Taxation and Corporate Governance – The State of the Art

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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:

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[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

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[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

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[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]

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[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]

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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.

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[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-

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[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]

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[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-

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[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.

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[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

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[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]

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[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.

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[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.

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[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.

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[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

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[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.

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[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

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[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]

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[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

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[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

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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

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[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]

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[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.

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[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]

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[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.

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[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.

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[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]

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[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

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[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.

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[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

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[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.

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[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

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[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-

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[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

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[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-

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[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-

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[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.

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[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 long-standing 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.

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[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

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[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

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[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]

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[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

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[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).

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[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]

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[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-

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[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

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[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-

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[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

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[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

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[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]

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[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]

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[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]

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[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]

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[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]

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[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

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[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-

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[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

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[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.