

Draft of 3/15/2018

IS ALL CORPORATE TAX PLANNING GOOD FOR SHAREHOLDERS?

Forthcoming, 52 U.C. Davis L. Rev. (2018)

Omri Marian*

“The executives who run America’s corporations have a fiduciary duty to maximize profit for their shareholders. That’s what they’re programmed to do. One way to maximize profits is to minimize taxes, something G.E. does better than just about any other company. If I were a G.E. shareholder, I would be thrilled to learn that its vaunted 1,000-person tax department is viewed within the company as a profit center.”¹

Abstract: *Does corporate tax planning benefit shareholders? The prevalent assumption is that it does, because lower corporate tax burden translates to enhanced shareholder value. In this article, I explain why this common perception is sometimes incorrect in practice. In many cases, successful (and legal) corporate tax planning schemes are not Pareto-optimal: some shareholders may see a net benefit, while others experience a net loss. Moreover, in certain instances it is reasonable to expect that legal corporate tax planning will be Kaldor-Hicks inefficient. Meaning, the financial losses incurred by some shareholders exceed the gains to others. I identify a previously underappreciated agency problem, due to which shareholders usually approve detrimental corporate tax plans, even when information about the detriment is freely available. I also show that shareholders who benefit from corporate tax plans would, in some instances, rationally cooperate with managerial rent extraction, when such rent extraction defuses managerial opposition to the corporate tax-saving plan. The transactions I describe operate to shift the corporate tax burden from some shareholders to others, while enriching managers in the process. I discuss the legal and the normative implications of this phenomenon and explore several potential remedies.*

* Professor of Law, University of California, Irvine School of Law. For helpful comments and critique, I am indebted to Adam Rosenzweig, Chris Sanchirico, Reed Shuldiner, Emily Satterthwaite, Reuven Avi-Yonah, Elizabeth Pollman, Frank Partnoi, Vic Fleischer, Cathy Hwang, Jeff Schwartz, Yariv Brauner, David Hasen, Danny Sokol, Sarah Lawsky and participants at workshops and conferences at The University of Florida College of Law, The University of Utah College of Law, Loyola Law School (LA), The University of Toronto Faculty of Law, the University of Pennsylvania Law School, and the University of California, Irvine School of Law. Any errors or omissions are my own.

¹ Joe Nocera, *Who Could Blame GE?*, N.Y. TIMES, Apr. 4, 2011, at A23.

INTRODUCTION

Under our corporate income tax system, corporate income is taxed twice, once at the entity-level (the corporate income tax), and once again at the shareholder-level (upon receipt of dividends or the disposition of corporate stock at a gain).² Tax-savings at either the corporate-level or the shareholder-level reduce the overall tax burden, and presumably increases net value to shareholders.³

Shareholders control their own individual tax planning and can act to reduce their shareholder-level tax liability, with the aid of their personal tax advisors. At the corporate-level, however, managers operate as the shareholders' tax-planning agents.⁴ The accepted view, therefore, is that managers should engage in tax planning that reduce corporate-level tax

² This "double taxation" system has been, and still is, the subject of an extensive academic inquiry. *See, e.g.*, Michael Doran, *Managers, Shareholders, and the Corporate Double Tax*, 95 VA. L. REV. 517 (2009); Steven A. Bank, *A Capital Lock-in Theory of the Corporate Income Tax*, 94 GEO. L. J. 889 (2006) [hereinafter *Capital Lock-In*]; Jennifer Arlen & Deborah M. Weiss, *A Political Theory of Corporate Taxation*, 105 YALE. L. J. 325 (1995); Alvin Warren, *The Relation and Integration of Individual and Corporate Income Taxes*, 94 HARV. L. REV. 717 (1981).

³ Arlen & Weiss, *id.*, at 338 ("Integration, corporate rate cuts, and capital gains cuts all confer windfalls on existing shareholders. The windfalls result from the fact that the price of any asset reflects expected after-tax returns"); David M. Schizer, *Tax and Corporate Governance: The Influence of Tax on Managerial Agency Costs*, in THE OXFORD HANDBOOK OF CORPORATE LAW AND GOVERNANCE Ch. 43, ¶5.2 (Jeffrey Gordon & Wolf-Georg Ringe eds., 2015) ("To shareholders, lowering the tax bill is likely to enhance returns... In general, shareholders have reason to value tax planning even more than managers, since shareholders do not bear the same downside risks").

⁴ Keith J. Crockera & Joel Slemrod, *Corporate Tax Evasion with Agency Costs*, 89 J. OF PUB. ECON. 1593, 1596 (2005) ("[I]n a large, publicly held corporation, decisions about taxes (and accounting) are not made by the shareholders directly but, rather, by their agents, whether that is the chief financial officer or the vice president for taxation").

liability, in order to enhance shareholders' value.⁵ Some commentators go as far as to suggest that corporate managers have a fiduciary duty to their shareholders to minimize corporate tax liability,⁶ though this view is questionable.⁷

⁵ See, e.g., Reuven S. Avi-Yonah, *Corporate Taxation and Corporate Social Responsibility*, 11 N.Y.U. J. OF L. & BUS. 1, 13 (2014) [hereinafter *Corporate Social Responsibility*] (Under the nexus-of-contracts view of the corporation, which is the dominant view among corporate scholars, "management arguably has a responsibility to maximize shareholder profits by minimizing corporate taxes as much as possible"); Michelle Hanlon & Joel Slemrod, *What does Tax Aggressiveness Signal? Evidence from Stock Price Reactions to News about Tax Shelter Involvement*, 93 J. OF PUB. ECON. 126, 126 (2009) ("Of course, in order to maximize the value of the firm, shareholders would like to minimize corporate tax payments net of the private costs of doing so."); Wolfgang Schön, *Tax and Corporate Governance: A Legal Approach*, in TAX AND CORPORATE GOVERNANCE 31, 46 (Wolfgang Schön, ed., 2008) ("The basic goal which offers guidance for the actions of the management under the 'corporate contract' is wealth maximization for investors. . . This makes the minimization of the corporate tax burden an integral part of the managers' duty of care");

⁶ See, e.g., Nocera, *supra* note 1; Boris Johnson, *We All want Apple to Pay more Tax*, TELEGRAPH (Jan. 24, 2016, 9:06 PM), <http://www.telegraph.co.uk/news/worldnews/europe/eu/12118898/We-all-want-Apple-to-pay-more-tax.html> ("It is the fiduciary duty of [corporate] finance directors to minimise tax exposure. They have a legal obligation to their shareholders"). Fred Imbert, *Cramer: Apple's Tim Cook 'Patriotic' on Taxes*, CNBC (Dec. 21, 2015, 11:08 AM), <http://www.cnbc.com/2015/12/21/cramer-apples-tim-cook-patriotic-on-taxes.html> (citing Jim Cramer responding to criticism on Apple Inc.'s tax planning stating that "'The main thing you learn is that tax avoidance is everybody's ... duty. You're supposed to try to avoid'").

⁷ There are very few cases directly addressing this issue. Courts that did address this issue were reluctant to rule that corporate managers have an affirmative duty to minimize corporate taxes. See, e.g., *Freedman v. Adams*, No. CIV.A. 4199-VCN, 2012 WL 1345638, at 12 (Del. Ch. Mar. 30, 2012), *aff'd* on other grounds, 58 A.3d 414 (Del. 2013) ("The Plaintiff does not cite any case law of this Court or the Delaware Supreme Court directly supporting the purported fiduciary duty to minimize taxes... For reasons that are both numerous and obvious, this Court is not convinced that it should endorse this proposed new duty"); *Seinfeld v. Slager*, No. CIV.A. 6462-VCG, 2012 WL 2501105, at 3 (Del. Ch. June 29, 2012) ("[A] decision to pursue or forgo tax savings is generally a business decision for the board of directors. Accordingly, despite the Plaintiff's contentions, Delaware law is clear that there is no separate duty to minimize taxes, and a failure to do so is not automatically a waste of corporate assets"). For additional analysis of the lack of managers' duty to minimize taxes see, e.g., Charles Gass, *Outer Limits: Fiduciary Duties and the Doctrine of Waste*, 92 DENV. U. L. REV. ONLINE 93, 97-98 (2015); Daniel Hemel, *A "Duty" to Minimize Taxes?*, THE UNIVERSITY OF CHICAGO LAW SCHOOL FACULTY BLOG (Dec. 22, 2015), <http://uchicagolaw.typepad.com/faculty/2015/12/a-duty-to-minimize-taxes.html>; Avi-Yonah, *Corporate Social Responsibility*, *supra* note 5, at 2 ("This Article will address the question of whether publicly traded U.S. corporations owe a duty to their shareholders to minimize their corporate tax burden through any legal means, or if instead, strategic behaviors like aggressive tax-motivated transactions are inconsistent with corporate social responsibility ('CSR'). I believe the latter holds true, regardless of one's view of the

In this article, I dispute the notion that legal corporate tax planning necessarily enhances shareholders' value. I explain how corporate-level tax reducing strategies may increase the overall tax burden on shareholders. Specifically, I contribute to the growing literature on taxation and corporate governance by making the following arguments: First, I show that in many cases, successful (and legal) corporate tax planning schemes are not Pareto-optimal.⁸ Some shareholders may see a net increase in value, while other experience a net loss. Second, I show that in certain instances it is reasonable to expect that legal corporate tax planning schemes will be Kaldor-Hicks inefficient (I sometimes refer to such transaction as "overall inefficient" transactions).⁹ Meaning, the losses to some shareholders may exceed the gains to others.¹⁰ Third, I show that because of an underappreciated agency problem, shareholders usually approve harmful corporate-level tax schemes, even when the information about the potential detriment is freely available.¹¹ Specifically, I describe instances of corporate tax planning in which some shareholders may rationally cooperate with managerial rent extraction.

The legal construct underlying these arguments is that corporate-level taxation and shareholder-level taxation are not separate from one another. Even though corporations are separate taxpayers from their shareholders, many corporate-level transactions affect shareholder-level tax liabilities. I denote corporate-level transactions that have a taxable effect on shareholder-level taxes "STCTs" (Shareholder Taxable Corporate Transactions). STCTs are a regular occurrence in U.S. financial markets.¹² For example, a corporation may pursue a merger under the assumption that the post-merger corporate structure is more tax-efficient than current structure. The merger itself, however, may be taxable to shareholders, even if shareholders do not dispose of their stock, but simply replace their original stock for stock of the merged corporation.¹³ Similarly, a foreign corporation may earn income that

corporation").

⁸ A transaction is "Pareto optimal" to shareholders if at least one shareholder is better off because of the transaction and no shareholder is worse off. *See*, RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW §1.2 (9th ed., 2014). ("A Pareto-superior transaction (or 'Pareto Improvement') is one that makes at least one person better off and no one worse off"). *See* discussion *infra*, at Part I.b.

⁹ A transaction is "Kaldor-Hicks efficient" if it maximizes shareholder wealth in the aggregate. Meaning, shareholders who benefit from the transaction gain enough, so they could theoretically compensate losing shareholders for their losses. *See*, Posner *id.* (A transaction is Kaldor Hicks efficient if "The winners *could* compensate losers, whether or not they actually do").

¹⁰ *See* discussion *infra*, at Part I.c.

¹¹ *See* discussion *infra*, at Part I.d.

¹² *See* discussion *infra*, at Part II.

¹³ *See* discussion *infra*, at Part III.a.ii.

is taxable to U.S. shareholders, even if shareholders receive no distribution from the corporation.¹⁴ There are multiple examples of in-corporate transactions that are taxable to shareholders.¹⁵ Thus, in order to assess whether shareholders benefit from corporate-level tax-savings, one must also consider potential shareholder-level tax costs. Current literature on corporate tax and corporate governance largely misses this point.¹⁶

Significantly, shareholder experience of the interaction of corporate-level and shareholder-level taxes varies, because shareholders have heterogeneous tax preferences.¹⁷ Shareholder-level tax outcomes depend on each shareholder's individual tax circumstances.¹⁸ In STCTs, different shareholders of the same corporation may face different amounts of taxable income, face different tax rates, and may be able to utilize different personal tax benefits. As a result, STCTs trigger different shareholder-level tax consequences to each shareholder. After netting shareholder-level tax outcomes against corporate-level tax savings, some shareholders may see a net tax benefit from an STCT, while other may see a net tax detriment. Nonetheless, if shareholders who benefit from an STCT have the majority vote—they will approve the transaction even if it is not Pareto-optimal or overall inefficient.

In U.S. equity markets, shareholders who benefit from STCTs indeed hold the majority vote in most cases. Specifically, several recent studies find that tax-exempt shareholders hold the majority of publicly traded equities in U.S. markets.¹⁹ These tax-exempt shareholders always see a net benefit from an STCT, because they share in corporate-level tax savings, but experience

¹⁴ For example, under “Subpart F” of the Internal Revenue Code (IRC §§951-965), certain income of foreign corporations controlled by U.S. shareholders is deemed distributed by the foreign corporations to their U.S. shareholders, even if no actual distribution took place. See *also*, discussion *infra*, at Part III.a.i.

¹⁵ See discussion *infra*, at Part III.a.

¹⁶ See Discussion *infra*, at Part II.

¹⁷ For a discussion of shareholders' heterogeneity in tax preferences with respect to their equity holdings, see Doran, *supra* note 2, at 542-547; Omri Marian, *Reconciling Tax Law and Securities Regulations*, 48 MICH. J. OF L. REFORM 1, 10-13 (2014) [hereinafter *Tax and Securities Regulation*].

¹⁸ Marian, *id.*, at 13 (“[T]he tax consequences of securities investments vary among investors, even if all are ‘reasonable investors’, and even if one makes numerous simplifying assumptions”).

¹⁹ See Leonard E. Burman, Kimberly A. Clausing, & Lydia Austin, *Is U.S. Corporate Income Double Taxed?* 70 NAT'L TAX J. 675, 701 (2017) (estimating “that the taxable share of U.S. corporate equity has declined dramatically in recent years, from more than 80 percent in 1965 to about 27 percent at present”); Steven M. Rosenthal & Lydia S. Austin, *The Dwindling Taxable Share of U.S. Corporate Stock*, 151 TAX NOTES 923, 923 (May 16, 2016) (Finding that “the share of U.S. corporate stock held in taxable accounts fell more than two-thirds over the last 50 years, from 83.6 percent in 1965 to 24.2 percent in 2015”).

no shareholder-level tax cost (due to their tax-exempt status). Since tax-exempt shareholders have the majority, we should expect shareholders to vote in favor of STCTs. STCTs are indeed a common occurrence in U.S. markets.²⁰ Being in minority, *taxable* shareholders cannot prevent an STCT, even if their shareholder-level tax cost outweighs their share in the corporate-level savings (in terms of net present value, or NPV). Their only recourse is litigation.²¹

By “tax-exempt shareholders” I mean all the special purpose entities that qualify for tax-exempt status under the Internal Revenue Code (I.R.C.), such as educational institutions’ endowments, charitable organizations, pension-funds, governmental entities and others,²² as well as foreign investors in U.S. equities, who are—for the most part—exempt from U.S. shareholder-level taxation.²³

Managers play a pivotal role in this context. In STCTs, managers have competing incentives. The first incentive stems from managers’ interest in

²⁰ See, e.g., Anton Babkin, Brent Glover & Oliver Levine, *Are Corporate Inversions Good for Shareholders?* 126 J. OF FIN. ECON. 1 227 (2017) (empirically analyzing tax inversion transaction and finding that “for taxable shareholders with a sufficiently low basis or high capital gains tax rate... the personal tax costs can exceed the corporate tax benefits”); Bradley T. Borden, *Rethinking the Tax Revenue Effect of REIT Taxation*, 17 FLA. TAX REV. 527, 562-566 (2015) (Analyzing tax-induced REIT spinoff transactions, describing a scenario under which overall shareholder tax liability (shareholder-level plus corporate-level) increases, even though corporate-level tax liability decreases).

²¹ STCTs have indeed been subject to litigation. See, e.g., *In re Medtronic, Inc. S'holder Litig.*, 900 N.W.2d 401 (Minn. 2017); *Gumm et al v. Molinaroli et. al.*, 2017 WL 1056052 (E.D.Wis.) [hereinafter: Johnson Controls Complaint].

²² I.R.C. §§501-530, 892 exempt multiple types of special purposes entities from taxation.

²³ While foreign taxpayers doing business in the United States are not per-se tax exempt, certain rule applicable to the taxation of cross border transaction make such investors functionally tax exempt or almost tax exempt. Generally, in the case of passive investment income by foreign residents (meaning, where the investor does not actively participate in the management of the investment), the United States only impose tax on foreign taxpayers’ income form source within the United States. I.R.C. §§871, 881. The source of gain from the disposition of non-depreciable personal property—such as corporate stock—is determined by reference to the residence of the taxpayer. I.R.C. §865. Thus when a foreign resident sells the stock of a U.S. corporation at a gain, the income is source outside the United States, and therefore not taxable in the United States. In addition, most developed countries would not tax their residents’ gains from the sale of foreign equity if certain conditions are met. Thus, in many instance, the gain from the sale of a U.S. corporation by a foreign resident is never taxed. Dividends distributed by a U.S. corporation to a foreign resident are nominally taxed at a flat rate of 30 percent. I.R.C. 871. However, the United States has bilateral tax treaties with multiple countries. Under such treaties, the withholding tax on dividends is reduced significantly. For discussion on the de-facto tax exemption of foreign investors in U.S. equity markets, see David Schizer, *Between Scylla and Charybdis: Taxing Corporations or Shareholders (Or Both)*, 116 COLUM. L. REV. 1849, 1880-81 (2016).

their capacity as shareholders. Managers usually hold equity in the corporations they manage as a form of incentive compensation.²⁴ Managers' personal shareholder-level tax interest may be different from the interest of other shareholders²⁵, such as tax-exempt shareholders. Specifically, because managers are likely taxable individuals,²⁶ their shareholder-level tax-interests align with the interests of taxable shareholders. As such, managers should rationally oppose inefficient STCTs. In addition, several provisions under the I.R.C. impose direct tax on managers in the context of certain STCTs.²⁷ This adds an additional incentive for managers to oppose STCTs. However, managers also have a second, competing interest, in their capacity as managers. If managers' compensation is linked to the after-tax performance of the corporation (which is likely to be the case), managers can enhance their compensation by minimizing corporate-level taxes.²⁸ This incentivizes managers to support STCTs.

Managers can solve their personal conflict of incentives. Since managers control the transaction structure, they can require the corporation to indemnify them for their personal shareholder-level tax cost associated with the transaction. This is known as a "tax gross up payment". Such gross-up payments are common in practice.²⁹ The tax gross up is an additional cost for the corporation in the transaction. However, if the corporate-level tax savings outweighs the cost of the gross-up, there is some corporate net savings left for other (non-manager) shareholders to share in. Since tax-exempt shareholders—who likely hold the majority vote—benefit from any corporate tax savings, they would rationally agree to gross up managers. It is probably always the case that there remains a net corporate benefit in spite of

²⁴ Doran, *supra* note 2, at 536 (“[M]any managers occupy a dual position: they are both managers and shareholders”).

²⁵ Hideki Kanda & Saul, Levmore, *Taxes, Agency Costs, and the Price of Incorporation*, 77 VA. L. REV. 211, 230 (1991). (“[Managers’] self-interest may not be aligned with the interests of other shareholders: the timing of the disposition of assets, and in tax returns, the recognition of gains and losses”).

²⁶ Only special purpose organizations that meet certain requirements qualify for the exemption under the I.R.C. Individuals are generally taxable.

²⁷ See, e.g., I.R.C. § 4985 (imposing excise tax on managers' value equity-based compensation in an inversion transaction); I.R.C. § 4999 (imposing an excise tax on managers' "golden parachute" payments).

²⁸ Mihir A. Desai & Dhammika Dharmapala, *Corporate Tax Avoidance and High-Powered Incentives*, 79 J. OF FIN. ECON., 145, 147 (2006). (“Greater incentive compensation helps align the incentives of agents and principals and leads managers to be more aggressive about increasing firm value through tax avoidance”).

²⁹ David I. Walker, *Another (Critical) Look at the Inversion Excise Tax*, 151 TAX NOTES 947, 951 (May 16, 2016) (“Although criticized by proxy advisory firms, agreements to make executives whole on an after-tax basis for some tax obligations remain persistent”) [Hereinafter *Another Critical Look*].

the gross up, because corporate-level tax savings are likely in orders of magnitude larger than the tax detriment to a few managers who hold only a small equity interest in the corporation.³⁰

When a corporation grosses-up managers in an STCT, the managers' personal shareholder-level tax cost is extinguished. This functionally converts managers into "tax-exempt" shareholders, but just for purposes of the specific transaction at issue. The only interest that managers are left with is their interest to enhance their compensation by increasing the after-tax corporate income. Tax-exempt shareholders still receive a net benefit (albeit smaller than if there was no gross-up), while taxable shareholders simply suffer an additional economic burden (their share of the cost of the gross-up). The gross-up payment is a simple case of managerial rent extraction, having the corporation carry managers' personal tax burden.

To summarize, STCTs present a previously underappreciated corporate governance issue: tax-exempt shareholders rationally cooperate with managerial rent extraction, and approve non Pareto-optimal, and even overall inefficient corporate tax-planning schemes. Taxable minority shareholders can do nothing as they see their net investment value decreases. Economically, one can view such transactions as a transfer of value from one group of shareholders to another group of shareholders, and to managers.

Ironically, another potential beneficiary of such inefficient corporate tax-planning transactions could be the United States Department of Treasury. If the tax detriment to taxable shareholders outweighs the corporate-level tax saving, it means the government collects more tax (but only from taxable shareholders) than it loses from the corporate tax plan.³¹ While this may be the case in the context of a few outlier transactions, on average (taking into account all corporate tax-savings transactions) the government probably still loses revenue.³²

³⁰ *Id.* ("[I]n cases in which gross-ups have occurred, the amounts, while eye-popping in isolation, represent only a small fraction of deal value").

³¹ Rita Nevada Gunn & Thomas Z. Lys, *The Paradoxical Impact of Corporate Inversions on US Tax Revenue* 37 (August 21, 2016) (unpublished manuscript) available at <https://ssrn.com/abstract=2596706> (Argue that "inversions actually increase taxes to the US Treasury, in the form of increases in post-inversion cash dividends and, potentially, capital gains").

³² While some transactions may actually be beneficial in terms of revenue collection, these are outliers. In most cases, the government loses revenue, and thus loses on an average basis. See, e.g., Babkin, Glover & Levine, *supra* note 20, at 228 ("the aggregate effect across all shareholders (taxable and tax-exempt) is a 3.0% increase in value." This suggests that the aggregate effect is still tax reducing, which means the government loses revenue); Austan Goolsbee & Edward Maydew, *Taxes and Organizational Form: The Case of REIT Spin-offs*, 55 NAT'L TAX J. 441, 443-444 (2002) (finding moderate revenue loss after taking into

The STCT governance problem I identify adds to the growing literature that criticize shareholder value maximization as a normative linchpin for assessing management behavior.³³ Managers cannot know what the personal tax position of each shareholder is, and what might be the tax effect of an STCT on each shareholder. Under such circumstances, claiming that managers should (or should not) engage in corporate tax planning because it benefits shareholders is a logically incoherent argument.

STCTs also have important normative implications in terms of efficiency and fairness. The efficiency problem can be summarized as follows: shareholder-level tax-heterogeneity, coupled with the fact that tax-exempt shareholders control most votes in the U.S. market, encourages inefficient corporate tax planning transactions, even when information is freely available in the market.³⁴

The fairness problem is more nuanced.³⁵ Assuming Congress designed our tax system with particular distributive policies in mind, STCTs violate such policies through private action. Specifically, an STCT increases the tax burden on some unwilling shareholders to a level that is in excess of the level intended by the government. At the same time, STCT decreases the tax burden on other shareholders to a level below the one intended by the government.

There are several potential solutions to this problem.³⁶ I consider market-based solutions, tax-based solutions, and corporate-law based solutions. Market based solutions are unlikely to be a panacea. As long as tax-exempt investors control the majority vote, the market is unlikely to correct managers' distorted tax incentives. Tax-based solutions to similar problems have failed in the past, or would simply result in different types of agency costs. I argue that corporate-governance based solutions that would empower taxable shareholders seem to be the most promising.³⁷

The rest of the Article continues as follows: In Part I, I present numerical stylized examples to explain my main descriptive argument. I show how STCTs may be detrimental to shareholders, and how agency costs may transpire in such transactions. I generalize the stylized examples in a formal model in the Appendix. In Part II, I explain how the unique corporate tax planning dynamics I identify contribute to the vast literature on the relationship between corporate tax and corporate governance. In Part III, I

account shareholder level taxes in REIT spinoff transactions).

³³ See discussion *infra*, at IV.a.i.

³⁴ See discussion *infra*, at IV.a.ii.

³⁵ See discussion *infra*, at IV.a.iii.

³⁶ See discussion *infra*, at Part IV.b.

³⁷ See discussion *infra*, at Part IV.b.iii

move from theory to practice. I use the framework I develop in parts II and III to explore two types of popular STCTs in U.S. financial markets: “corporate inversions”, and “REIT spin-offs”. I show that such transactions are usually not Pareto-optimal, and may sometimes be overall inefficient. In Part IV, I consider the normative and legal implications of my descriptive arguments and discuss several ways to address the governance issues associated with STCTs.

I. SUCCESSFUL CORPORATE TAX PLANNING MAY BE DETRIMENTAL TO SHAREHOLDERS

In this part, I use several stylized examples to explain how—contrary to common perception—corporate tax planning may result in an increased tax burden on shareholders. The tax rates I use in the examples are similar to the tax rates in place before the recent tax reform (also known as the Tax Cuts and Jobs Act, or TCJA).³⁸ The reason to use such rates is to approximate the potential tax outcomes of actual transactions (discussed in part III) that have taken place in recent years (before the enactment of the TCJA).

The new tax rates prescribed by the TCJA do not change the analysis. The stylized examples simply introduce the conceptual generic argument. Applying different tax rates does not affect that. Moreover, it is likely that the TCJA rates strengthen the conceptual argument. The reason is that the TCJA significantly reduced the corporate-level tax rate, from thirty-five percent, to twenty-one percent³⁹ while making relatively minor changes to the rates applicable to shareholder-level income. This means that corporate-level tax savings are now less valuable compared with previous law, while shareholder-level taxes are just as costly. This means that a STCT is more likely to be overall burden increasing to taxable shareholders.

In Subpart A, I outline the parameters for the examples to follow, and explain the underlying assumptions. In Subpart B, I demonstrate a simple case of non-Pareto-optimal outcome of corporate tax planning. In Subpart C, I show that an overall inefficient outcome is possible. In Subpart D, I discuss the effects of tax gross-up payments to managers. In Subpart E, I adjust the examples to account for multiple periods.

In the Appendix, I offer a generalized formal model for the issues discussed in this SubPart.

a. Set-Up and Assumptions

Assume ExCo is a domestic corporation, with a value of \$1,000. ExCo’s

³⁸ Tax Cuts and Jobs Act, Pub. L. No. 115-97, 131 Stat. 2054 (2017) [Hereinafter: TCJA].

³⁹ *Id.*, § 13001.

profits are subject corporate level tax at a rate of 40%.⁴⁰ ExCo has only one class of stock, and three groups of shareholders:

1. *Tax-exempt shareholders (TEs)*. TEs are not subject to tax in their individual capacity. For example, any gain from the sale of their stock in ExCo is not taxable. Similarly, they do not pay tax on any dividends they receive from ExCo. TEs own 60% of ExCo's stock.⁴¹
2. *Taxable shareholders (TXs)*. TXs own 30% of ExCo's stock. TXs are subject to tax in their individual capacity. For ease of analysis, we shall assume that all TXs have the same tax interest⁴² and are subject to the same personal tax rate of 25%.⁴³ This tax rate would apply, for example, to dividends TXs receive from ExCo, and to TXs' gain from the sale of their ExCo stock. Gain from the sale of capital assets (such as corporate stock) is generally the difference between the fair market value of the asset at the time of disposition, and the taxpayer's basis in the asset.⁴⁴ Assume that TXs' aggregate basis in their stock is \$60.
3. *Managers (Ms)*. Ms manage ExCo. Ms also own 10% of ExCo's equity as a form of incentive pay. Like TXs, Ms are taxable shareholders. Ms' basis in their ExCo stock is \$20.

Assume that all corporate tax savings accrue to shareholders. For example, if ExCo is able to save \$10 in tax liability, the value of the corporate stock increases by \$10, and shareholders share in the value-increase in

⁴⁰ Such an assumption is reasonable under the pre-TCJA rates. The top federal corporate tax rate in the United States was 35%. Adding state and local corporate taxes to the federal tax rate brings the average marginal tax rate on corporate income very close to 40%. See, Kari Jahnsen & Kyle Pomerleau, *Corporate Income Tax Rates around the World, 2017*, TAX FOUNDATION FISCAL FACT NO. 559 2 (Sep., 2017) (finding that "the federal statutory rate of 35 percent plus an average of the corporate income taxes levied by individual states" is 38.91%).

⁴¹ As explained above, this is a reasonable assumption based on recent studies finding that tax-exempt entities hold the majority in U.S. equity markets. See, *supra* note 19 and accompanying text.

⁴² In reality, taxable shareholders vary in their tax preferences. See, Marian, *Tax Law and Securities Regulation*, *supra* note 17. However, for purposes of the stylized model I simply divide all shareholder into two categories of tax interests in order to present the conceptual argument about shareholders tax heterogeneity.

⁴³ This assumption is reasonably close to reality. Under current law, the top statutory tax rate applied to long-term capital gains and certain qualified dividends is 20%. I.R.C. §1. In addition, certain taxpayers with adjusted gross income above a specific threshold are subject to tax on "net investment income" at a rate of 3.8%. This tax applies to capital gains and dividends income. I.R.C. §1411. Thus, the total tax paid at the shareholder level on gains from long term investments or qualified dividends is 23.8%.

⁴⁴ I.R.C. §1001

proportion to their ownership interests. In reality, of course, it is not at all clear who bears the burden of corporate taxation, and who benefits from corporate tax savings.⁴⁵ Theoretically, corporate tax can burden labor in the form of lower wages, burden capital in the form of lower stock price, or burden consumers in the form of higher prices on corporate products.⁴⁶ For purposes of the examples, the most conservative assumption is that shareholders reap all the benefits of corporate tax savings.⁴⁷

Also assume that any tax planning schemes by ExCo bear no planning costs, and that they are legal. This, again, is a conservative assumption. In reality there are always costs associated with a tax planning transaction,⁴⁸ and almost all tax planning schemes contain some level of legal uncertainty.⁴⁹ Planning costs and legal uncertainty reduce the utility of a tax planning arrangement.

Finally, assume that Ms' compensation is linked to ExCo's after-tax financial results. Namely, a decrease in corporate tax liability results in an increase in Ms' compensation.

Benchmark: Shareholder value with no Planning. For simplicity, let us assume that ExCo's value is its net asset value, and there is only one year of corporate operations (the examples can easily be extended to multiple period as I explain below⁵⁰; I use one period for simplicity). Assume that during the year, ExCo earns additional \$1,000 in taxable income, that ExCo does not engage in any tax planning, and makes no distributions to shareholders. Under such assumptions the expected after-tax value of ExCo at the end of

⁴⁵ For a recent summary of the discussion on who bears the corporate tax burden, see Kimberly A. Clausing, *In Search of Corporate Tax Incidence*, 65 TAX L. REV. (2012).

⁴⁶ WILLIAM M. GENTRY, DEP'T OF THE TREASURY, OFFICE OF TAX ANALYSIS, OTA PAPER 101, A REVIEW OF THE EVIDENCE ON THE INCIDENCE OF THE CORPORATE INCOME TAX 1 (2007) ("The corporate tax could be borne by some combination of the shareholders of corporations, investors in all capital through a decrease in the overall return to capital, workers through a decrease in wages, and customers through increased output prices").

⁴⁷ Less conservative assumption would take into account the fact that shareholders do not reap all the benefits from corporate savings. This would make it even more likely for shareholders to be overall losers from corporate tax planning.

⁴⁸ Ronald J. Gilson, Myron S. Scholes, & Mark A. Wolfson, *Taxation and the Dynamics of Corporate Control: The Uncertain Case for Tax-Motivated Acquisitions*, in KNIGHTS, RAIDERS, AND TARGETS: THE IMPACT OF THE HOSTILE TAKEOVER 271, 272 (John C. Coffee, Jr., Louis Lowenstein, & Susan Rose-Ackerman eds., 1988) ("For there to be a net tax gain as a result of an acquisition, the tax gain must exceed the transaction and information costs associated with the [acquisition]").

⁴⁹ Sarah B. Lawsky, *Modeling Uncertainty in Tax Law*, 65 STAN. L. REV. 241, 257-68 (2013) (developing a model to evaluate the utility of tax compliance taking into account legal uncertainties).

⁵⁰ See, *infra* at I.e

the year (V_1) is:

$$V_1 = \$1,000 + \$1,000 \times (1 - 0.4) = \$1,600$$

Considering the ownership interests in ExCo, the equity holding values of TEs, TXs, and Ms (expressed V_{TE} , V_{TX} , and V_M , respectively) at the end of the year are:

$$V_{TE} = 60\% \times 1,600 = \$960$$

$$V_{TX} = 30\% \times 1,600 = \$480$$

$$V_{MS} = 10\% \times 1,600 = \$160$$

These “no-planning” values will serve as benchmarks for the examples below.

In the case of TXs and Ms, there is an additional important assumption: That they do not intend to dispose of their stock in the foreseeable future. Otherwise, we should reduce the value to TXs and Ms by the expected tax cost upon disposition. Under the assumption in the examples, however, TXs and Ms plan to dispose of the stock far enough in the future, so the NPV of their shareholder-level tax is minimal, and therefore ignored.⁵¹ Even if this assumption is relaxed, the argument stands. The examples below could be replicated with a slightly reduced value to TXs and Ms (meaning, taking into account the NPV of their expected tax liability), by using slightly different numbers. I assume zero NPV of future taxes for the sake of simplicity.

For ease of reference, Table 1 summarizes the benchmark position of each shareholder.

Table 1

Shareholder Group	Ownership Percentage	Basis	No-Planning Value
Tax Exempt (TE)	60%	N/A	\$960
Taxable (TX)	30%	\$60	\$480
Managers (M)	10%	\$20	\$160

b. Example 1 – Corporate Tax Planning that is not Pareto-Optimal

⁵¹ This is a reasonable assumption, for example, for shares held in taxable investment for retirement (for example, in mutual funds). Consider TXs. Their expected gain from disposition of their stock would be the FMV of their stock *minus* their basis, or $\$480 - \$60 = \$420$. At a 25% tax rate, their expected shareholder level tax liability is $0.25 \times \$420 = \105 . Assuming TXs plan to hold the stock for 40 years until retirement, and market discount rate for a 40 year investment is 7%, the NPV of their currently expected tax liability is $\$105 / (1.07)^{40} = \7.01 . For purpose of the example, we shall assume the NPV of future tax liabilities nears zero.

Assume now that before the beginning of the year, ExCo's management identifies a tax planning opportunity. Under the plan, ExCo will be able to maintain its operational results (meaning, \$1,000 in income), but will only have to report a portion of such income on its tax returns. The rest of the income remains untaxed. For example, assume that ExCo changes its place of incorporation for tax purposes, and becomes New ExCo, a foreign corporation (such transaction is known as an "inversion").⁵² New ExCo is identical to ExCo, except by name and place of incorporation. Assume that the reincorporation enables New ExCo to avoid tax on 50% of its \$1,000 income. New ExCo's end of the year value after planning (V_p) is:

$$V_p = \$1,000 + \$500 \cdot (1 - 0.4) + \$500 = \$1,800$$

ExCo's value increases by the amount of tax saved ($40\% \times \$500 = \200). This makes the tax plan seem like a desirable transaction to all parties involved.

However, now assume that the transaction is an STCT (as most inversions are). Namely, the tax-planning scheme deems the shareholders to dispose of their ExCo stock in exchange for New ExCo stock, in a taxable transaction. Also assume that after the transaction is announced, ExCo's stock value increases to reflect the expected tax savings. This "deemed sale" of ExCo's stock in exchange for New ExCo's stock creates a taxable gain (with no associated cash flow) to each shareholder.

The taxable gain is the difference between the fair market value of the stock, and the shareholder's basis in the stock. For example, TXs now own stock valued at \$540 (30% of \$1,800). Their taxable gain is the difference between such value and their basis of \$60, meaning $\$540 - \$60 = \$480$. At a tax rate of 25%, their tax liability resulting from the transaction is $25\% \times \$480 = \120 . Taking into account the tax liability, TXs' net position value is $\$540 - \$120 = \$420$. This is *less* than the net value to TXs under the "no planning" benchmark of \$480.

Table 2 below compares the values to each shareholder, with and without tax planning.

⁵² I discuss inversions below. *Infra* at Part III.b.

Table 2

	(a)	(b) ⁵³	(c)	(d)	(e)
	No planning value	Gross planning value	Tax liability	After tax value (b) – (c)	Net gain (loss) (d) – (a)
ExCo's value	\$1,600	\$1,800	N/A	\$1,800	\$200
TEs	\$960	\$1,080	0	\$1,080	\$120
TXs	\$480	\$540	\$120	\$420	(\$60)
Ms	\$160	\$180	\$40 ⁵⁴	\$140	(\$20)
Total value SH	\$1,600	\$1,800	N/A	\$1,640	\$40

TEs benefit from the corporate-level savings. They enjoy an increase in their stock value proportional to their interest in the corporate-level tax saving (60% of total corporate tax savings of \$200, or \$120). Because they are tax exempt, they have no shareholder-level liability. The fact that TE hold the majority interest in ExCo assures that shareholders approve the proposed transaction.

Both TXs and Ms, however, suffer a net detriment. In both cases, their personal tax liability triggered by the transaction exceeds their benefit from the corporate-level tax savings. Consider TXs, for example. TXs enjoy thirty percent (their proportional holding in ExCo) of the \$200 savings, for a total of \$60. However, they also suffer a shareholder-level tax liability of \$120. Effectively, they are paying \$120 in shareholder-level tax, for a \$60 corporate-level tax benefit. In total, they suffer a \$60 of additional tax burden. Using similar calculations, Ms suffer a \$40 tax increase.

The result is not Pareto-optimal. TEs are better off, but all other shareholders are worse off. Even though the corporation saved \$200 in taxes, the total after-tax value to shareholder only improves by \$40. \$160 of the corporate-level tax savings are lost to shareholder-level tax (and show up as government revenue). The transaction, however, is Kaldor-Hicks efficient. Shareholder value increased by \$40 (from \$1,600 with no planning, to \$1,640 with planning).

The bottom line is that there is a value transfer of \$60 from TXs, and \$20 from Ms, to TEs. The total tax-planning value to shareholders is \$40. TEs,

⁵³ For each group, the gross planning value is its proportional share of the corporate equity after taking into account the increase attributable to the tax plan. For example, TEs' value is sixty percent of \$1,800, or \$1,080.

⁵⁴ Ms had a basis of \$20. Their taxable gain is therefore \$180 - \$20 = \$160. At twenty-five percent tax rate, their tax liability $0.25 \times \$160 = \40 .

however, receive a \$120 benefit (more than the total benefit). This is only possible because TXs and Ms pay for the \$80 difference (\$60 from TXs + \$20 from Ms).

Note that revenue collection also suffers. The government is not able to recuperate all the revenue lost due to the tax plan. The government is only able to recapture \$160 in shareholder-level taxes, after suffering a loss of \$200 in corporate tax revenue.

c. Example 2 – A Kaldor-Hicks Inefficient Result

Assume the same facts as in example 1 except for the following modification: Instead of reducing taxable income by fifty percent, the tax-planning scheme only reduces the corporate taxable income by twenty percent. Eighty percent of the corporate income (i.e., \$800) remains taxable.

ExCo's end of year value will be:

$$V_p = \$1,000 + \$800 \times (1 - 0.4) + \$200 = \$1,680$$

At 40% corporate tax rate, excluding \$200 from income saves ExCo \$80 in taxes. The transaction still increases ExCo's value. However, once we consider shareholder-level taxes, the overall tax burden *increases*. Table 3 summarizes these outcomes.

Table 3

	(a)	(b) ⁵⁵	(c)	(d)	(e)
	No planning value	Gross planning value	Tax liability	After tax value (b) – (c)	Net gain (loss) (d) – (a)
ExCo's value	\$1,600	\$1,680	N/A	\$1,680	\$80
TEs	\$960	\$1,008	0	\$1,008	\$48
TXs	\$480	\$504	\$111 ⁵⁶	\$393	(\$87)
Ms	\$160	\$168	\$37 ⁵⁷	\$131	(\$29)
Total value	\$1,600	\$1,680	N/A	\$1,532	(\$68)

As in the previous example, TEs receive a net financial benefit. Since TEs

⁵⁵ For each group, the gross planning value is its proportional share of the corporate equity after taking into account the increase attributable to the tax plan. For example, TEs' value is sixty percent of \$1,680, or \$1,008.

⁵⁶ TXs had a basis of \$60 in their stock. Their taxable gain is therefore \$504 - \$60 = \$444. At a twenty-five percent tax rate, their tax liability is 0.25 x \$444 = \$111.

⁵⁷ Ms had a basis of \$20 in their stock. Their taxable gain is therefore \$168 - \$20 = \$148. At a twenty-five percent tax rate, their tax liability is 0.25 x \$148 = \$37.

hold the majority vote, they will be able to have the transaction approved.

The striking difference compared with the previous example, however, is that the transaction is a net-loss overall. Shareholders' aggregate tax burden is heavier than the corporate-level tax savings. This is a counterintuitive outcome. At the corporate level there are tax savings of \$80. However, the combined tax cost to TXs (\$111), and Ms (\$37), exceeds the corporate level tax saving. As is shown in the table, ExCo's shareholders are \$68 worse off overall compared with the non-planning benchmark. In other words, even though the corporate tax plan saved corporate taxes, it destroyed value to shareholders.

One might expect managers to prevent such transactions because they are inefficient to shareholders, and because managers themselves are worse off (by \$29). However, as the next example shows, managers will be able to secure TEs' cooperation to compensate managers for their personal tax cost.

In this example, the government is *better off* because of the corporate tax-reducing scheme. While the government suffers a revenue loss of \$80 in corporate taxes, it more than compensated for it by collecting \$116 in shareholder-level taxes.

d. Example 3 – Tax Gross-Up Payments

The transactions described in examples 1 and 2 are detrimental to Ms, but Ms are in a position to change that. Ms are in charge of drafting the transaction documents. Theoretically, they could require ExCo to indemnify Ms for any personal tax cost resulting from the transaction. Certain types of such "tax gross up" payments are common in practice.⁵⁸

Consider Example 2 above. In that case, the managers expect to incur a personal tax cost of \$37. They can cause ExCo to reimburse them for this cost. The reimbursement payment, however, must be higher than \$37. The reason is that any tax payment by ExCo on behalf of Ms, is itself taxable income to Ms.⁵⁹ Thus, ExCo will have to pay Ms $\$37/(1-t)$ (where t is the managers' individual tax rate) in order for the gross up to account for Ms increased tax liability. Assuming managers are taxed at twenty-five percent rate like other shareholders, the grossed-up amount is about \$49.34. When Ms are charged with a twenty-five percent capital gains tax on such amount, they are left with \$37 at hand, just enough to cover their personal tax loss.⁶⁰

⁵⁸ Walker, *Another Critical Look*, *supra* note 29.

⁵⁹ *Old Colony Tr. Co. v. Comm'r of Internal Revenue*, 279 U.S. 716, 729, (1929) ("The discharge by a third person of an obligation to [a person taxed] is equivalent to receipt by the person taxed").

⁶⁰ Calculated as follows: $\$49.34 \times (1 - 0.25) = \37 .

\$49.34, however, is actually *too high* for a gross-up payment. The reason is that Ms also enjoy an increase in their equity value because of the corporate tax savings. Recall that in Example 2 the tax-planning scheme saved \$80 in taxes to the corporation. Ms, holding ten percent of the corporate stock, get a benefit of \$8 as a result (ten percent of \$80). However, we cannot simply reduce the amount of gross up payment by \$8, because any increase in corporate assets (here, as a result of reducing the gross up payments), conveys, again, a partial benefit to Ms in their capacity as capital owners of the corporation. Using the Goal Seek function in Excel to solve for this cascading calculation results in a gross-up payment of about \$42.96.

After the dust settles, ExCo's value is (where V_{pi} denotes value that includes management gross up):

$$V_{pi} = \$1,000 + \$800 \times (1 - 0.4) + \$200 - 42.96 \approx \$1637.04$$

Table 4 below summarizes the outcomes, taking into account the tax gross up payment:

Table 4

	(a) No planning benchmark	(b) Gross after- planning Value	(c) Shareholder tax (25% on taxable gain)	(d) Net value after planning (b - c)	(e) Tax Gross Up	(f) Tax on gross up (0.25 x (e))	(g) Net difference after planning (d - a + e -f)
ExCo's value	\$1,600	\$1,637.04	N/A	\$1,637.04	\$0		\$37
TEs	\$960	\$982.22	0	\$982.22	\$0	N/A	\$22.22
TXs	\$480	\$491.11	\$107.78 ⁶¹	\$383.33	\$0	N/A	(\$96.67)
Ms	\$160	\$163.70	\$35.93 ⁶²	\$127.78	\$42.96	\$10.74 ⁶³	\$0.00
Total value	SH \$1,600	\$1,637.04	N/A	\$1,493	N/A	N/A	(\$74.44)

⁶¹ TXs had a basis of \$60 in their stock. Their taxable gain is therefore $\$491.11 - \$60 = \$431.11$. At a twenty-five percent tax rate, their tax liability is $0.25 \times \$431.11 = \107.78 .

⁶² Ms had a basis of \$20 in their stock. Their taxable gain is therefore $\$163.70 - \$20 = \$143.70$. At a twenty-five percent tax rate, their tax liability is $0.25 \times \$143.70 = \35.93 .

⁶³ As explained above, the gross up payment is itself taxable income to Ms. *See, supra* note 59. For simplicity, assume that the tax rate on the gross up payment is also twenty-five percent. Ms' tax liability resulting from the gross-up payment is $0.25 \times \$42.96 = \10.74 .

Draft of 3/15/2018

Since the managers are now tax-indifferent in their capacity as shareholders, the transaction can move forward relying on TEs' majority vote. In fact, Ms are probably happy to move forward with the transaction. If their compensation is linked to ExCo's after-tax results, they will see an increase in compensation. TXs are in no position to prevent the transaction, even though it is detrimental to them. TEs would rationally support the transaction even though they are giving up a little bit of their tax benefit in order to gross-up managers. At the same time, they force TXs to carry some of the burden of the gross-up cost. This adds insult to injury, since for TXs the transaction is already a loss transaction. Also, note that the total loss was \$68 in example 2, but is about \$74.44 in example 3. The difference (\$6.44) is the deadweight loss resulting from the gross up payment to management.

Again, the transaction is potentially beneficial to the government. Here, the government loses \$80 in corporate tax revenue ($\$200 \times 40\%$). The government, however, collects more than that in shareholder taxes. The government collects \$107.78 from TXs, and \$46.67 from Ms (\$35.93 in capital gains and \$10.74 tax on the gross-up payment). In total, the government gains about \$74.47 ($\$107.78 + \$46.67 - \80).

Conceptually, one can think of such transactions as a shift of the corporate tax burden to taxable shareholders. Tax-exempt shareholders benefit from the increase in corporate net value. Managers benefit because their compensation increases. To summarize, tax-exempt investors and corporate managers have every incentive to cooperate and approve STCTs that include gross-ups, at the expense of taxable investors.

e. Adjusting the Examples to Account for Multiple Periods.

It is easy to adjust the examples to account for multiple periods (though it is not necessary for purposes of understanding the generic argument). Consider, for example, TXs in example 2.⁶⁴ Their current net tax detriment is -\$87. However, in NPV terms, this detriment is overstated. Assume, for example, that TX choose to hold on to their stock after the transaction, and that ExCo's earnings are always \$1,000 a year. As long TXs hold on to the stock, they enjoy their proportional share of future corporate tax savings. Meaning, they enjoy the future benefit of thirty percent of \$80 annual savings, or \$24. On the other hand, this \$24 value increase also carries with it a future tax burden of twenty-five percent on the increased stock value (the capital gains tax). In other words, there is a future annual benefit to TX of $\$24 \times (1 - 0.25) = \18 .

If, for example, the discount rate in the market is five percent, the NPV

⁶⁴ *Supra*, at Part I.b.

of recuperating \$18 next year is $\$18/1.05 = \17.14 . This means that for a shareholder planning to sell the stock next year, the true NPV of the tax detriment in example 1 is $-60 + 17.14 = -\$42.86$. The NPV of the tax saving two years from now is $18/(1.05)^2 = \$16.32$. Thus, for a taxable shareholder intending to hold the stock for two years, the NPV will be: $-\$60 + \$17.14 + \$16.32 = -\26.54 .

In other words, at some point taxable shareholders will recuperate their loss.⁶⁵ This does not change the argument, though, for two reasons: First, in reality, corporate tax savings are likely significantly less dramatic than the savings in the examples. Corporations will rationally engage in tax planning to save a few percentage points of effective tax rates. This argument is even stronger after the recent reform, which significantly cut corporate tax rates. This means that corporate tax savings are likely less valuable than before the reform. With small corporate level savings, taxable investor would have to hold the stock for long periods to recoup their losses, if at all.⁶⁶ Second, even if one assumes that at some point taxable shareholders recuperate the loss, this does not change the fact that an STCT takes away shareholders' control of their own tax outcomes (possibly against their will). Consider, for example, a shareholder who planned to retire next year, and is suddenly hit with a huge unplanned tax bill because of an STCT. Such shareholder will have to change her retirement schedule to recuperate her loss (if possible) or retire and accept less-than-planned retirement money.

II. STCTS AND THE LINK BETWEEN CORPORATE TAX AND CORPORATE GOVERNANCE

There is a large body of literature on the relationship between taxation and corporate governance.⁶⁷ In this part I survey relevant literature and

⁶⁵ For taxable shareholders in Example 2 this will happen if they plan to hold the stock for about four years after the transaction, since the NPV of the tax corporate savings will be \$63.83, result in NPV at the time of the transaction of $-\$60 + \$63.83 = \$3.83$.

⁶⁶ For example, in inversions transactions, recent modeling suggests that some taxable investor lose on an NPV basis. See, Babkin, Glover, & Levine *supra* note 20, at 228 (“We find that this upfront cost outweighs the future benefits for 19.5% of shareholders”).

⁶⁷ See, e.g., Doran, *supra* note 2; Arlen & Weiss, *supra* note 3; Kanda & Levmore, *supra* note 25; Steven A. Bank, *Capital Lock-In*, *supra* note 2, at 94 (suggesting that the corporate double tax is a governmental response to managers' practice of locking-in capital within the corporation); Reuven S. Avi-Yonah, *Corporations, Society, and the State: A Defense of the Corporate Tax*, 90 VA. L. REV. 1193, 1225 (2004) (arguing that the corporate tax was conceived “as a regulatory device to restrict managerial power”) [Hereinafter: *Avi-Yonah, Corporations, Society, and the State*]; Steven A. Bank, *Corporate Managers, Agency Costs, and the Rise of the Double Taxation*, 44 WM. & MARY L. REV. 167 (2002) (arguing that the double corporate tax system is a historical compromise aimed at appeasing corporate managers who objected the idea of tax on undistributed earnings.); Marjorie E. Kornhauser, *Corporate Regulation and the Origins of the Corporate Income Tax*, 66 IND. L. J. 53 (1990)

explain how the identification of STCTs as a distinct category of corporate transaction contribute to current academic discourse.

a. Agency Cost as an Explanatory Factor in the Persistence of the Double-Tax Model

Among academics, there is a widespread agreement that the double tax model of corporate income is flawed, and that a single tax model—integrating corporate and shareholder taxes—is better.⁶⁸ Tax literature offers multiple models of integration, each with its own benefits and drawbacks.⁶⁹ Multiple other countries implemented some form of integration.⁷⁰ Nonetheless, the two-tier system survived in the United States for more than a century now⁷¹, and even endured the 2017 tax reform. Attempts to reform our corporate tax system to integrate corporate and shareholder taxes have failed.⁷²

Scholars have offered various explanations to the persistence of our double-tax system.⁷³ Among others, scholars considered the possibility that agency costs hold some explanatory power. One oft-referred article is Arlen and Weiss' *Political Theory of Corporate Taxation*.⁷⁴ Arlen and Weiss argue that shareholders and managers have different tastes for tax breaks. Integration of corporate and individual tax, they argue, “confers a windfall on existing assets, thereby help existing shareholders”.⁷⁵ The underlying assumption here is that when shareholders price their investments, they account for the double-tax. If the double-tax is replaced with integration (that is, a single tax), shareholders receive a windfall.

(arguing that the corporate income tax was originally enacted to regulate managerial power and abuse). For summaries of this voluminous literature see, *e.g.*, Schizer, *supra* note 3; Mihir A. Desai & Dhammika Dharmapala, *Tax and Corporate Governance: an Economic Approach*, in TAX AND CORPORATE GOVERNANCE 13 (Wolfgang Schön, ed., 2008); John R. Graham, *Taxes and Corporate Finance: A Review*, 16 REV. OF FIN. STUD. 1075 (2003).

⁶⁸ Doran, *supra* note 2, at 528 (“Both policy makers and academics generally agree that the double tax results in significant distortions of economic and business decisions and argue for its repeal”); Arlen & Wise, *supra* note 3, at 326 (The two-tier taxation is ‘unusual, unfair and inefficient’); Warren, *supra* note 2, at 798 (Concluding that the double tax system “is defective because otherwise equivalent cases receive substantially different treatment. The results are undesirable in terms of the potential effects on economic welfare, the complexity of the resulting distinctions and the unfairness of treating similar transactions differently”);

⁶⁹ For a survey of various models of corporate and shareholder-level tax integration see, REUVEN AVI-YONAH, NICOLA SARTORI & OMRI MARIAN: GLOBAL PERSPECTIVES ON INCOME TAXATION LAW 143-46 (2011).

⁷⁰ *Id.*, at 146-48.

⁷¹ Doran, *supra* note 2, at 518-519.

⁷² *Id.*, at 521.

⁷³ For a survey of such literature see, Bank, *Capital Lock-in*, *supra* note 2, at 895-901.

⁷⁴ Arlen & Wise, *supra* note 3.

⁷⁵ *Id.*, at 338.

Unlike shareholders, managers have little “to benefit from tax cuts that produce a windfall”.⁷⁶ Managers—who are “heavily dependent of the fortunes of the firms they manage”⁷⁷—“gain from [tax breaks] for new investments.”⁷⁸ As such, managers lobby for tax breaks that encourage new investment (such as accelerated depreciation), but not for integration.⁷⁹ Arlen and Weiss suggest that managers would not necessarily oppose integration, but will also not vigorously advocate for it.⁸⁰ Unlike managers, shareholders face a collective action problem, and cannot effectively lobby for their preferred tax break.⁸¹ The essence of the argument is that shareholders’ tax preferences remain muted in corporate tax reform discourse. This difference between shareholders and managerial tax interests is the “key to explaining the failure of integration efforts”.⁸²

Arlen and Weiss agency-cost explanation was the subject of convincing criticism.⁸³ Their theory suffers from several problematic assumptions, and ignores important practical and legal realities. For example, the idea that shareholders cannot mount a successful lobbying effort in support of their own tax interests seems questionable. Large institutional investors (many of which are tax exempt), dominate U.S. equity markets.⁸⁴ Such investors do not face the same collective action problems as individual taxable shareholders, and can (and do) advance effective lobbying campaigns.⁸⁵

Another failure in Arlen and Weiss’ explanation is that—contrary to their assumption—there is a reason to expect that managers gain significantly from tax breaks that benefit existing capital. Recall that managers themselves are shareholders and hence would enjoy any “windfalls” of integration. In addition, tax breaks that reduce corporate-level tax liability in respect of

⁷⁶ *Id.*, at 338.

⁷⁷ *Id.*, at 336.

⁷⁸ *Id.*, at 341.

⁷⁹ *Id.*, at 342.

⁸⁰ *Id.* at 327 (“[W]hile many managers support integration, they would rather devote corporate resources to lobbying for tax preferences such as ACRS and ITC, that encourage new investment”).

⁸¹ *Id.*, at 363 (“Shareholders typically are too dispersed to exert significant control over corporate investment decisions or to lobby congress directly”).

⁸² *Id.*, at 327.

⁸³ See, e.g., Doran, *supra* note 2, at 523 (Responding to Arlen and Weiss, concluding that “the persistence of the corporate double tax cannot be explained simply as a failure of managers to act in the interest of shareholders”).

⁸⁴ For 2013, The Organisation for Economic Co-operation and Development (“OECD”) estimated that about 60% of all equities traded on U.S. markets are owned by institutional investors. See Serdar Çelik and Mats Isaksson, *Institutional Investors and Ownership Engagement*, 2013 OECD JOURNAL: FINANCIAL MARKETS TRENDS 93, 96 (2014).

⁸⁵ Doran documents several instances in which institutional shareholders had discernable effect on corporate tax reform proposals. See, Doran, *supra* note 2, at 581, 584.

existing investment, also benefit managers. If managers' compensation increases with the price of the corporate shares, tax saving on returns generated by existing corporate investments (which is likely to boost share prices) enhances managers' compensation.⁸⁶ Thus, even under Arlen and Weiss' framework, managers have a reason to lobby for tax breaks that confer windfall to existing investment. In fact, managers specifically design many STCTs to save potential future taxes on *existing investment*. For example, one of the main benefits of a corporate inversion transaction (discussed below)⁸⁷, is to save tax on *past* earnings held in offshore affiliates.

It is also misguided to detach tax breaks that confer windfall to existing investment, from new investment opportunities. Any reduction in shareholder-level tax liabilities leaves more funds in private hands, making it easier to finance new investment.⁸⁸ For example, even if integration is just a "windfall" to existing shareholders, it makes the cost of new equity investment lower, which in turn makes it cheaper for managers to raise new capital.

Most importantly for purpose of my argument herein, however, is the fact that Arlen and Weiss fail to take into account corporate stakeholders' tax heterogeneity.⁸⁹ Arlen and Weiss seem to assume that shareholders are homogenous in their tax preferences, and that shareholders' preferences are different from the homogenous preferences of managers. Michael Doran criticizes Arlen and Weiss precisely on this point.⁹⁰ He correctly notes that different managers have different tax interests depending on the tax status of the firms they manage. Similarly, different shareholders have different tax preferences, depending on their personal tax status. Heterogeneous tax preferences leads different corporate agents to prefer different integration models.

⁸⁶ For example, existing investment may produce a steady stream of income to the corporation from rents, interest or royalties. Reducing the tax rate on such income creates a windfall to the corporation. If managers' compensation is tied to corporate performance, they share in that windfall.

⁸⁷ *infra* at Part III.b.

⁸⁸ Randall Morck & Bernard Yeung, *Dividend Taxation and Corporate Governance*, 19 J. ECON. PERSP. 163, 167 (2005). ("Cutting taxes on dividends, all else equal, should raise share prices, lower companies' costs of capital and raise corporate investment").

⁸⁹ Different stakeholders may prefer different models of integration. For a discussion on shareholders' heterogeneity in preferences for integration models see, Doran, *supra* note 2, at 547-563.

⁹⁰ *Id.*, at 522-523 ("[Arlen and Weiss'] agency-cost explanation... does not adequately account for important points, including the substantial heterogeneity of interests that managers, shareholders, and other parties have with respect to the double tax or the differential effects that various integration models would have on managers, shareholders, and other parties").

There is no reason to assume that all shareholders would want integration or that if they do, they would all want the same type of integration.⁹¹ Consider the following most “generic” models of integration: “Dividend deduction”, “dividend exemption”, and “imputation”.

In a *dividend deduction model*, corporations receive corporate-level deduction for dividends paid to shareholders. The effect is to eliminate corporate tax on distributed profits, and generate a single level of tax at the shareholder-level. This is great for tax-exempt shareholders: corporate tax is eliminated, and the receipt of dividends is not taxed to them due to their tax-exempt status. Dividend deduction effectively eliminates all tax burden on tax-exempt shareholders. Dividend deduction may also benefit taxable investors, because it eliminates corporate level tax (though the dividends themselves remain taxable).⁹² However, taxable shareholders may have a different interest than tax-exempts for the timing corporate distributions. Tax-exempt shareholders would always benefit from a distribution, while taxable shareholder would only benefit if their personal tax cost is less than the corporate level tax savings. This depends on a taxable shareholder personal tax position at any given time.

Tax-exempt shareholders may object to a *dividend exemption model* of integration. Under a dividend-exemption model, corporate income is taxed at the corporate level, but distributions to shareholders are exempt. This makes no tax-difference to tax-exempt shareholders who are not subject to tax on corporate distributions. However, taxable shareholders would very much benefit from such an exemption. Stated differently, under the current system tax-exempt shareholders have a significant competitive edge over taxable investors when pricing corporate stock.⁹³ Under a dividend-exemption model, tax-exempt investors lose such advantage, and hence have a good reason to object to such model.

Finally, under an *imputation model*, corporate income is subject to tax, but shareholders receive a credit for their proportional part in corporate-level tax liability, and use the credit to offset their own taxes.⁹⁴ Corporate tax is

⁹¹ *Id.*, at 546 (different shareholder-level tax circumstance create “different, and potentially inconsistent, interests among shareholders”).

⁹² Thus, whether the deduction is beneficial depends on the rate differential between the investor’s personal taxes, and the corporate taxes saved.

⁹³ Tax-exempt investors can always outbid taxable investors for the same investment. For example, if a taxable investment generates ten percent annual return, but the tax rate is thirty percent, a taxable investor net return will be seven percent, and he will only be willing to offer a price reflecting such return. A tax-exempt investor can always offer a slightly higher price, because it expects to enjoy the full ten percent return.

⁹⁴ For example, assume that the corporate tax rate is 20%, and the individual tax rate is 40%. A corporation earns \$100, and pays tax of \$20, leaving \$80 of available dividend.

effectively an “advance” on shareholder tax. Taxable shareholders would obviously benefit from such a system. Tax-exempt shareholder will not. Tax-exempt shareholders have no use of the credit, because they have no personal taxable income against which to apply the credit.

Tax heterogeneity also affects managers’ incentives. There is no reason to assume that all (or most) managers have the same taste for integration, as suggested by Arlen and Weiss. For example, Doran argues that managers of low-taxed corporations “rationally should prefer a system of double taxation that imposes high relative tax rates on other corporations to a system of integration, even if the integrated system would reduce all corporate effective tax rates in absolute terms.”⁹⁵ Conversely, “managers at high-tax corporations... should prefer a leveling of effective tax rates through integration to the continuation of uneven effective tax rates under the status quo.”⁹⁶

Doran concludes that it is wrong to attribute the survival corporate tax system “to the divergence of interests between managers (understood as a single group) and shareholders (understood as a single group)”.⁹⁷ Instead, he attributes it “to the divergence of interests *among* managers, the divergence of interests *among* shareholders, and the divergence of interests *among* other parties affected by the double tax.”⁹⁸ The bottom line is that different integration proposal will have different winners and losers, and to-date, Congress was unable to design an acceptable political compromise.

The STCT frameworks adds another level to Doran’s criticism. Doran shows that by ignoring corporate stakeholder’s heterogeneity of tax preferences, Arlen and Wise misrepresent the rational interests of various agents in tax reform discourse. My addition is to show that tax heterogeneity also affects the interests of stakeholders in respect of on-going corporate operations. Under Arlen and Weiss’ framework, shareholders benefit from tax savings regardless if the saving is at the corporate or the shareholder level. What matters in their framework, is that there be a single, rather than double, tax. STCTs prove this assumption incorrect. Once we consider STCTs, it

Nonetheless, the shareholder dividend is grossed-up for the corporate tax paid, and the shareholder is treated as receiving \$100 in taxable dividend. The shareholder’s tax liability is therefore \$40 (forty percent of \$100), but the shareholder also receives a credit for the corporate tax paid (\$20). Thus, the shareholder only has to remit the remaining \$20 to the tax authority. The total tax paid is forty percent, which represents a single level of tax paid at the shareholder’s personal rates: \$20 are paid by the corporation, and \$20 by the shareholder.

⁹⁵ Doran, *supra* note 2, at 541.

⁹⁶ *Id.*, at 541-542.

⁹⁷ *Id.*, at 523.

⁹⁸ *Id.*

becomes clear that it is sometimes rational for shareholders to object corporate-level tax reduction. Stated differently, a single tax model does not necessarily produce a lower overall tax burden for all shareholders. In STCTs, the elimination of corporate level tax, is sometimes translated to a higher (single-level) shareholders tax.

b. Corporate Taxation as a Governance Instrument

i. Corporate tax and shareholders' heterogeneous tax preferences

Hideki Kanda & Saul Levmore's seminal paper⁹⁹ suggests that the separate taxation of corporate entities mitigates agency costs. They start with the presumption that managers' and shareholders have diverse tax interests.¹⁰⁰ Kanda and Levmore recognize that shareholders themselves have diverging tax interests and are "therefore in occasional conflict with one another."¹⁰¹ This is a source of a conflict of interest between managers who hold equity in the corporations they run, and other shareholders. In their capacity as equity holders, managers may prefer their own shareholder-level tax-interests to the tax-interests of other shareholders. Kanda and Levmore suggest that the double-tax model mitigates this problem, because it "equalizes' shareholders' preferences for corporate transactions even though shareholders are in diverse individual tax circumstances."¹⁰²

In order to explain how such "equalization" works, Kanda & Levmore imagine an alternative system of "pass-through" taxation, "in which corporations are *not* separately taxed"¹⁰³ but instead, "shareholders are taxed each year, at their respective individual rates, on their imputed shares of the firm's income."¹⁰⁴ This is, in fact, how taxation of partners in partnerships generally works under current law.¹⁰⁵ Such pass-through model is another potential model of integration.¹⁰⁶ In such a case, agency costs arise since the manager "will want to make corporate decisions that benefit managers' own tax situation."¹⁰⁷ For example, the manager's "self-interest is likely to involve retaining appreciated assets (inside the corporation) in order to postpone

⁹⁹ *Supra* note 25.

¹⁰⁰ *Id.*, at 229. (Our argument focuses on the fact that [managers'] individual tax rate will often be different from that of other shareholders, or principals.

¹⁰¹ *Id.*

¹⁰² *Id.*, at 213.

¹⁰³ *Id.*, at 229

¹⁰⁴ *Id.*, at 229.

¹⁰⁵ I.R.C. §701

¹⁰⁶ Under a "pass-through" model, all entity-level tax attributes simply flow through to the equity owners, who pay tax on their share in the entity profits.

¹⁰⁷ Kanda, and Levmore, *Supra* note 25, at 230.

recognizing gain, when lower-taxed shareholders would prefer that the corporation sell these assets and perhaps invest in other assets.”¹⁰⁸

When the corporate entity and its shareholders are taxed separately, however, the tax interest of the shareholders and managers are aligned. This is so because “in-corporate” tax consequences presumably do not affect shareholder-level taxation. “By ... taxing a corporation as a distinct entity, tax law causes all shareholders to agree (at least in tax terms) on timing questions. It is in [the manager’s] interest and in the interest of all the other shareholders for the corporation to be as profitable as possible regardless of their individual tax rates.”¹⁰⁹ Under such a framework, everyone benefits from successful corporate-level tax planning (because the overall tax burden is reduced), regardless of each shareholder personal tax stance.

However, Kanda & Levmore’s argument is only true if one assumes that entity-level taxation is in fact separate from shareholder taxation. This assumption does not always stand. In STCTs, “in-corporate” tax planning schemes directly affect shareholder-level tax liability. An STCT reintroduces the same agency problems Kanda and Levmore identify in the context of the pass-through model. Managers may prefer their own tax interests to the tax interest of other shareholders. The tax gross-up payment is one such example. This significantly narrows the breadth of Kanda and Levmore’s argument to non-STCT transactions.

ii. Corporate tax as a monitoring instrument

Some researchers suggest that the double-tax model enhances shareholders’ ability to monitor managers. Consider, for example, pyramidal ownership structures. Such structures are detrimental to corporate governance, because they are opaque and enable insiders to unbundle control from financial risk.¹¹⁰ The double-tax model is a strong incentive against pyramidal ownership structures, because each inter-company payment along the corporate chain potentially creates an additional layer of tax burden. While many countries provide a relief from intercompany dividend taxation, such dividends remain at least partially taxable in the United States.¹¹¹ This

¹⁰⁸ *Id.*

¹⁰⁹ *Id.*

¹¹⁰ Morck & Yueng, *supra* note 88, at 177. (“Numerous studies... attest to the importance of governance problems in pyramids, especially in countries that provide public shareholders with weak legal rights against corporate insiders”).

¹¹¹ IRC §243 allows a corporate recipient of a dividend to deduct seventy percent of the dividend received from another corporation (“dividend received deduction” or “DRD”). Functionally, this means that only thirty percent of the dividend is taxable to the recipient. The DRD amount is increased to eighty percent if the recipient holds at least twenty percent of the vote and value in the distribution corporation, and to a hundred percent (meaning,

fact likely plays a significant role in preventing pyramidal ownership structures in the United States, while such structures remain common elsewhere.¹¹²

Pyramids, however, make it less likely that a corporate-level tax plan will be taxable to the ultimate shareholders. The reason is that pyramids distance the tax-outcomes of public shareholders at the top of the chain, from the tax consequences of the corporation at the bottom of the chain. It is easy to envision a corporate transaction that is also taxable to the corporate shareholder one level up the chain (because, for example, it creates a deemed sale by the shareholder). It is harder to imagine corporate transactions that affects the tax liabilities of shareholders all the way to the top of the chain of the pyramid (though it is possible). For a transaction to be an STCT in a pyramid – there must be a taxable event at each level of the pyramid all the way to the top. While the double-tax model discourages pyramidal ownership, it makes STCTs (and their associate agency problems) more likely. This is so because in the absence of pyramidal structures, STCTs are less costly to engage in.

Ironically, one of the main agency problems of pyramids is the ability of “majority shareholders—often in collusion with directors—[to] divert company’s assets to themselves, departing from arm’s-length conditions in their contractual relationship with the company.”¹¹³ STCT enable exactly that: the ability of managers and tax-exempt shareholders to divert companies’ profits to themselves, against the interest of minority (taxable) shareholders.

Another line of literature identifies corporate taxation as a potential instrument for monitoring managers. Marjory Kornhuaser, for example, argues that the introduction of separate taxation of corporate entities in 1909 was a response to the corporate consolidation phenomenon at the turn of the twentieth century, and the ensuing increase in corporate influence.¹¹⁴ A key aspect of corporate tax as introduced at the time was that corporate tax information was public.¹¹⁵ The idea was to provide investors with

complete elimination of tax on the intercompany dividend), if the recipient holds at least eighty percent of the vote and value in the distributing corporation.

¹¹² Morck & Yueng, *supra* note 88, at 177 (“With its tax on intercorporate dividends, the United States has a highly exceptional corporate sector, almost devoid of pyramids... America’s intercorporate dividend taxation rules is probably a key, though largely unappreciated, reason for this exceptionalism”).

¹¹³ Schön, *supra* note 5, at 60.

¹¹⁴ Kornhauser, *supra* note 68, at 55-82 (describing the era of corporate consolidation, political responses and early attempts at corporate regulation). *See, also, id.*, at 133 (“Concern about corporations focused on the large corporations and their monopoly of the market”).

¹¹⁵ For a discussion of the various publicity features, see *Id.*, at 113-133.

information that would assist them to supervise management.¹¹⁶ Similarly, Reuven Avi-Yonah suggest that that the corporate tax as originally enacted was “primarily viewed as a regulatory device to restrict managerial power.”¹¹⁷ The regulatory feature “was achieved most directly through the publicity feature of the tax”¹¹⁸ but also because tax had “the potential to regulate management directly by reducing corporate wealth and therefore restricting managerial power.”¹¹⁹

This historical rationale seems to be outdated, given that corporate tax information is no longer public.¹²⁰ There is a healthy debate about whether corporate tax information should be public, and it is beyond the scope of this article to consider it.¹²¹ It is clear, however, that corporate tax privacy makes it harder for minority shareholders to monitor managers’ corporate tax decisions.¹²² STCTs exacerbate such negative effects: opaque corporate tax planning not only hinders shareholders ability to monitor managers, but may also result in a *direct* shareholder-level tax detriment.

More importantly, STCTs demonstrate that in some instances, the availability of tax information has little effect on the ability of shareholders to regulate managers. The information about the tax detriment to taxable shareholders STCTs is freely available. Information about tax gross-up payments to managers is also disclosed. But there is little that taxable shareholders can do long as they are in minority. Tax exempt shareholders have every incentive to cooperate with managerial rent extraction, because they also benefit from STCTs.

c. Double Taxation and Corporate Distribution Policies

The double-tax model affects corporate financing structure and distribution policies in ways that exacerbate agency costs.¹²³ It does so in two ways: First, it incentivizes managers to retain earnings. Second, it creates a

¹¹⁶ *Id.* 131 (“The regulations, therefore, required publicity of the returns of these corporations in order to provide potential investors the information needed to make informed decisions. In this respect the regulations became the forerunner of Securities and Exchange Commission reporting”).

¹¹⁷ Avi-Yonah, *Corporations, Society, and the State*, *supra* note 67, at 1225.

¹¹⁸ *Id.*

¹¹⁹ *Id.*

¹²⁰ I.R.C. §§ 6103 prescribes strong confidentiality protections on tax returns and return information.

¹²¹ For an excellent recent discussion on corporate tax privacy, see, Joshua D. Blank, *Reconsidering Corporate Tax Privacy*, 11 NYU J. OF L. & BUS. 31 (2014).

¹²² See, e.g., David. Kamin (moderator), *Panel 2: Should Corporate Tax Returns be Public?*, 11 NYU J. OF L. & BUS. 159 (2014).

¹²³ See, Desai & Dharmapala, *supra* note 67, at 27-29 (discussing the interaction between corporate financing choices, distribution policies, and corporate governance).

conflict among shareholders with regard to distribution policies.

Consider the earning retention problem first. “Dividends mitigate agency costs by reducing the resources under management’s control.”¹²⁴ Self-interested managers may therefore prefer not to declare dividends, even if it is in the best interest of shareholders. Since dividends are taxable to shareholders, “managers could invoke [shareholder] tax as a pretext not to pay dividends”¹²⁵ under the theory that shareholders would benefit from deferred tax liability. Thus, the double tax model may support managers retention of corporate earnings beyond an optimal level.¹²⁶ There is empirical evidence suggesting that this happens in practice.¹²⁷

Next, consider shareholder preferences for corporate distributions. Since different shareholders are in different tax positions, they may have diverging interests in such context.¹²⁸ Tax-exempt shareholders would like distributions because they are not taxable to them yet generate liquidity. Taxable shareholders may or may not like distributions, depending on their particular tax situation.

Kanda and Levmore recognize the agency problems associated with corporate distributions, but argue they are “less important” than the agency

¹²⁴ Schizer, *supra* note 367, at ¶4.1.3.; Arlen and Weiss, *supra* note 3, at 352-356 (discussing how the double-tax model may encourage some managers to retain earnings). Other commentators, however, suggest that management in U.S. corporations retained earnings even before the introduction of the corporate tax. *See*, Bank, *Capital Lock-in*, *supra* note 2, at 918 (the rise of retained corporate earnings “occurred prior to the ratification of the Sixteenth Amendment and thus during a period in which the income tax could not have been a factor”). Instead, Bank suggests that the double tax model should be viewed as a response to the retained earnings problem, and not the other way around. Specifically, Bank argues that the double tax model is a political compromise between supporters of the pass-through system (which would have taxed shareholders on a current basis), and supporters of taxation of retained corporate earnings (which corporate managers objected). *See*, Bank, *id.*, 946-947.

¹²⁵ Schizer, *id.*

¹²⁶ In practice, management incentives in such context are more nuanced. First, tax-exempt shareholders have no potential upside from deferral, since they are not subject to tax on dividend. In respect of tax-exempt shareholders, manager cannot use dividend taxation as a pretextual excuse not to distribute dividends. Second, it is not clear that taxable shareholder always benefit from dividend deferral, because retained earnings presumably accumulate income themselves, thus increasing the tax-base to shareholders upon future distribution. If the after tax return on profits grows at the same rate both inside the firm and at the hand of shareholders, than deferral makes not difference in net-present-value terms. For a discussion, see Schizer, *id.*

¹²⁷ For a summary of empirical evidence of the effect of the double-tax model on corporate distribution policies, see, Desai & Dharmapala, *supra* note 28, at 27-29.

¹²⁸ *See*, Kanda & Levmore, *supra* note 25, at 234-238 (discussing conflicts of interest in the context of corporate distribution policies).

problems associated with “in-corporate” decisions¹²⁹ (such as whether to engage in a particular transaction). Recall, that under Kanda & Levmore counter-factual scenario—where corporate transactions affect shareholder tax liability—managers have an incentive to structure “in-corporate” transaction to benefit the managers’ own tax-interests. This may result in inefficient transactions, for example, if a manager refrains from selling an asset because of manager’s self-tax-interest.¹³⁰ The problem is less acute in the distribution context, they argue, because investors who are disappointed with corporate distribution policies can simply “sell... their shares.”¹³¹ In other words, investors have control on when to dispose of their stock, which allows them to alleviate any shareholder-level tax detriment resulting from corporate distribution policies.

What Kanda & Levmore are referencing here is the “Clientele Theory”,¹³² under which investors’ tax preferences affect their portfolio composition. For example, the clientele theory predicts that taxable investors will gravitate towards investments in growth companies, which rarely distribute dividends. This way, taxable investors retain control on the timing of gain recognition (since they will only recognize shareholder-level taxes upon disposition of their stock). Tax-exempt investors, on the other hand, would prefer investment in firms that regularly distribute dividends. The reason is that tax-exempt investors enjoy the liquidity, but do not suffer any shareholder-level tax detriment that may be associate with the distribution.

In the presence of STCTs, however, Kanda & Levmore argument loses its strength. Clientele effects are only a good remedy to shareholder-level tax detriment if shareholders can control of the timing of shareholder-level gain recognition. This is not the case in STCTs. In an STCT, managerial decision about “in-corporate” transactions, dictates the timing of shareholder-level gain recognition.¹³³

Investors may be able react to ongoing known corporate distribution policies, and choose to invest in companies with distribution policies that match the investors’ tax preferences. Unlike distribution policy, however,

¹²⁹ *Id.*, at 236. (“[T]here is a reason to think that the agency costs associated with dispositions, or with in-corporate decisions in-general, are greater and socially more important than those associated with distribution policies”).

¹³⁰ *Id.* (“Assets that would otherwise move to higher valued uses will not be so moved because of [the manager’s] self-interested behavior”).

¹³¹ *Id.*

¹³² See, MYRON S. SCHOLES ET. AL., TAXES AND BUSINESS STRATEGY 142-145 (4th ed., 2009) (discussing clientele effects).

¹³³ Of course, taxable shareholder may try to sell their stock before the transaction closes, but capital market hypothesis assumes that any costs to the shareholder will be reflected in the stock price as soon as the transaction is announced.

there is no (and cannot be) “STCT policy”. STCTs are “one-off” transactions that are not part of a standard corporate policy that shareholder can anticipate and react to ahead of time. There is no efficient way for taxable investors to anticipate STCTs *before* they are announced and calibrate their portfolio accordingly.

There is an additional reason for which Kanda & Levmore believe that “in-corporate” inefficiency is worse than inefficiency resulting from distribution policies.¹³⁴ If earnings are simply retained, there is no “real inefficiency” because “it is actual investment decisions rather than financing decisions that matter.”¹³⁵ In this, Kanda & Levmore assume that in-corporate efficiency outweighs the shareholder-level inefficiency. As I demonstrated in Part I above, that is not necessarily the case in STCTs. It is plausible to expect that in some transactions the “in-corporate” tax benefit is outweighed by “shareholder-level” tax detriment.

d. Corporate-level Tax Planning and Collateral Governance Effects

While shareholders may benefit from reduced corporate tax liability, corporate tax planning may create corporate governance costs. “The basic intuition ... is that tax avoidance demands complexity and obfuscation to prevent detection. These characteristics, in turn, can become a shield for managerial opportunism.”¹³⁶

The best-known example for such dynamics is probably the demise of the Enron Corporation. A Congressional report by the Joint Committee on Taxation (JCT) notes: “as Enron’s management realized that tax motivated transactions could generate financial accounting benefits, Enron looked to its tax department to devise transactions that increased financial accounting income”.¹³⁷ In designing its tax-motivated transactions, Enron “excelled at making complexity an ally. Many transactions used exceedingly complicated structures and were designed to provide tax benefits significantly into the future. For any person attempting to review the transaction, there would be

¹³⁴ Kanda & Levmore, *supra* note 25, at 236.

¹³⁵ *Id.*

¹³⁶ Desai & Dharmapala, *supra* note 28, at 14. *See, also*, Schön, *supra* note 5, at 55 (“Shareholders face a trade-off between the tax advantages which can be derived from complicated corporate group and financing structures on the one hand and the lack of management control resulting from these structures on the other hand”); Schizer, *supra* note 3, at ¶4.3.5. (“Self-interested tax structuring is especially hard for shareholders to monitor, since tax rules are so esoteric”).

¹³⁷ JOINT COMMITTEE ON TAXATION, REPORT OF INVESTIGATION OF ENRON CORPORATION AND RELATED ENTITIES REGARDING FEDERAL TAX AND COMPENSATION ISSUES AND POLICY RECOMMENDATIONS 21 (2003) [Hereinafter: JCT ENRON REPORT].

no easy way to understand its terms or purpose.”¹³⁸ For example, at the end of 2001, Enron had about 1,300 foreign subsidiaries and other foreign affiliated entities.¹³⁹ About eighty percent of Enron’s foreign affiliates “were inactive shells that did not hold and were not engaged in or associated with any ongoing business.”¹⁴⁰ Under such circumstances, effective shareholder monitoring is exceedingly difficult. The JCT report identified multiple corporate governance deficiencies that were the result of Enron’s aggressive tax stances.¹⁴¹

Scholars explored various types of corporate tax planning transactions and their potential negative governance effects.¹⁴² One oft-cited transaction type is the “corporation inversion”, in which a domestic corporation becomes foreign in order to escape U.S. taxes. Even if such transaction saves taxes, moving corporate residence to a foreign jurisdiction comes at a cost.¹⁴³ Target jurisdictions may offer inferior shareholder protections compared with the ones offered by U.S. corporate and securities law.¹⁴⁴

¹³⁸ *Id.*, at 23.

¹³⁹ *Id.*, at 11.

¹⁴⁰ *Id.*

¹⁴¹ For example, issues relating to compensation and retirement planning. *Id.*, at 19 (“Some of the issues examined by the Joint Committee staff with respect to Enron’s retirement plans and compensation arrangements raise nontax issues, such as issues of corporate governance and fiduciary responsibility); Issues relating to Employee loans. *Id.*, at 41 (“The loans raise Federal tax issues as well as corporate governance issues”); Issues relating to commodities transactions. *Id.*, at 359 (“Enron’s reliance upon credit-linked notes in ... transactions to effectively create credit capacity for additional commodity prepay transactions raises questions that are pertinent primarily to corporate governance and financial accounting”).

¹⁴² See, e.g., Mihir Desai & Dhammika Dharmapala, *Corporate Tax Avoidance and High-Powered Incentives*, 79 J. OF FIN. ECON. 145, 176 (2006). (“[W]hile unexploited opportunities for tax sheltering with little or no risk of penalties could exist, increasing tax avoidance would create greater opportunities for managerial diversion. If managers cannot credibly commit to overlooking those opportunities, then shareholders could prefer that managers not engage in tax sheltering activity”);

¹⁴³ Cathy Hwang, *The New Corporate Migration: Tax Diversion through Inversion*, 80 BROOK. L. REV. 807, 837-51 (2015) (Discussing various collateral costs of inversion transactions).

¹⁴⁴ Schizer, *supra* note 3, at ¶5.1.1. (“Other jurisdictions may not offer comparable shareholder protections, especially tax havens like the Cayman Islands or Bermuda”); See, also, Eric L. Talley, *Corporate Inversions and the Unbundling of Regulatory Competition*, 101 VA. L. REV. 1649, 1652 (2015) (“Tax inversions can introduce material downstream legal risk, since they move the locus of corporate internal affairs out of conventional jurisprudential terrain and into the domain of a foreign jurisdiction whose law is—by comparison—recondite and unfamiliar”); Gregory R. Day, *Irrational Investors and the Corporate Inversions Puzzle*, 69 SMU L. REV. 453, 457 (2016) (“From a director’s standpoint, inversions are quite appealing for reasons beyond reducing corporate taxes. Principally, a company’s leadership may structure an inversion to diminish management’s

The unique dynamics of STCTs worsens the governance problems associated with corporate tax planning, by burdening taxable shareholders (and the corporation – in case of gross-ups) with direct tax cost. Cost-benefits analyses of tax-planning transactions seems to consider corporate tax savings against transaction costs and potential governance costs. In an STCT, direct shareholders' tax liability is an *additional* significant cost to account for.

III. STCTs IN PRACTICE: INVERSIONS AND REIT SPINOFFS

So far, I have identified STCTs as a distinct type of corporate transaction and explained the unique governance problems it presents. The purpose of this part is to shift the discussion from theory to practice. Again, given recent tax reform, the transaction described herein were designed and executed under the pre-reform law. There is no telling what types of corporate tax planning will take shape under the new law, but the generic point still stands: corporate tax planning may be detrimental to shareholders.

Subpart A provides a brief legal background, explaining how—under the I.R.C.—corporate transactions may be taxable to shareholders. In subparts B and C, I explore two types of popular STCTs: corporate inversions and REIT spin-offs, and analyze both under the framework developed in the previous parts of the article.

a. Shareholder-Taxable Corporate Transactions in General

Generally, the I.R.C. prescribes that corporations and their shareholders are taxed separately. As taxpayers, corporations pay corporate income tax.¹⁴⁵ Shareholders are individually liable to tax on taxable corporate distributions, such as dividends.¹⁴⁶ In addition, dispositions of corporate stock may trigger capital gains or losses.¹⁴⁷

The I.R.C., however, contains multiple instances in which corporate-level transaction may have a direct effect on shareholder-level tax liabilities. It is beyond the scope of this article to explore all such possible scenarios, but most fall into one of three categories: deemed distributions, deemed dispositions, and forced distributions.

i. Deemed Distributions

duty to comply with a number of burdensome corporate regulations”); Mitchell A. Kane & Edward B. Rock, *Corporate Taxation and International Charter Competition*, 106 Mich. L. Rev. 1229 (2008) (exploring how various corporate tax-residence rule distort corporate charter competition).

¹⁴⁵ I.R.C. § 11.

¹⁴⁶ I.R.C. § 61.

¹⁴⁷ *Id.*

The I.R.C. sometimes prescribes that income earned by a corporation is deemed distributed to shareholders, even if no actual distribution took place. In such a case, shareholders must pay tax on such deemed distribution.¹⁴⁸ Deemed distributions apply in the context of several “anti-deferral” regimes. The purpose of such regimes is to prevent U.S. shareholders from deferring taxation by channeling income into controlled corporations.¹⁴⁹

For example, under Subpart F of the I.R.C.¹⁵⁰, “Subpart F income” earned by “Controlled Foreign Corporations” (CFCs) is deemed distributed to “U.S. Shareholders” even if no distribution occurred.¹⁵¹ Generally, Subpart F income is income derived from passive activities.¹⁵²

Subpart F is the Congressional response to U.S. multinational corporations channeling income through foreign subsidiaries in low-tax jurisdictions.¹⁵³ For example, in the absence of Subpart F, a U.S. multinational could reduce its U.S. tax liability by making a deductible payment (such as interest on inter-company debt) to a controlled foreign affiliate organized in a tax haven. In order to prevent such perceived abuse, the I.R.C. deems any “Subpart F income” earned by a CFC as immediately distributed to U.S. Shareholders.

Before the recent tax reform, CFC’s income that was *not* Subpart F income was not taxable in the United States until repatriated to U.S. shareholders, usually in the form of a dividend. It would have been possible

¹⁴⁸ This creates what is sometimes referred to as “phantom income”. Namely, a situation in which a taxpayer is required to pay taxes in respect of income that taxpayer has not yet realized.

¹⁴⁹ For a discussion of anti-deferral regimes in general, see REUVEN S. AVI-YONAH, *INTERNATIONAL TAX AS INTERNATIONAL LAW: AN ANALYSIS OF THE INTERNATIONAL TAX REGIME 125-149* (2007) (Discussing the legal development in the United States of various anti-deferral regimes) [hereinafter: *INTERNATIONAL TAX AS INTERNATIONAL LAW*].

¹⁵⁰ “Subpart F” is the commonly used shorthand for Chapter 1, Subchapter N, Part II, Subpart F of the I.R.C. It is codified in I.R.C. §§951-65.

¹⁵¹ I.R.C. §951. A foreign corporation is a CFC if U.S. Shareholders own more than 50% of its vote or value. I.R.C. §957. A U.S. Shareholder is any U.S. person owning at least 10% of the vote of the CFC. I.R.C. §951.

¹⁵² This includes, for example, income from dividends royalties, rents, interest and other typed of income not generated by passive participation. *See*, I.R.C. §§952-54

¹⁵³ In the absence of Subpart F, a U.S. shareholder could set up a wholly owned foreign corporation in a tax haven, and earn all income through that corporation, thus avoiding U.S. taxation. As originally conceived, the idea of Subpart F was to force U.S. shareholders to currently include in income any profits earned by a controlled foreign corporation. The eventual political compromise led to the current regime, under which shareholders currently include only passive income, while active CFC income is not included in shareholders’ income until repatriation to the United States. For a description of the Kennedy Administration’s proposal and the eventual political compromise, see Luke Wagner, *Crisis and Deferral: How World Events Influence Subpart F*, 152 *TAX NOTES* 1027 (Aug. 15, 2016).

to avoid tax on repatriated earnings, however, by having the CFC directly invest its non-Subpart F earnings in the United States. To prevent that, the I.R.C. deemed any CFC's increase in net-investment in the United States also distributed to shareholders, and immediately taxable to them.¹⁵⁴ The TCJA made this rule unnecessary, since under the new law CFC's non-Subpart F income is not subject to tax upon repatriation (though the rule is relevant to inversion transactions I discuss below).

Another anti-deferral regime is the Passive Foreign Investment Company (PFIC) regime. It has a similar logic to the CFC regime. The idea, again, is to prevent shareholders from stuffing income into foreign holding companies in order to defer U.S. tax liability. This regime, however, targets individual shareholders. A PFIC is any foreign corporation if at least 75% of the gross income derived from passive income (the "income test"), or if at least 50% of the corporation's assets are passive-income-producing assets (the "assets test").¹⁵⁵ For that purpose, cash and cash equivalents are passive assets.¹⁵⁶ Thus, a public corporation that accumulates cash and cash equivalents may become a PFIC. Any U.S. person that holds stock in a PFIC is subject to one of three anti-deferral regimes. One of such regimes is the "Qualified Electing Fund" (QEF), under which PFIC gains are immediately taxable to shareholders, even if no corporate distribution was made.¹⁵⁷

The CFC and PFIC regimes are but two examples for regimes in which "in-corporate" operations directly affect shareholder-level tax liabilities. When a manager makes a decision to invest in certain types of assets, or earn certain types of income, the result may be immediate shareholder-level tax.

ii. Deemed Dispositions

Mergers and acquisition (known in tax jargon as "reorganizations"),¹⁵⁸ are another type of corporate event that may be taxable to shareholders.¹⁵⁹ The

¹⁵⁴ I.R.C. § 956, as in effect in 2017.

¹⁵⁵ I.R.C. § 1297

¹⁵⁶ Notice 88-22, *Passive Foreign Investment Company Provisions Operation of the Definitional Tests under Section 1296*, 1988-11 I.R.B. 19 (Feb. 26, 1988) (concluding that "[c]ash and other current assets readily convertible into cash" are passive assets for PFIC qualification purposes).

¹⁵⁷ I.R.C. §§ 1293-95

¹⁵⁸ I.R.C. § 368.

¹⁵⁹ BORIS I. BITTKER & LAWRENCE LOKKEN, *FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS* ¶ 94.1, 1997 WL 439996, 1 ("To the general practitioner, the term ordinarily connotes a financial rehabilitation of a bankrupt enterprise. To the tax lawyer, however, it embraces a much wider variety of corporate readjustments—most of which have the flavor of prosperity rather than depression. Section 368(a)(1) defines "reorganization" for tax purposes to include mergers, consolidations, recapitalizations, acquisitions by one corporation of the stock or assets of another corporation, and changes in form or place of

tax treatment of corporate reorganizations is probably one of the most intricate areas of tax law. The guiding principle, however, is that certain reorganization that maintain continuity of the original ownership and business activity should not be taxable.¹⁶⁰ The reason for this tax-favored treatment is to allow business-driven restructuring transactions to proceed unaffected by tax considerations.

For example, in a statutory merger of two corporations, shareholders of the merged corporations replace their shares in the “old” corporation for shares in the newly merged corporation. Under general principles of tax law, the disposition of one asset (old stock), in consideration for another asset (the new stock), would be a taxable event. In the case of statutory mergers, however, I.R.C. §368(a)(1)(A) exempts such exchanges from tax if certain requirements are met. Multiple other code provisions prescribe various requirements for tax-free treatment for multiple types of reorganizations.¹⁶¹

Some corporate acquisitions, however, are deemed to create enough of a difference compared with the structure before the transaction, to be taxable to shareholders. Thus, in many instances, a merger or a corporate acquisition is taxable to shareholders even if shareholders receive no cash in the transaction. The exchange by a shareholder of “old” stock for “new” stock is a taxable event. In such a case, the taxable gain is the difference between the shareholder’s basis in “old” stock, and the fair market value of “new” stock.

Another example for deemed disposition comes up in the context of PFICs discussed above. Instead of making a QEF election and pay tax on deemed distributions,¹⁶² shareholders can elect to mark-to-market their stock at the end of each taxable year, and recognize any gains or losses as if they sold their stock on the last day of the year.¹⁶³ Thus, if managers’ actions cause a corporation to become a PFIC, the result may be a deemed disposition to shareholders at the end of each taxable year.¹⁶⁴

To summarize, corporate transactions driven by “in-corporate” considerations may cause shareholders to be treated—for tax purposes—as if

organization.”)

¹⁶⁰ *Id.* (“Requisite to a reorganization under the Code are a continuity of the business enterprise...under the modified corporate form...and a continuity of interest...In order to exclude transactions not intended to be included, the specifications of the reorganization provisions of the law are precise”).

¹⁶¹ See, e.g., I.R.C. §§ 351, 355, 368.

¹⁶² *Supra* note 157 and accompanying text.

¹⁶³ I.R.C. § 1296.

¹⁶⁴ The third anti-deferral alternative for shareholder in PFIC is not to pay tax until an actual corporation distribution. I.R.C. § 1291. In such a case, however, shareholders are liable to interest on the tax liability of any deferred amount. This would be the default rule if no QEF election is made, and not mark-to-market election is available.

they sold their stock, even though shareholders did not receive cash consideration, and did not actually dispose of any of their holdings.

iii. Forced Distributions

A final category of in-corporate decisions that may create tax liability for shareholders comes up in instances in which the I.R.C. *requires* that a corporation make distributions to its shareholders, thus generating shareholder-level tax liability. Forced distributions are generally required (among other qualifications) to qualify for certain tax-preferred corporate regimes. The most common examples are REITs (Real Estate Investment Trusts) and RICs (Regulated Investment Companies).

Both REITs and RICs are classified as corporations for federal income tax purposes.¹⁶⁵ Qualifying as a REIT or a RIC, however, allows the corporation to deduct dividend payments to shareholders.¹⁶⁶ This effectively eliminates the double-tax, as the corporate profits are only taxed once – to the shareholders. The purposes of these preferred-tax regimes’ is to incentivize small and medium-size investors to pool resources and invest in specific asset categories.

Both RIC and REITs have to meet certain income and assets tests¹⁶⁷, as well as certain ownership thresholds tests¹⁶⁸ in order to qualify for the preferred treatment. Most importantly, however, both must distribute at least 90% of their profits each year to their shareholders.¹⁶⁹

Of course, shareholders know if a corporation is a REIT or a RIC before they decide to purchase its stock, and can therefore decide whether on-going taxable distributions match their individual tax preferences. However, in many instances regular “double-taxed” corporations may choose to turn themselves into REITs in the course of their lives (“REIT conversion transactions” or “REIT Spinoffs” are discussed below).¹⁷⁰ In such a case, a taxable shareholder who already holds stock may suffer a tax cost associated with the conversion transaction.

b. Corporate Inversions

Over the past few decades, multiple U.S. multinationals engaged in inversion transactions.¹⁷¹ The purpose of a corporate inversion is to turn a

¹⁶⁵ I.R.C. §851 (RICs); I.R.C. 856 (REITs). The result is a functional adoption of the dividend deduction model of corporate integration.

¹⁶⁶ I.R.C. §852 (RICs); I.R.C. 857 (REITs).

¹⁶⁷ The requirements are prescribed by I.R.C. §851 (RICs); I.R.C. 856 (REITs).

¹⁶⁸ *Id.*

¹⁶⁹ *Id.*

¹⁷⁰ See discussion *infra*, at Part III.c.

¹⁷¹ For a detailed description of the corporate inversion phenomenon, see, Omri Marian,

domestic corporation into a foreign corporation for tax purposes. Generally, in an inversion transaction a U.S. multinational corporation acquires a smaller foreign corporation through a merger in which the foreign corporation is the surviving entity. Thus, shareholders of the U.S. corporation maintain control of the foreign merged entity. The underlying rationale is that by gaining foreign status, the corporation will be able to reduce its tax liability.¹⁷² The inversion transaction itself, however, is usually taxable to shareholders. Corporate inversions thus fit the STCT category of “forced dispositions” discussed above. As detailed in this Subpart, corporate inversions are a vivid representation of the unique governance problems created by STCTs.

Inversion transactions have been very popular in recent years. A recent paper analyzing inversions counts sixty inversion transactions between 1993 and 2015.¹⁷³ At least forty-eight of such transactions took place on or after 2002.¹⁷⁴ Such transactions are not only popular in terms of absolute numbers, but also significant in dollar value. A recent study by the Congressional Budget Office found that in 2014 alone, “10 corporations—with assets totaling approximately \$300 billion—announced that they were considering inversions”.¹⁷⁵

i. The Corporate Inversions Phenomenon

In order to understand the structure of corporate inversion transactions and potential tax benefits, it is helpful to start with a brief background on U.S. tax law applicable to cross-border transactions.

Under the law in effect before the TCJA, the United States generally imposed tax on its domestic corporations’ worldwide income.¹⁷⁶ In order to prevent double taxation, domestic corporations receive a credit for foreign tax payments.¹⁷⁷ Foreign corporations, however, generally only pay tax in the United States on income earned from sources within the United States.¹⁷⁸

Most other countries tax multinational corporations on a territorial basis.¹⁷⁹ That is, only income earned within the geographical boundaries of

Home Country Effects of Corporate Inversions, 90 WASH. L. REV. 1, 7-13 (2015) (describing corporate inversions). Hereinafter: Marian, *Home Country Effects*.

¹⁷² *Id.*, at 11-13 (discussing the reasons for which corporations invert).

¹⁷³ Babkin, Glover, & Levine *supra* note 20.

¹⁷⁴ Nirupama Rao, *Corporate Inversions and Economic Performance*, NYU WAGNER RESEARCH PAPER NO. 2566429 (2015) (analyzing forty-eight inversions that happened since 2002) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2566429.

¹⁷⁵ CONGRESSIONAL BUDGET OFFICE, AN ANALYSIS OF CORPORATE INVERSIONS 7 (2017).

¹⁷⁶ I.R.C. §11(a), (d).

¹⁷⁷ I.R.C. §901.

¹⁷⁸ I.R.C. §§881, 882

¹⁷⁹ See Philip Dittmer, TAX FOUND., SPECIAL REPORT NO. 202: A GLOBAL PERSPECTIVE

the jurisdiction is subject to tax, regardless if the corporate taxpayer is foreign or domestic. With the TCJA, the United States adopted a similar approach.¹⁸⁰

Prior to the reform, some argued that U.S. multinationals are at a competitive disadvantage because they face taxation on worldwide earnings, while non-U.S. multinationals face territorial taxation.¹⁸¹ Such disadvantage was exacerbated by the fact that the United States used to have the highest corporate tax rate in the industrialized world.¹⁸² According to such competitiveness arguments, inversions were a response to these disadvantages.¹⁸³ Other commentators, however, argue that U.S. multinationals faced no competitive disadvantage, due to multiple loopholes in the U.S. tax system that enable U.S. multinationals to legally reduce their tax rate.¹⁸⁴ Rather, U.S. multinationals engaged in inversions simply because they could. It is rational for managers to engage in legal transactions that reduce corporate tax liabilities.¹⁸⁵

Notwithstanding the U.S. worldwide system of taxation, not all income of U.S. corporations was immediately taxable in the United States. Income earned by foreign subsidiaries was not taxed until repatriated back to the

ON TERRITORIAL TAXATION 3 (2012), available at http://taxfoundation.org/sites/taxfoundation.org/files/docs/sr202_0.pdf (concluding that “[o]verwhelmingly, developed economies are turning to the territorial approach”).

¹⁸⁰ TCJA, *supra* note 38, § 14101 (establishing a deduction for dividends received from foreign sources).

¹⁸¹ Omri Marian, *Meaningless Comparisons: Corporate Tax Reform Discourse in the United States*, 33 VA. TAX REV. 133, 164 (2012) (“Proponents of territoriality argue that the isolation of the United States in taxing its corporations on a worldwide basis puts U.S. MNCs at a competitive disadvantage”).

¹⁸² See Jane G. Gravelle, *International Corporate Tax Rates Comparisons and Policy Implications*, R41743 CONG. RES. SERV. 1 (2014) (“Advocates of cutting corporate tax rates frequently make their argument based on the higher statutory rate observed in the United States as compared with the rest of the world”).

¹⁸³ Edward D. Kleinbard, ‘Competitiveness’ has Nothing to Do with It, 144 TAX NOTES 1055, 1056 (September 1, 2014) (describing U.S. multinationals’ claim “that U.S. tax law has rendered them uncompetitive in international business, which in turn explains the sudden wave of inversion transactions”).

¹⁸⁴ *Id.*, at 1056 (explaining that U.S. multinational face no competitive disadvantage due to their ability to engage in income shifting); See, also Marian, *Home Country Effects*, *supra* note 171171, at 10 (describing the competitiveness argument as “tenuous”); Reuven S. Avi-Yonah & Omri Marian, *Inversions and Competitiveness: Reflections in the Wake of Pfizer-Allergan*, 41 INT’L TAX J. 39, 39 (2015) (suggesting that U.S. multinationals “engage in the inversions simply because they can and that inversions have nothing to do with maintaining a competitive edge”).

¹⁸⁵ Kleinbard, *supra* note 183, at 1055 (describing inversions as “economically rational deals”). I am making no judgment here on whether inversions are driven by competitiveness considerations. The assumption I am making here is that inversions are legal, and that they reduce the corporate-level tax liability. As such, management should—at the minimum—consider inversions.

United States (usually in the form of a dividend), assuming the foreign corporation is not a CFC, or, if it is a CFC, the income is not Subpart F income.¹⁸⁶

A system of worldwide taxation that allows for tax-deferral created an incentive for U.S. multinationals to accumulate income in foreign subsidiaries. U.S. multinationals indeed used various “profits shifting” techniques to “stuff” income into foreign affiliates. Profit Shifting refers to the ability of the taxpayer to shift income—for tax reporting purposes—from a high-tax jurisdiction to a low-tax jurisdiction, without relocating the corresponding activity that generated the income.¹⁸⁷ As long as the income remained in the foreign subsidiaries, it was not taxed to the U.S. parent. The magnitude of the problem was staggering. By one recent estimate, before the TCJA, U.S.-based multinational corporations held \$2.6 trillion of untaxed (or lightly taxed) earnings in offshore affiliates.¹⁸⁸

Such a system creates an incentive to invert. There are three main benefits associated with an inversion: First, as a foreign corporation, an inverted corporation is subject to tax in the U.S. only on U.S.-source income, rather than on worldwide income. Second, an inverted corporation is able to easily access the piles of cash accumulated in offshore subsidiaries. If the offshore subsidiaries pay dividend to the now-foreign parent, the funds are never “repatriated” to the United States (but rather “repatriated” to the foreign parent), and no tax on is ever due. Finally, if the ultimate parent corporation is foreign, income shifting away from the United States becomes much easier. For example, it is highly unlikely that a foreign publicly traded corporation is a CFC (due to the dispersed ownership).¹⁸⁹ Thus, income shifted to the foreign parent is never Subpart F income and will never be deemed repatriated to the United States.

In order for U.S. corporations to enjoy the tax benefits of an inversion, they must first gain foreign tax status. Moving real operations out of the United States is costly, and such costs may undo the benefits of an

¹⁸⁶ There are various legal ways for U.S. multinational to get around the CFC rules and there seem to be a consensus that the CFC regime is not an effective anti-deferral mechanism. See, e.g., J. Clifton Fleming Jr., Robert J. Peroni, & Stephen E. Shay, *Worse Than Exemption*, 59 EMORY L. J., 79, 93 (2009) (CFC “provisions do not reach substantial amounts of low-taxed foreign source earnings.”); Lawrence Lokken, *Whatever Happened to Subpart F? U.S. CFC Legislation after the Check-the-Box Regulations*, 7 FLA. TAX REV. 186, 210 (2005) (concluding that “subpart F has fallen increasingly short of the goal of curbing tax haven sheltering”).

¹⁸⁷ For an authoritative discussion on the income-shifting phenomenon, see Edward D. Kleinbard, *Stateless Income*, 11 FLA. TAX REV. 699 (2011)

¹⁸⁸ See House Ways & Means Committee Press Release, *Joint Committee on Taxation Estimates Even More Foreign Earnings from U.S. Companies Stranded Overseas* (Sept. 29, 2016).

¹⁸⁹ See, *supra* note 151 and accompanying text.

inversion.¹⁹⁰ There was no need for U.S. multinationals, however, to move real activities in order to gain foreign tax status. Under the I.R.C., a corporation is tax-resident in the United States only if it is incorporated in the United States.¹⁹¹ Thus, in order to invert, all that a U.S. multinational has to do is to change its place of incorporation.

Inversion transactions became popular in the 1980s. At that time, U.S. corporations engaged in inversions simply by changing their place of incorporation from the U.S. to tax havens such as Bermuda.¹⁹² For the most part, the change of incorporation was simply a formality. No change of ownership or operations followed. These inversions were known as “naked inversions”. Early transactions took advantage of certain code provisions granting tax-free treatments for reorganizations, so the inversions themselves were tax-free. The IRS responded with regulatory actions that made certain inversion taxable to shareholders, if at least 50% of the shareholders of the “pre-inversion” domestic corporation remained shareholders of the new foreign-incorporated corporation.¹⁹³ In such circumstances, shareholders are treated as if they dispose their stock in the “old” domestic corporation in a taxable exchange, and receive in return stock of the “new” foreign corporation.

If the inversion is taxable, the tax burden on shareholders depends on their basis in their shares, their holding period in their shares, and their level of income. As explained above, taxable gain on the disposition of capital assets is the difference between the fair market value at the time of disposition and taxpayer’s basis.¹⁹⁴ The lower the basis, the higher the taxable gain is.

The holding period in the shares determines the tax rate applicable to gain. If an asset is held for a period longer than a year, then upon disposition, the gain is taxed at preferred long-term capital gains (LTCG) rates.¹⁹⁵ The I.R.C. prescribes a progressive rate for LTCG, depending on the taxpayer’s income. Currently, the highest LTCG rate is twenty percent.¹⁹⁶ In addition to the capital gains tax, investors who earn income above certain thresholds are

¹⁹⁰ Marian, *Home Country Effects*, *supra* note 171, at 4 (“when the dislocation of real economic attributes is necessary in order to [invert], tax savings may not justify the cost of such dislocation”).

¹⁹¹ I.R.C. §7701(a)(4). This formal rule is quite exceptional. Most other countries employ substantive rules to determine corporate residence. *See*, Omri Marian, 54 B.C. L. REV. 1613, 1657-1658 (2013) (describing U.S. exceptionalism in adopting a formal corporate tax-residence test).

¹⁹² Marian, *Home Country Effects*, *supra* note 171, at 7-8 (describing the “first wave” of corporate inversions).

¹⁹³ Treas. Reg. § 1.367(a)-3(c).

¹⁹⁴ I.R.C. §1001. For most taxpayers corporate stock are classified as capital assets. Stock in the hands of dealers and traders in securities are likely to be classified as inventory.

¹⁹⁵ I.R.C. §1222(3).

¹⁹⁶ I.R.C. §1(h)(1)(D).

also subject to 3.8% tax on investment income.¹⁹⁷ Thus, shareholders who have held the stock for long periods may be subject to a total federal tax rate of 23.8% on their “gain” from an inversion transaction, even though they may have realized nothing. Moreover, the tax burden is higher once state and local taxes are considered.

If the shareholders had held the stock for a period of a year or less, the applicable rates will be short-term capital gains (STCG) rates.¹⁹⁸ STCG rates are generally the taxpayer’s marginal bracket rates, which—depending on the taxpayer income—were be as high as 39.6% before the TCJA (and 37% after the TCJA).¹⁹⁹ Adding the 3.8% investment tax on top means that some investors may see their “gain” taxed at a rate of 43.4%.

Notwithstanding the regulatory changes that made inversions taxable to shareholders, inversions remained popular well into the early 2000s. These transactions, however, received unfavorable public attention.²⁰⁰ Congress finally responded in 2004, by enacting the “anti-inversion” rules, codified in I.R.C. sections 7874 and 4985.²⁰¹ Section 7874 aims at the corporate level, while section 4985 targets managers.

Section 7874 denies the benefits of an inversion to the corporation itself. Specifically, Section 7874 creates two thresholds for ownership “continuation” that determine the tax treatment of an inverted corporation. If at least eighty percent of the shareholders (by vote or value) of the new foreign corporation are shareholders of the old domestic corporation, the foreign corporation is treated as “domestic” for tax purposes (notwithstanding its foreign incorporation).²⁰² If sixty percent of the shareholders of the new “foreign” corporation (but less than eighty percent) were shareholders of the old corporation, then the inverted corporation is unfavorably taxed in the U.S. for a period of ten years.²⁰³ An exception prescribes that if the new inverted corporation has “substantial business activity” in the foreign jurisdiction, Section 7874 does not apply.²⁰⁴ The logic is not to penalize transactions that are driven by substantive business

¹⁹⁷ I.R.C. §1411(a).

¹⁹⁸ I.R.C. §1222(1).

¹⁹⁹ I.R.C. §1(a)-(d).

²⁰⁰ Hale E. Sheppard, *Flight or Fight of U.S.-Based Multinational Business: Analyzing the Causes for, Effects of, and Solutions to the Corporate Inversion Trend*, 23 NW. J. INT’L L. & BUS. 551, 557–58 (2003) (describing how corporate inversions were perceived by media and policy makers in the early 2000s).

²⁰¹ P.L. 108-357 2004 (American Jobs Creation Act of 2004), §§ 801(a), 802(a).

²⁰² I.R.C. § 7874(b).

²⁰³ I.R.C. § 7874(a)(2)(B).

²⁰⁴ I.R.C. § 7874(a)(2)(B)(iii). The “substantial business activity” threshold is generally met if at least twenty five percent of the assets, income and employees of the foreign corporations are located in the foreign jurisdiction. Treas. Reg. 1.7874-3.

considerations.

While IRC 7874 successfully shut down “naked inversions”, other types of inversions transactions continued. After the enactment of Section 7874, U.S. multinationals engaged in inversions by merging with much smaller foreign corporate targets, but just large enough to avoid the sixty or eighty percent thresholds. Such transactions are almost always taxable to shareholders, because shareholders of the inverted corporation wish to maintain control of the merged entity. As a result, the transactions cross the fifty-percent ownership threshold that makes the transactions taxable.²⁰⁵ In response to this more recent wave of inversions, Treasury had issued three different sets of intricate guidance and regulations aimed at preventing inversions,²⁰⁶ with some success.²⁰⁷

The other Congressional response to inversions—Section 4985—discourage inversions by imposing an excise tax on managers. As noted, in most inversion transactions shareholders are required to recognize gain as if they sold their share of the inverted corporation in exchange for shares of the “new” foreign entity. Managers may hold shares in the corporation they manage, and thus suffer the shareholder-level tax like other shareholders. Managers, however, may hold substantial part of their performance-based compensation not in stock, but in other types of equity derivatives such as stock options. Many such compensatory instruments are not taxable in an inversion (or in other corporate mergers for that matter).²⁰⁸ In enacting Section 4985, Congress recognized this fact, expressing concern that “while shareholders are generally required to recognize gain upon stock inversion transactions, executives holding stock options and certain stock-based compensation are not taxed upon such transactions.”²⁰⁹ To address this problem, section 4985 imposes excise tax on executives’ stock-based

²⁰⁵ See, *supra* note 193 and accompanying text.

²⁰⁶ Notice 2014-52, *Rules Regarding Inversions and Related Transactions*, 2014-42 I.R.B. 712 (Sep. 22, 2014); Notice 2015-79, *Additional Rules Regarding Inversions and Related Transactions*, 2015-49 I.R.B. 775 (Dec. 2, 2015); T.D. 9790, 81 F.R. 72858-72984 (Oct. 21, 2016) (promulgating regulations to deny certain tax benefits of inversion transactions).

²⁰⁷ Andrew Velrade & Zoe Sagalow, *As Inversion Dries Up, FDI Fell in 2016*, TAX NOTES INT’L (Jul. 24, 2017) (Crediting the Obama Administration’s regulatory guidance with stopping several planned inversion transactions).

²⁰⁸ It is beyond the scope of this article to discuss the tax consequences of equity-based compensation. Many types of such compensation, however, are not treated as deemed disposed equity in an inversion. Even if it is, such compensatory instruments are frequently drafted to allow management significant control of the timing of taxable gain recognition. For a discussion of tax planning advantages of certain types of performance-based executive pay, see, David I. Walker, *The Way We Pay Now: Understanding and Evaluating Performance-Based Executive Pay*, 1 J. OF L. FIN. & ACC’ING 395 (2016).

²⁰⁹ H.R. REP. 108-548(I), 246.

compensation.²¹⁰ Generally, the tax is imposed a rate of 15% on gross value of equity-based compensation of top executives.²¹¹ The executives are individually liable for the tax.²¹² The idea is to make sure that an inversion transaction is taxable to managers, forcing them to internalize shareholder-level tax cost associated with the inversion. Section 4985 piggybacks off the Section 7874 thresholds. That is, the excise tax is only applicable if shareholders of the pre-inversion corporation own at least sixty percent of the inverted corporation.²¹³ Thus, it is theoretically possible to structure inversions that are taxable to shareholders but not to managers. This will happen if the transaction pass the fifty-percent ownership threshold (and hence taxable to shareholders) but not the sixty percent threshold (and hence does not trigger the excise tax on managers).

ii. Corporate Inversions as STCTs

Inversion transactions present an obvious case of the governance problems associated with STCTs. For example, when Medtronic announced its plan to invert by merging with Irish-based Covidien (itself an inverted corporation), the board—in recommending the transaction for shareholders’ approval—noted that “the combined company’s effective tax rate will be reduced by about one to two percentage points compared with the companies’ estimated blended rate.”²¹⁴ While a two-percentage point reduction in effective tax rate is a desirable corporate-level outcome, the transaction was taxable to shareholders.²¹⁵ The Medtronic board was aware of this fact, noting in the registration statement “the merger is expected to be taxable for U.S. federal income tax purposes to the Medtronic shareholders, which could particularly affect long-term Medtronic shareholders with a low basis.”²¹⁶

²¹⁰ I.R.C. § 4985(a).

²¹¹ As of Jan. 1, 2018, the § 4985 excise tax is imposed at a rate of 20%. *See*, TCJA *supra* note 38, § 13064.

²¹² I.R.C. § 4985(b). At the time of the enactment the fifteen percent rate was equivalent to the rate imposed on long term capital gains, which would be the rate faced by shareholders who have held their stock in the corporation for a period longer than a year. The intent was to make the rate imposed on managers equivalent to the rate imposed on shareholders. Since then, however, the long-term capital gains tax rate has increased to twenty percent. *See*, I.R.C. 1(h)(1). Congress, however, did not amend Section 4985 to maintain the parity between shareholders and managers. *See*, Walker, *Another Critical Look*, *supra* note 30, at fn. 9.

²¹³ I.R.C. § 4985(c).

²¹⁴ Medtronic Holdings Limited, Registration Statement (Form S-4/A) 93 (Nov. 20, 2014). Hereinafter: Medtronic Registration Statement.

²¹⁵ *Id.*, at 24 (“For U.S. federal income tax purposes, the receipt of New Medtronic ordinary shares and cash in lieu of fractional New Medtronic ordinary shares in exchange for Medtronic common shares pursuant to the merger will be a taxable transaction”).

²¹⁶ *Id.*, at 94.

An expected corporate-level tax savings of “one to two percent” compared with shareholder-level tax as high as 23.8%,²¹⁷ suggests that some taxable shareholders may have suffered a net loss. Indeed, shortly after the transaction, minority taxable shareholders filed a class action against Medtronic, arguing, among others, that shareholders lost value due to the fact they were required to pay capital gains taxes in the inversion.²¹⁸

Shareholders made similar claims in a class action filed after Johnson Controls inverted by merging Tyco (Tyco itself was also an inverted corporation). In that case, some of the plaintiffs were Johnson Control’s retirees who received stock as an incentive pay.²¹⁹ These retirees had a very low basis in the stock, which caused most of their stock value to be subject to tax in the inversion. The plaintiffs alleged that—taking into account state and local taxes—the resulting tax burden was “more than a third” of their value of their Johnson Controls stock.²²⁰

Nonetheless, shareholders approved both the Johnson Controls and Medtronic inversions. There is no surprise here. It is reasonable to assume that tax-exempt shareholders owned the majority shares in both cases.²²¹ For tax-exempt shareholders, the inversion is always wealth-increasing, so they will rationally vote to approve the inversion. The plaintiffs in the Johnson Controls class action specifically noted the conflict of interest between taxable and tax-exempt shareholders.²²²

As evident from the Johnson Controls and the Medtronic shareholders suits, inversions “[present] a dilemma in that difference in the personal tax statuses of shareholders can lead to disagreement over the optimal corporate policy.”²²³ In a recent study, Babkin, Glover, & Levine empirically analyze

²¹⁷ Shareholders with low basis likely have held the shares for a period longer than a year, so long term capital gains rates (rather than short term capital gains rates) are likely applicable.

²¹⁸ In re Medtronic, *supra* note 21, at 410 (Minn. 2017) (“The allegations of the Amended Complaint explain that the shareholders are harmed because the tax liability is imposed on them solely in their status as shareholders. Medtronic itself did not incur a capital-gains tax liability on the transaction, and therefore could not recover for the injury caused by this alleged harm... [T]he court of appeals correctly held that claims asserting this harm are direct”).

²¹⁹ Johnson Controls Complaint, *supra* note 21, at ¶ 138. (“Defendants knew its employees and retirees had little or no basis--i.e., large gains--because those employees and retirees bought their stock from JCI”). Hereinafter:

²²⁰ *Id.*, at ¶ 101

²²¹ See, *supra* note 19 and accompanying discussion.

²²² Johnson Controls Complaint, *supra* note 21, at ¶100 (“While the deal’s expected tax avoidance opportunities will, if realized, benefit JC plc and its non-taxpaying shareholders... that benefit will not be shared by the Minority Taxpaying JCI Shareholders”);

²²³ Babkin, Glover, & Levine *supra* note 20, at 228.

sixty inversion transactions, and find that “the aggregate effect [of inversions] across all shareholders (taxable and tax-exempt) is a 3.0% increase in value.”²²⁴ However, “[f]or an investor with a holding period greater than 3 years, half of the inversions... result in a negative after-tax return.”²²⁵ For a simulated California-based high-net-worth taxable investor, Babkin, Glover, & Levine find that—after taking into account local taxes—an inversion results in a 20.6% loss of value, on average.²²⁶

Babkin, Glover, & Levine study shows that inversions are usually not Pareto-optimal. This suggests that “an inversion results in a wealth transfer between shareholders.”²²⁷ While they do find inversions to be efficient overall, it is plausible that some inversion transactions are inefficient across shareholders (meaning, the value lost to taxable shareholders outweighs the gain to tax-exempt shareholders). This is a reasonable assumption, because Babkin, Glover, & Levine finding of 3.0% aggregate value increase is an *average* for all transactions they report. Such a low average benefit suggests that it is possible that outlier transactions result in an overall loss for shareholders. There is also some empirical evidence suggesting that this may be the case. For example, market reaction to inversion announcements has been mixed, with some corporations losing value after inversions.²²⁸ Since inversions save corporate-level taxes, one would expect a positive market reaction to inversion announcements. The mixed reaction suggests that corporate tax savings are potentially offset by other costs. One such cost may be shareholder-level taxes. If taxable shareholders own a large enough percentage of the inverted corporation, one can envision a plausible scenario under which shareholder-level tax cost is higher than corporate-level tax savings.

Another cost that may undo the tax-benefit, is the corporate governance cost. For example, Cortes et. al. empirical analysis of governance mechanisms in inverted corporations find that “[f]irms that invert award executive pay that is less sensitive to stock prices, have greater protection from hostile takeovers, higher bid-ask spread and lower institutional ownership.”²²⁹ This suggests, they argue, that corporate governance suffers after an inversion.

²²⁴ *Id.*, at 1.

²²⁵ *Id.*

²²⁶ *Id.*, at 24.

²²⁷ *Id.*, at 25.

²²⁸ Rao, *supra* note 174, at 13.

²²⁹ Felipe Cortes, Armando Gomes & Radhakrishnan Gopalan, *The Effect of Inversions on Corporate Governance* 5 (2016). <https://ssrn.com/abstract=2481345>; See also, Day, *supra* note, 144, at 458 (2016) (Noting that in inversions “shareholders vote in favor of--and thus authorize--the very transactions that limit their ability to acquire information and enforce other shareholder rights”).

Inversions also create a unique governance problem relating to managerial incentives. As noted, one Congressional response to the inversion phenomenon was to impose an excise tax on top executives in inverted corporations, in order to align executives' tax-interest with the interest of taxable shareholders.²³⁰ Management response, however, was to structure transactions to include management tax "gross-up" payments.²³¹ For example, the Medtronic inversion transaction included a "gross-up payment to each director and executive officer of Medtronic with respect to any excise taxes that may be imposed pursuant to Section 4985 of the Code"²³², for a total cost of \$72 million.²³³ It is rational for tax-exempt shareholders to agree to such additional cost. Medtronic registration statement estimated the tax savings from the transaction at about one to two percent reduction in effective rate. For 2014, Medtronic reported \$780 million in tax payments. A two percent reduction would result in an immediate tax saving of \$15.6 million. It will only take a few years for the corporate tax savings to outweigh the immediate cost of the gross-up. Shareholders in the Medtronic lawsuit alleged specific harm because of such gross-up payment, which was not available to all other shareholders.²³⁴

The Johnson Controls transaction offers an interesting twist to the problem of managerial rent extraction in STCTs. In that case—some shareholders claim—instead of having the corporation gross-up managers, managers structured the transaction to avoid the excise tax altogether. Recall, that the excise tax is applicable to the extent that Section 7874 is applicable, meaning, if the transaction crosses the sixty-percent continuity of ownership threshold. The Johnson Control's/Tyco inversion was a reverse acquisition, in which Tyco formally acquired Johnson Controls for a combination of cash and stock. After the transaction, former shareholders of Johnson Controls held fifty-six percent of the merged corporation, just below the sixty percent threshold.²³⁵ Thus, while the transaction was a taxable to shareholders, it did not qualify as an "inversion" for purposes of the Section 4985 excise tax. Shareholders in the Johnson Controls litigation argued that the management achieved the "below-sixty" threshold by undervaluing Johnson Controls'

²³⁰ See, *supra* notes 194-199 and accompanying discussion.

²³¹ Ajay Gupta, *News Analysis: Grossing Up an Inversion Tax*, 75 TAX NOTES INT'L 806 (Sep. 8, 2014) "Grossing up [managers for] the section 4985 excise tax appears to be the norm in inversion transactions."

²³² Medtronic Registration Statement, *supra* note 214, at 22.

²³³ *Id.*

²³⁴ *Supra* note 218.

²³⁵ Tyco International PLC, Registration Statement (Form S-4) 1 (Jul. 1, 2016) "After consummation of the merger, Johnson Controls shareholders and Tyco shareholders are expected to own approximately 56% and 44%, respectively, of the issued and outstanding ordinary shares of the combined company").

stock, and by forcing shareholders to receive a partial cash payment for their stock.²³⁶ A higher valuation that included no cash compensation would have required that Johnson Controls shareholders receive a higher share of the merged entity's equity, thus potentially crossing the sixty percent threshold. The avoidance of the excise tax, shareholders argued, "was accomplished by the improper dilution of [Johnson Controls] shareholders' equity interest."²³⁷

At this time, both the Johnson Controls and the Medtronic inversions are still being litigated. Other inversion transactions also resulted in lawsuits relating to shareholder-level tax cost.²³⁸ Regardless of what the outcomes may be, ongoing inversion litigation vividly demonstrate the unique governance challenges of STCTs.

c. REIT Spinoffs and REIT Conversions

REIT spinoffs transactions (and the conceptually similar REIT conversion transactions),²³⁹ became a common tax-reducing scheme in the early 2000s.²⁴⁰ REIT spinoffs received popular and academic attention.²⁴¹ Many viewed such transactions as an abusive form of corporate tax planning,²⁴² and in 2015 Congress eventually intervened to prevent such transactions.²⁴³ Commentators, however, have given little attention to the

²³⁶ Johnson Controls Complaint, *supra* note 21, at ¶ 13 ("The under-60% ownership was accomplished by JCplc's cash payment of \$3.86 billion to JCI shareholders in lieu of JCplc stock--i.e., JCI/JCplc forced JCI shareholders to sell to it \$3.86 billion (approximately 17%) of JCI shares at a substantial discount ... and by using the same steeply discounted value ... to determine the exchange ratio of JCI shares for JCplc shares...").

²³⁷ *Id.*, at ¶7.

²³⁸ See, e.g., Complaint for Violation of the Federal Securities Laws, Steamfitters Local 449 Pension Plan v. Eaton Corp. PLC., 2016 WL 3963518 (S.D.N.Y.) (alleging that as a result of an inversion transaction, a previously announced tax-free spinoff will become taxable to shareholders).

²³⁹ Borden, for example, refers to REIT conversions as the "cousin" for REIT spinoffs. See, Borden, *supra* note 20, at 529.

²⁴⁰ Goolsbee & Maydew, *supra* note 32, at 442-443 (describing 2001 changes in IRS practices that made REIT spinoffs possible); Martin A. Sullivan, *The Revenue Costs of Nontraditional REITs*, 144 TAX NOTES 1103 (Sep. 8, 2014) (examining twenty REIT spinoff and conversion transactions between 1999 and 2015).

²⁴¹ See, e.g., *Id.*; Borden, *supra* note 20; Liz Moyer, *R.E.I.T. Spinoffs in Washington's Cross Hairs*, N.Y. Times (Dec. 15, 2015), https://www.nytimes.com/2015/12/09/business/dealbook/reit-spinoffs-in-washingtons-cross-hairs.html?_r=1; Liz Hoffman, *IRS Raises Red Flag on Real-Estate Spinoffs*, Wall St. J. (Sep. 15, 2015, 7:16 PM) <https://www.wsj.com/articles/irs-raises-red-flag-on-real-estate-spinoffs-1442359003>.

²⁴² Borden, *supra* note 20, at 529-30 (describing the negative attention to REIT spinoff and conversion transactions).

²⁴³ P.L. 114-113, Protecting Americans from Tax Hikes Act of 2015 §311(a) (2015), codified in I.R.C. § 355(h) (Severely restricting tax-free treatment for REIT spinoff

unique governance issues arising in REIT spinoffs. REIT spinoffs turn a regular corporation—the income of which is subject to double taxation—into a corporation the income of which is taxed only once. However, the single tax is achieved through a “forced distribution” regime.²⁴⁴ As a result, shareholders pay a personal tax cost for a corporate-level tax benefit. It is not always clear that that the corporate tax savings outweigh the shareholder tax costs.

i. Background: The Tax Benefits of REIT Spinoffs

REITs are collective investment vehicles “through which small investors can pool their resources in order to invest in real estate and mortgages on real estate”.²⁴⁵ REITs are corporations for tax purposes. Unlike regular corporations, REITs receive a deduction for dividends paid to investors.²⁴⁶

The I.R.C. prescribes multiple intricate requirements for REIT qualifications, aimed to assure that they function as a pooled real-estate investment vehicle.²⁴⁷ For example, at least 75 percent of a REIT’s gross income must be from passive real-estate related payments (such as rents, or disposition of real property at a gain).²⁴⁸ In addition, at least 75 percent of the value of a REIT’s total assets must be attributable to real estate assets, cash and cash items.²⁴⁹ The most important qualifying requirement for our purpose is that a REIT must distribute ninety percent of its profits each year.²⁵⁰ Since REIT dividends are deductible, this requirement functionally assures that tax at the corporate level is eliminated (or almost completely eliminated).

The elimination of the corporate level tax, however, comes at a cost: shareholders relinquish control on the timing of gain recognition.²⁵¹ In the case of regular corporations, shareholders can choose to invest in corporations with a policy of minimum dividend distribution, and thus defer gain recognition until disposition of the stock. REITs, however, must distributed all (or most) of their profits each year.²⁵² Shareholders must therefore recognize gain on dividends received and pay tax. In addition, unlike dividends distributed by “regular” corporations, most REIT dividends

transactions, by making the spinoff transaction a taxable transaction).

²⁴⁴ See, discussion *supra* at Part III.a.iii.

²⁴⁵ David F. Levy, Nickolas P. Gianou & Kevin M. Jones, *Modern REITs and the Corporate Tax: Thoughts on the Scope of the Corporate Tax and Rationalizing Our System of Taxing Collective Investment Vehicles*, TAXES—THE TAX MAG. 217, 219 (Mar. 2016).

²⁴⁶ I.R.C. § 857.

²⁴⁷ I.R.C. § 856

²⁴⁸ I.R.C. § 856(c)(3)

²⁴⁹ I.R.C. § 856(c)(4)

²⁵⁰ I.R.C. § 857(a)

²⁵¹ Kanda & Levmore, *supra* note 25, at 246 (“The requirement of immediate distribution of income works to deny control over the timing of taxes”).

²⁵² This requirement excludes net capital gains. I.R.C. § 857(a).

do not qualify for long-term capital gains rates.²⁵³ This means that most REIT dividends are taxed at the shareholder's marginal tax rate. As explained above,²⁵⁴ the investor-level tax rate (before the TCJA) could be as high as 43.4%. The exception to this rule are REIT dividends that are attributable to capital gains from the disposition of real-estate assets by the REIT.²⁵⁵ These "capital gains dividends" do qualify for the lower 23.8% tax rate.²⁵⁶

On its face, the shareholder-level price seem to be worth the trouble. Under the classical double-tax model (applying pre-TCJA rates), the combined effective rate of 35% corporate level tax, plus 23.8% tax on dividends is 50.47%.²⁵⁷ This is higher is higher than the maximum possible effective shareholder-level rate of 43.4%.

The idea of a REIT spinoff transaction is to enable a corporation whose primary activity is *not* in real estate investment, to take advantage of the REIT regime. A stylized example can help to illustrate such scheme.

Assume RetailCo is a corporation that owns and operates large retail stores. RetailCo cannot qualify as a REIT, because its primary business is in retail, not in real estate investment. Nonetheless, the stores themselves are real estate assets, and represent a significant portion of RetailCo's assets. RetailCo can take advantage of the REIT regime by spinning off its retail stores into a REIT as follows:

First, RetailCo creates a new corporation, REITCO. RetailCo then contributes all of its stores to REITCO. Second, RetailCo distributes (spins off) REITCO to its shareholders. From a shareholder point of view, nothing of economic significance has changed. The only change is a legal change: instead of owning stock in one corporation, shareholders' interests are now divided between two entities. One that owns the stores (REITCO), and another that operates the stores (RetailCo). Before a 2015 change in law, the spinoff could be structured as a non-taxable transaction.²⁵⁸

After the spinoff, REITCO leases the stores (i.e., the real estate assets) to RetailCo, and RetailCo continue to operate them in its retail business. The

²⁵³ I.R.C. §§ 1(h)(1)(D), (h)(11). REIT managers may designate dividends attributable to REIT-level capital gains, as "capital gains dividend" taxed at preferred rates. I.R.C. § 857(b)(3)(c).

²⁵⁴ See, *supra* notes 198-199 and accompanying discussion.

²⁵⁵ In REIT spinoffs, however, very little REIT income is expected to be capital gains income. The reason is that the REIT is not organized with the primary purpose of acquiring and disposing of real estate (which would generate capital gains), but rather to service the operation of the original corporation. Most of the REIT income will be from the lease payments, which are classified as ordinary income (rather than capital gain).

²⁵⁶ *Supra* note 253.

²⁵⁷ If corporate income is taxed at 35%, this leaves 65% of the income to distribute. If all income is distributed and taxed at 23.8%, the shareholder is left with $0.65 \times (1 - 0.238)$, or 49.53% of the income, for an effective tax rate of 50.47%.

²⁵⁸ *Supra* note 243.

lease payments are deductible to the RetailCo, and eliminate much of the RetailCo's tax base. The income from the leasing payments shows up on REITCO's books. Ordinarily, such payment would be taxable to REITCO. However, REITCO can now elect to be a REIT. The reason is that all of REITCO's assets are qualifying real estate assets (the stores), and all of REITCO's income is qualifying real estate income (lease payments).

As a REIT, REITCO now must distribute all of its income from the lease payments to shareholders. While this distribution is deductible to REITCO (thus eliminating corporate-level income), the dividend receipts are includible to shareholders. The result is that nothing of substance had changed. The only income producing activity is still the retail income. The shareholders are the same shareholders. The only difference is that by the magic of paperwork RetailCo became two corporations. RetailCo can now make a deductible payment to REITCO, but REITCO is not required pay tax on such receipt as long as it distributes its profits to shareholders.

ii. REIT Spinoffs as STCTs

Consider, for example a taxable shareholder in a publicly traded corporation. If the corporation earns \$100, the corporation will be subject to a pre-TCJA tax of 35%, leaving \$65 for distribution. If such amount is distributed, the shareholders will be subject to additional tax of 23.8%, leaving the shareholder with net income of \$49.53. The combined double-tax burden is 50.57%. If, on the other hand, the corporation turns into a REIT and earns \$100, and the entire amount is distributed, there is no corporate-level tax. The shareholder, however, may be subject to tax as high as 43.4% on such distribution. This is better, so it seems, than 50.57%.

This assumes, however, that in the comparable non-REIT structures, the corporation distributes all its available earnings. There is no reason to assume that this is the case.²⁵⁹ Consider, for example, a situation in which only half of the corporate \$100 profit is distributed.²⁶⁰ At 35% corporate tax rate, the corporation will be subject to \$35 of tax. This would leave \$65 to be distributed. If only half is distributed (meaning, \$32.5) the shareholder-level tax liability is \$7.735 (23.8% times \$32.5). The total current tax liability is therefore $\$35 + \$7.735 = \$42.735$, which is *lower* than the current tax liability under the REIT alternative. This is, again, a counter-intuitive result, because REIT conversions are perceived to be beneficial to shareholders from a tax

²⁵⁹ See, Borden, *supra* note 20 at 542 (“[C]orporations are not subject to a distribution requirement. Corporations can therefore avoid subjecting their income to double tax by reinvesting the income and not making distributions”).

²⁶⁰ This is a conservative assumption, because corporations typically distribute less than half of their income. *Id.* (“In fact, in practice corporations distribute no more than 25 percent of their taxable income on average”).

point of view.

Table 5 below summarizes this outcome:

Table 5

	Regular Corporation (distributes 50% of available profits)	REIT (must distribute all available profits)
Gross corporate income	\$100	\$100
Corporate-level tax (35%)	(\$35)	\$0 (all profits distributed and deducted)
Profits available for distribution	\$65	\$100
Profits distributed	\$32.5	\$100
Shareholder-level tax	$23.8\% \times \$32.5 = (\$7.735)$	$43.4\% \times \$100 = (\$43.4)$
Total tax burden	$\$32.5 + \$7.735 =$ $(\$42.735)$	$(\$43.3)$

There is another important point to consider in the context of REIT spinoffs and conversions. In a regular corporation, shareholders can control the timing of recognition of the second level of tax. Assume for example, that the corporation (before turning into a REIT), did not regulatory distribute its earnings. While the 35% corporate-level tax is imposed when the corporation earns the income, the shareholder level tax (23.8%) is only due when the shareholder decides to sell the stock. The shareholder is able to defer the tax liability, and at least in theory, reduce the net present value of the tax burden.²⁶¹ Consider for example, a shareholder with a basis of \$25 that plans to defer the sale of a stock worth \$65 for four years, and that the market discount rate is five percent. The net present value of the future tax is about \$7.83 [$(23.8\% \times (65-25) / (1+0.05)^4$]. Combined with the \$35 corporate-level tax (due today), the NPV of the total tax burden is \$42.83. This is less than the \$43.4 due today under the REIT scenario.

Finally, recall that one of the potential benefits of corporate taxation—per Kanda and Levmore—is to alleviate conflicts of interest among shareholders regarding in-corporate dispositions. Under their theory, when entity-level actions generate shareholder-level tax liabilities, managers (who are also shareholders) may prefer their own tax interest and, for example, delay corporate dispositions in order to delay shareholder-level taxes. This problem is re-introduced in the REIT contexts. Since REIT must distribute most of its profits managers may engage in corporate-level profit management in order to delay or advance profits recognition, thus timing the required distributions to benefit management’s tax interests.

²⁶¹ “In theory”, since corporate earnings may also increase, and such increasing earnings are subject to tax and increase future distributions. Does it is not necessarily that deferral reduces the NPV of the tax liability.

IV. THE IMPLICATIONS OF STCTS AND WHAT TO DO ABOUT THEM

Thus far, I outlined a counter-intuitive descriptive claim: Management actions that reduce corporate tax liability may increase the overall tax burden on some shareholders. Such outcome is possible because managers and tax-exempt shareholders rationally cooperate against the interest of taxable shareholders. The purposes in this part is to explain why it matters (Subpart A), and to offer potential solutions to the problem (Subpart B).

a. *The Legal and Normative Implications of STCTS*

i. Shareholder Primacy and Managers' Duty to Reduce Corporate Taxes

Some commentators argue that managers have a fiduciary duty to shareholders to reduce corporate tax liability.²⁶² As a matter of positive law, this argument is questionable. No law that I am aware of requires managers to engage in corporate tax planning, and no court that I am aware of has interpreted the law to find such a duty.²⁶³

However, it is worth considering the rational of such arguments in the context of STCTS. The suggestion that management has a fiduciary duty to increase shareholders wealth by reducing corporate taxes makes an explicit normative choice, adopting the shareholder primacy view of the corporation. Under this view, normative assessment of corporate laws (and management actions) is based on whether they enhance shareholder value.²⁶⁴ “Shareholder primacy is said to offer management a way to evaluate decisions within the framework of a single-valued objective function”,²⁶⁵ that is, shareholder welfare. The shareholder primacy view is a prevalent view in academic discourse.²⁶⁶

²⁶² See, *supra* note 6.

²⁶³ See, *supra* note 7. Professor Reuven Avi-Yonah explored this question at length from both practical and theoretical point of view, considering the duty of managers to reduce corporate taxes under different corporate theories. See, Avi-Yonah, *Corporate Social Responsibility*, *supra* note 5. He concludes that “under *any* of the major views of corporations, corporations should not be permitted to engage in strategic behavior designed solely to minimize its taxes.” *Id.*, at 28.

²⁶⁴ Jill E. Fisch, *Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy*, 31 J. Corp. L. 637, 637-8 (2006) (describing shareholder primacy as a normative linchpin to assess corporate law); Oliver Hart & Luigi Zingales, Companies Should Maximize Shareholder Welfare Not Market Value, 2017 J. of L. Fin. & Account. 247 (2017) (Argue that companies should operate to increase shareholders welfare).

²⁶⁵ Fisch, *id.*, at 661

²⁶⁶ LYNN STOUT, THE SHAREHOLDER VALUE MYTH: HOW PUTTING SHAREHOLDERS FIRST HARMS INVESTORS, CORPORATIONS, AND THE PUBLIC 33 (2012) “[M]any legal

However, the shareholder primacy approach has been criticized, among others, because it contains an implicit assumption that common shareholders share homogenous interests.²⁶⁷ In reality, shareholders have diverse investment tastes, which translate to different preferences for corporate behavior. “Recognizing these differences reveals that the idea of a single objectively measurable “shareholder value” is not only quixotic, but intellectually incoherent.”²⁶⁸

STCTs offer a practical example supporting the critical view of the shareholder primacy approach. The argument that managers engage in corporate level tax planning to benefit shareholders implicitly assumes that shareholders tax interests are homogenous. As I have shown, this assumption cannot be reconciled with how tax law operates in practice. STCTs may increase value to some shareholders but reduce it to others. This fact exposes the logical incoherence of the argument that managers must engage in corporate tax planning. If a corporate tax-reducing scheme may result in increased tax-burden on shareholders, how can one argue that managers have a duty to engage in such behavior under a shareholder value-maximization theory?

Even if one adopts the view that managers must attempt to maximize shareholders’ value, there is a real practical difficulty with articulating managers’ duties in the context of STCTs. Managers do not know (and cannot know) what are the personal tax consequences to each shareholder stemming from a particular transaction. Managers simply do not have access to shareholders’ personal tax information.²⁶⁹ As a result, managers can never tell upfront whether an STCT is expected to increase or decrease shareholder value in the aggregate.

To see why this observation is important, it is helpful to unpack some of

scholars today passionately embrace shareholder value as a normative goal... The perceived superiority of the shareholder-oriented model has inspired a generation of would-be reformers to work tirelessly to ‘improve’ corporate governance so managers focus on shareholder value”).

²⁶⁷ Fisch, *supra* note 264, at 661. (“To the extent that the interests of different stakeholders conflict, the stakeholder model offers no principled basis for choosing among them. ... Within the shareholder class, the investors vary considerably among such dimensions as the time frame over which they invest, the extent to which they trade versus passively holding the corporation’s stock, their degree of diversification, the extent to which they hold nonequity interests in the issuer, any option or other hedging positions that they hold, and so forth”); STOUT, *id.*, at 60 (“The standard shareholder-oriented model assumes a hypothetical, homogeneous, abstract shareholder who does not and cannot exist.”)

²⁶⁸ Stout, *id.*, at 61.

²⁶⁹ Marian, *Reconciling Tax Law and Securities Regulations*, *supra* note 17, at 42-3 (“From a legal standpoint, privacy safeguards protect most taxpayer information, which makes it impossible to acquire such information without a waiver from investors”).

the components of managers' fiduciary duties and explore them in the context of STCTs. Managers' fiduciary duties include, in broad terms, the duty of loyalty (also known as the duty of fair dealing) and the duty of care.

Under the duty of loyalty, a manager "commits allegiance to the enterprise and acknowledges that the best interests of the corporation and its shareholders must prevail over any individual interest of his own."²⁷⁰ Corporate officers "can neither appear on both sides of a transaction nor expect to derive any personal financial benefit from it in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all stockholders generally."²⁷¹

Due to shareholders' tax heterogeneity, STCT benefits do not necessarily flow to "all stockholders generally". In some STCTs, the benefit may flow only to tax-exempt shareholders and managers at the expense of taxable shareholders. In such a case, it is not only that managers have no duty to engage in tax planning, but taxable shareholders may reasonably argue that by receiving a gross-up payment, managers engage in self-dealing. Courts have indeed recognized the duty of managers and majority shareholders to "deal fairly with their corporation and minority shareholders."²⁷² If managers would not have approved the transaction without the tax gross up, it could suggest that managers preferred their own interests to the interest of taxable shareholders and the corporation. Whether this is the case, is a transaction-specific question, and requires a fact-intensive inquiry.

The other major component of managers' fiduciary duties is the duty of care. The duty of care is the duty "to perform the director's or officer's functions in good faith, in a manner that he or she reasonably believes to be in the best interests of the corporation, and with the care that an ordinarily prudent person would reasonably be expected to exercise ..."²⁷³

While STCTs may reduce corporate-level taxes, it is difficult to argue that the duty of care imposes an affirmative requirement that managers engage in corporate tax planning. Rather, most corporate-level tax plans likely fall under the "business judgment rule". Under the business judgment rule, managers would not breach their duty of care, as long as the managers make a business judgment in good faith, are not self-interested in the transaction, make the decision on an informed basis, and rationally believe that the

²⁷⁰ RESTATEMENT OF PRINCIPLES OF CORP. GOVERNANCE §4 Intro. Note (Am. Law Inst. 1994) (hereinafter: RESTATEMENT OF CORPORATE GOVERNANCE).

²⁷¹ *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984), overruled on other grounds by *Brehm v. Eisner*, 746 A.2d 244, 254 (Del. 2000).

²⁷² RESTATEMENT OF CORPORATE GOVERNANCE, *supra* note 270, at §5.01, and cases cited therein.

²⁷³ *Id.*, at §4.01.

judgment is in the best interest of the corporation.²⁷⁴ The business judgment rule “sharply reduces [managers] exposure to liability.”²⁷⁵ Courts are reluctant to intervene in management business decisions, and generally presume that management’s action is proper.²⁷⁶ Under such circumstances, it is difficult to imagine that the duty of care includes a duty to engage (or not to engage) in corporate tax planning, especially given that tax outcomes are rarely certain.²⁷⁷

ii. STCTs are Inefficient

I explained throughout this article why STCTs might be inefficient. STCTs are rarely Pareto-optimal and can be inefficient overall.

STCTs expose a gap in current U.S. securities laws. The underlying assumption in U.S. securities laws is that as long as information is available, shareholders will vote against inefficient corporate transactions. Efficient capital market theory, however, does not take into account shareholders heterogeneity in tax preferences, nor does it take into account the existence of the unique ownership structures in U.S. equity markets.

Tax-exempt shareholders always stand to benefit from an STCT. They will rationally vote for the transaction. If tax-exempts hold the majority vote—as is usually the case in U.S. equity markets—every STCT will receive shareholders’ approval, even if it is inefficient and even if all information about the transaction is freely available in the market.

iii. STCTs Undo Distributional Policies

STCTs may have a negative effect on government distributional policies. The crux of the argument here is that STCTs effectively shift tax burden from one group of taxpayers to another, through private action.

Taxpayers may agree to shift the tax burden among themselves through contractual relationships. For example, sellers in private transactions may increase the price to account for the expected tax cost of the transaction.²⁷⁸ It

²⁷⁴ *Id.*

²⁷⁵ *Id.*

²⁷⁶ *Id.* (“Courts, when applying the business judgment rule, have often stated that a “presumption” exists in favor of the propriety or regularity of the actions of directors and officers. This correctly signifies that no inference of dereliction of duty can or should be drawn, for example, from the fact that a corporation has suffered a business reversal.”); *Kamin v. American Exp. Co.*, 86 Misc.2d 809, 914 (1976) (Finding no actionable claim when managers were aware that certain transaction structure would “result in the realization of a substantial income tax saving”, but chose a different structure due to “countervailing considerations”).

²⁷⁷ *See, e.g., Seinfeld v. Slager, supra* note 7.

²⁷⁸ For example, credit agreement include a standard provision under which borrowers agree

is difficult to argue against such arrangements if they are a result of a negotiation between willing parties, who agree to alter the legally prescribed tax burdens. STCTs, however, shift the corporate tax burden from the corporation and its managers to taxable shareholders. This shift can happen against the will of taxable shareholders, who have no legal recourse to prevent the transaction.

Under such circumstances—where tax reduction is achieved through shifting of the burden to an unwilling party—distributional considerations are paramount. Assuming government policy aims to achieve certain distributional effects through the tax system, STCTs frustrate such policy.

b. Paths to Address the Agency Problems of STCTs

In this subpart I offer three potential courses of action to address STCTs agency problems: Market based solutions, tax-law based solutions, and corporate-law based solutions.

i. Market based solutions

If left to its own device, capital markets will never correct the agency problems associated with STCTs. As explained above, assuming rational behavior of market participants, and majority ownership of tax-exempt shareholders, shareholders will always approve STCTs.

It has been suggested that “a gross-up could discourage the relevant practice by calling more attention to it.”²⁷⁹ This is unlikely to be a real deterrent. The corporate tax savings accruing to tax exempt shareholders will almost always outweigh the cost of the gross-up. Thus, rational decision making would dictate that tax-exempt shareholders vote for the gross-up. It is only possible to imagine a market-based solution under a capital market structure that is different from the one we currently have, where tax-exempt shareholders do not hold the majority vote.

Another possible argument for market-based approach is to rely on clientele effects. Namely, the idea that investors can choose to invest in companies that match the investors’ tax preferences. Under this scenario, rational taxable shareholders should avoid investing in firms that engage in STCTs. As explained above,²⁸⁰ clientele theory is probably unhelpful in the context of STCTs. Unlike in the case of known corporate distribution policies

to increase interest payment in order to gross up lenders for any withholding tax imposed on interest payments. *See*, MICHAEL BELLUCCI & JEROME MCCLUSKEY, THE LSTA'S COMPLETE CREDIT AGREEMENT GUIDE 122-125 (2nd ed., 2017) (Describing standard tax gross-op provisions in credit agreements).

²⁷⁹ Schizer, *supra* note 3, at ¶2.7.

²⁸⁰ *Supra* note 133 and accompanying discussion.

(which investors can rely on when making investment decisions), investors learn of an STCT only after the fact. At that point, taxable shareholders have already internalized any tax cost associated with the transaction, and have no recourse (other than to sue the corporation).

ii. Tax-Law based solutions

Tax law solutions can come in two forms. One, by addressing the underlying problem—the double-tax model—and adopt some form of corporate tax overhaul that would solve the problem. Second, by adopting a tailored solution aimed at undoing the agency problem. Both of these tax law avenues are not particularly promising.

Corporate tax overhaul. One overhaul of the corporate tax system worth considering is integration. The first obvious problem with such a solution is that it does not seem politically attainable, given the heterogeneity of interests involved. Even if we can achieve integration, however, integration will not necessarily solve the agency problem identified, and may create new agency problems. Moreover, the huge costs of integration weigh against adopting it as a solution to a corporate-governance problem.

Consider full imputation, for example. Under a full imputation system, corporate-level taxes serve as an “advance” on shareholder-level payment. In such a case, all shareholders would benefit from corporate tax reduction. However, other agency costs may present themselves.

For example, managers would still have interest in lowering the corporate-level tax liability, to the extent management’s compensation is connected to after-tax outcomes. This means that managers have an incentive to push the bulk of the taxes to the shareholder level, for example, by delaying the timing of dispositions of in-corporate assets in a manner that lowers corporate tax. If managers are also shareholders, they may have an incentive to time corporate dispositions in a way that benefits their personal tax status (for example, cause the corporation to incur high tax liability in a year managers know they will have personal tax attributes to offset such liability). This is the tax timing problem discussed by Kanda and Levmore.²⁸¹

Integration in the form of dividend-deduction will amplify the agency problems associated with distribution policies.²⁸² Managers will have an incentive to distribute earnings at times when distribution is the most beneficial to the corporation’s tax liability, for example, when the corporation has taxable income to offset. Thus, managers may have an incentive to distribute earnings for the benefit of the deduction, rather than reinvest the

²⁸¹ *Supra* note 109.

²⁸² *See*, discussion *supra* at Part II.c.

corporate earning in new capital.

A dividend-exemption system would presumably put all shareholders on equal footing (none pays shareholder-level tax and all enjoy corporate level tax reduction). However, tax-exempt shareholders are likely to object to such a system, because it denies them of the inherent advantage they have in current markets. Congress chose to grant tax-exempt status to specific institutions that advance certain public policy issues. A dividend-exemption system will undo much of the policies underlying tax exemption.

In summary, different actors have different preferences for different integration systems.²⁸³ Adopting integration is not a panacea to agency costs associated with the heterogeneous tax preferences of shareholders. In addition, any integration system carries with it multiple additional costs and benefits. For example, moving from a double tax to a single tax model is likely to cause a major revenue loss. On the other hand, it may have macro-economic benefits such as increased investment.²⁸⁴ These macro-economic effects seem to be much more important than any agency problems associated with STCTs. If Congress adopts integration, it should be because tax writers believe it is good corporate tax policy, and not because it is a solution to the agency problems associate with STCTs.

Another type corporate tax overhaul that can mitigate the STCT problem is to require shareholders to *mark-to-market* (MTM) their equity holdings. Under an MTM regime “financial products... would be valued periodically, and the holder would be taxable on the change in value over the period”.²⁸⁵ This means that shareholder basis of the end of each year would be adjusted to account for taxable gains or losses. For example, if a stock in which a shareholder had a basis of ten dollars appreciated by the end of the year to twelve dollars, the shareholder will be required to pay tax on the two-dollar difference, and the basis in the stock will increase to twelve dollars.

These MTM basis adjustments mean that in an STCTs, shareholders will be subject to tax—at most—on changes in stock value that happened since the beginning of the taxable year. In such a case, it is unlikely that shareholders would suffer a major shareholder-level tax detriment, since the taxable gain is limited. This is unlike the case of shareholders who, under current law, may hold corporate stock for long periods, in which the stock

²⁸³ Doran, *supra* note 89.

²⁸⁴ Scott Greenberg, *Corporate Integration: An Important Component of Tax Reform*, TAX FOUND. FISCAL NO. 506, 12 (Apr. 21, 2016) (“Corporate integration would lower the combined tax burden on corporate income, which would increase investment and economic growth in the United States”).

²⁸⁵ Redd Shuldiner, *A General Approach to the Taxation of Financial Instruments*, 71 TEX. L. REV. 243, 247 (1992).

accumulate significant appreciation while shareholder basis remains low. An MTM regime would make the shareholder-level tax costs associated with STCTs minuscule.

There are two problems, however, that make MTM an unsuitable solution. First, a MTM regime seem to be politically unattainable. MTM has been discussed for decades in the United States, and received widespread academic support.²⁸⁶ Political resistance, however, stopped all attempts at MTM reforms in their tracks. Second, like integration, MTM would constitute a major overhaul of the system by which we tax corporations. It seems extreme to adopt such a system just to solve the governance issues of STCTs. It will be a nice derivative benefit of such system, though, if it is ever adopted.

If integration and MTM seems like an overkill, it is worth considering *narrowly tailored tax solutions*. Unfortunately, tailored tax solutions for corporate governance problems have been tried in the past, and spectacularly failed. The reason is that insiders are simply able to contract around any such tax provision. An obvious example is gross-up payments in inversions, which bypass the excise tax of Section 4985. Section 4985 is a governance-driven provision, the purpose of which is to have managers internalize the shareholder-level tax costs of inversions. Managers and tax-exempt investors simply contract around this provision by allowing the corporation to gross-up the tax cost to managers.

Other governance-related tax provision that dot the IRC have failed in similar tasks.²⁸⁷ For example, Section 162(m) supposedly creates a tax disincentive for excessive executive compensation. It does so by denying a corporation a deduction for executive compensation in excess of one million dollars.²⁸⁸ However, Section 162(m) main effect has been to change the form (rather than the amount) of management compensation, from cash, to incentive pay in stock options and other derivatives that are exempt from the limitation.²⁸⁹ This created much more opaque compensation schemes, which

²⁸⁶ Mark Gergen, *How to Tax Capital*, 70 Tax L. Rev. 1, fn3 (2016) (“There are many proposals to replace the corporate income tax with an income tax assessed on the changes in the market value of corporate securities”, and source cited therein).

²⁸⁷ See, e.g., I.R.C. § 162(m) (denying deductions for excessive executive compensation); I.R.C. § 280G (denying deductions for certain golden parachute payments); I.R.C. § 4999 (imposing excise tax on certain golden parachute payments); I.R.C. § 5881 (imposing excise tax on greenmail payments); None of these provisions meaningfully remedied the corporate governance issue they were addressing.

²⁸⁸ I.R.C. § 162(m).

²⁸⁹ Schizer, *supra* note 3, at ¶3.1.3 (“Section 162(m) is not an encouraging precedent. When enacted in 1993, it was explained as a limit on the amount of pay. Nevertheless, its main effect has been on the type of pay, since it offers a widely used exception for

are harder for shareholders to monitor. It has even been suggested that section 162(m) carries a partial blame for the options backdating scandals of the early 2000s.²⁹⁰

To summarize, any specifically tailored tax disincentive is unlikely to prevent unwanted managerial behavior. It is more likely to increase the cost of unwanted behavior by incentivizing expensive contractual workarounds.

iii. Corporate Law Solutions

Corporate-law based solutions to the agency problems of STCTs can come in several forms: empowering the minority (taxable) shareholders in STCT voting, compensating minority shareholders for their tax costs, or forcing managers to internalize personal costs associated with STCTs.

Empowering taxable shareholders. Since only taxable shareholders are likely to suffer a net detriment in an STCT, a possible course of action would be to require that—in addition to regular shareholder majority—a majority of taxable shareholders approve the transaction. Assuming taxable shareholders behave rationally, they will only approve transactions in which the net corporate tax benefits flowing to them exceed the shareholder-level tax cost.

While such requirement offers an elegant theoretical solution, it suffers from several real-world problems. First, it would be a mistake to treat to all taxable shareholders as a single class of shareholders for tax purposes. Taxable shareholders individualized tax-positions vary significantly based on, among others, each shareholder's personal tax attributes, tax rates, and holding period in the stock.²⁹¹ It is possible that a majority of taxable shareholders would vote for an STCT, when some taxable shareholders still suffer a detriment. Nonetheless, because fewer shareholders suffer a detriment, the inefficiency cost is likely much smaller in such a case compared with current situation. Requiring a majority vote of taxable shareholders is an imperfect proxy to shareholders' tax preferences, yet one that offers an improvement.

A second problem of requiring a majority of taxable shareholders to vote for an STCT may be the holdout problem. For example, in corporations with very few taxable shareholders, a small minority of shareholders may find

'performance-based compensation'); *See, also*, JCT ENRON REPORT, *supra* note 137, at 43 ("The \$1 million deduction limitation was designed to address corporate governance concerns that top executives were receiving excessive compensation. The experience with Enron indicates that the limitation is not effective in achieving its purposes").

²⁹⁰ Schitzer, *id.* ("Section 162(m) may even have motivated some firms to commit fraud. By favoring options that were at-the-money when granted, the rule creates a tax incentive to lie about the grant date"); For a description of the options backdating scandal, see, Jesse M. Fried, *Option Backdating and its Implications*, 65 WASH. & LEE L. REV. 853 (2008)

²⁹¹ *See, supra* notes 17-18 and accompanying discussion.

itself in a position to prevent an otherwise efficient transaction, using such position to extract a payout from the corporation. Whether such problem is significant is an empirical question. It depends on the size of the taxable shareholders' holding. However, a payout to taxable holdouts is functionally no different from tax gross-up payments to managers. As long as the gross-up payment is less than the corporate tax savings, the transaction is still efficient, and shareholders will approve it. If holdout shareholders operate rationally, it will make no sense for them to require a payout that is in excess of the corporate tax savings, because in such a case they are likely to incur a loss themselves.

On balance, I believe that a solution empowering taxable shareholders in the context of STCTs is worthy of serious consideration.

Compensating taxable shareholders for shareholder-level taxes. A different way to assure STCTs are efficient is by requiring the corporation to compensate taxable shareholders for their tax cost, the same way that gross-up payment compensate managers. This "global tax gross-up" will burden the corporation with significant additional cost. However, as long as the corporate tax saving outweighs the cost of the global gross-up, rational shareholders will approve the transaction. The elegance of this theoretical solution is that it forces tax-exempt shareholders to internalize the cost to taxable shareholders, instead of shifting the cost to taxable shareholders.

Again, there are several real-world problems with this solution. First, it may not be the least-wasteful solution. Under the previous solution discussed (requiring a majority of taxable shareholders to approve the transaction), only some taxable shareholders may demand compensation. Under a global gross-up, a payoff is required to all taxable shareholders. This seems like an excessive, largely avoidable cost. It is better to pay a few taxable shareholders rather than all taxable shareholders.

Another problem with the global gross-up idea is that it is impossible for the corporation to assess the cost of the global gross-up. The corporation does not have private taxpayer-information on shareholders necessary to calculate the expected tax cost for each shareholder.²⁹² Nonetheless, a solution would be to use (again) an imperfect proxy to calculate such cost. For example, one could assume that the tax cost for which managers are being grossed-up, is incurred by each of the other taxable shareholder. It is possible to calculate a proportion of gross-up amount per share (or other equity rights) held by managers, and pay each taxable shareholder based on such ratio.

Forcing managers to internalize costs. Finally, it is possible to think of a regulatory solution that forces managers to internalize their personal tax cost. For example, we could have an outright legal prohibition on tax gross-up

²⁹² *Supra* note 269.

payments.

This solution is unlikely to be successful, mainly because it is impossible to enforce. A ban of gross-up payments is likely to result in contractual work-around that result in other inefficiencies. For example, managers will demand increased compensation, or compensation in formats that are not subject to taxation in STCTs. Not only the problem remains, but it is also likely that the opacity of managers' compensation structure will increase.

To summarize, market-based and tax-based solutions to the agency problems of STCTs do not hold much promise. Of the corporate-law-based solutions I discussed above, it seems that the best course of action is to empower taxable shareholders. This can be achieved, for example, by requiring that a majority of taxable shareholders vote to approve an STCT.

CONCLUSION

I questioned whether legal and successful corporate tax reduction schemes are always beneficial to shareholders. I find the answer is in the negative.

I identified a category of common corporate transactions, the generic characteristic of which is that they directly affect shareholder-level taxes. In such "shareholder taxable corporate transactions" (STCT), any corporate level tax savings must be weighed against the shareholder-level tax cost.

Since shareholders have heterogeneous tax positions, some shareholders may lose value in STCTs, while others gain value. STCTs are therefore rarely Pareto-optimal at the shareholder level. It is also reasonable to assume that some STCTs are Kaldor-Hicks inefficient. This would be the case where the losing shareholders lose more value in an STCT, than the gain accruing to shareholders who are benefiting from the STCT.

I also explained why the unique ownership structure in U.S. equity markets cause shareholders to approve inefficient STCTs, even when information is freely available in the market. Tax-exempt investors hold the majority vote in many corporations traded on U.S. equity markets. Such investors have no shareholder-level tax to consider. They will always vote for a corporate tax-saving transaction, even if it is detrimental to other (taxable) shareholders.

Corporate managers, who hold taxable equity in the corporation or are otherwise subject to personal tax because of an STCT, may not favor STCTs. However, if the managers' personal tax cost is less than the corporate-level tax savings, managers and tax-exempt investor would rationally agree to have the corporation indemnify managers for their personal tax cost. This will defuse management's disincentive in the transaction, while imposing an additional cost on taxable shareholders, in the form of an additional financial burden on the corporation.

The problems described above are likely to get worse under the recently enacted tax reform. The reason is that recent reform significantly reduced corporate tax rates, while leaving shareholder-level tax rates largely unchanged. This means that any corporate tax saving is likely to be less beneficial (it saves less taxes), while shareholders taxes remain just as detrimental.

I explored several potential solutions to the problem and concluded that the best (even if not perfect) solution is to empower taxable shareholders in the context of STCTs.

APPENDIX

It is helpful to generalize the arguments presented in Section II by presenting simple a formal model. The model demonstrates the conditions under which STCTs hurt taxable shareholders (meaning, are not Paetro-optimal), or are Kaldor-Hicks inefficient.

Assume, as in the stylized examples in Section II, that in the absence of an STCT, taxable shareholders pay no shareholder-level tax. In the presence of an STCT, taxable shareholders are subject to shareholder-level taxes both on the marginal earnings resulting from the STCT, as well as the built-in appreciation in their equity prior to the STCT. I denote the relevant variables as follows:

V – Corporate Value before an STCT.

R_c – Corporate Tax Rate.

I – Reduction in Taxable Income Due to an STCT.

ΔV – Corporate savings due to structuring (meaning, $\Delta V = I \cdot R_c$).

P = Proportional Interest of Taxable Shareholders.

R_p = Shareholders Personal Tax Rate.

B = Taxable Shareholders' Basis in the Stock.

A. Pareto Inefficient STCTs

Taxable shareholders are worse off when increase in value of their corporate holding flowing to them from corporate tax savings, is less than increased tax owed due to the STCT. Formally:

$$P\Delta V < R_p(P(V + \Delta V) - B) = R_pPV + R_pP\Delta V - R_pB$$

$$P\Delta V - R_pP\Delta V < R_pPV - R_pB$$

$$P\Delta V(1 - R_p) < R_p(PV - B)$$

We substitute ΔV :

$$\frac{IR_C}{V - \frac{B}{P}} < \frac{R_p}{1 - R_p} \quad (1)$$

This makes vivid that, as the corporate rate decreases, the left side of the equation decreases, meaning that all else equal, a decrease in corporate tax rate will push toward taxable shareholders being worse off.

B. Kaldor-Hicks Inefficient STCTs

STCTs are Kaldor-Hicks inefficient when taxable shareholders tax cost exceeds the total tax saved at the corporate level. Formally, when:

$$\Delta V < R_p(P(V + \Delta V) - B) = R_pPV + R_pP\Delta V - R_pB$$

$$\Delta V - R_pP\Delta V < R_pPV - R_pB$$

$$\Delta V (1 - R_pP) < R_p(PV - B)$$

$$\frac{\Delta V}{PV - B} < \frac{R_p}{1 - R_pP}$$

Then substituting for corporate value, we get:

$$\frac{IR_C}{PV - B} < \frac{R_p}{1 - R_pP} \quad (2)$$

C. Management Tax Gross-Up

Finally, it is also possible to derive the formula for the management gross-up payment, under the assumption that a gross up makes management indifferent to personal tax cost. Assume that:

M = Proportional Equity Interest of Management

G = Gross-Up Payment

S = Tax Savings to the Corporation.

V₁ = Corporation's gross value after the transaction.

To make this modeling a bit more realistic (and for the sake of simplicity), we shall assume that management's shareholder-level tax is in the form of an excise tax, imposed on management equity value.

Managers are indifferent to shareholder-level tax if their pre-STCT value is the same as their post-STCT gross value, reduced by their shareholder-level taxes, increased by the gross up payment, and reduced again by the tax on the gross-up payment. Formally, when:

$$MV = MV_1 - R_p MV_1 + G - R_p G.$$

$$= MV_1(1 - R_p) + G(1 - R_p)$$

$$= (1 - R_p)(MV_1 + G)$$

Note, However, that in this case, the post-transaction value must account for the fact the any tax benefit to the corporation, is reduced by the gross-up payment. Namely:

$$V_1 = V + S - G$$

We substitute:

$$MV = (1 - R_p)(MV + MS - MG + G)$$

$$MV = MV + MS - MG + G - R_p MV - R_p MS + R_p MG - R_p G$$

$$0 = M(S - R_p V - R_p S) + G(1 - M + R_p M - R_p)$$

$$G = \frac{M(R_p V + R_p S - S)}{1 - M + R_p M - R_p}$$

$$G = \frac{M(R_p(V + S) - S)}{(1 - R_p)(1 - M)} \quad (3)$$