2005-8 I.R.B. 606.
[182] 2005-12 I.R.B. 756.
[183] *See* 71 CFR 64488, 71 CFR 65596-01, and 71 CFR 64501.

3.6.7.1 Proposed Regulations Under Treas. Reg. Section 301.6011-4 (Requirement of Statement Disclosing Participation in Certain Transactions)

a. Eliminate the transactions with a significant book-tax difference category of reportable transaction.
b. Create as a new category of reportable transaction the “transactions of interest” reportable transaction. A “transaction of interest” is a transaction that the IRS and Treasury Department believe has a potential for tax avoidance or evasion, but for which the IRS and Treasury Department lack enough information to determine whether the transaction should be identified specifically as a tax avoidance transaction. Transactions of interest will be identified in published guidance.
c. Eliminate the special rule for lease transactions. Under the current regulations this special rule provides that certain customary commercial leases of tangible personal property described in Notice 2001-18, 2001-1 C.B. 731, are excluded from all of the reportable transaction categories except listed transactions. Because the confidential transaction category has been narrowed and the significant book-tax difference transaction category is being removed, the proposed regulations require leasing transactions to be subject to the same disclosure rules as other transactions.
d. Amend the brief asset holding period category to exclude transactions resulting in a claimed foreign tax credit in Treas. Reg. Sec. 1.6011-4(b)(7).
e. Allow protective disclosures to be filed in situations where a taxpayer is unsure of whether the transaction should be disclosed under Sec. 6011 if the taxpayer complies with the rules of Treas. Reg. Sec. 1.6011-4 as if the transaction is subject to disclosure and the person furnishes the IRS the information requested under these regulations.
f. Provide that if a taxpayer in a partnership, S corporation, or trust receives a timely Schedule K-1 less than 10 calendar days before the due date of the taxpayer's return (including extensions) and, based on receipt of the timely Schedule K-1, the taxpayer determines that the taxpayer participated in a reportable transaction, the disclosure statement will not be considered late if the taxpayer discloses the reportable transaction by filing a disclosure statement with OTSA within 45 calendar days after the due date of the taxpayer's return (including extensions).
g. Eliminate the tolling of the time for providing disclosure when a taxpayer requests a private letter ruling. Temporary regulations removing the tolling provision were issued concurrently with these proposed regulations.

3.6.7.2 Proposed Regulations Under Treas. Reg. Section 301.6111-3 (Disclosure of Reportable Transactions)

a. Require each material advisor with respect to any reportable transaction to file a return.
b. Provide that a person is a material advisor with respect to a transaction if the person provides any material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, insuring, or carrying out any reportable transaction, and directly or indirectly derives gross income in excess

of the threshold amount for the material aid, assistance, or advice. A person provides material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, insuring, or carrying out any transaction if the person makes or provides a tax statement to or for the benefit of certain persons.

c. Provide that a person will be treated as becoming a material advisor when all of the following events have occurred (in no particular order): (A) The person provides material aid, assistance or advice; (B) the person directly or indirectly derives gross income in excess of the threshold amount; and (C) the transaction is entered into by the taxpayer.
d. Provide that the threshold amount of gross income that a person may derive, directly or indirectly, for providing any material aid, assistance or advice is $50,000 in the case of a reportable transaction, substantially all of the tax benefits from which are provided to natural persons ($10,000 in the case of a listed transaction). This threshold amount of gross income is increased to $250,000 in any other case ($25,000 in the case of a listed transaction).
e. Provide that the disclosure statement for a reportable transaction must be filed by the last day of the month that follows the end of the calendar quarter in which the advisor became a material advisor with respect to the reportable transaction.

3.6.7.3 Proposed Regulations Under Treas. Reg. Section 301.6112-1 (Material Advisor Must Keep Lists)

a. Provide that each material advisor must maintain a list identifying each person with respect to whom the advisor acted as a material advisor and containing other information described in the regulations.
b. Provide that the information that must be contained in the list under these proposed regulations is similar to the information required to be included on the list under the current Treas. Reg. Sec. 301.6112-1, with some additions or clarifications, such as, the name of each other material advisor to the transaction, if known by the material advisor, and any designation agreement to which the material advisor is a party.
c. Clarify that the list to be maintained by the material advisor and furnished to the IRS upon request consists of three separate components: (1) An itemized statement of information, (2) a detailed description of the transaction, and (3) copies of documents relating to the transaction.
d. Clarify that the list must be maintained even if a claim of privilege is made by a material advisor.
e. Contain no provision to toll the requirement for maintaining the list when a potential material advisor requests a private letter ruling on a specific transaction. Final regulations were issued concurrently with the proposed regulations removing the tolling provisions for all ruling request received on or after November 1, 2006.
f. Provide that failure to maintain the list in accordance with this provision subjects a person to the penalty under Sec. 6708.

3.6.8 Section 6501(c)(10)

The AJCA also changes the statute of limitations for listed transaction. New Sec. 6501(c)(10) provides that "if a taxpayer fails to include on any return or statement for any taxable year any information with respect to a listed transaction (as defined in Section 6707A(c)(2)) which is required under Section 6011 to be included with such return or statement, the time for assessment of any tax imposed by this title with respect to such transaction shall not expire before the date which is 1 year after the earlier of:

(A) the date on which the Secretary is furnished the information so required, or
(B) the date that a material advisor (as defined by section 6111) meets the requirements of Section 6112 with respect to a required by the Secretary under Section 6112(b) relating to such transaction with respect to such taxpayer."

New Sec. 6501(c)(10) continues the bias in AJCA in favor of disclosure; the statute of limitation is only extended on a listed transaction on which both the taxpayer has not disclosed under Sec. 6011 *and* the material advisor has also failed to fulfill its disclosure obligation. Revenue Procedure 2005-26, 2005-17 I.R.B. 965, provides additional guidance on Sec. 6501(c)(10).

3.6.9 Section 6404(g)

The AJCA also amended the circumstances under which interest which otherwise would have been suspended by operation of Sec. 6404(g) is not suspended. In general, Sec. 6404(g) provides that, in certain circumstances, where the Secretary does not provide a notice to the taxpayer specifically stating the taxpayer's liability and the basis for the liability before the close of the 18 month period beginning on the later of the date on which the return is filed or the due date of the return without regard to extensions, the Secretary suspends the imposition of interest (and other additional amounts) related to the suspension period.

Prior to the changes in the AJCA, interest would be suspended on certain listed transactions if they were not otherwise in a category defined in Sec. 6404(g)(2).

The AJCA provided that, under Sec. 6404(g)(2)(D) and (E), any interest, penalty, addition to tax, or additional amount would not be suspended:

a. with respect to any gross misstatement; or
b. any reportable transaction with respect to which the requirement of Sec. 6664(d)(2)(A) is not met and any listed transaction (as defined in Sec. 6707A(c)).

3.6.10 Limitations on Privilege – Changes to Section 7525

The AJCA also limits the scope of the Sec. 7525 privilege for communications regarding tax shelters. In general, the change in the AJCA broadened the scope of the limitation in Sec. 7525(b) from communications between a federally authorized tax practitioner and a "director, shareholder, officer, or employee, agent, or representative *of a corporation*" (emphasis added) to "(A) any person, (B) any director, officer, employee, agent or representative of that person, or (C) any other person holding a capital or profits interest in the person" where the communication is in

connection with the promotion of the direct or indirect participation of the person in any tax shelter (as defined in Section 6662(d)(2)(C)(ii))."

3.6.11 TIPRA – New Excise Taxes, Disclosure Requirements and Penalties

The Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA), enacted on May 17, 2006, includes new excise taxes under Sec. 4965 that target prohibited tax shelter transactions to which a tax-exempt entity is a party.

For this purpose, the term "tax exempt entity" means an entity which is described in Sec. 501(c) or 501(d), Sec. 170(c), an Indian tribal government (within the meaning of Sec. 7701(a)(40), Sec. 4979(e)(1-3), Sec. 529, an eligible deferred compensation plan described in Sec. 457(b) which is maintained by an employer described in Sec. 4457(e)(1)(A), or an arrangement described in Sec. 4973(a).

Prohibited tax shelter transactions under these rules consist of listed transactions, confidential transactions, and transactions with contractual protection under Sec. 6011.

TIPRA also contains new disclosure requirements, under Sec. 6033, which apply not only to tax-exempt entities but also to taxable entities that are parties to prohibited tax shelter transactions involving tax-exempt entities, and makes penalties under Sec. 6652 applicable for failure to comply with each new disclosure requirement.

3.7 Marketplace Response

3.7.1 Sarbanes-Oxley Act of 2002[184]

The auditor independence provisions of the Sarbanes-Oxley Act have particular significance for the tax and accounting professions since they deal with the relationships that public companies have with outside providers of tax and other non-audit services. The auditor independence provisions of the Act were aimed at addressing the concerns that an unlimited relationship between a company and its auditors keeps an auditor from performing its long perceived role as a "public watchdog" and undermines the integrity of its financial statements.

According to the Government Accountability Office (GAO), 61 "Fortune 500" companies obtained tax shelter services from their external auditor during 1998 through 2003. Estimated multi-year potential tax revenue lost to the federal government from the 61 companies' auditor-related transactions was about $3.4 billion. More companies – 114 – obtained tax shelter services from any accounting firm. In addition, the GAO reports that, in 17 companies, at least one officer or director used the company's auditor to obtain individual tax shelter services.[185]

In July 2005, the Public Company Accounting Oversight Board (PCAOB) published final rules addressing public accounting firms' provision of tax services to public company audit clients.[186] The rules focus on the following three classes of tax

---

[184] P.L. 107-204, July 30, 2002.

[185] *See* GOVERNMENT ACCOUNTABILITY OFFICE, Tax Shelters: Services Provided by External Auditors, GAO-05-171 (2005).

[186] *See* PCAOB Release No. 2005-014, July 26, 2005.

services that PCAOB believes impair an auditor's independent judgment, in fact or appearance, in its audit work.

3.7.1.1 Services Related to Potentially Abusive Tax Transactions (Rule 3522)

This rule applies to two types of transactions: confidential transactions and aggressive tax position transactions.

With regard to confidential transactions, the rule provides that a registered public accounting firm is not independent of its audit client if the firm provides any non-audit service to the audit client related to marketing, planning, or opining in favor of the tax treatment of a transaction that is a confidential transaction.

With regard to aggressive tax position transactions, the rule provides that a registered public accounting firm is not independent of its audit client if the firm provides any non-audit service to the audit client relating to marketing, planning, or opining in favor of the tax treatment of a transaction that was initially recommended, directly or indirectly, by the firm and a significant purpose of the transaction is tax avoidance, unless the proposed tax treatment is at least more likely than not to be allowable under applicable tax laws. This rule covers (but is not limited to) transactions that are listed transactions within the meaning of Treas. Reg. Sec. 1.6011-4(b)(2).

3.7.1.2 Services to a Public Company Audit Client for a Contingent Fee (Rule 3521)

The rule provides that a registered public accounting firm is not independent of its audit client if the firm provides any service or product to the audit client for a contingent fee or a commission. A contingent fee is "any fee established for the sale of a product or the performance of any service pursuant to an arrangement in which no fee will be charged unless a specified finding or result is attained, or in which the amount of the fee is otherwise dependent upon the finding or result of such product or service."

3.7.1.3 Services to Certain Persons Who Serve in Financial Reporting Oversight Roles at a Public Company Audit Client (Rule 3523)

The rule provides that a registered public accounting firm is not independent of its audit client if the firm provides tax services to certain members of management who serve in financial oversight roles at the audit client or to immediate family members of such persons.

3.7.2 Lawsuits vs. Big Four Accounting Firms and Law Firms

In light of the significant publicity in 2003 concerning the tax shelter products sold by Ernst & Young to the senior executives of Sprint Corporation, it appears that the Big Four accounting firms, along with law firms that partnered with them, will be facing a backlash from companies and individuals (like the Sprint executives) who were advised by them to engage in so-called "tax shelter" products, particularly in cases where the IRS is challenging the intended tax benefits.

In February 2002, there were a number of articles in not only the tax press, but also in national publications like The Wall Street Journal and The New York Times noting that lawsuits are beginning to be filed by individuals who are under audit by the IRS. Furthermore, as the Congress, Treasury and IRS (perhaps along with the SEC) continue their attacks on tax shelters, it is not hard to foresee that some corporations will eventually turn on their tax consultants, particularly where the consultant is not the auditor for the company (*i.e.*, where a "one off" tax product was sold by a Big Four accounting firm to a non-audit client).[187]

On September 17, 2003, a class action was filed by a number of investors against Ernst & Young, Jenkens & Gilchrist, Brown & Wood, Deutsche Bank and others seeking damages from a foreign currency digital option scheme.[188]

In 2005, KPMG and law firm Jenkens & Gilchrist took the first major steps toward dealing with civil claims made by shelter investors against accounting and law firms. In the case of KPMG, the firm agreed in September 2005 to a $225 million settlement with 280 shelter investors who bought BLIPS, FLIPS, OPIS, and SOS shelters sold by KPMG through law firm Brown & Wood. In February 2005, Jenkens & Gilchrist, the first law firm to be served with a John Doe summons in the government's shelter promoter investigations, agreed to pay $85 million to settle class action litigation brought by investors in its COBRA shelter (a variation of the Son-of-BOSS shelter described in Notice 2000-44).

3.7.3 Second Opinions Demanded by Corporate Boards

In the aftermath of the Enron scandal and the enactment of the Sarbanes-Oxley Act, the boards of directors of many public companies have become painfully aware of the downside of investing in the corporate tax shelter products that Big Four accounting firms and others are marketing. More and more, boards are requesting company management to attend board meetings and explain why they want to participate in these transactions and what the risks of participation are.

Final rules related to auditor independence were released by the SEC on January 28, 2003.[189] Under these rules many board audit committees have had no problem

[187] *See* "Accounting Firms Face Backlash Over the Tax Shelters They Sold", Wall Street Journal, February 7, 2003; "Accountants Seek Shelter From Suits", New York Times, February 2003; "Tax Shelter Sellers Lie Low for Now, Wait Out Storm", Wall Street Journal, February 14, 2003; "Wall St. Banks Said to Help Enron Devise Its Tax Shelters", New York Times, February 14, 2003; "Costly Questions Arise on Legal Opinions for Tax Shelters", New York Times, February 9, 2003; "Wealthy Family is Suing Lawyer Over Tax Plan", New York Times, July 19, 2003; "Opinion Writers Getting Off Scot-Free, Former Commissioners Say", 2003 Tax Notes Today 214-8, November 5, 2003; and BRAVERMAN, The Bleeding Edge, 25 American Lawyer 94 (6/2003).

[188] *See* 2003 Tax Notes Today 198-40.

[189] Final Rule: Strengthening the Commission's Requirement Regarding Auditor Independence, Securities Act Rel. No. 33-8183, Exchange Act Rel. No. 34-47265, Public Utility Holding Co. Act Rel. No. 35-27642, Investment Co. Act Rel. No. IC-25915, Investment Advisers Act Rel. No. IA-2103, Financial Reporting Rel. No. FR-68, January 28, 2003, 68 Fed. Reg. 6006 (2003) (available at http://www.sec.gov/rules/final/33-8183.htm).

in formulating a policy that their auditor should not provide tax shelter related services.

In addition, many public companies have adopted as a best practice the requirement that its regular outside legal counsel or independent tax counsel review tax products that the company is considering implementing. Generally, this policy applies to any tax product regardless of the promoter.

Consultation with regular outside counsel or independent tax counsel often ends up with the taxpayer declining to engage in the proposed transaction. In those cases where the proposed transaction works technically and there is a good business non-tax reason for implementing the transaction, consultation with counsel often results in improving the transaction and properly implementing it so that it will be more likely to withstand IRS scrutiny and stand up in court if the case goes that far.

3.8 Codification of the Economic Substance Doctrine

3.8.1 Introduction

The AJCA gave the Service a number of tools to help address abusive tax shelters. However, one tool Congress considered, but rejected, was codification of the economic substance doctrine.

In general, there has been some resistance to the codification on the economic substance doctrine.[190] In a recent interview, Eric Solomon (the Acting Treasury Deputy Assistant to the Secretary for Tax Policy) and I expressed some of concerns regarding codification of the economic substance doctrine, including:

a. Codification could lead to more potentially abusive transactions, rather than fewer, as some practitioners construct transactions that fall just outside of the codified doctrine;
b. Promoters and others could use legislation detailing the codified doctrine to "fashion deals that were unintended by Congress"; and
c. Courts are a more appropriate venue to rule on tax shelter cases because courts are able explore more fully the facts of each case (which a statute could not).[191]

At the beginning of the year, I spoke at length on where we are, and where the courts are, on the economic substance doctrine. I have suggested that the judicial economic substance doctrine should be asserted "rarely and judiciously" and not as a general anti-abuse rule. The doctrine should be considered where the transaction "does not appear to be in accord with Congressional intent and common sense."[192]

---

[190] BNA Daily Tax Report, February 14, 2005; *see also* BNA Daily Tax Report, May 24, 2005; and BNA Daily Tax Report, February 2, 2007.

[191] *Id.*; for a discussion of recent court cases involving the economic substance doctrine, *see* SILVERMAN/LERNER/KIDDER, The Economic Substance Doctrine: Sorting through the Federal Circuit's "We Know It When We See It" Ruling in Coltec, 58 Tax Executive 423 (2006).

[192] KORB, The Economic Substance Doctrine in the Current Tax Shelter Environment, Remarks at the 2005 University of Southern California Tax Institute, January 25, 2005 (hereinafter "the Economic Substance Speech"); KORB, Remarks at the 2007 University of Southern California Tax Institute, January 23, 2007.

Rather than address where the legal profession and the courts have been on the doctrine, what do taxpayers (and their tax advisors) need to know about the economic substance doctrine in the future?

Below is a discussion of the current legislative proposals on clarifying the economic substance doctrine and the current discourse on the pros and cons of the codification of the economic substance doctrine.

3.8.2 Background – Codification of the Economic Substance Doctrine

Codification of the economic substance doctrine in concept was considered as early as 1999.[193] Legislation was introduced in 1999 to add a disallowance rule for "noneconomic tax attributes", which were any deductions, loss, or credit unless the transaction changed the taxpayer's economic position in a meaningful way and the present value of the potential income from the transaction is substantial in relation to the tax benefits claimed.[194] Legislative proposals were also made in 2001, 2002, and 2003.

Earlier this year, the Senate Permanent Subcommittee on Investigations recommended that Congress should legislatively clarify and strengthen the economic substance doctrine.[195]

3.8.3 Current Proposals: Safe, Accountable, Flexible, and Efficient Transportation Equity Act of 2005[196]

This bill (as amended by the Senate) would add Sec. 7701(o) – "Clarification of Economic Substance Doctrine; Etc." New Sec. 7701(o) would provide that "[i]n any case in which a court determines that the economic substance doctrine is relevant for purposes of this title to a transaction (or series of transactions), such transaction (or series of transactions) shall have economic substance only if the requirements of this paragraph are met."[197]

Under the Safe, Accountable, Flexible, and Efficient Transportation Equity Act of 2005 (H.R. 3 as passed by the Senate), a transaction "has economic substance only if –

(I) the transaction changes in a meaningful way (apart from Federal tax effects) the taxpayer's economic position, and

---

[193] For a more complete history of the economic substance doctrine, *see* KORB/LASKY, Sham Transaction and Economic Substance, Federal Bar Association Insurance Tax Seminar, June 20-21, 2002.

[194] *See* Abusive Tax Shelter Shutdown Act of 1999, H.R. 2255, 106th Cong. § 3 (1999). In February of 1999, the Treasury Department also included in its Fiscal Year 2000 Budget Proposals a proposal to expand the scope of section 269 to address other "tax avoidance transactions." *See also* NEW YORK STATE BAR ASSOCIATION TAX SECTION, Report on the Treasury's Proposal to Codify the Economic Substance Doctrine, July 25, 2000.

[195] PERMANENT SUBCOMMITTEE ON INVESTIGATIONS OF THE COMMITTEE ON HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS, *supra* note 7.

[196] Safe, Accountable, Flexible, and Efficient Transportation Equity Act, H.R. 3, 109th Cong., §5521, May 17, 2005.

[197] *Id.*, at proposed section 7701(o)(1)(A).

(II) the taxpayer has a substantial nontax purpose for entering into such transaction and the transaction is a reasonable means of accomplishing such purpose."[198]

However, the legislation provides "[i]n applying subclause (II), a purpose of achieving a financial accounting benefit shall not be taken into account in determining whether a transaction has a substantial nontax purpose if the origin of such financial accounting benefit is a reduction of income tax."[199]

Where a taxpayer is relying on the presence of a profit potential, the legislation provides that "A transaction shall not be treated as having a potential for profit unless –

(I) the present value of the reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected, and
(II) the reasonably expected pre-tax profit from the transaction exceeds a risk-free rate of return."[200]

For purposes of determining pre-tax profit, fees and other transaction expenses (including foreign taxes) are taken into account as expenses.[201]

Proposed Sec. 7701(o)(2) provides special rules for transactions with tax-indifferent parties.

a. For financing transactions:
"The form of a transaction which is in substance the borrowing of money or the acquisition of financial capital directly or indirectly from a tax-indifferent party shall not be respected if the present value of the deductions to be claimed with respect to the transaction is substantially in excess of the present value of the anticipated economic returns of the person lending the money or providing the financial capital. A public offering shall be treated as a borrowing, or an acquisition of financial capital, from a tax-indifferent party if it is reasonably expected that at least 50 percent of the offering will be placed with tax-indifferent parties."[202]
b. For transactions involving artificial income shifting and basis adjustments:
"The form of a transaction with a tax-indifferent party shall not be respected if –
(i) it results in an allocation of income or gain to the tax- indifferent party in excess of such party's economic income or gain, or
(ii) it results in a basis adjustment or shifting of basis on account of overstating the income or gain of the tax-indifferent party."[203]

The proposed legislation defines a tax-indifferent party as "any person or entity not subject to tax imposed by subtitle A. A person shall be treated as a tax-indifferent

---

[198] *Id.,* at proposed section 7701(o)(1)(B)(i).
[199] *Id.*, at proposed section 7701(o)(1)(B)(i) succeeding flush.
[200] *Id.*, at proposed section 7701(o)(1)(B)(ii).
[201] *Id.*, at proposed section 7701(o)(1)(C).
[202] *Id.*, at proposed section 7701(o)(2)(A).
[203] *Id.*, at proposed section 7701(o)(2)(B).

party with respect to a transaction if the items taken into account with respect to the transaction have no substantial impact on such person's liability under subtitle A."[204]

The proposed legislation also provides an exception for personal transactions of individuals:

a. "In the case of an individual, this subsection shall apply only to transactions entered into in connection with a trade or business or an activity engaged in for the production of income."[205]
b. The version of economic substance contained in the JOBS Act (although not adopted in the AJCA) provided an exception for personal transactions of individuals.[206]

The proposed legislation also contains:

a. Special rules for lessors;[207]
b. Provision that, except as specifically provided, the section does not affect other rules of law;[208] and
c. A grant of regulatory authority to the Secretary.[209]

The Safe, Accountable, Flexible, and Efficient Transportation Equity Act of 2005 (H.R. 3 as passed by the Senate) also provides a separate penalty (new Sec. 6662B) for transactions lacking economic substance.[210] In general, if a taxpayer has a "non-economic substance transaction, there shall be added to the tax an amount equal to 40 percent of the amount of such understatement."[211] The amount of the addition to tax is 20 percent, as opposed to 40 percent, "with respect to the portion of any non-economic substance transaction understatement with respect to which the relevant facts affecting the tax treatment of the item are adequately disclosed in the return or a statement attached to the return."[212]

The codification of the economic substance doctrine (including the penalty associated with the codification) has been scored by the Joint Committee on Taxation as raising $16 billion in revenue.[213]

---

[204] *Id.*, at proposed section 7701(o)(3)(B).
[205] *Id.*, at proposed section 7701(o)(3)(C).
[206] Jumpstart Our Business Strength (JOBS) Act, S.1637, 108th Cong. § 401 (2003), at Section 7701(n)(3)(C).
[207] *Id.*, at proposed section 7701(o)(3)(D).
[208] *Id.*, at proposed section 7701(o)(4).
[209] *Id.*, at proposed section 7701(o)(5).
[210] *Id.*, at § 5522, adding section 6662B.
[211] *Id.*, at proposed section 6662B(a).
[212] *Id.*, at proposed section 6662B(b).
[213] STAMPER, "Highway Bill Survives Point of Order, Tax Title Power Struggle", Tax Notes Today, Doc. 2005-10338, May 12, 2005.

3.8.4 "Options to Improve Tax Compliance and Reform Tax Expenditures"

The Joint Committee on Taxation (JCT) proposed another method of codifying economic substance on January 27, 2005.[214]

JCT recommends a two-pronged conjunctive test for economic substance. Thus, under this proposal, a transaction must satisfy both a subjective business purpose test and objective economic substance test. JCT describes the test as follows:

> "Under the proposal, an applicable transaction must satisfy both the objective and subjective prongs of the economic substance doctrine – *i.e.*, it must change in a meaningful way (apart from Federal income tax consequences) the taxpayer's economic position, and the taxpayer must have a substantial non-tax purpose for entering into such transaction – in order to satisfy that doctrine. This clarification eliminates the disparity that exists among the circuits regarding the application of the doctrine to applicable transactions."[215]

The proposal provides that codification of the economic substance doctrine would not affect any existing rule of law.[216] In addition, the JCT exempts the codified economic substance doctrine a transaction if the taxpayer can establish that the transaction is clearly consistent with all applicable provisions of this title and the purposes of such provisions.[217]

JCT's proposal to codify the conjunctive two-prong economic substance test is similar to prior legislative attempts to codify economic substance.[218]

3.8.4.1 Non-Tax Purpose (Subjective Test)

Under the JCT proposal regarding nontax business purpose, the non-tax purpose for entering into the transaction must be "substantial" and must "bear a reasonable relationship" to the taxpayer's business or investment activities.

The purpose of achieving a financial accounting benefit is not taken into account if the source of this benefit is a reduction in income tax (for example, the

---

[214] STAFF OF THE JOINT COMMITTEE ON TAXATION, Options to Improve Tax Compliance and Reform Tax Expenditures, JCS-02-05 (2005) (hereinafter "JCT Report").

[215] *Id.*, at 21. The Senate Permanent Subcommittee on Investigations called on Congress to "clarify and strengthen" the economic substance doctrine. PERMANENT SUBCOMMITTEE ON INVESTIGATIONS OF THE COMMITTEE ON HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS, *supra* note 7.

[216] *Id.*, at 30, statutory draft language at section 7701(n)(3)(D). If this includes the common law economic substance doctrine, this could lead to the anomalous result that a transaction would not be subject to the codified economic substance doctrine, but might be subject to the common law economic substance doctrine, if the Service chose to assert it.

[217] *Id.*, at 30, statutory draft language at section 7701(n)(3)(B).

[218] Jumpstart Our Business Strength (JOBS) Act, *supra* note 206. *See also* CARE Act of 2003, S.476, 108th Cong. § 701 (2003); Tax Shelter Transparency and Enforcement Act, S.1937, 108th Cong. § 101 (2003); Rebuild America Act of 2003, S.1409, 108th Cong. § 1101 (2003); American Competitiveness and Corporate Accountability Act of 2002, H.R. 5095, 107th Cong. § 101 (2002); Abusive Tax Shelter Shutdown Act of 2001, H.R. 2520, 107th Cong. § 101 (2001).

generation of tax deductions or losses without corresponding financial accounting charges).[219]

The Economic Substance Speech discussed that the taxpayer must demonstrate "that the taxpayer was motivated by the opportunity to profit from the transaction, or at least had a valid business reason for entering into the transaction other than tax savings."[220] Evidence of a taxpayer's intent includes whether a profit was possible, whether the taxpayer has a nontax business reason to engage in the transaction, and whether the taxpayer (or its advisors) considered or investigated the transaction, including market risk.[221]

Under the JCT's proposal, the nontax business purpose must be "substantial". Also, it must bear a "reasonable relationship" to the taxpayer's business or investment activities.

The JCT cites to *ACM* and Treas. Reg. Sec. 1.269-2, provides that a distortion of tax liability indicating a principle purpose of tax avoidance or evasion might be evidenced by "the fact that the transaction was not undertaken for reasons germane to the conduct of the business of the taxpayer."[222]

The proposed codification of the economic substance doctrine in the JOBS Act (which was not adopted) enhanced the test for nontax business purpose by requiring both that the taxpayer have a substantial nontax business purpose and that the transaction is a reasonable means of accomplishing that purpose.[223]

3.8.4.2 What is a Meaningful Change in Taxpayer's Economic Position (Objective Test)?

The JCT proposal expresses objective economic substance as a meaningful change in the taxpayer's economic position.[224] An example provided in the proposal as "suspect" is "if money (or any other asset or liability) moves in a circular manner, such that the taxpayer's or another party's apparent financial outlay is largely protected from risk and is reasonably expected to be returned to that party or a related party when the transaction is complete."[225]

The Economic Substance Speech indicates that one measure of objective economic substance is a legitimate potential for pre-tax profit. Evidence that this potential exists is that the transaction is "carefully conceived and planned in accordance with standards applicable to a particular industry, so that judged by

[219] The prior legislation also contained language relating to financial accounting as a nontax business purpose. *See id.*
[220] KORB (Economic Substance Speech), *supra* note 192, at 9.
[221] *Id.*
[222] *Id.*, at fn. 58.
[223] JOBS Act, *supra* note 206. As noted above, this language is the same as the language used in H.R. 3, as passed by the Senate.
[224] In the statutory draft included in the JCT Report, objective economic substance is described as: "the transaction changes in a meaningful way (apart from Federal tax effects) the taxpayer's economic position." STAFF OF THE JOINT COMMITTEE ON TAXATION, *supra* note 214, at 29.
[225] *Id.*, at 22.

those standards the hypothetical reasonable businessman would participate in the investment."[226]

In the prior legislation, Congress sought to limit taxpayer's ability to argue that a scintilla of profit was sufficient to imbue a transaction with economic substance. For example, the Senate Report accompanying the JOBS Act expressed concern regarding the case law that a nominal profit was sufficient to demonstrate objective economic substance.[227]

Based on that concern, the JOBS Act contained language that, where a taxpayer relies on a potential for profit to demonstrate economic substance, the taxpayer must demonstrate that "the present value of the reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected" and "the reasonably expected pre-tax profit from the transaction exceeds a risk-free rate of return."[228]

In addition, the draft statutory language provided that fees and foreign taxes must be taken into account in determining whether a transaction has a possibility for profit.[229] The draft statutory language also provided a special rule for lessors that the expected net tax benefit with respect to leased property does not include the benefits of depreciation, any tax credit, or any other deduction as provided by the Secretary, and special rules for tax-exempts.[230]

As noted, this is the same standard as in the Safe, Accountable, Flexible, and Efficient Transportation Equity Act of 2005 (H.R. 3 as passed by the Senate).

3.8.4.3 Circumstances Where the Economic Substance Doctrine Would be Asserted Under the JCT Proposed Legislation?

Under the JCT approach, statutory economic substance only applies to an enumerated list of transactions called "applicable transactions". The applicable transactions are:

a. A transaction in which the taxpayer holds offsetting positions which substantially reduce the risk of loss, and tax benefits would result from differing tax treatment of the positions;
b. A transactions which is structured to result in a disparity between basis and fair market value which creates or increases a loss or reduces a gain;
c. A transaction which is structured to create or increase a gain in an asset any portion of which would not be recognized for Federal income tax purposes if the asset were sold at fair market value by the taxpayer (or a related person);

---

[226] KORB (Economic Substance Speech), *supra* note 192, at 10.
[227] Senate Rpt. 108-192, 108th Cong., 1st Session (2003).
[228] JOBS Act, *supra* note 206, at Sec. 401. *See also* CARE Act, *supra* note 218, at Sec. 701 (draft language at Section 7701(n)(1)(B)(ii)); Tax Shelter Transparency and Enforcement Act, S.1937, 108th Cong. § 101 (2003); Rebuild America Act of 2003, S.1409, 108th Cong. § 1101 (2003); American Competitiveness and Corporate Accountability Act of 2002, H.R. 5095, 107th Cong. § 101 (2002); Abusive Tax Shelter Shutdown Act of 2001, H.R. 2520, 107th Cong. § 101 (2001).
[229] *Id.*
[230] *Id.*

d. A transaction which is structured to result in income for Federal income tax purposes to a tax indifferent party for any period which is materially in excess of any economic income to such party with respect to the transaction for such period;
e. A transaction in which the taxpayer disposes of property (other than inventory, receivables, or stock or securities regularly traded on an established securities market) which the taxpayer held for a period less than 45 days. The rules of Sec. 246(c)(3) and (4) shall apply in determining holding period for this purpose;
f. A transaction which is structured to result in a deduction or loss which is otherwise allowable under this title and which is not allowed for financial reporting purposes; or
g. A transaction which is specified in regulations prescribed by the Secretary.[231]

The JCT proposal would also allow the Secretary to add or exempt transactions from this list.

To compare, the Safe, Accountable, Flexible, and Efficient Transportation Equity Act of 2005 (H.R. 3 as passed by the Senate) does not have a specific list of transactions to which the economic substance doctrine would apply.

As mentioned above, the JCT exempts the codified economic substance doctrine a transaction if the taxpayer can establish that the transaction is clearly consistent with all applicable provisions of this title and the purposes of such provisions.[232] The Safe, Accountable, Flexible, and Efficient Transportation Equity Act of 2005 (H.R. 3 as passed by the Senate) does not have this restriction. Prior proposals did not contain the exception provided in the JCT version for transactions consistent with Congressional intent.

As indicated above, I have suggested that the economic substance doctrine should be asserted "rarely and judiciously" and not as a general anti-abuse rule.[233] The doctrine should be considered where the transaction "does not appear to be in accord with Congressional intent and common sense."[234] However, under current law, there is no limitation on the types or categories of transaction in which the Service can assert economic substance.

3.8.5 Pros and Cons on the Codification of the Economic Substance Doctrine

As indicated above, Eric Solomon and I have discussed concerns regarding codification of the economic substance doctrine. However, numerous tax professionals have expressed opinions about whether the codification of the economic substance doctrine is advisable.

---

[231] *Id.*, at 29, statutory draft language at Section 7701(n)(2).
[232] *Id.*, at 30, statutory draft language at Section 7701(n)(3)(B).
[233] KORB (Economic Substance Speech), *supra* note 192, at 12.
[234] *Id.*

3.8.5.1 Pros

a. Because, under certain versions of the codified economic substance doctrine, the codified section only applies when a court determines that the economic substance doctrine applies:

> "All that the codification will do is conform the standard to be applied by the courts in applying the economic substance doctrine. It will be up to the courts to determine, in the first instance, that the doctrine applies to the transaction before it."[235]

> "By forcing the courts to apply a strengthened and uniform standard of economic substance in cases where the courts believe that the common law doctrine applies, taxpayers and their advisors will, prior to implementation of the transaction, need to seriously evaluate the potential application of the codified economic substance statute in tax-advantaged, as well as in common business, transactions instead of merely relying on language in some favorable economic substance court case that can be read literally to validate an arguably inappropriate transaction."[236]

b. Codification would be consistent with some court's concerns that "[u]nder our time-tested system of separation of powers, it is Congress, not the court, that should determine how the federal tax laws should be used to promote economic welfare."[237]

3.8.5.2 Cons

a. The codification of the economic substance doctrine could lead to more complexity because, although the statute could resolve certain questions of how the doctrine would apply, many formulations of the codified economic substance doctrine do not resolve the issue of to what transactions the doctrine should apply.[238] For this reason, the ability of taxpayers to engage in legitimate transactions may be impaired.[239]
b. With the codification of the economic substance doctrine, "the court otherwise would be unable to adapt its judgment to the special facts and circumstances of a particular case."[240]

> "To codify the doctrine, however, would put in the hands of revenue agents a vague and subjective tool best used by those whose job is to be a neutral arbiter."[241]

c. Because the court must still review the transactions "for what they are": "The cheap, easy way out that codification of the economic purpose doctrine might seem to offer is not way out at all."[242]

---

[235] JACKEL, "For Better or For Worse: Codification of Economic Substance", 2004 Tax Notes Today 96-33, May 18, 2004.
[236] *Id.*
[237] *Coltec Industries, Inc. v. United States*, 62 Fed.Cl. 716, 756 (2004) (citations omitted).
[238] SILVERMAN/WEST/NOCJAR, "The Case Against Economic Substance", 2004 Tax Notes Today 139-43, July 12, 2004.
[239] *Id.*
[240] *Id.*
[241] *Id.*
[242] WOLFMAN, Why Economic Substance is Better Left Uncodified, 104 Tax Notes 445 (2004).

> "The clarification which the proposal purports to provide, whether the economic substance test is a disjunctive or conjunctive one, is not one that would likely affect the outcome of any particular case, particularly where the stated business purposes are vigorously tested and evaluated."[243]

d. Differing interpretations of the Circuit courts should be resolved by the Supreme Court, not Congress.[244]
e. Codification "has the potential to slow IRS audits, and anything that slows IRS audits is not a good thing."[245]
f. Codification may not change the result from the application of the common law doctrine in many cases.[246]
g. A codification of economic substance should not be codified without a carveout for results that are "reasonably intended to be available under the circumstances in which they arise (based on a reasonable reading of the relevant statutes and regulations, considered in the light of the purposes of which they were promulgated)."[247]

4. How Do You Make the Corporate Tax Shelter Problem Go Away?

Codify the economic substance doctrine? Amend particular Code sections to limit specific identified abuses? Enact a Sec. "469A" (an analogue to the Sec. 469 passive loss rules of Sec. 469) designed to fit modern corporate tax shelters?

For one view, *see* McMahon, "Beyond a GAAR: Retrofitting the Code to Rein in 21st Century Tax Shelters".[248] For another view, *see* Marvin Chirelstein and Lawrence Zelenak, "Essay: Tax Shelters and the Search for a Silver Bullet".[249] *See* also "No Partnership in Boca Investerings Tax Shelter"[250] for another suggestion of using a "scheduler system" to stop corporate tax shelters.

---

[243] KEYES/LIGHT, Developments in the Economic Substance Doctrine, Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations and Restructurings (2004) (electronic cite: 638 PLI/Tax 891, 927).

[244] FROELICH/WESTMORELAND, Common Law vs. Rule of Law, 106 Tax Notes 723 (2005), citing KORB (Economic Substance Speech), *supra* note 192.

[245] CUMMINGS/HANSON, American Jobs Creation Act of 2004: A Selective Analysis (2005), citing Hearing Before the Comm. On Fin., U.S. Senate, 107th Cong., 2d Sess., on the nomination of Pamela F. Olson to be Assistant Secretary of the Treasury, S. 107-742, August 1, 2002, at 8-9.

[246] SHEPPARD, News Analysis: Drafting Economic Substance, Part 3, 106 Tax Notes 1020 (2005): "Readers, Castle Harbour would be decided exactly the same way under the JCT business purpose test."

[247] *See* NEW YORK STATE BAR ASSOCIATION TAX SECTION, *supra* note 194, Section V.

[248] 2003 Tax Notes Today 52-35, March 18, 2003.

[249] 105 Colum. L. Rev. 1939, 1964 (2005).

[250] 2003 Tax Notes Today 14-7, January 22, 2003.

Report on the Discussion

Simon Link

1. Presentation by Daniel Shaviro and Comments by Philip Baker and Roman Seer (Chair: Caroline Silberztein)

The first part of the discussion focused on the actual features of the U.S. tax shelter disclosure rules. In terms of context it was noted that the attorney-client-privilege only applied to communication intended as confidential, which by nature is not the case for shelter protection memos. In the United States shelter protection opinions do not generally protect against penalties but merely constitute an aspect that has to be taken into account. One participant noted that there had been big cases in which opinions did not provide protection against penalties.

According to another participant the main effect of the tax shelter disclosure rules was the possibility for the administration to receive information on shelter structures at an early stage. In addition the increased transparency had a deterring effect. It was considered legitimate to take disputable positions in the application of tax law as long as the taxpayer himself does fully stand behind these positions. However, it was not considered legitimate to rely on concealing the whole picture from tax authorities. The tax shelter disclosure rules constituted an enforcement tool that was particularly compatible with this framework. In addition, practical experience showed that the disclosure rules were very effective against tax shelters.

Another participant noted that penalties in the past had a severe effect because they created a significant mark against the people involved inside the companies and were perceived as a stigma especially in the upper echelons. The concern was that if penalties were introduced for less severe cases and applied more frequently this effect could wear off and thereby reduce the impact of penalties.

It was also pointed out that the question, under which circumstances penalties should be imposed, also depended on the exact role that the taxpayer plays in the self-assessment process. According to one participant, there was a big difference between a situation where the taxpayer only has to present all relevant facts and a situation where the taxpayer also has to apply the tax law. In this respect there are differences between the U.S. American and the continental European approach. If only the full disclosure of facts is demanded then the distinction between good faith and bad faith was less important. Generally the imposition of penalties should not depend on whether the application of the law was correct but only on the proper disclosure of all relevant facts and especially the disclosure of the business purpose of a transaction.

With regard to another difference between the situation in the U.S. and in Europe, it was noted that in Europe privilege and confidentiality did not have the same requirements as in the U.S. Especially exceptions from confidentiality and privilege

had to be justified. Such justification was especially possible where confidentiality and privilege are abused for violations of the law.

Another participant asked whether the Compliance Assurance Program (CAP) – a new approach in enforcement in the U.S. comprising real time audits in which tax authorities accompany transactions and thereby gain better insight – did not allow to relax enforcement measures. In reply *Desmond* noted that CAP was currently only a test program with 25 to 40 participants. It was also noted by a participant that the program was based on complete transparency and therefore required the agreement of the participants. However real time auditing was seen as a promising approach for the future because currently 95% of honest taxpayers suffered from requirements that are imposed because of the 5% of dishonest taxpayers. It was also noted that a similar program existed in the Netherlands.

Another participant described that practical cases usually began with a valid business decision. Then in a second step people strive to structure its implementation in a tax efficient way. In the past this would not have been considered tax sheltering. The question was raised whether this assessment would have to be changed in the light of current developments and discussions.

It was also commented on the suggestion in *Shaviro's* paper to generally impose penalties for understatements without a bad faith test and at the same time allow insurances against such penalties. A participant noted that at present, the professional liability insurance of advisors had the same effect because if opinions turned out to be wrong, taxpayers could sue their advisors who then had to rely on their professional insurance. Also prior letter rulings served as a kind of insurance against tax penalties so that the question was raised whether fees should be introduced for prior letter rulings. Also according to the law of big numbers, structures that are frequently advised are less likely to turn out to be against the law.

Shaviro observed that the funding situation of tax authorities also poses a problem. He cited the common argument according to which it is not justified to impose more restrictive enforcement measures because the real problem is the under-funding of the authorities. However he noted that under-funded authorities still do not justify tax evasion.

It was also noted that it was the most important duty of advisors to give fair assessments even if there was pressure to reach a certain result because the client was still better off with a correct opinion that does not have the desired conclusion than with a wrong opinion. Work should not be conducted under the assumption that certain facts will not be disclosed to the authorities. Yet working under the presumption that all facts will be disclosed was still considered something different from being forced to disclose communication between the client and his advisor to the authorities. Another participant emphasized the influence of the penalties imposed in connection with disclosure requirements.

At the end, possible reasons for the growth of the tax shelter problem were discussed. Especially contingent fees were pointed out here because they turn the advisors into joint entrepreneurs of the tax schemes and therefore constitute an incentive to set up such schemes.

2. Presentation by Michael J. Desmond and Comments by Tobias Beuchert and Paul Morton (Chair: Caroline Silberztein)

Before the discussion *Freedman* made an observation regarding the frequently cited Henderson survey. According to her, the survey was based on a very small population, had a low response rate and also appears to suffer from self-selectivity of responses. Therefore the results from the survey had to be used cautiously.

Starting the discussion, she wondered why the newly introduced disclosure rules are less disputed than a general anti-avoidance rule, which had also been discussed, although the general anti-avoidance rule would have been under-inclusive while the disclosure rules now are vastly over-inclusive and even may influence the notion of tax shelter itself.

Throughout the discussion retroactive legislation was considered a third possibility to fight tax shelters. However, it was the predominant opinion that retroactive legislation would be the least favorable solution even compared to a general anti-avoidance rule or disclosure rules. However one participant observed that such legislation would at least have to pass parliament.

Desmond remarked that disclosure rules have not been so controversial in the past because disclosure was generally viewed as positive. Now, there are even rules outside tax law that relate to the disclosure rules, *e.g.* provisions regarding the independence of auditors that have advised on listed transactions. He also noted that the new category of "transactions of interest" had been introduced in order to create a category of transactions that have to be disclosed but which do not trigger penalties and excise duties as do listed transactions in other categories. He was afraid that opinion standards would keep advisors from rendering their advice in a written form or from giving any advice at all.

One participant suggested that it should make no difference at all whether an opinion exists or not, especially when deciding on penalties. On the other hand there should be no pressure that might keep taxpayers from obtaining legal advice. Opinions are often required for totally different purposes, *e.g.* for structuring transactions. The main criterion should be whether there is a valid business purpose.

Shaviro pointed out that opinions also have an important role in the agency situation.

One participant diagnosed a breakdown of the governance in the tax system and of trust in the tax authorities. The disclosure rules were one symptom of this breakdown. Therefore the main task should now be trust-building.

Because of this situation the companies did not want the advisors to challenge the disclosure rules and the advisors themselves refrained from challenging them, too, because the result might be even worse. However, another participant pointed out that if the rules are illegal they should not prevail just because there is no one to challenge them.

Korb noted that a similar imbalance between tax authorities, taxpayers and advisors occurred in the U.S. in the nineties. Since then the restoration of the relationship is an important mission there, too. Circular 230 could be seen as a tool for this purpose of restoring relationships and building trust.

Part 5

Taxation and Corporate Governance – The State of the Art

Taxation and Corporate Governance – The State of the Art

Arne Friese, Simon Link and Stefan Mayer

Contents

1. Introduction . . . 358
   1.1 What is Corporate Governance? . . . 359
   1.2 Theoretical Background . . . 360
   1.3 The Scope of this Study . . . 363
2. The Influence of Taxation on Corporate Governance . . . 365
   2.1 Introduction . . . 365
      2.1.1 Differences of Corporate Governance Systems . . . 365
      2.1.2 Tax Systems and Underlying Understanding of Corporate Governance . . . 366
      2.1.3 Corporate Governance and Tax Reforms . . . 367
      2.1.4 Intended and Unintended Consequences; Tax Incentives/Penalties . . . 368
      2.1.5 Levels on which Influences Operate . . . 369
      2.1.6 Taxation and Corporate Governance as a Historical Phenomenon – Reasons for the Effectiveness of Corporate Governance Motivated Tax Reforms . . . 369
      2.1.7 Pursuance of Policy Goals by Use of the Tax Code . . . 370
   2.2 Taxation and the Market for Corporate Control . . . 371
      2.2.1 Introduction . . . 371
      2.2.2 Neutrality of Asset and Share Deals . . . 372
      2.2.3 Golden Parachute Contracts . . . 372
      2.2.4 Greenmail Taxation . . . 374
      2.2.5 Taxation and Reorganization Provisions . . . 375
      2.2.6 Conclusion . . . 376
   2.3 Taxation and Transparency . . . 376
      2.3.1 Introduction . . . 376
      2.3.2 Principle of Authoritativeness . . . 377
      2.3.3 Deferred Taxes . . . 378
      2.3.4 Tax Influences on Corporate Structures . . . 379
      2.3.5 A Separate Corporate Income Tax as “Certification Tax” . . . 379
      2.3.6 Regulatory Tax Rules . . . 380
      2.3.7 Conclusion . . . 380
   2.4 Distribution Policy and the Access to Capital . . . 381
      2.4.1 Introduction . . . 381
      2.4.2 Lock-In Effect of the Classical Tax System . . . 382
      2.4.3 Reverse Authoritativeness Principle . . . 383
      2.4.4 Deferred Taxes . . . 384
      2.4.5 Company Pension Funds . . . 385
      2.4.6 Stock Options . . . 386
      2.4.7 Capital Gains Preferences . . . 386
      2.4.8 Conclusion . . . 387
   2.5 Business Decisions of Management/Diversion of Profits to the Disadvantage of Shareholders . . . 387
      2.5.1 Introduction . . . 387
      2.5.2 Taxation of Stock Options and Incentive Stock Options . . . 388
      2.5.3 Caps on Salaries of Managers/Exceptions for Performance-Based Remuneration . . . 389
      2.5.4 Compensation of Supervisory Board Members . . . 391
      2.5.5 Deductibility of Desired Payments . . . 392
      2.5.6 Treatment of Third Party Interest . . . 392
   2.6 General Criticism: Tax Code vs. Direct Regulation . . . 393
   2.7 Summary and Perspective . . . 395

3. The Influence of Corporate Governance on Taxation . . . 396
3.1 Which Tax Strategy Complies with Corporate Governance Requirements . . . 397
3.1.1 Standard Economic Model of Tax Compliance . . . 397
3.1.2 The Decision to Comply . . . 398
3.1.2.1 Compliance vs. Aggressiveness . . . 398
3.1.2.2 The Limits of Legality in Conventional Tax Law . . . 399
3.1.2.3 "Unacceptable" Behavior as a New Category between Legal and Illegal Conduct . . . 399
3.1.2.4 Immoral Behavior as a New Category . . . 401
3.1.2.5 The Role of Tax Opinions . . . 402
3.1.3 Risk of Detection . . . 402
3.1.3.1 Additional Disclosure Obligations . . . 403
3.1.3.2 Risk Management in Enforcement . . . 403
3.1.4 Returns from Aggressive Tax Behavior . . . 405
3.1.4.1 Penalties . . . 405
3.1.4.2 Publicity and Reputation . . . 405
3.1.5 Side Effects on Business Operations . . . 406
3.1.5.1 Real-World Risks and Misallocations . . . 406
3.1.5.2 Deterioration of Business Ethics . . . 407
3.1.5.3 Interference with Control Systems . . . 407
3.1.5.4 Loss of Auditor Independence . . . 408
3.2 Tax Decisions within the Organization . . . 408
3.2.1 Principal-Agent Setting . . . 409
3.2.2 Managerial Duties . . . 409
3.2.3 Performance Measurement . . . 410
3.2.4 Tax Law Enforcement in the Organizational Setting . . . 411
3.2.5 Social Responsibility . . . 413
3.3 Corporate Governance Influences on Tax Behavior of Corporations . . . 414
3.3.1 Existing Regulatory Measures . . . 414
3.3.2 Further Suggestions for Legislatory Measures . . . 416
3.3.3 Other Influences . . . 417
3.4 Changes in Corporate Governance . . . 417
3.4.1 Former Situation . . . 418
3.4.2 Changes . . . 418
3.4.2.1 Top Management and Shareholder Involvement . . . 418
3.4.2.2 Corporate Tax Policy . . . 419
3.4.2.3 Control Systems . . . 419
3.4.2.4 Tax Risk Management . . . 420
3.4.2.5 Communication with Operational Business Units . . . 421
3.4.2.6 Shareholder Transparency . . . 422
3.4.2.7 Relationship with Advisors . . . 422
3.4.3 Implications for Tax Enforcement . . . 423
4. Summary and Conclusions . . . 424

1. Introduction

The OECD Principles state

> "Corporate governance requirements and practices are typically influenced by an array of legal domains, such as company law, securities regulation, accounting and auditing standards, insolvency law, contract law, labor law and *tax law*. Under these circumstances, there is a risk that the variety of legal influences may cause unintentional overlaps and even conflicts, which may frustrate the ability to pursue key corporate governance objectives. It is important that policy-makers are aware of this risk and take measures to limit it."[1]

---

[1] OECD, Principles of Corporate Governance, 31 (2004).

This quote from the OECD Principles of Corporate Governance already makes clear why it is useful to analyze the interaction of tax systems and corporate governance issues. From the tax perspective, one may add that the mentioned overlaps and conflicts not only may frustrate the pursuit of key corporate governance objectives, but also those of a sound and efficient tax system and economic neutrality.

However, there is relatively little literature on the interaction of corporate governance and taxation. Some specific aspects draw more attention, *e.g.* tax rules related to the remuneration of directors or to measures taken by management in context of takeover bids. Yet, apparently no-one has until now undertaken to analyze comprehensively the interplay between the two systems of taxation and corporate governance. The authors of this study aim at initiating a discussion that bridges this gap by collecting and systematizing the existing literature on this topic.

The study starts with a short look at the definition of corporate governance and the theory underlying this area. The authors also delineate corporate governance from related fields such as corporate social responsibility.

In the subsequent chapters, several ways are identified how tax systems and corporate governance interrelate. Those interactions can in principle have one of two directions.

Firstly, tax systems can influence corporate governance. *E.g.*, taxes can encourage or discourage reorganizations or the payment of dividends to shareholders. They can also affect decisions on whether and how corporate reorganizations and mergers or take-overs take place, in this way having effects on the ongoing governance of corporate groups and on the market for corporate control. Tax obligations and incentives may also have an influence on the way in which companies comply with their obligations of internal and external reporting, especially accounting. These effects are discussed in part 2 of this study.

In contrast, part 3 deals with the question how rules and mechanisms of corporate governance influence the way in which companies fulfill their tax obligations. Especially in the wake of recent corporate scandals changes in corporate governance have had an influence on which institutions deal with tax decisions in companies and in what form and to what degree tax decisions and risks have to be reported. Understanding the "corporate governance of tax compliance" is also relevant for tax administrations in their efforts in promoting compliance with tax legislation and curbing excessive tax avoidance.

1.1 What is Corporate Governance?

Corporate governance is, under this name, a relatively young field of study.[2] The term corporate governance was first used more commonly in the north American legal literature of the 1970s.[3] Yet, already Adam Smith pointed out in 1776:

---

[2] MALLIN, Corporate Governance, 9 (2004).

[3] SMERDON, A Practical Guide to Corporate Governance, 2 (2nd ed. 2004). CHAMBERS, Tolley's Corporate Governance Handbook, 82 (2003) even states that he has "not found very visible use of the term" before 1984.

> "The directors of such companies, however, being the managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own ... Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company."[4]

In recent years scandals such as Enron or WorldCom brought corporate governance into sharp focus. They have promoted legislative activity, most notably the Sarbanes-Oxley Act (SOX)[5] in the United States, and other initiatives such as governmental and non-governmental committees and reports for improving the control and supervision of corporate conduct.

From the outset, corporate governance has an interdisciplinary character,[6] as it incorporates influences from disciplines as diverse as finance, economics, accounting, law, and management.[7] This necessitates a rather general and abstract definition that covers the different facets of discussions. Most authors currently define "corporate governance", with certain variations, as "the process in which the conduct of enterprises is controlled and supervised, and the factual and legal framework that influences or governs this process."[8]

However, in order to define and structure the scope of this study, this general definition has to be seen in connection with the fundamental conflict that lies at the heart of corporate governance.

1.2 Theoretical Background

That conflict has already been identified by Adam Smith in the quote above: the existence of companies has the effect of separating ownership in capital from the control over that capital,[9] especially in the case of publicly held corporations. While companies allow the accumulation of large amounts of capital from a large number of investors in order to realize capital-intensive and risky projects, the investors will

---

[4] SMITH, An Inquiry into the Nature and Causes of The Wealth of Nations, Vol. 2 Bk. 5 Ch. 1 Pt. 3 Art. 1 (1776).

[5] Sarbanes-Oxley Act of 2002 (P.L. 107-204).

[6] *See* BÖCKING/DUTZI, Corporate Governance und Value Reporting, in: SEICHT (ed.), Jahrbuch für Controlling und Rechnungswesen 2003, 213, 215 (2003); MALLIN, *supra* note 2, at 9.

[7] MALLIN, *supra* note 2.

[8] SCHEFFLER, Corporate Governance – Auswirkungen auf den Wirtschaftsprüfer, 2005 WPg 477, 477. Similarly V. WERDER, in: RINGLEB/KREMER/LUTTER/V. WERDER, Kommentar zum Deutschen Corporate Governance Kodex, Preliminary Remarks, note 1 (2nd ed. 2005); HABERER, Corporate Governance: Österreich – Deutschland – International, 1-3 (2003). *See also* ABELTSHAUSER Corporate Governance – Standort und Dimensionen, in: ABELTSHAUSER/BUCK (eds.), Corporate Governance: Tagungsband der 1. Hannoveraner Unternehmensrechtstage, 1, 7 (2004), who emphasizes the double meaning of the term "corporate governance" as the process of control and supervision on the one hand and the regulatory system governing that process on the other.

[9] *See e.g.* the preamble to the OECD Principles, OECD, *supra* note 1, at 12: "While a multiplicity of factors affect the governance and decision-making process of firms, and are important to their long-term success, *the Principles focus on governance problems that result from the separation of ownership and control.*"

either be unwilling or ill-equipped for directly managing those ventures.[10] Furthermore, the mere number of shareholders prevents them from directly controlling the conduct of the enterprise.[11] Therefore, mechanisms and institutions are necessary that enable shareholders to retain at least a minimum of indirect control over and insight into the operations of the enterprise.

In the analysis of corporate governance regimes, a differentiation is generally made between internal and external corporate governance.[12] Internal corporate governance refers to the interplay of the different institutions that govern a company, *i.e.* the (board of) directors, senior management, and external auditors, whereas external corporate governance is concerned with the relationships of the company and its governing institutions with the company's stakeholders, most notably the shareholders.

As regards the possible structure of internal corporate governance regimes, the most important difference between national systems is that between unitary boards and dual boards.[13] In unitary board systems, the board comprises both executive and non-executive directors, while in dual board countries companies have both a supervisory board (*Aufsichtsrat*) and an executive board of management (*Vorstand*). The latter structure is predominantly used in Austria, Germany, the Netherlands and Denmark, but the two different systems have been converging in recent years.[14]

The culture of corporate governance also varies internationally in respect of the scope of the interests that are taken into account. On the basis of the fact that corporate governance is concerned with the principal-agent conflict arising from the separation of ownership and control in companies, the *shareholder value* approach to corporate governance focuses solely on the relationship between shareholders and managers of the company.[15] This is the view predominantly taken in Anglo-American jurisdictions. In contrast, the *stakeholder approach* also takes into account the position of stakeholders other than shareholders, such as the employees, creditors, suppliers and customers of companies.[16] Unfortunately, it is far from clear in which way the interests of those other stakeholders are taken into account and to what degree.[17]

The theoretical analysis of corporate governance is influenced to a large part by the work of Berle and Means, who in 1932 presented their groundbreaking analysis of the effects that the separation of ownership and control has on the conduct of companies.[18]

Today, the separation of ownership and control is most often considered as a typical case of a principal-agent conflict. In this analytical framework, shareholders are

---

[10] ABELTSHAUSER, *supra* note 8, at 4.
[11] ABELTSHAUSER, *id.*
[12] BÖCKING/DUTZI, *supra* note 6, at 230; V. WERDER, *supra* note 8, at note 1; HABERER, *supra* note 8, at 157, 241.
[13] *See* MALLIN, *supra* note 2, at 93.
[14] ABELTSHAUSER, *supra* note 8, at 13.
[15] ABELTSHAUSER, *id.* at 5.
[16] ABELTSHAUSER, *id.*, at 6.
[17] *See e.g.* HABERER, *supra* note 8, at 52 on the lack of clarity of the OECD Principles in that respect.
[18] ABELTSHAUSER, *supra* note 8, at 11.

understood as the principals, who delegate decisions on the invested capital to the company managers as their agents.[19] Those managers have incentives to exercise their discretion in ways that are inconsistent with those of the owners of the capital, *e.g.* because they pursue their own interests or because they have a different attitude to risks than the shareholders. Furthermore, the shareholders do not have the same amount of information on the enterprise's activities as do the managers. Consequently, according to the agency theory, corporate governance is concerned with mitigating the effects of the principal-agent relationship by setting up a system that enables the shareholders to control and monitor corporate managers. The costs of the shareholders that are incurred for monitoring and controlling the managers and that are suffered because managers depart from the shareholders' interests are understood as "agency costs".[20] Some further aspects of agency theory in the context of taxation and corporate governance are discussed below.[21]

It is important to note, however, that the classical "Berle and Means corporation" with widely dispersed shareholdings is not the most common form of companies in many jurisdictions.[22] Indeed, worldwide, companies are more often held mainly by families or by other controlling shareholders.[23] In the latter case, the fundamental owner-management conflict is modified into the question how to protect the interests of the minority shareholders against the majority shareholders.[24]

A closely related analytical framework for corporate conduct is provided by the theory on transaction cost economies.[25] According to this approach enterprises grow because they can undertake certain transactions internally at lower costs as if they were effectuated externally, in the market. However, because it would be too costly to write contracts between the managers and the shareholders that comprehensively ensure that the managers act in the interest of their principals, those contracts will necessarily be imperfect and corporate governance structures fulfill the role of monitoring and controlling the managers where those contracts are incomplete.[26]

---

[19] *See* on the following MALLIN, *supra* note 2, at 10-12.

[20] MALLIN, *supra* note 2, at 11.
The important role of agency costs in corporate governance is exemplified by the statement of Alastair Ross Goobey, the chairman of the International Corporate Governance Network, made in 2003 that "Corporate Governance is only about reducing the cost of capital: If we can't establish that beyond peradventure then we are wasting our time. This is not a moral crusade." *See* SMERDON, *supra* note 3, at 1.

[21] *See* 3.2.1 below.

[22] HABERER, *supra* note 8, at 7 *et seq.*; MALLIN, *supra* note 2, at 12.

[23] LA PORTA/LOPEZ-DE-SILANES/SHLEIFER, Corporate ownership around the world, 54 Journal of Finance 471 (1999).

[24] HABERER, *supra* note 8, at 12 *et seq*.

[25] *See* MALLIN, *supra* note 2, at 12-13.

[26] *See also* WHITEHOUSE, Corporate Social Responsibility as Regulation: The Argument for Democracy, in: O'BRIEN (ed.), Governing the Corporation. Regulation and Corporate Governance in an Age of Scandal and Global Markets, 141, 146 (2005): "... the 'transaction costs' version of the nexus of contracts theory contends that rational actors seek to contract in a way that minimises transaction costs. Shareholders, however, unlike other parties related to the company, put their entire investment at risk and cannot protect themselves contractually because of the open-ended character of their rights so, instead, they receive governance rights."

1.3 The Scope of this Study

In principle, there is a vast number of ways in which taxes can influence corporate behaviour and *vice versa*. In order to provide this study with clear contours and to keep its scope manageable, the analysis presented here will be limited to those aspects which are related in some way to the principal-agent conflict characteristic of incorporated business. The touchstone applied in this study will therefore be whether the provision or mechanism in question is in some way related to issues arising from the separation of ownership and control.

With this focus the study will also deal mainly with issues that affect companies with this characteristic, *i.e.* mainly large companies that are publicly traded.

Concerning the influence of taxation on corporate governance, this implies that not all tax provisions that are not neutral in respect of business conduct will be taken into consideration, as non-neutral tax rules in principle affect other forms of business in the same way as companies. Rather, the authors will only scrutinize those areas in which taxes affect the management of companies or, more specifically, the relationship between shareholders and corporate managers, *e.g.* by reducing the transparency of managerial decisions and business structures or by facilitating the diversion of corporate profits to the disadvantage of shareholders.

As has already been indicated, another important aspect of defining the scope of the present study is delineating the authors' understanding of corporate governance from doctrines that consider corporate conduct from the perspective of ethics, most notably corporate social responsibility (CSR). Although CSR itself also represents a broad concept, the main differences to corporate governance can be identified if various definitions of CSR are compared: In a report on Corporate Social Responsibility of 2002, the U.K. Department of Trade and Industry described CSR as follows:

"A responsible organisation does three things:

1. it recognises that its activities have a wider impact on the society in which it operates;
2. it takes account of the economic, social, environmental and human rights impact of its activities across the world;
3. it seeks to achieve benefits by working in partnership with other groups and organisations."[27]

According to Smerdon, "[a] key element of CSR is the notion that businesses need to meet the expectations of groups other than shareholders, even though directors remain formally accountable only to the investors who own the company."[28] Finally, another good hint at the relationship between corporate governance and corporate social responsibility is given by Whitehouse when stating that "it seems safe to assume that CSR is concerned with ensuring that companies go beyond the 'profit maximisation within the law' formula; that they do more than simply obey the law and make money for their shareholders."[29]

---

[27] Cited according to SMERDON, *supra* note 3, at 250.
[28] SMERDON, *id.*, at 251.
[29] WHITEHOUSE, *supra* note 26, at 148.

These definitions of CSR raise to a varying degree two aspects that distinguish CSR from corporate governance: first, the stakeholders taken into consideration, and secondly, the interests pursued and conflicts addressed.

Regarding the first aspect, corporate governance is mainly concerned with the relationship between companies and their shareholders, whereas it is exactly the objective of CSR to promote a conduct of companies that also takes into account the interests of other stakeholders. The authors do not want to limit themselves to a narrow shareholder value approach to corporate governance and therefore follow the example of the OECD Principles by not excluding from their analysis those stakeholders that contribute to the profitability of the company and have a legitimate interest in it, *i.e.* creditors, employees and suppliers.[30] In contrast, the interests of other groups or of a more general nature such as environmental issues or interests of societies as such are understood as the domain of CSR.

This already touches upon the second aspect distinguishing CSR from corporate governance: While the latter focuses on the principal-agent conflict of incorporated business, the interests represented by the promoters of CSR in principle apply to businesses in every legal form and basically form the fundamental requirements of business ethics or – even more fundamentally – good management.[31] There seem to be two reasons why CSR nevertheless focuses specifically on the social responsibility of companies: It will be demonstrated below why the separation of ownership and control in corporations may have indeed the effect that publicly held companies are less likely to meet corporate social responsibility demands than owner-managed businesses, and the ability and actual purpose of accumulating large amounts of capital and managing those large amounts in a centralized way have given large corporations an unproportionately large amount of power that is according to Whitehouse not legitimate in the sense of democracy.[32]

In short, in our understanding the term "corporate governance" describes the sum of all mechanisms of control and supervision that are aimed at ensuring the successful operation of a business[33] in a corporate form and in this respect to remedy the effects of the separation of ownership and management. In contrast, corporate social responsibility is concerned with the norms that define ethical corporate behavior, which has become necessary because large corporations can exercise disproportionate power in societies,[34] including disproportionate powers to pollute the environment, defraud debtors, customers and suppliers, corrupt public servants and evade taxes.

---

[30] OECD, *supra* note 1, at 12.

[31] "The good company – A survey of corporate social responsibility", The Economist, January 22, 2005, 6.

[32] WHITEHOUSE, *supra* note 26, at 142-143, 159.

[33] In which way success may ever be defined by the shareholders.

[34] *See* WHITEHOUSE, *supra* note 26, at 142 *et seq.*

2. The Influence of Taxation on Corporate Governance

2.1 Introduction

Taxes and corporate governance can intersect in various aspects since taxation as a cost-factor works as an incentive or disincentive for management behavior and can therefore also be used by the legislator for influencing managerial decisions.[35] As the separation of management and ownership was identified as the basic corporate governance conflict, tax rules should in principle be drafted in a way that ensures that they do not encourage behavior of management that is in conflict with the interests of the shareholders or the company itself. Formulated in a positive way: the tax system attempts in many ways to align management objectives closely with stockholder objectives and to eliminate inefficiencies that can result from the separation of ownership and management.[36]

This part of the article aims at providing a comprehensive overview about the influence of taxation on corporate governance. Apparently, there has been very little academic research on the intersection of taxation and corporate governance.[37] The authors will present the different aspects of tax law which are currently discussed in literature with respect to corporate governance and will assess them also in the light of discussions the authors had with tax practitioners from internationally operating businesses. Insofar as specific provisions are analysed in detail, we mostly concentrate on examples from the United States, as most of the existing literature originates there.

2.1.1 Differences of Corporate Governance Systems

In the western world basically two different systems of corporate governance have developed. Whereas in the United States (and other Anglo-American countries) the control of management in the interest of the shareholders is mainly achieved by a market of corporate control (takeovers and capital market control), the corporate governance system of other countries such as Germany is still much more influenced by a closely knit net of cross-affiliated companies.[38] Accordingly, the discus-

---

[35] *See* for a brief overview OWENS, The Interface of Tax and Good Corporate Governance, 37 Tax Notes Int'l 767 (2005).

[36] OWENS, *id.*, at 767; REPETTI, Accounting and Taxation: The Misuse of Tax Incentives to Align Management-Shareholder Interests, 19 Cardozo L. Rev. 697, 699 (1997).

[37] Only a few scholars have comprehensively analysed the interactions of tax law and corporate governance. *See* SALZBERGER, Wechselwirkungen zwischen Corporate Governance und Besteuerung, 2000 Die Betriebswirtschaft (DBW) 210; KRAFT, Das Corporate Governance-Leitbild des deutschen Unternehmenssteuerrechts. Bestandsaufnahme – Kritik – Reformbedarf; Arbeitspapiere aus dem Institut für Wirtschaftsrecht, Heft 13 (2003); WAGNER, Unternehmenssteuerreform und Corporate Governance; 2000 StuW 109; KANNIAINEN, Failures in Corporate Governance: Can the Corporation Tax Improve Efficiency?, 1999 FinanzArchiv 310; DESAI/DYCK/ZINGALES, Theft and Taxes, ECGI-Finance Research Paper No. 63/2005 (2005) (available at SSRN: http://ssrn.com/abstract=629350); OWENS, *supra* note 35.

[38] SALZBERGER, *id.*, at 210; on the development of corporate governance in the United States *see* ROE, Strong Managers, Weak Owners. The Political Roots of American Corporate Finance (1994).

sion in the United States on the interface of taxation and corporate governance relates mainly to executive remuneration in connection with takeovers.[39] Conversely, in Germany a tax reform intended to decartelize a large part of Germany's incorporated economy was discussed in the light of corporate governance.[40]

2.1.2 Tax Systems and Underlying Understanding of Corporate Governance

On an abstract level some scholars distinguish between two views of corporate governance that are mirrored by different corporation tax systems. One can distinguish between a capital market oriented view of corporate governance and a view focusing on the company in itself. The first view incorporates two levels of participation: the corporate level and the shareholder level, whereas the second view solely considers the corporation. This differentiation is reflected in taxation by the imputation system, in which the taxes paid by the company are credited to the individual shareholders' liabilities, and the classical two-tier taxation, in which companies and their shareholders are taxed independently.

Two-tier taxation is supposed to be based on a perception of the corporation as an independent body with an inherent object of its own. According to the first view, the company's management is perceived as independent, solely representing this corporation. This view refers to the "company in itself". According to some scholars, this view results with respect to tax matters in an exclusive focus on company taxes, not including the taxation of individual shareholders' profits. As a consequence, the targets of the company are supposed to be set (only) by the management.[41]

In contrast, the "capital market oriented view" assumes that the targets of the company are set externally by the shareholders. The importance of capital markets supports this view, which focuses both on the company and the shareholder level. It therefore takes into account all taxes on the corporate and individual level.[42] This view is supposed to correspond to the imputation system: The imputation system is based on the underlying understanding that public companies' objectives are not distinguishable from the shareholders' interests.

The two views are supposed to result in different approaches to tax planning for investment decisions. The perception in Germany is that a two-tier or "classical" tax system does not reflect the modern capital market oriented understanding of corporate governance. An imputation tax system would be more appropriate, as it conceptually includes the tax liability of the shareholders as providers of capital. As opposed to the classical corporate tax system, in the imputation system the taxes paid by the company are credited, resulting in taxation with the tax rate of the respective shareholder. The conception of the classic two-tier tax system is considered to ignore any obligations of the company to the shareholders and to almost prevent payments of dividends.[43]

---

[39] *See* 2.2.3 and 2.2.4 below.
[40] *See* 2.2.5 below.
[41] *See* for example WAGNER, *supra* note 37, at 109.
[42] *See* KRAFT, *supra* note 37, at 8.
[43] *See* KRAFT, *id.*, at 8; WAGNER, *supra* note 37, at 109.

From our point of view it is doubtful whether this antagonism is really correct: to the extent that the individual tax rate exceeds the corporate tax rate the imputation system also results in an incentive to retain profits. The effects of both systems are insofar comparable: retained profits are taxed at a lower rate because either the difference to the individual progressive tax rate of the individual shareholders or the separate tax on the shareholder level in the classical tax system is on top of the amount already paid by the company. Therefore, the effects of both systems are similar when the individual tax rate exceeds the corporate rate.

2.1.3 Corporate Governance and Tax Reforms

A similar aspect of the relationship between taxation and corporate governance is discussed in respect to tax reforms. The assumption is that the underlying understanding of corporate governance as distinguished above is also of importance for tax reforms that intend to encourage investment. When legislators attempt to encourage business investment via tax reforms, in particular by decreasing the tax burden of companies, it is seen as important to consider who is the relevant person for the investment decision: the companies and their management or the shareholders. The answer to this question would determine which taxes will be taken into account. Consequently, the actual corporate governance structure should be considered by the legislator before restructuring tax systems, as those two regimes might otherwise influence investment decisions in an inconsistent way.[44]

As has been described in the previous section, two different views are distinguished: First, if the company's goals are set by the management, then only company taxes will be considered or, second, if the company's objectives are determined by the shareholders, then the tax burden of the shareholders will be relevant for investment decisions as well.

As a consequence, a certain understanding of corporate governance structures is required for drafting any sensible and consistent tax reform: Taxes can only have the intended effects on investment decisions if they are part of this decision.

Recently, it has become apparent that the German capital market is of such strong influence that also the interests of the investors have to be considered by managements. As a consequence, "autonomous company interests" are of less importance. Examples for the increased influence of capital markets are hostile takeovers and stock option remuneration, which aligns shareholder and management interests.

To the extent that the goals of companies are determined by shareholder interests rather than their management, the relevant taxes determining investment decisions comprise the company taxes as well as the tax burden of individual shareholders. It is argued in favor of the imputation system that it is possible in its framework on the one hand to align the corporate income tax burden with the burden on other types of income and on the other hand to take into account both the tax burden of companies and shareholders. The imputation system treats the company as a mere income source of the shareholder and the corporation tax has mainly the function of a withholding tax: if the individual shareholder's tax rate is nil or very low he will be reim-

---

[44] *See* WAGNER, *id.*, at 109.

bursed the pre-paid company tax. In contrast, it is doubted whether classical corporation tax systems with two levels of taxation actually address the relevant decision-makers. Politicians demanding tax reductions for companies generally focus only on the company level and thereby disregard the additional important level of shareholder taxation. Accordingly, it is argued that the classical tax system mirrors an antiquated understanding of corporate governance with its concentration on the management/company level.

So the two-tier system is in general not considered to be in line with the actual corporate governance structure of a strong capital market because the claimed "tax reduction for companies" does not reflect by whom decisions are actually made.

However, from the authors' point of view the relevance of this corporate governance understanding for the effectiveness of tax reforms can be doubted: any serious investor as well as the management will in any case consider both levels of taxation. Business decisions are usually sufficiently informed to consider all tax consequences of any contemplated course of action, whether occurring on the company level or on the shareholder level. So this aspect is in the authors' opinion overestimated in respect of corporate governance.

2.1.4 Intended and Unintended Consequences; Tax Incentives/Penalties

Tax provisions are often aimed at influencing certain behavior. Not surprisingly, legislators therefore also try to make use of their tax statutes with respect to desired or undesired actions in the context of corporate governance. Yet, apart from those provisions intended to improve corporate governance explicitly there are various tax provisions with unintended consequences.

Tax provisions which are meant to influence corporate governance may try to encourage certain developments the legislator seeks to promote or considers to be of importance. Alternatively, tax provisions aim at *dis*couraging behavior of certain stakeholders which the legislator seeks to prevent or at least minimize.

Tax provisions which aim at encouraging certain behavior are called "tax expenditures".[45] Various types of tax expenditures exist, such as deductions, credits, exclusions, exemptions, deferrals and preferential tax rates. Their effect is always a reduced cost of a certain course of action.

In contrast, "tax penalties" are intended to discourage certain behavior. Negative consequences are attached to a certain conduct, such as a limitation of deductibility on otherwise deductible expenses or imposing a "penalty tax" on a certain activity.[46]

The list of undesired negative consequences of tax provisions which were drafted in order to influence corporate governance is probably endless. The most relevant and discussed consequences of tax provisions with respect to corporate governance are shifts of power in the relationship between management and shareholders or management and supervisory boards, limited controllability of management, misallocation of profits and incentives for managerial misconduct.

---

[45] HARTMANN, Comment: the Market for Corporate Confusion: Federal Attempts to Regulate the Market for Corporate Control through the Federal Tax Code, 6 DePaul Bus. L. J. 159, 166 (1994).

[46] HARTMANN, *id.*, at 169.

Finally, such negative unintended consequences on corporate governance may also result from general tax provisions such as the corporation tax system or the way corporate profits are computed.

2.1.5 Levels on which Influences Operate

Tax law has an impact both on the personal level of shareholders, managers, board members and other stakeholders as well as on the company level.

On the individual level, tax law typically is intended to control management behavior with respect to suspected fraudulent actions. Accordingly, the discussion on taxation and corporate governance in the United States mainly focuses on executive remuneration. This reflects the basic corporate governance problem in companies: the division of management and ownership. The legislator seeks to safeguard the interests of shareholders when decisions affecting these interests are made by their agents. This kind of provisions will be found in many areas of business law. The most significant example might be the possibility of stock option remuneration for managers in corporate law. Another important aspect in aligning the interests of managers and shareholders is the attempt to discourage managerial misconduct: tax incentives or disincentives are enacted to prevent mangers from abusing their power to divert profits of the company either for their individual private benefit or to strengthen their power within the company, both to the disadvantage of the shareholders.[47] Of particular importance – from a legislator's point of view – is the tax treatment of payments in connection with takeover situations. This is of special interest because takeovers as such are seen as a mechanism which disciplines corporate managers and therefore acts as means of governance control.

On the corporate level, legislators often seek to achieve economic policy goals via tax law. Tax law can have the same regulatory effect as direct regulation: as tax increases or tax expenditures modify the financial consequences of a certain conduct, the legislator is able to influence the process of decision making. As a consequence, the tax system can have a similar effect on business decisions as direct regulation in the area of corporate governance would have.[48]

2.1.6 Taxation and Corporate Governance as a Historical Phenomenon – Reasons for the Effectiveness of Corporate Governance Motivated Tax Reforms

Tax law has been used as an instrument for influencing corporate governance for a long time. Sometimes it was used in addition to corporate law, sometimes instead of corporate law.[49] Among the most significant examples are measures that were taken

[47] *See* HARTMANN, *id.*

[48] OWENS, *supra* note 35.

[49] *See* for example BANK, Tax, Corporate Governance, and Norms, 61 Wash. & Lee L. Rev. 1159, 1161 (2004): "In fact, almost since the inception of corporate income tax, [the U.S.] Congress has recognized its potential to serve as a *de facto* system of federal corporate law… Federal taxation was a means to pre-empt the traditional state role in the regulation of corporations without actually establishing a system of federal incorporation."

in context of the "New Deal" in 1934 and 1936, when the United States Congress tried to influence corporate governance. The "New Deal" included two tax reforms drafted in order to restrict the growth of large corporations, to eliminate the holding company structure, to lower the amounts of executive compensation, to encourage the distribution of dividends, and to reduce the number of mergers, acquisitions and other business combinations. The reform of 1936 enacted an undistributed profits tax and the 1934 act reformed the provisions on tax-free reorganizations.[50] The proposed provisions had very unequal success and so illustrate which risks of failure of such reforms exist.[51] While the reformed reorganization provisions are still more or less intact, the undistributed profits tax has never been enacted. It is suggested that among the reasons for the different success is the opposition of managers. This opposition in turn is supposed to be related to the degree in which a tax measure reinforces existing norms in contrast to the attempt to establish new norms: it is argued that tax reforms that pursue corporate governance goals will generally be more successful if they aim at strengthening or reforming existing norms or rules, while the risk of failure of such reforms seems to be higher if completely new norms are set or fundamental changes of longstanding standards are required.[52] When existing norms of corporate behavior are re-established, managers would be more supportive than when they are confronted with new rules or a change of existing norms.

In this respect, the historic example might provide a model for modern corporate governance related tax reforms. So it was concluded in respect of executive compensation that tax measures limiting executive hedging might be effective whereas more general attempts to control executive compensation will rather be ineffective because there is a norm of corporate behavior competences of the board of management to decide on executive compensation.[53] Bank[54] concludes: "Tax can be considered an ally of Corporate Governance, but not a *de facto* system of federal corporate law."

2.1.7 Pursuance of Policy Goals by Use of the Tax Code

The relationship between shareholders and management can also be influenced by the tax code for other legislative reasons than business reasons. Governments do not only pursue their political goals by sanctioning behavior positively with direct incentives and negatively with prohibitions, but also by means of tax legislation. The deduction or non-deduction of certain payments results in an incentive for the management to use the shareholders' money in a certain way. So *e.g.* all OECD countries deny a tax deduction for bribes and other illegal payments, thus increasing the costs of those payments.[55]

---

[50] BANK, *id.*, at 1164 with detailed reference to all provisions.
[51] *See* BANK, *id.*, at 1163: "Perhaps the best prism through which to understand the use of taxation to modify corporate behaviour is the experience of the New Deal."
[52] *See* BANK, *id.*, at 1164, 1166; SCHIZER, Executives and Hedging: The Fragile Legal Foundation of Incentive Compatibility, 100 Colum. L. Rev. 440, 446 (2000).
[53] *See* BANK, *id.*, at 1164, 1231.
[54] BANK, *id.*, at 1164, 1232.
[55] OWENS, *supra* note 35.

2.2 Taxation and the Market for Corporate Control

The most discussed aspect of the U.S. tax code with respect to corporate governance is the treatment of payments received by executives in connection with takeovers.

2.2.1 Introduction

With respect to the economic aspects it is highly disputed whether takeovers constitute a desirable restructuring of capital ownership that maximizes asset value and lowers agency costs or deplorable looting that discourages long-term investment, increases corporate debt, and encourages dangerous concentrations of market power in industries vulnerable to monopolistic behavior.[56]

Since this article just focuses on the corporate governance related aspects of the tax code, we will not discuss the general importance of takeover bids. For an economic and non-economic justification of takeovers and their benefits for the economy and the respective shareholders *see* the article by Hartmann.[57] We will in the following focus only on the question to what extent the tax code affects takeover situations and whether the intended effects are achieved and whether they can be justified.

However, we assume as a general starting point that there are both harmful and beneficial takeovers, depending on the situation of the targeted company and the intents of the bidders. Below, after assessing some provisions in detail, we will show that the most important problem of takeover taxation is that the provisions are not able to differentiate between those harmful and beneficial situations.

Summing up the most important argument, it is assumed that takeovers, whether realized or threatened, can reduce the agency costs generated by the divergent interests of management and owners in large corporations because they serve as means of market control. Despite these generally positive effects of the market of corporate takeovers, various tax initiatives in the United States have aimed at discouraging takeovers, *e.g.* by eliminating favorable tax consequences associated with them (for instance: transferability of net operating losses).[58] On top of that, the United States Congress introduced direct taxes on allegedly abusive conduct during takeover transactions. Two very significant provisions will be described in detail below.

In contrast to direct regulation, tax provisions directed at influencing behavior in takeover situations achieve this goal by limiting favorable tax consequences or threatening increased tax costs if a certain conduct is not consistent with the government's policy. This method of indirect regulation may in certain situations be more elegant from the view of the legislator as the consequences and aims of tax provisions are often less transparent than direct regulatory measures.

---

[56] *See* for example STEPHAN, Disaggregation and Subchapter C: Rethinking Corporate Tax Reform, 76 Va. L. Rev. 655, 656 (1990).

[57] HARTMANN, *supra* note 45.

[58] HARTMANN, *id.*, at 177 with reference to Sec. 382 IRC (1982).

2.2.2 Neutrality of Asset and Share Deals

Takeovers require a change of ownership either at the corporate or at the shareholder level, either through a transfer of corporate assets or through a transfer of shares. To the extent either event constitutes a realization event, it will generate tax consequences. A tax would raise the cost of takeovers and undermine their effectiveness as means for reducing agency costs. Since a takeover takes place either on the management (assets) or stockholder (stock) level, competition between both levels lowers the cost of takeovers. Tax rules that fall unequally on asset or stock transfers would interfere with the choice and accordingly disturb the positive and cost reducing effect of the competition between the two different types of takeovers.[59]

2.2.3 Golden Parachute Contracts

One significant example for corporate governance motivated taxation of payments in the context of takeovers is the taxation of so-called golden parachute payments. Golden parachutes can be described as generous payments to top managers in the event of a substantial change in ownership or a change of control, or upon termination of the officials' contracts as a result of such a change.[60] The payments must also have a present value equal to or in excess of an amount of three times the average income of the executive, *see* Sec. 280G(b)(2)(A) and Sec. 4999(b) IRC.[61]

In Sec. 280 IRC, the deductibility of "excess parachute payments" is limited. Additionally, in Sec. 4999 IRC a 20% tax is imposed on the taxpayer who receives a golden parachute payment. Hence, the code restricts deductibility as well as imposes a direct tax penalty on payments in connection with takeover situations. It affects both the bidding company (by increasing the costs of the payment) and the receiving manager (limiting the profit of the recipient of the payment). The result of both tax penalties (Sec. 280G and Sec. 4999 IRC) is that the after-tax costs of a takeover are increased. Consequently, these payments are less attractive for both the bidding company and the management of the target.

Sec. 280G and 4999 IRC were enacted to reduce the critical influence on corporate decision-making in takeover situations by executives' concern for their own personal benefit by influencing management and hostile bidders both in the interest of the shareholders.[62] Hence, the intent was to facilitate an effective market for corporate control via an effective market of takeover bids.[63] The aim was on the one hand to discourage management from profiting at the expense of the shareholders. It was feared that management would support inefficient takeovers that are not in the best interest of the company and the shareholders due to personal benefits from lucrative payments. On the other hand, those measures are meant to prevent managements from entrenching themselves in the case of a hostile takeover by deterring

[59] *See* STEPHAN, *supra* note 56.
[60] HARTMANN, *supra* note 45, at 178.
[61] *See* MISKE, Can't Cap Corporate Greed: Unintended Consequences of Trying to Control Executive Compensation Through The Tax Code, 88 Minn. L. Rev. 1673, 1677 (2004).
[62] *See* MISKE, *id.*, at 1678.
[63] HARTMANN, *supra* note 45, at 179.

takeover bids through the adoption of expensive golden parachute plans and thereby increasing the costs of takeovers to a degree that they would become inefficient.[64] In sum, these measures were hoped to reduce the effects of managerial opportunism of either supporting a takeover not in the interest of the company or deterring a takeover in the interest of the company by making golden parachute payment less attractive for both parties due to the negative tax consequences.

From the authors' point of view it seems rather doubtful whether the aim to prevent management from averting takeovers which are in the interest of the company can really be achieved by these provisions: by increasing the cost of the payments it becomes even more unlikely that a payment will be made by the bidding company. Accordingly, in cases when the takeover would be in the interest of the company the tax consequences seem counterproductive. Because the provisions cannot distinguish between harmful and beneficial takeover bids but rather any payment triggers tax consequences it may have negative results from the corporate governance perspective.

Consequently, it is suggested to provide an exemption from the golden parachutes payment provisions if the shareholders confirm the payment.[65] The provisions would only apply to those payments which are not in the interest of the shareholders: They would for example not apply when well-managed companies try to avert a hostile takeover by golden parachute contracts to protect efficient management from hostile bidders, subject to the approval of the shareholders. The denial of a deduction for golden parachute payments creates an incentive for stockholders to monitor the use of such payments because the payments are even more costly for the company when not deductible. It would therefore be appropriate to provide for an option for the shareholders to influence the consequences of the payments.[66]

One other problem with the taxation of golden parachute payments is that the absolute amount of the penalty is related only to the tax base of the respective taxpayer. For the bidding company the tax base is the amount of consolidated income because further deduction is denied. Accordingly it depends on the tax base to what extent the deduction could have been used. With respect to the individual manager it is the amount of the payment in relation to the "base amount", *i.e.* the average compensation of the manager. In particular, there is no link between the disadvantage for the company or the shareholders and the amount of the penalty, which can be criticized from the equity perspective.

According to some scholars, setting parachute payments at three times the base salary has, as an unintended result of the golden parachute provisions, become the sanctioned standard of reasonableness, and some companies willingly exceed the standard and grant gross-ups which provide an additional payment to the executives, such that executives receive the same after-tax amount as they would without the tax penalties.[67] Both are of course detrimental to the shareholder interest.

---

[64] HARTMANN, *supra* note 45, at 179.
[65] REPETTI, *supra* note 36, at 704.
[66] *See* REPETTI, *id.*, at 706 with reference to such an exception for non-publicly held corporations in the United States.
[67] *See* MISKE, *supra* note 61, at 1680.

2.2.4 Greenmail Taxation

Greenmail refers to a hostile bidder's sale of shares of the targeted firm back to that firm at a premium. In order to deter the payment and acceptance of such payments, Sec. 5881 of the IRC imposes a 50% tax on the gains resulting from such a sale of stock.

The background of the provisions can be summarized as follows: Despite potential positive effects of takeovers it was assumed that *hostile* takeovers were detrimental to the interests of the general economy and damaging for the interests of the targeted company, including its employees. Accordingly, transactions tending to increase the potential returns associated with hostile takeovers should be discouraged.[68] In addition it was assumed that short-term profits resulting from a greenmail payment were inefficient and should therefore be discouraged.[69] The greenmail tax reduces the return from greenmail payments and accordingly the expected returns from hostile takeover attempts.[70]

Similarly to the taxation of golden parachute payments the taxation of greenmail payments lacks also precision: On the one hand hostile takeovers and accordingly profits related with them (resulting from an unsuccessful attempt) may have negative effects. Furthermore, greenmail payments can have a negative effect in cases when they permit an inefficient management to defeat a takeover that possibly could have enhanced the situation of the company. In this case, a tax on greenmail payments benefits society and the shareholders by discouraging such payments.[71] On the other hand, however, if an efficient management is confronted with a hostile takeover attempt it would be better for the shareholders if the management could pay off the bidders.[72] In these situations, the tax on greenmail payments has a negative influence on the shareholders' situation because it is less likely that the bidding company will accept the payment and abandon the attempted takeover. The provision does not distinguish whether or not the takeover would be in the interest of the shareholders and consequently whether a greenmail payment would be in their interest.[73] The tax is imposed in every case on the greenmail profit and accordingly discourages the bidders without exception.

As a result the greenmail payment provisions have the inherent problem of not distinguishing between harmful and beneficial takeovers. This results in possible disadvantages for the shareholders when takeovers could have the result of replacing inefficient managements.

---

[68] *See* H. R. Rep. No. 3545, 100th Cong., 2d Sess. 1086 (1987) and in detail: HARTMANN, *supra* note 45, at 182; REPETTI, Corporate Governance and Stockholder Abdication: Missing Factors in Tax Policy Analysis, 67 Notre Dame L. Rev. 971, 1027 (1992); REPETTI, *supra* note 36, at 706.

[69] HARTMANN, *id.*, at 182.

[70] REPETTI, *supra* note 36, at 706.

[71] HARTMANN, *supra* note 45, at 184.

[72] *See* HARTMANN, *id.*, at 184, 187 in more detail with respect to the potential benefits for the shareholders, such as increased market information, the tendency to encourage other bids, thus ensuring that assets are reallocated to users who attribute the highest value to them.

[73] *See also* REPETTI, *supra* note 68, at 1031.

2.2.5 Taxation and Reorganization Provisions

As already mentioned with respect to the required neutrality of share and asset deals, takeovers require a change of ownership either at the corporate or at the shareholder level, through a transfer of a company's assets or its shares. Both events may constitute a realization event and therefore result in an additional tax burden. That would raise the cost of takeovers and so limit possibly positive effects of the control function of takeovers. As a result, it is necessary that takeovers resulting in a reorganization of the company should be possible in a tax neutral way.

Special reorganization provisions such as Subchapter C of the United States IRC or the Reorganization Tax Act (*Umwandlungssteuergesetz*) in Germany are intended to provide for tax neutral reorganizations to ensure that the most efficient allocation of resources is achieved and that inefficient management is controlled by a market for corporate control by potential outside buyers. In this sense, tax law should not interfere with corporate governance.[74]

From the corporate governance point of view reorganizations should have the same effect whether they are pursued by the incumbent management or by a potential new management (or owners with a new management) to ensure that the market for corporate control is not distorted by tax considerations.[75] Hence, a change of control should not be restricted for tax reasons because otherwise management could take the shareholders "hostage".[76]

In connection with reorganizations resulting from takeovers also group-reorganizations through a sale of investments in affiliates should be mentioned. Due to recent reforms these changes were discussed with respect to corporate governance.

This refers to the above-mentioned difference of corporate governance structures between the capital market oriented approach of Anglo-Saxon countries and other countries such as Germany, which are much more characterized by cross-owned companies. Due to a recent tax reform in Germany in which a tax exemption of profits resulting from sales of holdings in affiliated companies was enacted there is a discussion whether this change leads to better corporate governance structures. The exemption was enacted in order to unravel the close net of cross-holdings, which has been characteristic for the German business environment. The exemption of profits resulting from the sale of interests in other companies was discussed by a few scholars in the light of corporate governance both negatively and positively. On the one hand it was argued that the reduced influence of strong shareholders might reduce the monitoring power of shareholders in general,[77] on the other hand, the reduction of cross-holdings was seen as a way of avoiding conflicts of interests.[78]

To the authors' knowledge the effects of this change in 2003 have not been evaluated in depth yet. However, it is safe to observe that the portion of cross-company

---

74 On the U.S. provisions *see* STEPHAN, *supra* note 56, at 677.
75 STEPHAN, *id.*, at 704.
76 STEPHAN, *id.*
77 *See* SALZBERGER, *supra* note 37, at 211.
78 KRAFT, *supra* note 37.

holdings in overall shareholding in Germany has substantially declined in recent years.[79]

Whether this change has positive or negative consequences on corporate governance depends on the perception of the influence of cross-company holdings. Those who considered the strong monitoring power as positive for corporate governance will see disadvantages. Those who perceived conflicting interests will support these changes.

It will be interesting to see whether other strong shareholders (with respect to pension funds *see* below) can replace the current structures as agents of effective corporate control once they are unraveled.

2.2.6 Conclusion

Tax provisions with corporate governance purposes are generally not sophisticated and fact specific enough. Furthermore, they can often easily be circumvented or ignored. In some cases provisions on the taxation of executive remuneration in the United States in fact lead even to increased payments. Most importantly, they cannot distinguish between harmful and beneficial takeover situations. In addition, both in the case of greenmail and golden parachutes taxation, the tax penalty is not linked to the actual harm (possibly) caused by the targeted conduct.

As a result, it seems inappropriate to use tax legislation as a policy tool with respect to takeover transactions. It would be preferable to develop more sophisticated systems that distinguish between situations that result in a benefit for the shareholders and those which are to their detriment. One possibility is to subject management support for takeovers to shareholder approval.

2.3 Taxation and Transparency

2.3.1 Introduction

Accounting rules also raise questions with respect to corporate governance as the interests pursued by different parties in financial and tax accounting diverge. The basic conflict can be described as follows: The rules of financial accounting (*Handelsbilanzrecht*) are aimed at providing a prudent picture of the financial situation of companies. The system serves mainly the interest of the investors. From the companies' point of view the declared profit should preferably be high to satisfy creditors' and shareholders' interests. In contrast to this position, the tax accounting rules (*Steuerbilanzrecht)* are on the one hand aimed at showing a preferably high profit in order to ensure that the tax authorities receive a tax payment in proper relation to the ability to pay of the company. On the other hand taxpayers will try to reduce their taxable profits as far as possible in order to reduce their tax liability.

In the following we will try to identify how tax accounting rules affect corporate governance in their interplay with financial accounting rules.

---

[79] *See* recently SCHÖN, Capital Gains Taxation in Germany, 2005 British Tax Review (BTR) 620, 626.

2.3.2 Principle of Authoritativeness

In German tax law, the principle of authoritativeness links generally the taxable profits of business enterprises to their business accounting results. The tax balance is basically deduced from the financial statement. At the same time, options in business accounting have to be exercised in the same fashion as they are in tax accounting ("reverse authoritativeness"). In the course of tax reforms in 2002 the reverse authoritativeness principle was abandoned as far as the financial accounts of corporate groups are concerned: Sec. 308 Para. 3 of the German Commercial Code (*Handelsgesetzbuch*) was abolished. According to Sec. 298 Para. 1 of the Commercial Code some tax items, which formerly have been important for the financial accounts, are not allowed anymore. One example is a provision that allows in the separate financial accounts of companies taking account of lower asset values due to accelerated depreciation according to tax provisions (Sec. 254 *juncto* Sec. 279 Para. 2 and Sec. 281 of the Commercial Code). Other examples are special reserves with an equity portion (*Sonderposten mit Rücklageanteil*, Sec. 247 Para. 3 and Sec. 273 of the Commercial Code) and reversals of impairment losses (*Wertaufholungswahlrecht,* Sec. 280 Para. 2 and 3 of the Commercial Code).[80] The result of these changes is an increased discrepancy between the tax accounts and the consolidated financial group accounts. As a consequence, the importance of deferred taxes (*latente Steuern*) is also increased (*see* Sec. 274 of the Commercial Code) to close this gap.

However, to the extent the reversed authoritativeness principle is still in place, it has several consequences both in respect of the information function of tax and financial accounting and with respect to the distribution policy of companies.[81]

One aspect is the reciprocal effect the two accounting standards have on each other: management presents two statements of profits with conflicting goals: on the one hand, financial accounting should preferably indicate high profits, on the other hand, tax accounts should preferably show low profits. In the balance, this conflict might lead to a quite realistic result, which is from the corporate governance point of view a positive consequence.

Negative results can arise when the tax accounting rules are connected with the financial accounting rules (reverse authoritativeness principle) in such a way that the tax accounting rules prevail and lead to less transparent balance sheets. This results in a weakened control by shareholders.

A similar question arises in relation to the scope of IAS/IFRS.[82] In the authors' view a link between financial and tax accounting is desirable also under new, more capital market orientated accounting rules. To the extent profits are (or can be) shown in the financial statements they should as well serve as the corporation tax

---

[80] *See* for further details LEMNITZER, Transparenz- und Publizitätsgesetz – Rechnungslegungsrelevante Aspekte, 2002 Bilanzbuchhalter und Controller (BC) 248, 251.

[81] For an example *see* KRAFT, *supra* note 37, at 10, 11.

[82] *See* SCHÖN, Eine Zukunft für das Maßgeblichkeitsprinzip, in: SCHÖN (ed.), Steuerliche Maßgeblichkeit in Deutschland und Europa, 1 (2005), and SCHÖN, The David R. Tillinghast Lecture: The Odd Couple: A Common Future for Financial and Tax Accounting?, 58 Tax L. Rev. 111 (2005).

base. Generally speaking, the capital market and the shareholders are in a similar position to tax authorities: they participate in the realized profits of the company.[83] Accordingly, it would be inconsistent to determine the base for the respective portion in different ways. From the corporate governance perspective the result is positive: rather than having two different statements, which are both manipulated to the detriment of the public finances or the companies' investors respectively and consequently do neither show a realistic picture of the companies' situation, financial and tax accounts that are linked by the principle of authoritativeness might in the end result in sensible views on the financial position of businesses because they balance the divergent interests of financial and tax accounting.

2.3.3 Deferred Taxes

As mentioned above in the context of the discrepancy between tax and financial accounts, different levels of profits in tax and financial accounting will be accounted for in the financial accounts as deferred taxes. To the extent the tax result is lower than the financial result and in consequence future tax liabilities are probable, those future tax liabilities have to be booked as a provision in the financial accounts.[84] In contrast, when the tax results exceed the financial results it is possible to account for lower future tax liabilities with a deferred tax on the asset side, resulting in higher financial profits.[85]

Regarding corporate governance and transparency, the possibility to increase the financial results due to expected tax savings in the future is critical: one method for presenting Enron in a much better shape than it was in actually relied on structuring transactions in a way that resulted in a tax treatment different from financial accounting so that the future tax benefits could be used for generating financial statement income.[86]

As a result, it has to be noted that the large margin of discretion in respect of booking deferred taxes and accordingly increasing financial accounting results leads to an increased manipulability of the financial results. Those positions are often very uncertain and impede the information function of financial accounting.[87]

---

[83] *See also* under 2.3.5 the discussion of the concept of a "certification tax", and MAYER, Entwicklung der Maßgeblichkeit in Deutschland, in: SCHÖN (ed.), Steuerliche Maßgeblichkeit in Deutschland und Europa, 147, 154 *et seq.* (2005) on the justification of the authoritativeness principle in Germany with the notion that states participate in the profits of businesses similarly to partners or shareholders (*Teilhaberthese*).

[84] Sec. 274 Para. 1 of the German Commercial Code.

[85] However, this profit is distributable only under certain conditions, Sec. 274 Para. 2 Sentence 2 of the German Commercial Code.

[86] *See* STAFF OF THE JOINT COMMITTEE ON TAXATION, Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, And Policy Recommendations. Volume I: Report, 8 (2003).

[87] LINK, Die Maßgeblichkeitsdiskussion angesichts der Einführung von IAS/IFRS in die Rechnungslegung, in: SCHÖN (ed.), Steuerliche Maßgeblichkeit in Deutschland und Europa, 207, 230 (2005); SCHREIBER, Hat das Maßgeblichkeitsprinzip noch eine Zukunft?, in: BUDDE/MOXTER/OFFERHAUS (eds.), Handelsbilanzen und Steuerbilanzen. Festschrift zum 70. Geburtstag von Prof. Dr. h.c. Heinrich Beisse, 491, 500, 509 (1997) in respect of U.S. tax accounting.

2.3.4 Tax Influences on Corporate Structures

Taking into account the important role transparency plays as a condition for market and shareholder control, the effects of tax-driven restructuring have been examined.

According to recent research, tax incentives affect the organizational structure and financial behavior of firms.[88] Tax incentives have resulted in tax haven driven activities. The effects from a corporate governance perspective are that the companies become less transparent with respect to an inter-temporal aspect: due to frequent and complicated tax-driven reorganizations, the development of the business performance of certain companies or their parts often cannot be easily determined because the entities involved are not comparable over time. The same is true for comparing company accounts.

A similar result may arise with respect to other disadvantages resulting from tax haven driven reorganizations: to the extent tax-driven corporate inversions result in a change of the jurisdiction of incorporation, corporate governance is affected as the law changes that governs the fiduciary duties of management.[89]

2.3.5 A Separate Corporate Income Tax as "Certification Tax"

It has already been mentioned in connection with the authoritativeness principle that tax authorities can be seen as being in a similar position to shareholders and the capital market. Both aim at participating in the profits of the company and both are accordingly interested in realistic and transparent information on the company's situation.

In the United States some authors invoke the notion of a "certification tax" as a justification for a separate corporate income tax.[90] Originally, the corporate income tax was introduced in the United States inter alia to regulate corporations, mainly by receiving tax returns, but also the tax itself was considered to regulate the power of corporate management. Two aspects can be distinguished: A corporate income tax imposed on corporate profits reduces the after-tax resources that are under the control of management. From this perspective, managements' power is reduced by a separate income tax.[91] In addition the obligation to pay a business tax and to prepare tax accounts results in transparent information on the situation companies are in. The tax provided an attractive alternative to more radical proposals that would have imposed obligations on incorporations in order to achieve publicity about companies' conduct.[92] Hence, one important aspect was that a separate company tax could

---

[88] STEWART, Fiscal incentives, corporate structure and financial aspects of treasury management operations, 29 Accounting Forum 271 (2005).

[89] *See* KUN, Corporate Inversions: The Interplay of Tax, Corporate, and Economic Implications, 29 Del. J. Corp. L. 313 (2004).

[90] *See* DESAI/DYCK/ZINGALES, *supra* note 37, at 37.

[91] *See* AVI-YONAH, The Story of the Separate Corporate Income Tax: A Vehicle for Regulating Corporate Managers, in: BANK/STARK (eds.), Business Tax Stories, 11, 17 (2005) and KORNHAUSER, Corporate Regulation and the Origins of the Corporate Income Tax, 66 Ind. L. J., 53 (1990), who provides an extensive overview of the history of the U.S. Corporate Income Tax.

[92] KORNHAUSER, *id.*

provide the government with information about the companies. Disclosure of financial information (in the tax return) was also supposed to provide investors with required information. Disclosure was a well-recognized method of regulation.[93] This interest of tax authorities goes along with the corporate governance aspect that the same information is available to shareholders of the company.

In the modern discussion about the "certification tax", a separate tax on corporate income is perceived as a certification of the corporations' profits to the minority shareholders and as providing an incentive for the enforcement of this certification.[94] It was stated that this can be seen as a corporate governance-related justification of a tax on business profits: when the state itself is interested in verifying the companies' profits it ameliorates the agency problems between insiders and outside shareholders, as management behavior aimed at diverting profits also reduces corporate tax liabilities and accordingly procedures that ensure tax compliance are also in the interest of the shareholders.[95] Thus, increased tax enforcement can increase the value of companies despite increased tax liabilities.[96]

In contrast to this relationship between tax enforcement and corporate governance, the diversion of profits is assumed to increase with higher tax rates.[97] Accordingly a reduction of tax rates can be recommendable from the corporate governance perspective in order to reduce the incentive to divert profits.

2.3.6 Regulatory Tax Rules

In very general terms, tax rules drafted for regulatory purposes (in contrast to the purpose of revenue generation) are criticized for their unclear effects. Direct regulation has a much more visible impact. Furthermore, tax provisions might lead to a "regulatory confusion" in the interplay with direct regulation.[98] This term describes a situation in which taxes and direct regulation reciprocally influence each other in an uncertain and potentially inconsistent way.

The pros and cons of regulation through tax legislation vs. direct regulation will be discussed in detail below.[99]

2.3.7 Conclusion

In summary, tax rules tend to foster complexity and reduce transparency because they promote convoluted, tax-driven corporate structures. With respect to accounting standards the authors generally support the connection between tax and financial statements, in the belief that it leads to a more balanced and realistic picture of the financial situation of companies. However, insofar as tax rules influence financial

93 KORNHAUSER, *id.*, at 54.
94 DESAI/DYCK/ZINGALES, *supra* note 37, at 37, also with reference to the historic introduction of the corporate tax in the United States in 1909.
95 DESAI/DYCK/ZINGALES, *id.*, at 3.
96 *See* 3.4.3.
97 DESAI/DYCK/ZINGALES, *supra* note 37, at 2.
98 HARTMANN, *supra* note 45, at 198.
99 *See* chapter 2.6 below.

accounts due to a reverse authoritativeness, this results in a risk of less informative financial statements due to unrealistic tax-driven accounting positions.

2.4 Distribution Policy and the Access to Capital

2.4.1 Introduction

The separation of ownership and control being the basic problem of public corporations, taxation has a significant corporate governance relevance when it influences the possibilities of the shareholders to monitor the management of companies. Shareholders attempt to monitor the managers' investment decisions to prevent investments that do not maximize shareholder profits. Managers, in turn, often seek to avoid this monitoring.[100]

The monitoring to which firms are subject depends to a large degree on how the companies' capital needs are financed.[101] New investments can either be financed by debt, equity or retained earnings. Apparently the monitoring power of the shareholders is best when investments have to rely on new equity. In contrast, managerial power is increased to the extent to which retained earnings can be used. To receive external financing either in the form of equity or debt at the capital market, managers must provide substantial information about the company's situation and the business plans. In general they will only receive new equity for investments which are considered by the capital market as profitable. As a result of the need to fund the company with external money the power of decision-making is partly shifted to the shareholders or other outside investors. To pursue suboptimal investments, managers will accordingly have to rely mostly on retained earnings.[102] Therefore, from the corporate governance point of view, capital markets and shareholders are weakened if managers have retained earnings available instead of having to raise capital on the markets. The power to allocate profits is shifted from the shareholders to the management. Hence, the distribution or retention of profits is one aspect of shareholder control over managers. Only when profits are distributed shareholders are free to choose between investing those profits in the same company or rather re-allocating those funds to more profitable projects. They will select the most profitable investment and thereby force companies to organize their activities in the most profitable way in order to persuade the shareholders to re-invest distributed profits again. Because any investor or lender will control the efficiency of the investment, retention of profits is seen as a way to avoid this control.[103] In other words: "The company is freer to make investment decisions concerning the retained funds, which are not subject to direct market discipline".[104]

Regarding another negative consequence of a retention of profits, some authors argue that management might abuse its power for personal benefits. Due to the lack

[100] ARLEN/WEISS, A Political Theory of Corporate Taxation, 105 Yale L. J. 325, 349 (1995).
[101] ARLEN/WEISS, *id.*
[102] ARLEN/WEISS, *id.*, at 350.
[103] *See* REPETTI, *supra* note 36, at 698.
[104] OWENS, *supra* note 35, at 768.

of monitoring power of shareholders, profits could be diverted for personal benefits of the managers, could be used for "empire building", *i.e.* for company investments in the personal interest of the directors rather than in the interest of shareholders and the company, or could be diverted for "consumption on the job".

Accordingly reasons and effects of the retention of corporate profits are often discussed in the light of taxation and corporate governance when tax rules influence the decision to retain profits.[105] Below we will discuss features of tax systems from this perspective.

2.4.2 Lock-In Effect of the Classical Tax System

The aspect of taxation which is discussed most with respect to corporate governance and the retention of profits is the double taxation resulting from the so-called classical tax system.[106]

In classical corporate tax systems, income is taxed twice, once on the corporate level and, after the profit has been distributed to the shareholders, again on the shareholder level. As a result the pressure of shareholders on the management to distribute profits rather than retaining them is reduced because the distribution of dividends triggers a second tax liability and thus increases the costs of the company. The resulting effect is called lock-in effect[107] because the profits are locked within the company. The double taxation may even cause shareholders to accept a lower pre-tax rate of return from internal firm investment projects than they would require from external investment projects, because shareholders benefit from leaving retained profits in the corporation rather than receiving dividends.[108]

In the history of taxation double taxation is seen as a key factor for the retention of profits[109] and is still the object of an ongoing debate. Arlen and Weiss conclude that the double taxation of corporate profits creates significant distortions in the American economy.[110] In 2003, President Bush proposed to enact a dividend exemption to eliminate the double taxation of corporate profits.[111] The proposal of the Bush administration was supposed to increase shareholder pressure on managements to distribute profits as dividends.[112]

It is argued that classical tax systems not only have negative effects on corporate governance but that also one reason why the two-tier tax system is still used in many

---

[105] *See* recently BANK, The Story of Double Taxation: A Clash over the Control of Corporate Earnings, in: BANK/STARK (eds.), Business Tax Stories, 153, 177 (2005).

[106] *See* OWENS, *supra* note 35, at 768; KRAFT, *supra* note 37, at 8, 9; ARLEN/WEISS, *supra* note 100; WAGNER, *supra* note 37, at 118 *et seq.*; BANK, Corporate Managers, Agency Costs, and the Rise of Double Taxation; 44 Wm. & Mary L. Rev. 167 (2002); KANDA, Taxes and the Structure of Japanese Firms: The Hidden Aspects of Income Taxation, 74 Wash. U. L. Q. 393 (1996); BANK, Is Double Taxation a Scapegoat for Declining Dividends? Evidence From History; 56 Tax L. Rev. 463 (2003).

[107] KRAFT, *id.*, at 8.

[108] ARLEN/WEISS, *supra* note 100, at 352.

[109] ARLEN/WEISS, *id.*, at 356.

[110] *See* BANK, *supra* note 105.

[111] *See* BANK, *id.*, at 179.

[112] *See* BANK, *id.*

tax systems can be found in the separation of management and ownership. As the double taxation reduces the return on investments funded with equity the pressure exercised by shareholders is weakened. Although it would be beneficial for shareholders to integrate corporate and personal taxation, corporate managers oppose this step as they fear a disadvantage for their perceived interests.[113]

In conclusion, it is said that the retention of profits as supported by the classical tax system encourages managerial misbehavior for personal motives. The position of the management in relation to the shareholders is strengthened. The focus is shifted from shareholder value to ostensible tax advantages or savings that benefit the companies as such and therefore their managers. At the same time, the effect of weakening the monitoring function of capital markets might be an inefficient allocation of capital.

However, from the authors' point of view similar problems as in the classical system might arise in imputation systems that apply different tax rates at the corporate and the individual shareholders' level. A higher individual tax rate may lead to a lock-in effect, because to the extent the shareholders' rate exceeds the corporate rate it would be preferential in respect of tax costs to retain profits rather than to distribute them.[114]

Secondly, it seems doubtful that the negative effect of the preferential treatment of retained profits is actually as relevant as suggested in the literature: the pressure of the capital market and analysts also requires a high rate of profit distribution. A management that extensively retains profits for the reasons described above faces critical remarks and negative investment decisions by the market.

Thirdly, as third party debt is deductible it can be preferential to finance new projects with debt rather than retained earnings to reduce taxable profits.[115]

2.4.3 Reverse Authoritativeness Principle

As another reason for a tax-induced retention of profits the reverse authoritativeness principle is discussed.[116] This feature of the German income tax has already been described in relation to negative consequences regarding the information function of financial reports: as the reverse authoritativeness principle requires the same entries in the financial statement as in the tax accounts, it creates a tendency for complexity and opacity because entries are made for tax reasons and do not reflect the actual situation of the company as required for corporate governance reasons.[117]

---

[113] *See* BANK, *supra* note 49, and ARLEN/WEISS, *supra* note 100, for an extensive and detailed analysis of the reasons for the corporation tax existing at all. They also provide empirical evidence that double taxation does not in any case lead to the retention of profits.

[114] *See also* WAGNER, *supra* note 37, at 115.

[115] *See* with the same result: ARLEN/WEISS, *supra* note 100, at 368.

[116] *See* for example NOWOTNY, Auswirkungen der Maßgeblichkeit auf Corporate Governance, in: BERTL/EGGER/GASSNER/LANG/NOWOTNY (eds.), Die Maßgeblichkeit der handelsrechtlichen Gewinnermittlung für das Steuerrecht, 95, 101 (2003); SALZBERGER, *supra* note 37, at 212, 213; SOLFRIAN/SIEBRAßE, Der Wegfall der umgekehrten Maßgeblichkeit im Konzern, 2004 Steuern und Bilanzen 111.

[117] *See* 2.3.2 for the limited scope of the principle after its abolition in respect of the reports of corporate groups.

Regarding the distribution policy of companies, the reverse authoritativeness principle leads to an increased influence of management.[118] The management board has the duty to reduce the actual tax burden as much as possible. For tax reasons the company will therefore seek to show as little profits as possible in its accounts. To the extent that the balance sheet is linked to tax accounting due to the reverse authoritativeness principle, this tendency might lead to an inefficient retention of profits because profits that otherwise could be distributed are "hidden" in the balance sheets.[119]

On the other hand it should be kept in mind that another incentive for the management is to present the company in a healthy shape. In the modern times of strict capital market monitoring, management will hardly present financial results which cannot fulfill the expectations of the shareholders and investors.

In addition to the possibility of a manipulation of the tax accounts there are mandatory rules which have the same effect of stimulating the retention of profits.[120] Some rules on the valuation of assets (*Bewertungswahlrechte*) in the tax accounts are designed to promote goals of public policy (*Sozialzwecknormen*), drafted by the legislator to motivate the taxpayer. A case in point are provisions allowing an accelerated depreciation of assets for public policy purposes. To the extent the balance sheet is connected to tax accounting, the resulting tax advantage is linked with the disadvantage that profits available for distribution are accordingly lower as well.[121]

The result with respect to corporate governance is the same as described above: the reverse authoritativeness principle for those reasons encourages the retention of profits and consequently increases the discretion of the board in the allocation of capital. The capital of the shareholders is therefore not reallocated by the capital market but rather directly available for further investments. In other words, the retained profits are not distributed even though an alternative investment might be more beneficial for the shareholders.[122]

2.4.4 Deferred Taxes

As has already been described under 2.3.2 and 2.3.3 the discrepancy of tax and financial accounting leads to the booking of provisions with respect to future tax liabilities when the profits in tax accounting are lower than they are in financial accounting and this difference might lead to higher tax liabilities in subsequent years.

Accounting for deferred taxes on the liabilities side enables management to deprive shareholders from distributable profits because the higher financial accounting result profit is "blocked" by a provision for future tax liabilities and accordingly not distributable to that extent.

---

[118] SALZBERGER, *supra* note 37, at 212 *et seq.*

[119] NOWOTNY, *supra* note 116, at 101.

[120] *See* NOWOTNY, *id.*, at 101; WAGNER, Die umgekehrte Maßgeblichkeit der Handelsbilanz für die Steuerbilanz, 1990 StuW 3, 6; HENSCHEID, Ökonomische Wirkungen der umgekehrten Maßgeblichkeit, 1992 Betriebs-Berater (BB) 1243, 1244; ROBISCH/TREISCH, Neuere Entwicklungen des Verhältnisses von Handelsbilanz und Steuerbilanz – Anhaltspunkte für eine Trendwende, 1997 WPg 156, 167.

[121] HEY, in: TIPKE/LANG, Steuerrecht, 663 (18th ed. 2005).

[122] SALZBERGER, *supra* note 37, at 212 *et seq.*

From a corporate governance perspective, the possibility to show deferred taxes as a result of tax-driven accounting increases the power of management to add to liquidity without the duty to distribute profits. As a result, deferred taxes can be another reason for the retention of profits.

2.4.5 Company Pension Funds

The treatment of payments in connection with company pensions can also have effects on corporate governance. Two aspects are discussed in relation of corporate governance. The first one concerns the aspect of retained profits and their assumed consequences for the balance between management and shareholders. The second refers to the structure of the corporate governance system which has in general terms been examined under 2.1.1.

The first aspect refers to a preferential treatment in tax accounting of company pension liabilities in the form of book reserves (*Direktzusagen*) under former German tax law: The possibility to make provisions (*Rückstellungen*) in the accounts for those future pension liabilities leads to increased present liquidity and tax deferral advantages. Because the cash value of the pension for the employee was not taxed until the actual payment of the pension, whereas all other forms of pensions were taxed on the individual level at the time of payment to the fund, it was preferential to use book reserves. With respect to company control, provisions for pension liabilities in this way decreased the necessity to raise capital on the capital market and third party loans were replaced by provisions.[123] In short, regarding the preferential treatment of provisions for pension liabilities the same negative consequences for corporate governance are perceived: the possibility to retain profits for tax reasons and to rely on the resulting liquidity for financing new investments increases the powers of management because it can invest without being monitored by shareholders or third parties.

In order to align the treatment of the different kinds of retirement provisions and to increase the capital available for the capital market, all forms of retirement provisions are now taxed in Germany when paid to the beneficiary. However, the advantage of obtaining liquidity by entering provisions for pension liabilities in the accounts still exists as an incentive to choose company pension liabilities in the form of book reserves.

The second aspect refers to the monitoring and influencing function which third party pension funds can have in the corporate governance system. The hope is that the third party pension funds could play an important role in improving external control over companies.[124] In the United States, pension funds are much more important than in Germany due to the amount of capital they can invest. It will be interesting to see whether similar developments will occur in Germany.[125]

---

[123] SALZBERGER, *id.*, at 212, 214.
[124] SALZBERGER, *id.*, at 212, 214.
[125] On the influence of large shareholders over managers *see* ROE, Political Theory of American Corporate Finance, 91 Colum. L. Rev. 10 (1991) with a sceptical view on the influence of company pension funds due to non-tax law restrictions.

2.4.6 Stock Options

Another aspect of tax law which is mentioned with respect to corporate governance and the retention of profits is the tax treatment of stock options. Management compensation schemes are supposed to strengthen the tendency to inefficiently retain profits: The payment of a dividend decreases share prices because they reflect expected future distributions. Thus the value of stock options is decreased by distributions.[126] Accordingly, stock option plans may have the same effect as those described with respect to the classical tax system: the resulting incentive in favor of retaining profits might increase the conflict between shareholders and management.

Another risk is seen in the fact that managers could focus only on stock performance, because that affects their interest, rather than on long-term success.

2.4.7 Capital Gains Preferences

One interaction between the tax system and corporate governance occurs when the tax system gives preferential tax treatment to certain forms of income.[127] One aspect is a tax preference in favor of capital gains in comparison to dividends. The assumption is that long-term capital gains preferences encourage the inefficient retention of earnings and thus exacerbate the problems arising from the separation of ownership from control.[128]

Two arguments are mentioned with respect to the long-term capital gains preference: A long-term capital gains preference can be invoked as a justification for management to retain profits even though it may be economically more efficient to distribute profits as dividends. Shareholders would benefit from a reduced capital gains rate by selling their shares rather than realizing profits in the form of dividends that are taxed more heavily.

The second argument is that the long-term capital gains preference creates a tax bias for non-corporate shareholders to realize profits by selling their shares rather than retaining them and receiving dividends. This bias may increase the reluctance of shareholders to devote resources to monitoring management and, therefore, may exacerbate the separation of ownership from control.[129]

In addition to the perceived increased power through retained profits, a preferential tax rate on capital gains may exacerbate shareholder abdication: The first aspect raised is that shareholders will more likely accept the inefficient retention of profits because they also benefit from the lower tax rate this way. The second aspect is that preferential capital gains tax rates might support a short-term oriented investment strategy. Shareholders may be more interested in reaping short-term profits, which then would be realized by selling the shares, rather than in showing a long-term ownership attitude by receiving profits in the form of dividends.

---

[126] ARLEN/WEISS, *supra* note 100, at 350; REPETTI, *supra* note 36, at 701.

[127] OWENS, *supra* note 35, at 768. *See also* REPETTI, *id.*, at 711.

[128] REPETTI, *supra* note 68, at 999. *See id.*, at 1010, on the assumption that stockholders are able to realize the value of retained earnings at a preferential tax rate when selling their shares. This implies that the market value of shares reflects positively that less dividends are paid.

[129] REPETTI, *id.*, at 999; OWENS, *supra* note 35, at 768.

However, the validity of this argument seems as doubtful as the perception of classical tax systems mentioned above: The capital markets focus also on the level of dividend distributions. Therefore, management would not likely retain profits for tax reasons but rather comply with the expectations of markets and analysts. Accordingly, it is also argued that different tax rates have no impact on the decision whether to pay dividends, which is rather driven by the fact whether companies have excess cash after financing their investment needs.[130]

For corporate shareholders in Germany as well as in the United States, dividend taxation is preferential anyway: either dividends are nearly completely exempted (*see* Sec. 8b of the German Corporation Tax Act (*Körperschaftsteuergesetz*)) or the corporation receives a deduction with the same effect (*see* Sec. 243 IRC).

Currently, dividends from domestic companies and most foreign companies qualify in the U.S. as "net capital gains" and accordingly qualify for a preferential tax rate. Therefore, there is momentarily no tax incentive to rather sell shares than monitor the management in order to realize profits as dividends.[131]

2.4.8 Conclusion

Theoretically the retention of earnings leads to a shift of power from shareholders towards management. However, tax experts of leading German companies doubt whether this effect exists in practice. It was stressed that in modern business society the expectations of the capital market and the statements of analysts are of paramount importance and that the level of profit distribution, the dividend rate, is the most significant figure by which companies are analyzed. Consequently, the retention of profits is not seen as a relevant problem. The potential tendency in favor of an efficiency-reducing retention of profits due to the tax system is, according to this view, balanced by the detrimental effects of a low dividend rate.

As a result, inefficient retention of profits due to the classical tax system, the reverse authoritativeness principle, the treatment of company retirement provisions, stock options or capital gains preferences is in practice not perceived as a current corporate governance problem. However, this may be due to the fact that these practitioners view the problem from inside their institutions.

2.5 Business Decisions of Management/Diversion of Profits to the Disadvantage of Shareholders

2.5.1 Introduction

As mentioned above, the United States discussion on taxation and corporate governance mostly concerns executive remuneration. This reflects the basic corporate governance problem, the agency conflict.

Apart from the attempt to positively align the interests of management and shareholders, another important aspect is how to prevent managers from diverting profits of the company to their own benefit.

---

[130] *See* REPETTI, *id.*, at 1001.
[131] *See* BANK, *supra* note 105, at 180.

2.5.2 Taxation of Stock Options and Incentive Stock Options

For almost half a decade, the preferential taxation of certain types of incentive stock options has been seen as an instrument for aligning the interests of shareholders and management by providing management with equity interests.[132] The German Corporate Governance Codex also includes a provision that recommends the remuneration of managers to comprise to a certain degree performance-based elements.[133]

The impact of tax legislation on corporate governance can be direct when provisions provide for a specific treatment of stock options for corporate governance reasons. It can also be merely indirect if just general tax principles are applied.

The advantage of *incentive* stock options in particular can be described as follows: When an executive receives shares because he exercises an option, in U.S. tax law the employee normally realizes ordinary taxable income to the extent the fair market value of the stock received exceeds the option exercise price. In contrast, when the stock option qualifies as an incentive stock option (*see* Sec. 421 IRC) the taxpayer enjoys two advantages: First, the shareholder realizes no taxable income when exercising the option. Rather, the profit is taxable when the shares are sold. Second, all profit is treated as capital gains and as such taxed at a preferential rate.

To qualify as an incentive stock option, the option must be granted with shareholder approval and it must have an exercise price equal to the shares' fair market value at the time when it is granted. Additionally, the shares must be held for more than one year from the time when the option is exercised and more than two years after the receipt of the option.[134]

It is disputed whether increased stock ownership of management actually leads to the intended alignment of interests.[135] The main reason for questioning the ability of stock options to align the interests of managers and shareholders is seen in the missing downside risk of stock option holders.[136] Another risk is seen in the fact that managers could focus only on stock performance, because this is what determines their profits when exercising options, rather than on long-term success. Critics argue that stock options even make it preferable for managers to retain profits in the company, since the value of the stock increases by the amount of earnings retained.[137]

---

[132] For a brief summary of the historical background *see* REPETTI, *supra* note 68, at 1018. For a general overview not related to taxes *see* FERRARINI/MOLONEY, Executive Remuneration and Corporate Governance in the EU: Convergence, Divergence, and Reform Perspectives, 2004 European Company and Financial Law Review (ECFR) 251. For a different perspective *see* BOOTH, Executive Compensation, Corporate Governance, and the Partner-Manager, 2005 U. Ill. L. Rev. 269.

[133] *See* Sec. 4.2.3 of the German Corporate Governance Codex.

[134] REPETTI, *supra* note 36, at 701.

[135] REPETTI, *supra* note 68, at 1022; PAK, Toward Reasonable Executive Compensation: An Outcry for Reform and Regulatory Response, 1994 Ann. Surv. Am. L. 633, 643; REPETTI, *supra* note 36, at 701.

[136] PAK, *id.*; REPETTI, *supra* note 36, at 701.

[137] *See* in detail above, 2.4.6, and REPETTI, *supra* note 36, at 701.

Since this is actually not a tax-related problem, we won't discuss pro and contra of (incentive) stock options in detail.[138] However, what has been demonstrated above is that stock options might increase the tendency to retain profits because the stock price and accordingly the value of the unexercised stock option is related to the amount of retained profits. Hence, executive stock option plans may increase the conflict between stockholders and managers over the source of financing.[139]

To conclude, the preferential treatment of incentive stock options is intended to connect managers' personal interests with those of shareholders. However, it seems doubtful whether stock options in fact represent an adequate instrument to this end.

2.5.3 Caps on Salaries of Managers/Exceptions for Performance-Based Remuneration

Concerning the danger that corporate managers might abuse their powers to the disadvantage of shareholders, also apart from takeover-related situations, U.S. tax legislation first of all targets excessive compensation plans (as perceived by the legislator). Secondly, these provisions provide for exceptions in favor of performance-based remuneration.

In very general terms, Sec. 162(a)(1) IRC limits the deductibility of expenses to "all the ordinary and necessary expenses ...", including "a reasonable allowance for salaries or other compensation for personal services rendered".

By virtue of this section, the Internal Revenue Service (IRS) has a very broad authority to disallow deductions for compensation that is viewed to be unreasonable. However, the IRS seems in fact not to utilize this possibility very much.[140]

Yet, this broad provision can be interpreted as the basic model of the legislator's approach: it is perceived that management detaches its interests from those of the company and diverts the company's profits for private benefit. This again reflects the underlying corporate governance conflict, the agency problem, and it indicates the way the tax code works in this respect: by increasing the after-tax cost (in denying the deductibility of business expenses) a certain conduct becomes less attractive.

In 1993 a more specific provision was included to limit the deductibility of certain expenses for executive compensation. Sec. 162(m)(1) IRC provides that "no deduction shall be allowed (...) for applicable employee remuneration (...) to the extent that the amount of such remuneration for the taxable year with respect to (one) employee exceeds $1,000,000."

Exceptions to this limitation are in particular performance-based payments, *see* Sec. 162(4)(C) IRC. This again reflects the basic conflict: the legislator assumes that the separation of management and ownership leads to misuse of power in particular with respect to executive remuneration. Therefore the deductibility of payments to

---

[138] For a summary of economic studies on the effectiveness of stock options *see* REPETTI, *supra* note 36, at 701.

[139] ARLEN/WEISS, *supra* note 100, at 351.

[140] STABILE, Is There a Role for Tax Law in Policing Executive Compensation?, 72 St. John's L. Rev. 81, 85 (1998). In contrast *see* PAK, *supra* note 135, at 653 with respect to close corporations but emphasizing the reluctance of the courts in regard of public corporations.

managers is limited.[141] However, Sec. 162(m) IRC includes an exemption that serves as an example for the basic thrust of the rule because it provides for exemption when, from the legislator's perspective, shareholder interests are not at risk. This is assumed to be the case when payments are based on performance, because it is assumed that the measure of performance that forms the basis of payments reflects the shareholders' interests.

In practice, it is doubtful whether these exceptions leave much scope for the general rule of Sec. 162(m) IRC: many companies will shift from high base salaries to annual bonus payments and other performance-based payments. Namely, stock options are excluded from the limitation, as well as most amounts paid pursuant to short-term incentive plans.[142]

The tax deductibility cap proposal was criticized mainly for three reasons: On the one hand, the concern was that the result for the shareholders, whose interest was supposed to be served, would be even aggravated by the provision: Excessive compensation would not only weaken the company and accordingly reduce the profits of the shareholders, but on top of that it would also be even more expensive because these expenses would not be fully deductible. On the other hand, the non-deductibility provision is assumed to be ineffective as it provides for many exceptions and even encouraged a higher overall level of remuneration through higher performance-related payments (mainly stock options). The exceptions in favor of performance-based payments are too broad and the limitation on deductibility can furthermore easily be circumvented by deferring payments until retirement as such payments are not subject to the cap.[143] Finally, the one-million threshold lacks any relationship with the specific facts of individual cases: a salary of more than a million dollars might be justified when executives increase the corporate value accordingly and a salary well below one million dollars can represent an overpayment in the case of other companies with lower revenues.[144]

In fact, the restructuring of payments has not decreased the overall amount of payments to executives.[145] Unintended consequences are the fact that the million dollar cap apparently is seen as standard compensation amount, that a shift towards stock options has taken place, and that executives receiving performance-based salaries tend to focus on short-term earnings rather than on long-term success.[146]

The conclusion is therefore that tax provisions with an intended corporate governance function will show little results if they are easily avoided.

---

[141] *See* for a detailed analysis KAUTTER, The $1 Million Cap on Compensation Deductions, 1994 Tax Adviser 327.

[142] STABILE, *supra* note 140, at 88.

[143] *See* Sec. 162 (m)(4)(E) and Sec. 3121(a)(5) IRC and MISKE, *supra* note 61, at 1692.

[144] *See* PAK, *supra* note 135, at 660.

[145] STABILE, *supra* note 140, at 90; KENNEDY, A Primer on the Taxation of Executive Deferred Compensation Plans, 35 J. Marshall L. Rev. 487, 490, 538 (2002), also referring to the $200,000 limitations imposed on qualified retirement and profit sharing plans (Sec. 401(a)(17) IRC).

[146] *See* MISKE, *supra* note 61, at 1687; HALL/LIEBMAN, The Taxation of Executive Compensation, NBER Working paper No. W7596 (2000) (available at SSRN: http://ssrn.com/abstract =220848).

It could of course be argued that by way of restructuring the payments in favor of performance-based payments, the provision at least decreased the agency conflict. Hence, there are also affirmative comments on the provision: It is argued that Sec. 162(m) IRC has encouraged shareholder involvement in the executive compensation process by increasing disclosure (due to Sec. 162(m)(4)(C)(ii) IRC), which would be a positive effect from the corporate governance point of view: "by requiring disclosure not only of amounts paid but also of the reasons for granting particular executive compensation packages, it appears that the new rules will effect substantive change in executive compensation decision-making without appropriating managerial authority from directors."[147]

Yet, the arguments against such provisions seem to be more convincing. Very generally, doubts remain whether constraints on the type and amount of executive remuneration can be justified at all. What corporations pay to their executives is a fundamental business decision of companies and their shareholders, which governments should not interfere with. They should rather assure that all payments are transparent and that the shareholders can determine or at least object to payments which are – from a business point of view – not justified.[148] In other words, the role of the legislator should rather be to assure a well functioning market of corporate control than disturbing the market by constraints in the tax code.

In fact, those provisions might actually not be related with corporate governance at all: the limitation on executive payments is motivated by goals of social policy. It is perceived that management salaries are outrageously high compared to normal standards and the tax code is deemed to be an instrument for preventing an even bigger disparity between ordinary and executive income.

2.5.4 Compensation of Supervisory Board Members

From the corporate governance point of view, not only the relationship between management and shareholders is of importance but also – in a two-tier system – the relationship between management and the supervisory board.

In the discussion of corporate governance in Germany one important aspect is that the supervisory board should be professionalized.[149] The perception prevailed that supervisory board members used to pay too little attention to their duties and failed to serve the shareholders' interests by not monitoring the management board properly.

In the light of this discussion, Sec. 10 No. 4 of the German Corporation Tax Act, which provides for a reduced deductibility of remuneration paid to board members, is viewed critically.[150] According to Sec. 10 No. 4 of the Corporation Tax Act half of the remuneration paid to supervisory board members is not deductible as business

[147] PAK, *supra* note 135, at 661.
[148] STABILE, *supra* note 140, at 98.
[149] SALZBERGER, *supra* note 37, at 210, 216.
[150] CLEMM/CLEMM, Die körperschaftsteuerliche Behandlung von Aufsichtsratsvergütungen ist sinn-, system- und verfassungswidrig, 2001 Betriebs-Berater (BB) 1873; SALZBERGER, *id.*, at 210, 216; KRAFT, *supra* note 37, at 13.

expenses. In turn, however, the full amount is taxable in the hands of the board members pursuant to Sec. 18 No. 3 of the German Income Tax Act (*Einkommensteuergesetz*).

The critics emphasize that one element of good corporate governance should be an efficient and professional supervisory board to monitor and counsel the management board. It is also criticized that reduced deductibility is not subject to a test whether the remuneration is appropriate or not.[151] In practice, supervisory board members often receive additional payments because they are hired as external consultants in order to avoid non-deductibility.[152]

2.5.5 Deductibility of Desired Payments

The deductibility of charitable contributions is an example for the legislator encouraging a certain conduct by providing tax expenditures.[153] As they represent an interference of the legislator with the relationship between shareholders and management they are of relevance from the corporate governance perspective. By treating the corporation as a person who can act charitably, the Internal Revenue Code has legitimized the power of management to spend the shareholders' money for charitable purposes.[154]

2.5.6 Treatment of Third Party Interest

Another corporate governance related aspect is the differential treatment of equity and third party interest because it may influence the management decision how to fund the company and accordingly whose interests are served. Hence, the tax treatment of third party interest may cause a corporate governance conflict when it results in a preferential treatment compared to equity costs.

For example, the German Trade Tax Act (*Gewerbesteuergesetz*) includes a provision which results in a preferential tax treatment of third party loan funding compared to equity funding: According to Sec. 8 No. 1 of the Trade Tax Act – only – half of the interest paid is added to the profit of the corporation. Accordingly, 50% of third-party interest reduces profits. Because profits distributed as dividends (the cost of equity) are taxed fully, third party funding is treated preferentially. Interests of shareholders and creditors may be in conflict: creditors tend to investments with limited risk because they don't benefit from higher returns but bear the risk of losing their investment. Thus, a preferential treatment of creditors results in a disadvantage for shareholders.[155]

In the United States, the different treatment of debt and equity was recently discussed due to a proposal of the Bush administration in 2003. While interest pay-

[151] CLEMM/CLEMM, *id.*, at 1878.
[152] KRAFT, *supra* note 37, at 14.
[153] *See* OWENS, *supra* note 35, at 768; TRIANTIS, Organizations as Internal Capital Markets: The Legal Boundaries of Firms, Collateral, and Trusts in Commercial and Charitable Enterprises, 117 Harv. L. Rev. 1102, 1108 (2004).
[154] SUGIN, Theories of the Corporation and the Tax Treatment of Corporate Philantropy, 71 N. Y. L. Sch. L. Rev. 835, 856 (1997).
[155] *See* SALZBERGER, *supra* note 37, at 212, 214.

ments are taxed in the hands of creditors but are currently deductible as expenses on the corporate level, dividends are part of both the company's and the shareholders' income. Accordingly, there is an incentive to finance the corporation with debt rather than with equity.[156] The proposed elimination of the taxation on the shareholder level of dividends resulting from already taxed profits would have closed the gap in the treatment of debt and equity, although the alignment would have been achieved on different levels (corporate level and shareholder level).[157] Yet, the proposal was not successful.

However, it was doubted whether the different treatment of equity and debt will in the long run have a large impact because share prices will in the end capitalize any incentive. Nevertheless, abrupt changes of the preferential tax treatment could be expected to produce significant shifts in debt-equity ratios.[158]

2.6 General Criticism: Tax Code vs. Direct Regulation

To the extent that the legislator specifically tries to influence corporations by means of the tax code, the general question is why to use the tax code instead of direct regulation (subsidies or penalties instead of tax expenditures and penalties). What advantages are there? What are the disadvantages?

Overall, the majority of scholars are very skeptical towards tax provisions for influencing corporate governance.[159] The following section will summarize in abstract terms the pros and cons of the tax code as a regulatory tool for corporate governance.

Among the arguments in favor of using the tax code as means of influencing economic conduct instead of administrative measures is the "administrative argument": The IRS represents a system for collecting revenues and controlling companies and therefore tax provisions could save administrative costs. Consequently, it could be efficient not to implement another control and penalty system but rather rely on established institutions.

In favor for tax provisions as a regulatory instrument some mention the argument of "simplicity".[160] Tax provisions are perceived as less complicated than direct regulation provisions. However, this is not convincing, since the drafting of a provision can be complicated in any area of law and even sometimes unavoidable due to the complexity of the relevant subject matter. In any case, there is no reason why tax law – theoretically – should be less complex than company law provisions.

---

[156] *See* BANK, *supra* note 105, at 179.

[157] *See* BANK, *id.*, at 179; *see also* STEPHAN, *supra* note 56, at 696.

[158] STEPHAN, *id.*, at 697.

[159] *See* for example REPETTI, *supra* note 68, at 1033: "This Article strongly recommends that policymakers fully consider the interaction of the separation of ownership from control in public corporations with tax provisions intended to increase productivity or otherwise promote desired stockholder or management behaviour." *See also* REPETTI, *supra* note 36, at 710; KANDA, *supra* note 106, and in detail HARTMANN, *supra* note 45, at 190.

[160] HARTMANN, *id.*, at 191; SURREY, Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures, 83 Harv. L. Rev. 705, 717 (1970).

Even less persuasive is the argument that regulation through the tax code would leave more discretion to the taxpayer and would therefore enhance individual decision making. As long as a direct fine is compared with an indirect tax penalty it seems very unlikely that there is any difference for the affected individual because the after-tax costs of the regulatory measure are equal in both cases. If the regulated conduct was prohibited instead, a tax would obviously be more flexible. But this would not be an appropriate comparison because two cost-related incentives should be compared.

One of the most important arguments against tax penalty provisions as means of influencing economic conduct is that those provisions contravene the ability to pay principle.[161] Horizontal equity requires that taxpayers with similar income are treated similarly. Vertical equity focuses on the relevant treatment of taxpayers with different levels of income.[162] As the effect of tax measures typically depends on the marginal tax rate of the individual taxpayer, tax expenditures are more lucrative for taxpayers with higher income and tax penalties will affect them more than taxpayers with lower incomes. On the one hand it could be argued that this is always the case in a tax system with progressive tax rates. It could even be seen as a necessary effect of the principle of vertical equity because taxpayers are treated differently – depending on their income. On the other hand, there is no justification for linking penalties with the amount of income. Whereas the aim of taxation – in broad terms – is raising revenues for the state, tax penalties as well as tax expenditures are enacted to influence certain behavior. Accordingly, the effect of a regulatory measure should depend on the impact of the targeted conduct and not on the tax base or ability to pay of the taxpayer.

Another argument against tax penalties is that they operate in an inconsistent way: First of all, as mentioned above, taxpayers engaging in exactly the same kind of conduct are treated differently due to their different tax bases. Companies that do not pay taxes, *e.g.* companies incurring losses, will not be affected at all by the non-deductibility of certain expenditures, even though the conduct might cause the same harm. Secondly, measures enacted in the United States pursue conflicting interests. For example the purpose of taxing golden parachutes payments is inconsistent with that of greenmail taxation: On the one hand, among the reasons for golden parachutes taxation was to prevent management from defeating takeovers that would be in the best interest of the shareholders, which means that – insofar – takeovers should be encouraged. On the other hand, the primary purpose of the greenmail provisions is to prevent hostile takeovers by providing a disincentive to bidders because any pay-off would be subject to tax. Thus, there is a contradiction between the purposes of golden parachute and greenmail taxation. Furthermore, the purposes of greenmail taxation are inconsistent in themselves: Greenmail payments can often be a useful tool for companies for averting hostile takeovers: once a bidder's offer is made, it might be possible to avert the takeover by paying the bidder off. In these cases it becomes more difficult to avert the takeover due to the tax consequences and so – if

[161] *See* for a very thorough and detailed analysis HARTMANN, *id.*, at 194; SURREY, *id.*, at 720.
[162] HARTMANN, *id.*, at 194.

the company is well managed – this is to the disadvantage of the shareholders. This means that there are contradictions not only between the purposes of golden parachute and greenmail taxation, but also between two detrimental purposes of greenmail taxation, which on the one hand should discourage hostile bidders but also management from defeating hostile takeover attempts.

Furthermore, an argument against tax provisions instead of direct regulation is that they lead to a distortion in the allocation of resources.[163] However, from the authors' point of view this is not a strong argument because it can be equally applied to direct regulation: Although it is true that the effect of tax penalties is obviously that business activities are not solely influenced by market conditions, it is so because – from the perspective of the legislator – the result is on the whole more beneficial to the company and the shareholders. The criticism that tax incentives distort the choices of the marketplace and produce non-neutralities in the allocation of resources is equally applicable to direct expenditures.[164] The actual problem is that the provisions fail to achieve this goal in many situations and in this case might even be counterproductive.

Another argument against a regulation of corporate governance in the tax code is that tax incentives keep tax rates high by narrowing the tax base and thereby reducing tax revenues.[165] Yet, direct expenditures also will affect the revenues and the money that is spent must be raised, which would also result in higher tax rates.

A lack of transparency can also be brought forward against tax provisions as regulative tools. Direct regulation has a much more visible impact. Furthermore, tax provisions might in connection with other – direct – forms of regulation lead to "regulatory confusion".[166] This term describes a situation in which tax and direct regulation reciprocally influence each other in an unclear way.

2.7 Summary and Perspective

To conclude, most research has been undertaken on the intended effects of tax provisions with respect to corporate governance. The respective provisions mostly deal with remuneration. Overall, tax provisions are in most cases not suitable for influencing corporate governance as it is difficult to link the tax measures to specific fact patterns that allow a differentiation between beneficial and harmful behavior. Furthermore, the analyzed measures tend to have uncertain effects and to pursue conflicting interests.

As a consequence, it could be argued that rather than ineffectively attempting to influence management conduct by tax norms the legislator should eliminate provisions of the tax system that allow the management to act without control of the shareholders when control of the management behavior seems necessary. Tax rules are generally not sophisticated enough to reflect whether or not a certain conduct is actually detrimental to the companies' interest. To the extent control – from the legisla-

---

[163] HARTMANN, *id.*, at 199.
[164] SURREY, *supra* note 160, at 725.
[165] SURREY, *id.*
[166] HARTMANN, *supra* note 45, at 198.

tor's point of view – seems appropriate it would be preferable to have a real control by those whose interests ought to be preserved.[167] Shareholders should be encouraged to monitor their own interests, rather than relying on the legislator. To achieve this it is necessary to link management decisions with shareholders' funding decisions.

With respect to unintended consequences of tax law such as incentives in favor of an inefficient retention of profits, the majority of scholars identify negative aspects. From the authors' perspective the capital markets will ameliorate the tendency to retain distributable profits because the dividend rate is of high importance in the valuation of companies.

According to tax planners of leading German companies, the actual influence of tax provisions on corporate governance is very low. From those practitioners' point of view, there are at best impacts of the tax system on the transparency of corporate structures and actions, which lead to a weaker control of the management by the shareholders. Of very little importance with respect to the balance of power between shareholders and management is – according to practitioners – the taxation of executive remuneration (or the influence of taxation with regard to the internal use of retained profits). Concerning the retention and distribution of profits it is suggested that the capital market control, which highly values the dividend level, works as a means to align management and shareholder interests.

However, this apparently only reflects the view of practitioners from inside corporate management. As was demonstrated above, most conflicts arise to the disadvantage of shareholders or other investors, thus their perception may well be different. Additionally, those involved in the institutional framework of companies may not consider the institutional setting as a whole and therefore not see problems on that level. The same may be true for shareholders and other investors.

From a theoretical point of view there are certainly significant interactions between taxation and corporate governance. This discrepancy between theory and practitioners' perceptions may well be the starting point for future discussion.

3. The Influence of Corporate Governance on Taxation

Not only do taxes influence the corporate governance in companies. There are also effects that work in the other direction. The corporate governance system and culture in place in a company will have effects on the way this company handles its tax affairs. Especially the company's approach to tax planning and tax compliance will be affected.

As stated above, corporate governance is the process in which the conduct of enterprises is controlled and supervised.[168] When discussing the conduct of enterprises, it is necessary to have an idea about what should determine this conduct and be its ultimate goal. In the general discussion about corporate governance this question results in the debate whether only shareholder value should be the benchmark

---

[167] *See* REPETTI, *supra* note 36, at 710.
[168] *See* above 1.1.

for the enterprise's conduct or whether stakeholder interests should be taken into account, too.

In the discussion about the corporate governance of an enterprise's tax matters a similar problem exists, concerning the question what tax strategy should be followed by the enterprise as a whole.[169] The answer to this question is the starting point for the discussion of corporate governance of tax matters in a narrower sense, concerning issues that result from the separation of ownership and control.[170]

3.1 Which Tax Strategy Complies with Corporate Governance Requirements

The general discussion about what should be the guiding line of a company's conduct is structured as a conflict between different stakeholder groups, namely shareholders and other stakeholders like creditors, employees, the general public. In the corporate governance of tax matters, the debate about the tax goals of a company can also be seen as such a conflict between different stakeholder groups. Its dividing line will run between those stakeholders that benefit from a company's profits and therefore suffer from the reduction of these profits by taxes (namely shareholders, but also creditors, employees, *etc.*) and those stakeholders that profit from the tax revenue, namely the revenue authorities and the general public.

3.1.1 Standard Economic Model of Tax Compliance

The discussion about a company's tax strategy focuses on the question how strictly and willingly it complies with tax law.

From a macroeconomic perspective, it would be desirable that economic agents strictly comply with the law. Individual profit maximizing behavior should take place only within the legal framework. Otherwise, the state would not be able to provide the stable basis for markets to operate properly. Efforts invested into circumventing the law without creating any value constitute a social loss, as they could be invested in more productive activities.[171]

The situation, however, is different from an individual perspective. Here, standard theory views the decision to comply with applicable laws as a portfolio selection problem.[172] Some of the possible choices of the individual lie within the legal framework and some do not. Those that do not carry the risk of detection, with a certain probability. If the violation of the law is not detected, the choice yields a certain return. If it is detected, it yields another, usually lower and/or negative return,

[169] *See* below 3.1.

[170] *See* below 3.2.

[171] SLEMROD, The Economics of Corporate Tax Selfishness, 57 Nat. Tax J. 877, 894 (2004).

[172] ALLINGHAM/SANDMO, Income Tax Evasion: A Theoretical Analysis, 1 Journal of Public Economics 323 (1972); DEVOS, Penalties and Sanctions for Taxation Offences in the United Kingdom: Implications for Taxpayer Non-Compliance, 2005 European Taxation (ET) 287, 289, with a summary of empirical evidence. Work following ALLINGHAM/SANDMO, *id.*, is presented by WU/TENG, Determinants of Tax Compliance – A Cross-Country Analysis, 2005 FinanzArchiv 393 and SLEMROD, *id.*, at 882.

depending on applicable penalties and other consequences. Here it is the task of the individual market participants to choose between the illegal, risky choices and the risk-free legal choices and thus select a portfolio that suits their risk preference. In this way, the question of compliance with the law can be viewed as a question of risk preference.[173]

If the social requirement of strict obedience to the law is to be fulfilled in this analytical framework, then the state has to raise penalties and the probability of detection to a degree that no individual will choose to act illegally.[174] However, in reality the situation is not as simple as this model suggests. Especially all of its elements have to be analyzed for their applicability to the tax behavior of corporations.

3.1.2 The Decision to Comply

First of all, the distinction of two basic cases, to comply or not to comply, may not be correct in the case of tax law. With the high level of complexity and ambiguity in modern tax law, combined with the system of self-assessment, the taxpayer often cannot be sure of the correct amount of taxes to be declared.[175] The same factual situation can justify different tax assessments, depending on the interpretation of the law. Furthermore, tax law allows to structure business transactions in a tax-efficient way, but only up to a certain point.[176] Beyond that, the structure may be recognized as abusive and thus disregarded. This also leads to uncertainty as to what tax liability to declare.

3.1.2.1 Compliance vs. Aggressiveness

Consequently, when a taxpayer files his tax return he does not have the pure choice between compliance and non-compliance, with the latter bearing the risk of detection und thus carrying a risky return. Instead, the taxpayer can choose between different ways of assessment, each of which carries two different kinds of uncertainty. The first uncertainty is whether structures and self-assessment comply with applica-

---

[173] GASSNER, Steuergestaltung als Vorstandspflicht, in: BERNAT/BÖHLER/WEILINGER (eds.), Zum Recht der Wirtschaft. Festschrift Heinz Krejci zum 60. Geburtstag, 605, 621 (2001). *See* DEVOS, *id.*, at 296 *et seq.* with empirical evidence on the effect of sanctions and the probability of detection and their relationship. For an application of prospect theory on tax compliance and enforcement *see* GUTHRIE, Prospect Theory, Risk Preference, and the Law, 97 Nw. U. L. Rev. 1115, 1142 *et seq.* (2003), who predicts that taxpayers will be more risk averse and thus rather comply with tax law when they are in a "win-situation", *e.g.* because they expect a refund, and for corresponding policy recommendations.

[174] On doubts about the effectiveness of a deterrence approach in tax enforcement *see* BRAITHWAITE/BRAITHWAITE, Managing taxation compliance: The evolution of the ATO Compliance Model (2001) (available at http://ctsi.anu.edu.au/publications/taxpubs/Braithwaites.ATAX.pdf). According to DEVOS, *id.*, at 289, "legal sanctions are only effective when perceived to be very severe."

[175] KREIENBAUM/WERDER, Amerikaner verschärfen Kampf gegen Corporate Tax Shelters, 2005 IStR 721.

[176] On the details in substantive law, especially the "valid business purpose" and "economic substance" doctrines *see e.g.* KEINAN, Corporate Goverenance and Professional Responsibility in Tax Law, 17 Journal of Taxation and Regulation of Financial Institutions 10, 15 *et seq.* (2003).

ble laws. Only the second one is the uncertainty recognized in the standard model, *i.e.* whether a potential act of non-compliance will be detected.

Therefore, the taxpayer does not face the clear-cut decision between legal and illegal behavior. Instead, he can only choose the aggressiveness of the tax-positions taken, not knowing where the exact border line of legality lies.[177] This renders the macroeconomic claim that the law should be adhered to, no matter what, doubtful. Therefore, the obvious conclusion from the portfolio selection model that penalties should be set at prohibitively high levels in order to achieve full compliance may not be viable.

3.1.2.2 The Limits of Legality in Conventional Tax Law

The approach of conventional tax law to this situation is to apply criminal penalties only when the taxpayer knew or was frivolously ignorant of his non-compliance or acted in negligence.[178] In such a case, the taxpayer knew that he was not complying or didn't care and therefore faced only the uncertainty of detection identified by the standard model.[179] Therefore, the standard model works and deterrent penalties are adequate.

Conversely, in cases when the conditions of compliance are unclear for the taxpayer and non-compliance can only be identified with certainty *ex post* by the courts, penalties are usually limited to interest on the taxes that should have been paid. This prevents the taxpayer from profiting from his misinterpretation of the law by receiving a zero-interest credit.

Of course, the boundary between these two cases is not clear-cut and it can sometimes be doubtful whether the taxpayer was frivolously ignorant of his non-compliance. Therefore tax authorities are trying to prevent taxpayers from getting too close to this borderline and to define it in a way so as to prevent them from acting too recklessly without having to fear punishment.[180]

3.1.2.3 "Unacceptable" Behavior as a New Category between Legal and Illegal Conduct

Yet, in recent years tax authorities seem to have been trying not only to enforce the classical border line between legal (tax avoidance) and illegal (tax evasion) tax plan-

---

[177] *See* the distinction between "the good, the aggressive, and the ugly" by former IRS Large and Midsize Business Division Commissioner Larry Langdon, cited by STRATTON, Sarbanes-Oxley Symposium Squares Off Tax Directors and Regulators, 102 Tax Notes, 835, 836 (2004). *See also* KEINAN, *id.*, at 20.

[178] For details on British law *see* DEVOS, *supra* note 172, at 292, and on Austrian law *see* GASSNER, *supra* note 173, at 620.

[179] Consequently, one aspect of tax evasion is usually concealment of the facts: "The common thread in all cases of evasion is concealment", FREEDMAN, Defining Taxpayer Responsibility: In Support of a General Anti-Avoidance Principle, 2004 British Tax Review (BTR) 332, 347. *See also* JOHNSON, U.K. Tax Update: Go Ahead, Tax Adviser, Make My Day!, 39 Tax Notes Int'l 1003, 1004 (2005).

[180] On the different standards possible *see* BEALE, Putting SEC Heat on Audit Firms and Corporate Tax Shelters: Responding to Tax Risk with Sunshine, Shame and Strict Liability, 29 J. Corp. L. 219, 244 *et seq.* (2004). *See also* KREIENBAUM/WERDER, *supra* note 175, at 723.

ning, but also to prevent taxpayers from venturing into the area of legal ambiguities at all. They aim at preventing them from using any structures or self assessments the legal status of which seems unclear or which might even be clear but are claimed nevertheless to not have been intended by lawmakers (aggressive avoidance, loopholes)[181] and therefore are categorized as unacceptable tax planning.[182] To this end, they make use of a large range of deterring measures such as threatening intensive auditing, procedural pressure, negative publicity, *etc*. Thereby they create a quasi-illegal status[183] that is not in line with the classical distinction. In such an environment, ambiguous tax statutes become a method for raising revenues as taxpayers are forced to stick to unchallenged positions.[184]

However, this puts the burden from complex and unclear tax law exclusively on the taxpayers. A large part of this complexity, though, is due to the policy aims that are being pursued through the tax law. The differentiations necessary for achieving these aims of public policy through the tax law normally create uncertainty and planning possibilities,[185] especially if the specific public policy goals pursued remain unclear.[186]

In their attempt to keep taxpayers from seizing planning opportunities that result from unclear law, tax authorities assume the power to define which tax behavior they view as acceptable. They base this definition on their own interpretation of tax law. In consequence, taxpayers are deterred from deviating from this "authorized" interpretation. In this way, tax authorities take over from the courts the competence of determining the authoritative interpretation of the law.

---

[181] KPMG, Tax in the Boardroom. A Discussion Paper, 8 (2005) (available at www.kpmg.co.uk/pubs/beforepdf.cfm?PubID=1129#). Connected with this issue is the question whether transactions that yield tax advantages have to have a valid business purpose in order to be accepted. This is a question of substantive tax law and does not influence questions of corporate governance. The problem here is defining whether a valid business purpose exists. The most obvious cases are of course those in which a complete transaction is synthetical and is undertaken solely for tax-saving purposes. These often occur as marketed tax schemes that companies subscribe to without any implications for their day-to-day business. The differentiation becomes more difficult when actual business transactions are structured in a tax-efficient way, which in itself is completely legitimate. Here theories try to identify aspects of the transaction that differ from the route that would have been taken without any tax considerations and question the business purpose of these "deviations". However, in complex transactions it is difficult to define what the normal way of implementation would have been. Often tax law explicitly and intentionally demands structuring transactions in a certain way. In such a case, following this demand of course only happens for tax reasons. Nevertheless, this is certainly not against the purpose of the law.

[182] FREEDMAN, *supra* note 179, at 335 *et seq.*

[183] KPMG, *supra* note 181, at 8. *See e.g.* statements cited by KENNEY, New Rules Should Deter Risky Tax Planning, Korb Says, 106 Tax Notes 1033 (2005).

[184] FREEDMAN, *supra* note 179, at 347.

[185] HARVARD LAW REVIEW, Governmental Attempts to Stem the Rising Tide of Corporate Tax Shelters, 117 Harv. L. Rev. 2249, 2250 (2004); FREEDMAN, *id.*, at 342 *et seq.* On the impact of the perception of tax fairness on compliance behavior *see* RICHARDSON, A Preliminary Study of the Impact of Tax Fairness Perception Dimensions on Tax Compliance Behaviour in Australia, 20 Australian Tax Forum 407 (2005).

[186] FREEDMAN, *id.*, at 343 *et seq.* with a very instructive example.

Last but not least, taxpayers often rely on taking positions that deviate from a challengeable authority view or for which no official guidelines on interpretation have been formulated in order to facilitate their business transactions.[187] If they are deterred from doing this, the economic burden of taxation is higher than necessary because transactions that would be feasible under an acceptable interpretation of the law cannot be undertaken because they are not covered by the authorities' interpretation of the statutes.

3.1.2.4 Immoral Behavior as a New Category

For similar purposes as for the introduction of the category of "unacceptable tax planning", tax authorities invoke the notion of "immoral behavior" in the case of tax structures that are intended to lower tax payments beyond a certain extent.[188] Then they also exert pressure on taxpayers to adhere to conduct defined as moral by the authorities. The main difference is that this category is justified by reference to principles of ethical behavior.

Doubtlessly, moral aspects do have a role in determining tax behavior. However, the boundaries between moral and immoral behavior would conventionally be seen along the same lines as statutory and case law have drawn them in the past and which have been described above.[189] According to these, it is of course immoral to take positions in tax structures or returns that rely upon not being discovered because they would not sustain scrutiny by authorities and courts. However, according to a longstanding view there is nothing immoral about "arranging one's affairs so as to keep taxes as low as possible",[190] as long as the taxpayer's conduct remains within the boundaries of legality.

What is moral or not can certainly be influenced by the law and can therefore – to a certain extent – be influenced by legislation.[191] However, the very reason for the problem of aggressive tax planning lies in the fact that the legislator tends to not express his intentions clearly in the tax code. Consequently, the law does not explicitly state what is the "fair share" that taxpayers should contribute. Again, this most clearly applies if the legislator seeks to implement goals of social or economic policy via tax measures.[192]

When tax authorities demand that the taxpayers contribute their fair share or pay what business ethics demand, they implicitly base this upon their own notion of what is ethical or fair instead of deriving such measures from the law. In this interpretation they may not be free from conflicts of interest because of rising public financing needs.

---

[187] "[Taxpayers] have become used to the need to take artificial steps simply to achieve sensible taxation in some cases …", FREEDMAN, *id.*, at 345.

[188] FREEDMAN, *id.*, at 332.

[189] It is certainly beyond the scope of this study to make statements about what is moral and what is immoral.

[190] SLEMROD, *supra* note 171, at 883, citing the judgment by judge Learned Hand in *Commissioner v. Newman*, 159 F.2d 848 (2nd Cir. 1947, dissenting opinion).

[191] FREEDMAN, *supra* note 179, at 335, 338 *et seq.*

[192] FREEDMAN, *id.*, at 337 *et seq.*, 343.

3.1.2.5 The Role of Tax Opinions

A special aspect of the question whether the taxpayer knew that he was in violation of tax law is the role of opinions given by tax professionals. In most legal systems, a taxpayer who has acquired an opinion by a tax professional satisfying certain requirements and confirming that a certain tax structure or self-assessment does comply with applicable tax law cannot be accused of having acted negligently if it later turns out that the opinion was wrong. This has been exploited by promoters of abusive tax schemes by delivering with their tax scheme ready-made opinions confirming their viability, in order to protect customers from penalties in case the structures did not work.

However, such opinions were usually very liberal in their interpretation of the law. Especially, they did not consider the individual circumstances of a specific taxpayer as they were produced for off-the-shelf tax structures that were intended to be sold to multiple clients. Obviously, such a generic opinion cannot properly analyze whether the structure in question has a valid business purpose for the business of a specific taxpayer. Therefore, the opinion would simply assume that such a business purpose existed.[193] Another aspect is that the tax professionals providing such opinions usually earned fees contingent upon the success of the marketing of the tax structure, which makes it doubtful whether they were sufficiently independent for delivering professional advice.[194]

These aspects raise the question whether such opinions can indeed have the effect of relieving the taxpayer from his responsibility of ensuring the legality of his tax positions and protecting him from penalties if illegal positions are discovered.

As a result, lawmakers are trying to limit the use of generic opinions that are combined with generic tax structures. One way of achieving this is to restrict their effectiveness in protecting against penalties and to set up minimum standards for the contents of the opinions or the confidence level[195] of conclusions reached.[196] So the IRS states that opinions that simply assume a valid business purpose without analyzing the specific situation of a taxpayer will not offer protection against penalties.[197] Another approach taken is to raise professional standards for advisors providing tax opinions and to prevent conflicts of interest with new rules of incompatibility.

3.1.3 Risk of Detection

The risk of detection of incorrect tax returns depends strongly on the auditing efforts by the tax authorities. Intensified auditing will raise the number of returns

[193] KENNEY, *supra* note 183.

[194] *See* STRATTON, Senate Panel Takes Industrywide Look at Shelter Business, 106 Tax Notes 750 (2005).

[195] *See* ANONYMOUS, A Detailed Guide to Tax Opinion Standards, 106 Tax Notes 1469 (2005).

[196] Some of these measures are heavily criticized for making everyday tax advice burdensome and increasing compliance costs.

[197] KENNEY, *supra* note 183.

that are being checked and the level of detail to which each return can be verified.[198]

3.1.3.1 Additional Disclosure Obligations

Increasing the risk of detection is also the aim of the current activities of British, Canadian, Australian and American tax authorities against the tax shelter industry.[199] These focus on generic tax structures which are developed by companies' advisors, especially auditing firms, and then sold to a large number of companies, who apply them all in the same way, and which usually have no connection to their normal business.[200] New and updated laws and regulations impose obligations on the advisors to register structures, keep track of participants in such structures and to notify the tax authorities of the newly devised structures.[201] The information obtained in this way facilitates the authorities' efforts of auditing companies that participate in schemes that go beyond the limits of legitimate tax planning.[202] This is of special importance as shelter structures were previously designed in ways to make them difficult to detect even if the authorities actually audited a participating firm.[203]

As it is primarily illegal to engage in transactions that rely on concealment, this approach of strengthening disclosure obligations can help authorities in enforcing the tax law without blurring or shifting the distinction between tax avoidance and evasion, which has been criticized above.[204]

In the case of legal structures that are nevertheless unwanted by lawmakers, the reporting requirements provide them with the opportunity for timely changes of laws or regulations.[205]

3.1.3.2 Risk Management in Enforcement

In their struggle to raise tax revenues by intensifying audit activities that are constrained by limited resources for auditing personnel, *etc.*,[206] tax authorities are also

---

[198] For empirical data on the relationship between auditing efforts and compliance *see* SLEMROD, *supra* note 171, at 878 *et seq.*

[199] *See* BEALE, *supra* note 180, at 250; KREIENBAUM/WERDER, *supra* note 175, at 721. For further details on this topic *see* the extensive coverage in Tax Notes and Tax Notes Int'l. For planned legislation in France *see* LINKLATERS, International Tax News – September/October 2005, 4.

[200] *See e.g.* STRATTON, *supra* note 194.

[201] *See* VOGELSANG, The Final Tax Shelter Disclosure Rules: Reporting, Registration, and List Maintenance Requirements, 78 Florida Bar Journal 30 (2004); HARVARD LAW REVIEW, *supra* note 185. On the British regime *see*: FOSTER/BARRY, A Very British Muddle!, 762 Tax Journal, October 25, 2004, 4. On the U.S. regime *see* MCNULTY/PROBASCO, Tax Shelter Disclosure and Penalties: New Requirements, New Exposures, 18 Journal of Taxation and Regulation of Financial Institutions 22 (2005). For comparisons of different systems *see* BLUMENTHAL, How the U.S. Deals with Tax Avoidance, 804 Tax Journal, September 12, 2005, 5, and KREIENBAUM/WERDER, *supra* note 175.

[202] KREIENBAUM/WERDER, *id.*, at 724.

[203] SLEMROD, *supra* note 171, at 889; BEALE, *supra* note 180, at 220.

[204] *See* 3.1.2.3 and 3.1.2.4. FREEDMAN, *supra* note 179, at 349.

[205] BEALE, *supra* note 180, at 251; KREIENBAUM/WERDER, *supra* note 175, at 724.

[206] BEALE, *id.*, at 220.

beginning to try to classify taxpayers into different categories, depending on their aggressiveness in tax matters, and then focus auditing efforts on the "difficult cases" and take a more cooperative and supportive approach for others.[207]

This necessitates businesses to view their affairs with the tax authorities as a long-term relationship[208] in which exceedingly aggressive behavior may yield consequences beyond potential penalties in the specific case. Especially, increased scrutiny by authorities may raise future compliance costs because frequent audits and disputes cause costs on the side of the taxpayer as well and consume management attention that would be better spent on profit earning activities.[209] Also, future tax planning structures may be challenged more often. Therefore, being on good terms with the tax authorities may be a value of its own and may justify some restraint in tax management.[210]

In practice, well-managed companies have of course taken this view already in the past and this approach has recently become even more widespread.[211]

In addition, tax authorities also try to change their enforcement approach *vis-à-vis* companies that appear to be quite willing to comply with tax law but struggle with the task. Companies face substantial costs for tax compliance, even if they do not embrace overly aggressive approaches in tax planning.[212] Complex and ambiguous tax statutes make it difficult to properly report taxes even for standard business processes, let alone sophisticated restructurings and the like.
In such cases, supporting taxpayers in their compliance efforts yields better results than control and repression.[213] This approach is combined with the one mentioned above, *i.e.* identifying companies with a bad track record and putting them under closer scrutiny, in order to arrive at an adequate treatment of different taxpayers.[214]
The combination of more focused enforcement activities against non-compliant taxpayers with intensified cooperation in the case of compliant ones is also called "tax-risk-management", but here the term is meant from the authorities' perspective, and the risk targeted is the one of foregoing taxes that are legally owed.[215]

---

[207] KPMG, *supra* note 181, at 5; BRAITHWAITE/BRAITHWAITE, *supra* note 174; AUSTRALIAN TAXATION OFFICE, Large business and tax compliance, 4 (2003).

[208] On the theory of multi-period relationships *see* SALZBERGER, Corporate Governance – Begriff und Aufgaben, in: BRECHT (ed.), Neue Entwicklungen im Rechnungswesen. Prozesse optimieren, Berichtswesen anpassen, Kosten senken, 153, 169 (2005).

[209] BEALE, *supra* note 180, at 239 *et seq.*; BRAITHWAITE/BRAITHWAITE, *supra* note 174.

[210] KPMG, *supra* note 181, at 8; HENDERSON GLOBAL INVESTORS, Tax, risk and corporate governance, 4 (2005) (available at www.henderson.com/global_includes/pdf/corporate_governance/tax_paper.pdf).

[211] KPMG, *id.*, at 4.

[212] On compliance costs increasing with recent legislation *see* CREST, How Sarbanes Oxley is changing tax services, 16 International Tax Review 11 (4/2005).

[213] The U.S. compliance assurance program might be seen as such an effort. *See e.g.* KENNEY, IRS Officials Discuss Progress Of Corporate Compliance Program, 108 Tax Notes 1502 (2005). *See also* KENNEY, Focus on Voluntary Compliance, Not Enforcement, Olson Says, 108 Tax Notes 169 (2005); from an empirical perspective: DEVOS, *supra* note 172, at 297.

[214] *See* BRAITHWAITE/BRAITHWAITE, *supra* note 174.

[215] "Risk-based approach": KPMG, *supra* note 181, at 5. Tax risk management from the companies' perspective is discussed in 3.4.2.4. The term "compliance risk management" is also used in OECD, OECD's Current Tax Agenda, 19 (2005).

3.1.4 Returns from Aggressive Tax Behavior

3.1.4.1 Penalties

As discussed, the returns from the "aggressive" option of tax behavior depend on whether the chosen tax positions turn out to be legal or not and whether this is discovered by the authorities. If illegal positions are discovered, the taxpayer faces the payment of taxes originally due plus different additional payments such as penalties, interest for late payment, *etc.*[216] As tax payments can be among the most important cost factors of a company, unexpected tax liabilities combined with high penalties can lead to significantly lower earnings and even liquidity problems.[217] The possibility of higher compliance costs has already been noted.[218]

3.1.4.2 Publicity and Reputation

An additional aspect of the choice of tax strategy that is increasingly being taken into account is that of public opinion.

It is submitted that corporations taking an approach in their tax strategy that appears too aggressive and results in relatively low tax payments combined with frequent disputes with the tax authorities and the imposition of penalties will face increased pressure from public opinion. This, in turn, may possibly result in reservations towards these companies by potential customers, employees and investors and thus reduce their ability of selling products, finding qualified staff and raising capital.[219]

Tax authorities are more and more trying to exploit this effect by using negative publicity as a threat against aggressive taxpayers.[220] So they may face the possibility of being publicly shamed, *e.g.* by publicizing the amount of tax payments or penalties imposed.[221]

However, as the case against an aggressive approach to tax management is – as shown above – not as clear as one might think, public opinion might not be as hostile towards companies that try not to pay more taxes than necessary as tax authorities may hope.[222] After all, paying excessive tax raises prices for products, depresses

---

[216] BEALE, *supra* note 180, at 220, 239 *et seq*. From an authority perspective some authors suggest that penalties perceived as too fierce may crowd out intrinsic motivation to pay taxes and thus have the effect of decreasing compliance instead of increasing it. *See e.g.* SLEMROD, *supra* note 171, at 883.

[217] BEALE, *id.*, at 220, 239 *et seq.*

[218] *See* 3.1.3.2.

[219] KPMG, *supra* note 181, at 8, 16; skeptical on possible gains from generosity versus the treasury: GASSNER, *supra* note 173, at 622 *et seq. See* SMERDON, *supra* note 3, at 251-256 on the general notion that socially responsible business conduct may improve profitability, *e.g.* by improving the brand image and reputation, increasing customer loyalty or – due to the socially responsible investing movement – increasing the access to capital of companies.

[220] KPMG, *id.*, at 16.

[221] BEALE, *supra* note 180, at 222. Note that some jurisdictions explicitly prohibit the publication of tax information, *see e.g.* Sec. 30 of the German General Tax Act (*Abgabenordnung*) and Sec. 355 of the German Criminal Code (*Strafgesetzbuch*).

[222] Especially if the tax strategy followed is clearly legal, public opinion towards it may not be so unfavorable; *see* FREEDMAN, *supra* note 179, at 342.

investor returns and leaves less money for paying wages.[223] Nevertheless, recent studies show that company officials do more and more view public opinion as a factor that has to be taken into account in the formulation of a tax strategy.[224]

However, the suggestion of shaming tax wrongdoers suffers from the same weakness as does the idea of simply raising penalties: A certain amount of tax planning is necessary from an individual as well as from a macroeconomic point of view,[225] and since complex tax law makes the distinction between tax avoidance and evasion difficult, it is also difficult to single out the real wrongdoers, which would be necessary for an effective shaming policy. Politicians use tax law to pursue a vast array of policy aims and thereby produce complexity. It is this very complexity resulting from policy aims implemented in tax law that creates opportunities for advanced tax planning and in many cases even makes it necessary.[226]

Some authors even suggest that publicizing data like the taxpayer's effective tax burden may actually facilitate benchmarking the performance of companies' tax departments and thus increase tax avoidance instead of curbing it.[227]

As regards illegal tax evasion, however, research on the effect of legal sanctions is being claimed to show that these are more effective in an environment of strong social norms against tax evasion.[228] This could make it efficient for tax authorities to try to influence public opinion.

3.1.5 Side Effects on Business Operations

The tax strategy of a business may have adverse effects on its normal business operations that have to be considered in the analysis. Aggressive tax strategies may lead to risks apart from the risk of penalties and other direct consequences of detection as well as to a misallocation of corporate resources.[229]

3.1.5.1 Real-World Risks and Misallocations

Complex tax strategies that try to exploit loopholes in the tax law do usually not work in a way that is completely detached from normal business operations (save completely synthetic transactions that are anyway close in character to tax evasion).

---

[223] GASSNER, *supra* note 173, at 609; SLEMROD, *supra* note 171, at 884, citing FRIEDMAN, New York Times Magazine, September 13, 1970.

[224] ERNST & YOUNG, Tax Risk Management. The evolving role of tax directors, 4 (2004) (available at www.ey.com/global/download.nsf/International/EY_-_Tax_-_Tax_Risk_Management/$file/EY_Tax_Risk_Survey_Report.pdf); KPMG, *supra* note 181, at 4, 16; HENDERSON GLOBAL INVESTORS, *supra* note 210, at 2.

[225] BEALE, *supra* note 180, at 241.

[226] *See* 3.1.2.3 and 3.1.2.4.

[227] SLEMROD, *supra* note 171, at 886.

[228] DEVOS, *supra* note 172, at 290.

[229] CHEN/CHU, Internal Control vs. External Manipulation: A Model of Corporate Income Tax Evasion; 36 RAND Journal of Economics 151 (2005) discuss a model showing that illegal tax evasion leads to an incompleteness of the compensation scheme offered to employees, resulting in an efficiency loss in internal control. However, this result is based on the assumption that compensation contracts compensating employees for tax evasion penalties will not be honored by courts. This may not be the case in all jurisdictions.

To take advantage of tax saving opportunities, usually certain requirements affecting real operations have to be met. So contracts may have to be signed with counterparties, operations or management resources have to be set up in certain locations, *e.g.* tax havens, *etc*. These real-world requirements can expose the company to real-world risks or misallocations of resources. For example, there may be the risk of default or the breakdown of a counterparty. Minimum-size operations in tax haven locations may also be less cost efficient than where they would usually be set up. Additionally, tax planning can constitute an incentive to structure business operations in a more complex way, which renders them more difficult to manage and thus creates unproductive overheads and inefficiencies.[230] As an illustrative example, the highly complex corporate structure of Enron with numerous subsidiaries in various jurisdictions, which was also owed to aggressive tax structuring, played an important role in making it difficult to oversee the company's financial situation and disguised the looming economic breakdown.[231]

With the promise of high tax savings, these disadvantages may be underestimated, especially since tax structuring decisions are sometimes not taken in connection with operational decisions, or under participation of non-tax personnel.

3.1.5.2 Deterioration of Business Ethics

Another side effect may be an influence on general business ethics in the corporate culture. The question is whether an aggressive attitude tolerating occasional violations of the law can be limited to one area such as taxation. This attitude may rather negatively affect other fields of employee behavior as well, *e.g.* by promoting bribery or corruptibility. In this way, the effects of poor business ethics in one field could multiply, leading to much greater damages that are not limited to tax questions.[232]

3.1.5.3 Interference with Control Systems

Complex tax structures can also have effects on control systems in corporate organizations.

Firstly, tax planning usually aims at reducing the taxable income of the company in order to decrease taxes without negatively affecting figures reportable to the capital markets, so as not to impair the reported shareholder returns that influence financing possibilities, stock prices, and management remuneration. This differentiated treatment of business figures is possible insofar as different legal regimes apply to tax accounting and accounting for business reporting. The extent of possible differences varies between countries.

Therefore, tax planning adds to differences between book and tax earnings reported. Nevertheless, both figures claim to represent a measure of the company's success. With the discrepancy increasing, doubts may arise whether either figure is correct and trust in corporate reporting deteriorates.[233]

---

[230] BEALE, *supra* note 180, at 240.
[231] STAFF OF THE JOINT COMMITTEE ON TAXATION, *supra* note 86.
[232] BEALE, *supra* note 180, at 240.
[233] BEALE, *id.*, at 230: "credibility gap".

Again, Enron represents an impressive example of this development, having reported high book earnings while at the same time declaring high tax losses over several periods.[234] Judging with hindsight, the tax figures seem to have been more representative of the group's true economic situation.

Therefore, excessive tax planning impairs the value of corporate reporting by reducing its trustworthiness. This in turn hampers the functioning of capital markets and makes corporate financing more expensive.[235]

3.1.5.4 Loss of Auditor Independence

Another effect is not so much created by tax planning itself, but rather by the way the market for tax consulting operates. Big auditing firms are especially active players in this market and offer tax planning advice in addition to their auditing services. They are also especially successful in selling their tax products to companies that are already their auditing clients. They benefit from their contacts to top management when cross-selling their tax products and can offer competitive advantages because they already have a detailed knowledge of their clients' business operations, corporate structure and financial situation and therefore have a head start when consulting on tax planning.[236]

The combined offer of tax planning advice and auditing services from the same service providers may have adverse consequences. Many tax structures are based on a certain accounting treatment of the structures employed. If this accounting treatment is not acceptable, then the tax savings envisioned cannot be achieved. If the same firm that advised on the tax structure also acts as the company's auditor, it will audit the structures it had developed itself. The same applies if tax-related figures in the companies' reports such as tax provisions and deferred taxes are being audited, as these also depend on the assessment of tax structures. This effect casts doubts on the independence of auditors and thereby may again impair the trust in corporate reporting with the same effects on capital markets as described above.[237]

Auditing firms try to counter these doubts by separating their personnel employed in tax advice from the auditing personnel with "Chinese walls", meaning that they cannot share information about their work. Yet, doubts about the effectiveness of these measures remain, especially as they invalidate the very competitive advantages that gave rise to the auditing firms' success in the tax planning market.[238]

3.2 Tax Decisions within the Organization

The aspects discussed so far in principle affect all businesses, whether incorporated or not. For incorporated businesses, however, one important shortfall of the standard theory of tax compliance is that it views the taxpayer as a single individual and gen-

---

[234] STAFF OF THE JOINT COMMITTEE ON TAXATION, *supra* note 86, at 6 *et seq.*, 25.
[235] On this effect from a tax policy viewpoint *see* above 2.3.2.
[236] BEALE, *supra* note 180, at 230; BEALE, Law Professor Offers Suggestions For Fighting Shelters, 103 Tax Notes 125 (2004).
[237] BEALE, *supra* note 180, at 241, 243 *et seq.*; BEALE, *supra* note 236; SCHEFFLER, *supra* note 8, at 484 *et seq.*
[238] For regulatory measures and actions by companies in this respect *see* 3.3.1, 3.3.2 and 3.4.2.7.

erally does not contemplate cases in which the taxpayer is indeed an organization that consists of a multitude of agents and in which ownership and control are separated. Even if an efficient tax strategy can be identified for a specific company according to the theory discussed so far, it is quite another question how the interaction of agents influences the overall tax behavior of the organization.[239]

3.2.1 Principal-Agent Setting

As has already been mentioned above, the organizational aspects of corporate tax strategy can be viewed in the categories of principal-agent theory. In this theoretical framework, the managers are the agents for the owners as their principals, while at the same time embedded principal-agent relations exist inside the organization between higher and lower ranking staff.[240] According to principal-agent theory, agents have interests that differ from those of the principals, due to differing risk and other preferences, so that the agents' interests have to be aligned with those of their principals by using proper contracts and incentives.[241]

The situation in corporate tax policy is comparable to this classical principal-agent setting. In companies it is the shareholders who bear the burden of taxes because taxes reduce the companies' profits and thus the shareholders' returns.[242] The managers, on the other hand, make the decisions that influence the tax liability of the corporation.[243]

One hypothesis especially supported by tax authorities is that complex and risky tax structures devised by tax departments (being the agents in this case) are not actually in the interest of top management and companies' owners (their principals) because in face of the aspects of a company's tax strategy discussed above, the latter would prefer a more conservative approach.[244]

Additionally, owners and top management, who are generally less caught up in the technicalities of tax law, may be more receptive to moral arguments in favor of paying taxes.[245]

While this may be disputable, it is certainly clear that owners and different levels of management can have different preferences in respect of the company's tax strategy, and these differences have to be considered when analyzing the tax behavior of a corporation.

3.2.2 Managerial Duties

One instrument for aligning the actions of managers with the interests of companies and their shareholders are of course the duties imposed on managers.[246] Violations

[239] SLEMROD, *supra* note 171, at 884 *et seq.*
[240] *See* SCHEFFLER, *supra* note 8, at 478. For the background of the corporate governance discussion in agency theory *see* SALZBERGER, *supra* note 208, at 155 *et seq.*
[241] On the goals the corporation as a whole should follow *see* KEINAN, *supra* note 176.
[242] A detailed analysis of this point would have to consider the theory of tax incidence.
[243] SLEMROD, *supra* note 171, at 884 *et seq.*
[244] *See* KEINAN, *supra* note 176, at 10.
[245] On the intrinsic motivation of individuals in tax matters *see* SLEMROD, *supra* note 171, at 883.
[246] For an Austrian perspective *see* GASSNER, *supra* note 173, at 610.

of these duties can result in liabilities and other sanctions, in this way creating incentives to comply with the respective duties.

In U.S. corporate law, managers are subject to the duty of care, which is in turn balanced by the business judgment rule. The business judgment rule protects decisions that "were rational, made in good faith, and without conflict of interests."[247] In other jurisdictions similar standards apply.

Concerning tax decisions, these principles translate into the requirements for managements that the facts relevant for a specific decision have to be investigated diligently and the legal situation properly assessed, especially by obtaining a tax opinion that has been drafted according to professional standards. On the other hand, managers are also perceived as having the duty to seize opportunities that allow to minimize the company's tax liabilities.[248] These requirements can also be derived from the fiduciary duties of managers acting as the agents of the shareholders.

The combination of both aspects should properly reflect the interests of the corporation and its shareholders as derived above by obliging managers to reduce taxes in order to maximize profits but at the same time to take into account the additional effects like public opinion, the relationship with tax authorities, and consequences for the internal organization.

3.2.3 Performance Measurement

Another important factor in aligning managers' conduct with an efficient corporate tax strategy is how the performance of managers is being evaluated. In this respect, a distinction between members of the tax department and other – "mainstream" – managers is useful.

Concerning performance measurement in tax departments, recent studies find a development that corresponds to changes in corporate tax policies. In the 1980s, taxes were mainly seen as business costs and it was the priority of the tax function to reduce these costs. In the 1990s, the tax function was discovered as a possible source of value.[249] Recently, companies have been becoming more risk averse in tax matters.[250] In short, the development of the role of the tax function in companies can be described as a shift from cost efficiency over shareholder value to accuracy of compliance. The resulting criteria for performance measurement included factors such as the tax rate (*Steuerquote*), cash flow impact, compliance, risk management and success in dealing with tax authorities.[251]

One specific problem in tax departments is that indicator results often cannot be linked to individual performance. So tax costs or tax rate (*Steuerquote*) results do not only depend on tax department performance but also on cooperation by the mainstream management and even on government actions such as tax rates and regula-

---

[247] KEINAN, *supra* note 176, at 19.
[248] KEINAN, *id.*; GASSNER, *supra* note 173, at 609, 621 *et seq.*; SLEMROD, *supra* note 171, at 884.
[249] BEALE, *supra* note 180, at 233 *et seq.*; SLEMROD, *id.*, at 885.
[250] KEINAN, *supra* note 176, at 11; ERNST & YOUNG, *supra* note 224, at 7.
[251] ERNST & YOUNG, *id.*, at 5. *See also* KEINAN, *id.*, at 11 *et seq.*

tions. Also, the cycle of tax results tends to be very long. Several years can pass between the time when a tax structure is set up and the time when it is audited and a potential dispute is resolved, taking into account that legal procedures and dispute resolution mechanisms also may last several years. Consequently, performance measurement may often fail to achieve the goal of making agents responsible for their actions because those persons having made a decision may well have left the tax department before the final outcome is clear.

For managers who are not themselves directly concerned with the tax function, the question is whether and how tax results should be recognized in the measurement of their performance. Of course, they cannot be evaluated solely on the basis of tax-related factors, as they are mainly concerned with the actual trade of their company, but tax consequences can be considered by using after-tax performance measures. Since the shareholders are also interested in after-tax returns, such measures should result in a good alignment of interests. They also translate the trade-off between tax savings and possible negative business effects into a uniform measure.

However, there is again the problem that managers often cannot effectively influence the tax result. They are expected to cooperate with the tax function and to avoid costly mistakes, but usually they cannot influence the tax burden on the company for the better. In this regard, they depend on proper tax planning and influences from outside the company.

A recent study finds that while board members are in most cases being evaluated on after-tax measures, for lower-level managers pre-tax measures are used.[252] The reason for this may be that top management can be made responsible for tax results because it also oversees the tax function, while for lower-level managers the above-mentioned problems apply. The study suggests that it may be seen as unfair to evaluate managers' performance partly based on a cost line they have no control over and that after-tax measurement may induce a tax behavior that focuses solely on single parts of the business that produce negative overall effects.[253] According to the study, companies are even anxious that after-tax measurements may indicate an aggressive position and so raise suspicions with tax authorities.[254] This also shows that companies try to retain good long-term relationships with tax authorities.[255]

3.2.4 Tax Law Enforcement in the Organizational Setting

As discussed in relation to the standard model, tax authorities influence the behavior of taxpayers with their auditing efforts, by threatening or imposing penalties or by helping them with their compliance tasks. However, tax authorities, too, have to take into account that corporate taxpayers are complex organizations made up of agents with different interests and responsibilities.

When tax authorities impose penalties to enforce tax compliance, they have to consider whom to impose those penalties on. Financial penalties can be imposed

---

[252] KPMG, *supra* note 181, at 4.
[253] KPMG, *id.*, at 4.
[254] KPMG, *id.*
[255] *See* 3.1.3.2.

both on the corporation itself and on individual persons. Conversely, prison sentences can only be imposed on individuals.

If penalties are imposed on the corporation as a whole, the shareholders will ultimately bear them, as the penalties will reduce their returns.[256] As a consequence, they will react to the penalties according to the standard model. Depending on their risk profile and their assessment of the other factors mentioned, they will decide on the preferred tax policy for the company. But as the actual tax behavior of the corporation is not determined by the owners but by the individual agents, the owners face the problem, which has already been discussed above, of aligning the agents' goals and actions with the tax policy the shareholders desire. Therefore, the effect of penalties in this case is very indirect. They primarily affect the shareholders and these effects have to be translated into incentives for the managers.

A more direct way of affecting the agents' actions is to apply penalties directly to them.[257] This shortcuts the principal-agent relationship.[258] Another advantage is that single agents are supposed to be more risk averse,[259] therefore reacting more readily to the threatened penalties. While shareholders can diversify their risk through portfolio selection, managers are affected personally by the penalties and do not have this possibility.

Another aspect is that penalties that have a tangible impact on companies usually have to be quite severe, resulting in the risk of ruining the whole company and in this way causing serious unwanted effects on the economy such as the loss of employment and economic substance. When penalizing single agents, effective penalties can be much lower and their effects are limited to the individual and consequently do not affect the organization as such or employees unrelated to tax offences.

However, it is difficult to single out individuals that can be made responsible for certain tax behavior in order to apply penalties directly to the acting agents. In complex organizations, several agents cooperate in making tax decisions and sometimes can influence them only in part. Therefore, individuals use the division of responsibility in complex organizations as a shield against individual accountability.

One possible solution put forward would be to have top management take individual responsibility for the tax returns of the corporation.[260] This would also have the effect that top management would have to control the tax strategy of the company more effectively. As authorities assume that top management would personally

[256] In more extreme situations, other stakeholders can of course also be affected. A more precise analysis would have to take into account effects of tax incidence.

[257] Against the imposition of criminal or regulatory liabilities on directors and other corporate officers: KEINAN, *supra* note 176, at 10 *et seq.*

[258] SLEMROD, *supra* note 171, at 886.

[259] *See* SALZBERGER, *supra* note 208, at 168.

[260] *See* KEINAN, *supra* note 176, at 10. In German law top management is responsible for the proper organization, instruction and supervision of tax compliance work and is liable for the companies' tax payments if they violate this duty in gross negligence: EICH, Brennpunkt: Steuerhaftung des GmbH-Geschäftsführers, 2005 Kölner Steuerdialog (KÖSDI) 14759, 14764.

favor a more conservative tax strategy,[261] this requirement might make them enforce a more conservative policy in the companies they manage.

The penalties imposed on individuals can range from normal criminal punishments such as fines or prison sentences to making them responsible for tax claims foregone. However, if penalties merely impose a financial burden on managers, the possibility remains that they could be compensated by their employers for such penalties.[262] This would defy the advantages of applying them directly to the decision makers. One possible solution could be to prohibit such compensation.[263]

3.2.5 Social Responsibility

The discussion about the tax behavior of corporations is connected with the discussion about corporate social responsibility. According to this theory, managers should not only seek the maximization of profits within the legal framework but also make sure that the enterprise acts socially responsible as a good corporate citizen.[264] One justification for this is that the owners of an enterprise would themselves also take social aspects into account when making business decisions. But through the separation of ownership and control, corporate conduct is also separated from loyalty and personal ethics. This missing link is exacerbated by the ongoing growth of cross-border business and shareholdings: Especially in the case of larger corporate groups, companies will pay taxes in countries in which neither senior management nor a substantial portion of shareholders are present. In this case of a geographical separation of ownership and corporate activities, neither the shareholders nor the absent (or highly mobile) managers necessarily have a sense of loyalty *vis-à-vis* the jurisdiction in which they are engaged in business and liable to tax.[265]

Concerning the tax policy of a company this claim translates into the demand to ensure that the company pays its fair share of taxes to ensure public financing.

As discussed above, there are several reasons why a tax strategy that is too aggressive may have negative effects that outweigh the advantage of tax reductions.[266] Therefore it may be efficient to take a less aggressive approach, and managerial duties as well as incentives should lead managers in this direction. Such a policy will probably already satisfy part of the demand for corporate social responsibility.

When managers are being asked to go beyond this and pay taxes purely out of altruistic reasons the problem arises that they will end up giving away other people's money.[267] Certainly there will be some shareholders that would have done this themselves and therefore do perfectly agree. But others may have other preferences or

---

[261] *See* 3.2.1.
[262] SLEMROD, *supra* note 171, at 885.
[263] On the effects of such an invalidation of compensation contracts on internal control efficiency *see* CHEN/CHU, *supra* note 229.
[264] *See* 1.3 above for some definitions of corporate social responsibility.
[265] The implications of the geographic and national separation of a company's activities from its shareholders is also hinted at by FREEDMAN, *supra* note 179, at 334.
[266] *See* 3.1.
[267] "The good company – A survey of corporate social responsibility", The Economist, January 22, 2005, 8.

simply be just as much in need of the profits as tax authorities are in need of tax revenues. Therefore it is much more efficient to leave the decision about charity to those who bear the financial burden.

3.3 Corporate Governance Influences on Tax Behavior of Corporations

Tax reporting, planning and structuring occur within the corporate organization and are carried out by corporate agents. Therefore, these activities are not independent of corporate governance systems and measures. Quite to the contrary, they are very much influenced by corporate control and information systems and recent regulatory measures taken to strengthen them. Because of this influence, tax authorities discover corporate governance regulation as a tool for ensuring the desired tax behavior by corporations. They try to impose corporate governance structures that discourage or inhibit unwanted tax planning or at least make it easy to detect and retrace.[268]

Another line of reasoning is based on the assumption that the implications of aggressive tax behavior described above[269] lead to the conclusion that it is not efficient for a company to engage in aggressive tax planning and that shareholders and top management would normally not support it. However, the tax function may not be sufficiently transparent and controlled by shareholders and top management, so that aggressive tax behavior does happen nevertheless. Therefore, increasing transparency and control through corporate governance measures should automatically curb unwanted tax planning.[270]

3.3.1 Existing Regulatory Measures

The most important example for corporate governance measures influencing tax departments is of course the Sarbanes-Oxley Act. According to its Sec. 302, the "Commission shall, by rule, require" that financial and executive officers certify in annual and quarterly reports that they have designed "internal controls to ensure that material information relating to the issuer and its consolidated subsidiaries is made known to such officers…". According to Sec. 404, an internal control report has to be included in annual reports, attested to and reported on by the auditor.[271] The requirements of Sec. 404 SOX have been implemented by the SEC in final rules.[272] The auditor's attestation to and report on the management assessment of internal controls is governed by the PCAOB auditing standard 2.[273]

---

[268] *See* KPMG, *supra* note 181, at 5.

[269] *See* 3.1.

[270] BEALE, *supra* note 180, at 221 *et seq.*

[271] *See e.g.* LOITZ, Auswirkungen von Sec. 404 des Sarbanes-Oxley Act auf die Tätigkeit von Steuerabteilungen, 2005 WPg 817, 817. On the implementation in tax departments *see* 3.3.1 and 3.4.

[272] SECURITIES AND EXCHANGE COMMISSION, Management's Report on Internal Control over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports (2003) (available at www.sec.gov/rules/final/33-8238.htm).

[273] PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD: An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements, approved by the SEC on June 17, 2004.

These requirements aim at ensuring the reliability of annual and quarterly reports and other shareholder information. Therefore, they do not directly influence the tax function. However, they affect the work in the tax departments via those parts of annual reports in which tax information has to be published.[274] In order to ensure the accuracy of this tax-related information, the internal controls demanded by Sec. 404 SOX have to be implemented in the tax departments as well. Especially the required documentation and reporting of processes and procedures is viewed as a major influence on current tax practice.[275]

Another notable provision of this act is Sec. 202 SOX, according to which the audit committee has to approve every non-auditing mandate for the auditing firm. This bureaucratic burden leads many companies not to use their auditors as advisors in tax matters. This addresses the problem of auditor independence discussed above.[276]

Another regulatory measure to be mentioned is the German "Law on Control and Transparency in Business" (KonTraG) of 1998.[277] It introduced into Sec. 91 of the German Stock Companies Act (*Aktiengesetz*) the requirement for the executive board of a public company to install a control system for the early detection of developments that possibly jeopardize the existence of the company. Although it is disputed whether this requires the introduction of a fully fledged risk management system in the common sense of business theory,[278] some elements of such a risk management system are certainly necessary. These requirements also reach into the tax function because tax risks can have grave effects on the company. Tax bills make for a very large part of corporate expenditures and large, unexpected tax demands after an audit, possibly combined with high penalties, can lead to a liquidity crisis.

The German Accounting Law Reform Act (*Bilanzrechtsreformgesetz*) has introduced the obligation to report on a company's risk management in the *Lagebericht* (part of the annual report) that has to be publicized yearly together with the financial statement.[279] Details on this report on risk management are regulated in German Accounting Standard 5 – Risk Reporting.[280]

In various jurisdictions all over the world, similar regulatory measures that influence the corporate governance of tax departments have been introduced in the wake

---

[274] For details *see* LOITZ, *supra* note 271, at 818.

[275] KPMG, *supra* note 181, at 10.

[276] *See* 3.1.5.4.

[277] Gesetz zur Kontrolle und Transparenz im Unternehmensbereich (KonTraG), April 27, 1998; BGBl. I 1998, 786.

[278] Hüffer, Aktiengesetz, Sec. 91 Stock Companies Act, notes 6 *et seq.*, 9 (6th ed. 2004); HEFERMEHL/SPINDLER, in: KROPFF/SEMLER, Münchener Kommentar zum Aktiengesetz, vol. 3, Sec. 91 Stock Companies Act, notes 15 *et seq.* (2nd ed. 2004).

[279] Gesetz zur Einführung internationaler Rechnungslegungsstandards und zur Sicherung der Qualität der Abschlussprüfung (Bilanzrechtsreformgesetz – BilReG), December 4, 2004, BGBl. I 2004, 3166, 3167.

[280] German Accounting Standard (GAS) 5 – Risk Reporting; *see* GERMAN ACCOUNTING STANDARDS COMMITTEE, German Accounting Standards, loose-leaf, last update October 2005.

of recent corporate scandals.[281] Another prominent example is the explicit demand by Australian tax authorities towards corporations to make taxes a corporate governance issue in order to ensure conscious decisions by top management about vital questions in taxation.[282]

There are also regulatory measures that do not aim at improving corporate governance as such and rather constitute classical tax enforcement measures but nevertheless operate in the same manner as corporate governance regulation. Especially, tax authorities demand in the course of audits an increasing amount of documentation on internal processes and business activities. Without such documentation, the companies' assessments will not be recognized. A prominent example is the area of transfer pricing, in which tax authorities impose a huge compliance burden with requirements to comprehensively document their transfer pricing policy and its implementation.[283]

3.3.2 Further Suggestions for Legislatory Measures

One suggestion for further legislatory measures responds to the concerns discussed above that auditors may lack independence if they provide tax advice to companies they are currently auditing or previously have audited.[284] A strict separation of tax advice and auditing could be implemented. Nevertheless, recent U.S. legislation has not introduced an incompatibility between tax advice and auditing (Sec. 206 SOX). Only Sec. 202 SOX indirectly creates such an effect, as discussed above.[285]

Beale further suggests[286] that every company should be required to compile a company tax risk profile containing information about participation in tax schemes and the incurred "cumulative failure rate" in those transactions. This information could be provided to directors and form a basis for company reports. This suggestion is based on the assumption that directors and shareholders do not agree with aggressive tax planning and would prevent it if they only had adequate information and instruments of control. It also counts on public pressure on companies engaging in aggressive tax structures.[287]

---

[281] *See also* COMMISSION OF THE EUROPEAN COMMUNITIES, Communication from the Commission to the Council and the European Parliament on Preventing and Combating Corporate and Financial Malpractice, COM(2004) 611 final, 7 *et seq.*, and COMMISSION OF THE EUROPEAN COMMUNITIES, Communication from the Commission to the Council and the European Parliament: Modernising Company Law and Enhancing Corporate Governance in the European Union – A Plan to Move Forward, COM(2003) 284 final; BUNDESMINISTERIUM DER JUSTIZ, Maßnahmenkatalog der Bundesregierung zur Stärkung der Unternehmensintegrität und des Anlegerschutzes (2003).

[282] *See e.g.* the various speeches delivered by representatives of the Australian tax administration: www.ato.gov.au/corporate/pathway.asp?pc=001/001/001&cy=1; HAYES, Australia's Tax Office Sets Out to Link Corporate Governance with Tax Compliance, 2003 Worldwide Tax Daily 208-10; AUSTRALIAN TAXATION OFFICE, *supra* note 207.

[283] CREST, *supra* note 212, at 12.

[284] *See* 3.1.5.4.

[285] *See* 3.3.1.

[286] BEALE, *supra* note 180, at 222, 262 *et seq.*; BEALE, *supra* note 236.

[287] *See* 3.1.4.2.

Other suggestions take up ideas from the different aspects of corporate tax behavior discussed above, like raising penalties,[288] customizing enforcement to the history of the respective taxpayer,[289] using publicity,[290] *etc*.

3.3.3 Other Influences

Apart from these regulatory influences, some additional trends have contributed to highlight the tax aspects of corporate governance. In the past, the public perception of companies as taxpayers and public sensibility for their tax behavior has increased,[291] making it necessary for managers to take the publicity effects of tax planning into account.[292] Indeed they are now very aware of public opinion in tax matters.[293] Tax authorities try to strengthen this effect and also increase their enforcement pressure by all other available means in order to raise tax revenues in the face of rising public financing needs.

The tax aspects of recent big corporate breakdowns emphasize the risks that can be contained in the tax figures on balance sheets.[294] These trends work together to underscore the perception of corporate tax policy as an important issue and raise top management awareness.[295] Also, shareholders begin to view taxes as an important aspect in the analysis of their investments,[296] again raising the significance of the topic for the managers.

3.4 Changes in Corporate Governance

The realization of corporate governance requirements for the tax function as well as the pressures from regulatory measures lead to fundamental changes in the work of tax departments. Generally, the tax function receives more attention from inside and outside the company and this "heightened profile" leads to a pressure to adapt to the expectations.[297]

---

[288] *See* 3.1.1 and 3.1.4.1.
[289] *See* 3.1.3.2.
[290] *See* 3.1.4.2.
[291] KPMG, *supra* note 181, at 1; VAN BLERCK, Tax Risk Management, 2005 Bulletin for International Fiscal Documentation (BIFD) 281, 285; SULLIVAN, Reputation or Lower Taxes?, 39 Tax Notes Int'l 896 (2005).
[292] *See* 3.1.4.2.
[293] ERNST & YOUNG, *supra* note 224, at 7; KPMG, *supra* note 181, at 4 *et seq.*; CREST, *supra* note 212, at 11; KEINAN, *supra* note 176, at 11; KENNEY, Risk Management Moves Corporate Tax Departments to Center Stage, 106 Tax Notes 416 (2005). *See also* STRATTON, Finance Tax Counsel Addresses Economic Substance Codification, 106 Tax Notes 403 (2005).
[294] BEALE, *supra* note 180, at 239 *et seq.*, BÜSSOW/TAETZNER, Sarbanes-Oxley Act Sec. 404: Internes Kontrollsystem zur Sicherstellung einer effectiven Finanzberichterstattung im Steuerbereich von Unternehmen – Pflicht oder Kür?, 2005 Betriebs-Berater (BB) 2437; HENDERSON GLOBAL INVESTORS, *supra* note 210, at 2, 4.
[295] KPMG, *supra* note 181, at 4.
[296] KPMG, *id.*, at 17; KEINAN, *supra* note 176, at 10; HENDERSON GLOBAL INVESTORS, *supra* note 210.
[297] STRATTON, *supra* note 177.

3.4.1 Former Situation

In the past, taxation was primarily viewed as a rather technical matter that did not receive much attention from outside the tax department.[298] Only the chief financial officer was involved in tax management and reporting lines ended with him. Goals and policies were set by the CFO or by the head of taxes.[299] Especially complex structures were not transparent for the board or, even more so, the shareholders.[300]

Additionally, there was not much interaction between the tax department and operational business units, as the view prevailed that tax decisions should not interfere with normal business and that tax departments should manage tax affairs taking the situation and operations in operational business as given.

Finally, processes in tax departments were often not formally documented, neither as generic processes to be used generally nor as the documentation of specific activities taking place.

3.4.2 Changes

According to literature as well as statements by practitioners these structures are currently in a process of significant change.

3.4.2.1 Top Management and Shareholder Involvement

First of all, as already noted, the attention of the board and top management in companies towards tax matters is claimed to be rising.[301] According to recent studies, these higher levels of management now want to be informed about the general tax policies of companies, the risks taken and the opportunities that are available. As a next step, they start to influence or set tax policies and to control the risks. Due to the technical and complex nature of tax matters, this involvement remains on a general level, focusing on the policies and the overall outcomes.[302]

To facilitate information of the board and top management about tax matters, firstly communication with the tax departments is being intensified, *e.g.* by giving the tax director direct access and making him report on risks and policies.

In addition to the top management, also shareholders start to be more interested in the tax matters of their corporation, as they realize the significant impact that tax risks can have on their returns.[303]

---

[298] "Splendid isolation": KPMG, *supra* note 181, at 1. *See also* ERLE, Steuermanagement als Aufgabe des Vorstands?, 2005 Betriebs-Berater, issue 38, I.

[299] KPMG, *id.*, at 3; BEALE, *supra* note 180, at 220.

[300] BEALE, *id.*, at 246.

[301] KPMG, *supra* note 181, at 4; KENNEY, *supra* note 293; THORPE, After the storm, 2005 Tax Business 26, 29 (8/2005). Recognizing little board attention for tax matters: TAX BUSINESS, Unhinged, 2005 Tax Business 40 (9/2005).

[302] *See* LOITZ, *supra* note 271, at 826; KEINAN, *supra* note 176, at 19.

[303] ERLE, *supra* note 298; HENDERSON GLOBAL INVESTORS, *supra* note 210.

3.4.2.2 Corporate Tax Policy

One instrument for the board to set the general standards for tax matters in the company is the formulation of a tax policy or, on an even more abstract level, a code of ethics for tax matters.[304] These instruments can help align the tax behavior of individual managers within the organization. These tools are well-known in standard corporate governance and usually exist in companies in a general form, not specifically related to taxation.[305] Therefore, the tax policy and the envisaged tax code of ethics need to be adjusted to the general policies and codes in place,[306] as there can be only one consistent ethical approach for the whole company.[307]

Especially in the tax area, a global policy can be important, as the decision about the appropriate tax behavior is difficult and many factors have to be taken into account. In a global policy, also aspects concerning ethics and social responsibility can be addressed and the company's attitude can be defined. A corporate tax policy can also, depending of course on its contents, serve as a tool for building a constructive relationship with tax authorities by establishing trust about the company's attitude.[308]

Recent studies show that an increasing number of companies have set up a global tax policy or are in the process of developing one.[309]

3.4.2.3 Control Systems

More sophisticated measures to satisfy corporate governance challenges in taxation are the introduction of risk management and control systems. Both may be explicitly demanded by regulatory measures. So the Sarbanes-Oxley Act demands a control system for information that is relevant to reports and publications.[310]

Control systems aim at ensuring the correctness and reliability of information about tax matters. They contain reporting obligations, processes for double-checking information, documentation requirements, external audits, *etc*. To be able to detect intentional violations of policies or the law, mechanisms are created by which employees can anonymously submit information on unlawful conduct or conduct violating policies (whistle-blowing).[311]

---

[304] Sec. 406 of the Sarbanes-Oxley Act requires companies to disclose whether they have adopted a code of ethics for senior financial officers, primarily relating to full and accurate disclosure and compliance with applicable rules and regulations.

[305] SALZBERGER, *supra* note 208, at 167 *et seq.*, discusses the effect of such codes as a signal to participants in capital markets.

[306] KPMG, *supra* note 181, at 6.

[307] *See* 3.1.5.2.

[308] On the use of corporate policies for signaling *see* SALZBERGER, *supra* note 208, at 167 *et seq.*, who discusses signaling effects towards the capital markets.

[309] HENDERSON GLOBAL INVESTORS, *supra* note 210, at 7.

[310] *See* 3.3.1. On the control system demanded by SOX 404 from the perspective of German law *see* BÜSSOW/TAETZNER, *supra* note 294; BUDERATH, Auswirkungen des Sarbanes-Oxley-Acts auf die Interne Revision, 2004 Betriebswirtschaftliche Forschung und Praxis (BFuP) 39.

[311] LOITZ, *supra* note 271, at 821.

The standard generic framework for control systems in the U.S. is the COSO framework developed by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).[312] It presents elements that are assumed to be vital for effective control systems. Due to its generic nature, the requirements of the COSO framework need to be implemented in the actual structure of each company. The framework is an acknowledged tool for introducing and sustaining a control system. For complying with Sarbanes-Oxley requirements, other approaches can also be used. However, they will generally contain similar elements.

Although control systems demanded by the Sarbanes-Oxley Act and similar regulatory instruments primarily aim at ensuring the accuracy of financial information, they contain many requirements for the work of tax departments that are also demanded by good corporate governance[313] such as corporate policies,[314] documentation, enhancement of communication,[315] top management involvement,[316] risk management,[317] *etc*.[318] The reason for this broad impact is the fact that financial information is based on processes throughout the tax department so that measures intended to ensure the accuracy of this information will necessarily affect all of these processes.[319] As tax liabilities and payments are in most cases among the major positions on a company's balance sheet or profit and loss statement, controlling tax-related information is in effect very important for ensuring overall accuracy of financial statements.[320]

3.4.2.4 Tax Risk Management

Risk management systems aim at identifying and controlling the risks that tax positions may bear.[321] Such risks mainly come in the form of unforeseen tax payments

---

[312] COMMITTEE OF SPONSORING ORGANIZATIONS OF THE TREADWAY COMMISSION (COSO), Internal Control – Integrated Framework (1994). For further details on the implementation of a control system *see* LOITZ, *id.*, at 818 *et seq.*, 821 *et seq.*; HALL/CALLAHAN, Tax and SOX 404, 771 Tax Journal, January 10, 2005, 17; GOODMAN, Internal Controls for the Tax Department, 103 Tax Notes 579 (2004). From a German perspective *see* BÜSSOW/TAETZNER, *supra* note 294, at 2439 *et seq.*

[313] *See* 3.1 and 3.2.

[314] *See e.g.* the tone-at-the-top aspect of the "control environment"-element of the COSO-framework, COSO, *supra* note 312.

[315] *See* 3.4.2.5. *See* the "information & communication"-element of the COSO-framework, COSO, *id.*

[316] *See* 3.4.2.1. *See* again the "control environment"-element of the COSO-framework, COSO, *id.*

[317] *See* 3.4.2.4. *See* the "risk assessment"-element of the COSO-framework, COSO, *id.*

[318] With regard to transfer pricing *see* SILVERMAN/CARMICHAEL/HERR, Sarbanes-Oxley and its implications for transfer pricing, International Tax Review – Tax Reference Library, no 23, 56 (2005).

[319] The COSO-framework has actually been designed with a broader approach in mind: GOODMAN, *supra* note 312, at 579.

[320] BÜSSOW/TAETZNER, *supra* note 294, at 2437.

[321] On risk management and corporate governance *see* SALZBERGER, *supra* note 208, at 167 *et seq.* On a tax risk management framework *see* VAN BLERCK, *supra* note 291, who also notes (at 284) that tax risk management shares certain aspects with control systems. On risk management in multinational organizations *see* ELGOOD/PARROISSIEN/QUIMBY, Managing Global Risk for Multinationals, 2005 Journal of International Taxation 22 (5/2005).

or high penalties and can severely affect liquidity and profitability. In order to effectively control these risks, risk management systems firstly contain processes for identifying, evaluating and classifying them and for the documentation of these results. Secondly, tax risk management policies can define escalation steps, *e.g.* by demanding signoff by higher level managers depending on the magnitude of the risk in question.

Due to the new focus on the possible risks from taxation such as high and unexpected tax liabilities or penalties, as well as due to regulatory requirements, risk management systems have been or are being introduced in tax departments on a broad scale.[322]

Obviously, the most problematic aspect of risk management is the effective identification and evaluation of risks, which in the end will depend on the competence of the personnel compiling the risk evaluations. The probability of a realization of the risk in question, impacts on liquidity and profitability, effects on public opinion, and the influence on the relationship with tax authorities belong to the indicators that can be used for evaluating risks. These represent the theoretical factors of the decision on tax behavior, which have already been discussed above.[323] However, their assessment can be difficult and depends strongly on individual perception.

An important aspect of an appropriate risk management system is the detailed documentation of the policies applied in general as well as of single decisions. This may even be the main difference to the approach applied in former times: while common approaches to assessing and controlling risks existed then as well, they were neither documented in a generalized form nor were decisions in specific cases.[324]

Commentators stress that the aim of tax risk management is not the *per se* avoidance of risks.[325] Instead, it focuses on making risk transparent, enabling conscious decisions about what risks to take and ensuring that this happens in well-defined processes with clear responsibilities.[326]

3.4.2.5 Communication with Operational Business Units

Another aspect of corporate governance in the tax function is the communication between the tax department and operational business units.[327] Such communication is necessary in two ways.[328] First, the tax department needs to have detailed knowledge of the state of operations. This information is the basis for tax assessments, tax reporting as well as planning. Timely information about changes and new

[322] *See e.g.* KENNEY, *supra* note 293. VAN BLERCK, *supra* note 291, at 281 stresses in the light of recent corporate breakdowns: “Business must react to this, not because of compulsion, but because it makes business sense.” *See also* ERNST & YOUNG, *supra* note 224, at 4, 6 *et seq.*

[323] *See* 3.1. According to VAN BLERCK, *supra* note 291, at 281, risk comprises the components “uncertainty and exposure”.

[324] *See also* KPMG, *supra* note 181, at 10; LOITZ, *supra* note 271, at 817.

[325] KPMG, *id.*, at 15.

[326] ERNST & YOUNG, *supra* note 224, at 7 *et seq.*

[327] SYLVESTER/TAYLOR, Navigating Corporate Culture and Avoiding U.S. Tax Pitfalls for Multinationals, 37 Tax Notes Int’l 255, 256 (2005).

[328] LOITZ, *supra* note 271, at 823.

projects is particularly important in order to allow the tax department to consider the tax consequences and assess possible planning opportunities or needs.[329] IT-systems play an important role in this intra-business communication.[330] But also personal communication is necessary, as IT-systems only transport structured information.

Second, tax departments need to convey the implications of any chosen tax strategy to the business units, so they can observe its implications in their daily decisions. Many tax strategies require a certain pattern of behavior in actual business operations to function. This can only be ensured if managers outside the tax function understand these implications.

The greater the geographic distribution of business operations, the more difficult both types of communication become. Possible means of improving communication include exchanges of personnel, regular meetings or conferences, assigning tax specialists to branch offices, and similar measures.[331]

3.4.2.6 Shareholder Transparency

Transparency towards shareholders can be achieved by reporting on tax matters in capital markets publications and in shareholders' meetings.

Improved shareholder transparency in tax matters is increasingly demanded by public authorities. The rationale behind this demand is the assumption that, due to the implications of aggressive tax behavior, shareholders do not want their companies to take such an aggressive position and would prevent such conduct if they were informed sufficiently.[332]

3.4.2.7 Relationship with Advisors

Good corporate governance also has implications for the relationship with external advisors. One important issue here is to prevent conflicts of interest.

As described above,[333] conflicts of interest can especially arise if one firm advises on tax planning and structuring and at the same time provides auditing services. As many tax structures rely on a certain treatment in the books of the business, advisors will in this case end up auditing the structures they have devised themselves. Therefore, companies try to avoid receiving auditing services and tax advice from the same consultants. The mentioned requirements of obtaining audit committee approval for non-audit assignments to the audit firm intensified this trend as companies try to avoid this bureaucratic burden.[334]

However, avoiding these conflicts of interest is not as easy as one might think. Especially for large corporations, only few firms are capable of providing the nec-

---

[329] SYLVESTER/TAYLOR, *supra* note 327, at 256.

[330] *See* LOITZ, *supra* note 271, at 827, pointing out the problem of heterogeneity of information systems.

[331] *See* ELGOOD/PARROISSIEN/QUIMBY, *supra* note 321, at 27, who describe such measures for communication with overseas tax departments.

[332] *See* 3.3; KEINAN, *supra* note 176, at 10.

[333] *See* 3.1.5.4.

[334] CREST, *supra* note 212, at 11 *et seq.*

essary services.[335] If different firms are employed *e.g.* for auditing different subsidiaries, it may be difficult to find yet another firm for tax advice, or even to keep track of which firms are employed in any given place.[336]

Attention should also be paid to hiring only independent firms for the preparation of opinions on tax planning structures and not those firms that cooperate closely with the promoters of a scheme.

When implementing control systems for the tax function, *e.g.* for complying with Sec. 404 SOX, external advisors that are part of the process of producing financial information, *e.g.* by gathering, compiling and preparing relevant information, these advisors, too, have to be included in the control system.[337]

Professional standards for advisors also impose special duties for cases when they detect fraudulent or otherwise illegal behavior by companies' agents.[338] These usually comprise the escalation of the issues to higher levels of management. Such duties compound the conflict of advisors' duties on the one hand to represent their clients' cause with commitment and on the other hand not to participate in illegal conduct.[339] Authorities also try to take advantage of the advisors' position for detecting such illegal conduct. This, however, further exacerbates the conflict of advisors' duties.

3.4.3 Implications for Tax Enforcement

Many of the corporate governance measures for the tax function require extensive reporting and documentation.[340] Thus, tax structures and planning measures leave a bigger paper trail than in the past. This makes it easier for tax inspectors to understand the structures that have been implemented and to find critical issues that are in danger of being challenged. Therefore, the reporting and documentation requirements stemming from corporate governance play into the hands of tax authorities and simplify their enforcement task.[341] This is probably one of the main reasons why tax authorities all over the world emphasize the corporate governance aspects of taxation in recent times.[342]

However, according to the theory discussed above, it should not be legitimate for taxpayers to rely on the possibility that questionable structures will not be detected. In the case of unclear or complex legal situations, taxpayers should only take doubtful positions if they have tenable arguments for doing so. If the position is subsequently challenged by the tax authorities, the dispute can confidently be taken to the

---

[335] CREST, *id.*
[336] CREST, *id.*, at 15.
[337] LOITZ, *supra* note 271, at 828.
[338] KEINAN, *supra* note 176, at 20 *et seq.*
[339] ALLEN, Corporate Governance and a Business Lawyer's Duty of Independence, 38 Suffolk U. L. Rev. 1, 3 (2004) further calls for advisors "to exercise independent judgement concerning the detectible spirit animating the law" and not to follow clients in all their demands.
[340] *See e.g.* 3.4.2.3 and 3.4.2.4. On this aspect *see also* THORPE, *supra* note 301, at 29.
[341] On the influence of corporate governance systems on the sensitivity of tax revenues to changes in the tax system *see* DESAI/DYCK/ZINGALES, *supra* note 37.
[342] *See* THORPE, *supra* note 301, at 29.

courts. In contrast, if taxpayers take a specific tax position because they rely on it not being detected, this casts strong doubts on their good faith when arranging their affairs in such a way.

If complex structures can be audited more easily and arising disputes be settled by the tax courts, then tax authorities do not have to resort to preventing complex structures at all by deterrent measures such as threats with onerous audits and the like.

4. Summary and Conclusions

Reflecting the result of the whole study, the conclusions to be drawn vary substantially depending on which perspective is taken.

As regards the effects of tax systems on corporate governance, mainly the taxation of executive compensation and unintended effects of tax rules resulting in shifts of power towards the management are discussed.

The main result on intended effects of tax provisions is that they are in most cases not suitable for influencing corporate governance, as it is difficult to link the tax measures to specific fact patterns that allow a differentiation between beneficial and harmful behavior. Furthermore, the analyzed measures tended to have uncertain effects and to pursue conflicting interests. In practice, most provisions proved to be easily circumvented. Some provisions can also be criticized from an equity perspective. The authors suggest to subject management decisions which are perceived as potentially endangering shareholders' interests to their approval rather than influencing them by tax law.

As regards transparency, the authors conclude that tax rules often result in opaque and complex tax-driven structures. The authors generally support the connection between tax and financial statements, in the belief that this link results in a more balanced and realistic picture of the situation companies are in. However, there is a risk of less transparent financial statements due to unrealistic tax-driven accounting positions.

The inefficient retention of profits as the most important unintended effect of the classical tax system, the reverse authoritativeness principle, the treatment of company retirement provisions, stock options or capital gains preferences is in practice not perceived as a current corporate governance problem. The monitoring function of the capital market may ameliorate the tendency to retain distributable profits. Yet theory suggests that problems may not be completely inexistent. This discrepancy could be an opportunity for future research.

In respect of the influence of corporate governance, especially in the light of recent changes, on taxation, the authors' main conclusion is that there is more to the decision on the corporate tax policy than a choice of risk preference. The effects on the internal organization as well as on companies' long-term relationships with authorities, markets and the public should not be underestimated and therefore suggest a policy that is less aggressive than the pure penalty-risk preference would allow. Authorities try to reinforce these effects to support their enforcement efforts. However, in doing so, they should not forget that taxpayers do not face a simple deci-

sion between compliance and non-compliance but complex tax law with different policy aims that makes a certain amount of tax planning necessary in order to operate their business in an efficient manner.

The changes in corporate governance legislation as well as in practical corporate governance in companies show that authorities as well as businesses have recognized the importance of corporate governance in the tax function. Companies use this conclusion to bring their actual tax behavior in line with the tax policy that they find efficient considering the various effects discussed above and to manage their tax affairs as professionally as the rest of their business.

Tax authorities use this trend towards more effective and transparent corporate governance structures in tax departments to facilitate their enforcement task. Their goal is to induce corporations to implement structures that make it impossible for them to engage in unlawful conduct, at least without it being easily retraceable by authorities. This seems to be an effective approach and at the same time compatible with the needs of companies, as it uses mechanisms that are also positive for the companies themselves so that their administrative burden may in a way prove productive for them, too. Nevertheless it also creates frictions because the companies' own structures are being used against them and part of the enforcement burden is shifted from the authorities to the companies.