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How Much Is “Substantial Evidence” and How Big Is a “Significant Gap”? The Telecommunications Attorney Full Employment Act

Susan Lorde Martin

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CAN TAXES MITIGATE CORPORATE GOVERNANCE INEFFICIENCIES?

NOAM NOKED*

ABSTRACT

Policymakers have long viewed tax policy as an instrument to influence and change corporate governance practices. Certain tax rules were enacted to discourage pyramidal business structures and large golden parachutes, and to encourage performance-based compensation. Other proposals, such as imposing higher taxes on excessive executive compensation, have also attracted increasing attention.

Contrary to this view, this Article contends that the ability to effectively mitigate corporate governance inefficiencies through the use of corrective taxes is very limited, and that these taxes may cause more harm than benefit. There are a few reasons for the limited effectiveness of corrective taxes. Importantly, the same conditions that give rise to corporate governance problems also undermine the effectiveness of corrective taxes. Poorly governed firms are more likely to incur a higher tax without changing their practices that benefit their managers. Where the same corporate governance practices are harmful in some situations and beneficial in others, imposing tax is unlikely to be optimal. Corrective taxes are unlikely to be superior to other forms of regulation where the legislature knows what governance terms are optimal, or where the legislature cannot assess the negative externalities.

This Article also examines the effects of general tax rules on corporate governance. The impact of general tax rules and corrective taxes on corporate governance should be carefully considered when designing a tax reform.

* Assistant Professor, Faculty of Law, The Chinese University of Hong Kong. I am grateful to Louis Kaplow, Kobi Kastiel, Stephen Shay, John Vella, Alvin Warren, and the participants of the 2017 symposium of the Oxford University Centre for Business Taxation for helpful comments on previous drafts of this Article. Support was generously provided by the John M. Olin Center for Law, Economics, and Business at Harvard Law School.

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INTRODUCTION

Policymakers have long viewed tax policy as an instrument to influence and change corporate governance practices. Certain tax rules were enacted to discourage pyramidal business structures¹ and large golden parachutes,² and to encourage performance-based compensation.³ Other proposals, such as imposing higher taxes on excessive executive compensation, have also attracted increasing attention.⁴

Contrary to that view, this Article contends that the ability to effectively mitigate corporate governance problems and increase efficiency through the use of corrective taxes is very limited. The existing corrective taxes should be reconsidered, and in certain cases revoked and replaced with other more efficient forms of regulation.

The relevant tax rules can be divided into two groups. The first group consists of *corrective taxes* that aim to encourage or discourage a specific behavior or practice, such as the rules concerning the taxation of intercompany dividends, golden parachutes, and nonperformance-based compensation, discussed below. The second group consists of *general taxes* that were imposed to raise tax revenues, such as corporate, dividend, and individual taxes, which do not directly aim to influence corporate practices. The impact of both groups of taxes on corporate governance should be carefully considered when designing a corporate tax reform.

The Roosevelt administration in the 1930s enacted taxation on intercorporate dividends in order to break pyramidal business groups.⁵ Some other tax rules aim to limit certain kinds of executive compensation. For example, section 162(m) tries to discourage high levels of compensation, which are not linked to performance, by disallowing the deduction of nonperformance-based compensation expenses exceeding \$1 million, granted to a top executive of

¹ See Randall Morck, *How to Eliminate Pyramidal Business Groups: The Double Taxation of Intercorporate Dividends and Other Incisive Uses of Tax Policy*, 19 TAX POL'Y ECON. 135 (2005).

² See I.R.C. §§ 280G, 4999. Unless specified otherwise, all references to sections are to the Internal Revenue Code (I.R.C.) of 1986, as amended.

³ *Id.* § 162(m).

⁴ See David I. Walker, *A Tax Response to the Executive Pay Problem*, 93 B.U.L. REV. 326, 346 (2013).

⁵ See Morck, *supra* note 1, at 148–58.

a publicly held firm.⁶ Tax penalties apply to large executive compensation packages granted in connection with a change in control (“golden parachutes”): the compensation paid to executives is subject to an additional tax of 20 percent and is not deductible to the firm.⁷

In addition to these tax rules, there are proposals for using corrective taxes to mitigate corporate agency costs. One suggestion is to impose a surtax on executive compensation above a certain threshold in public firms, combined with a tax relief to the investors equal to the surtax paid by the executives.⁸ This Article discusses that proposal and two other proposals for corrective taxes on related-party transactions and on anti-takeover devices.

Several factors limit the effectiveness of corrective taxation in mitigating corporate governance inefficiencies. First, the same conditions that gave rise to the agency problem also undermine the effectiveness of corrective taxes. Firms with better governance are more likely to alter their practices in response to a corrective tax, whereas firms with worse governance are more likely to incur the tax penalty without changing their practices.⁹ Managers in poorly governed firms are more likely to shift the tax burden onto the firm without changing the practices that benefit the managers. The experience with many firms deciding to adopt nonperformance-based compensation and golden parachutes that trigger tax penalties indicate that taxation might not be an effective means of changing practices in poorly governed firms.¹⁰ Therefore, unlike negative externalities that can be internalized through corrective taxation, corporate agency problems might not be effectively countered through the use of taxation, because the same

⁶ § 162(m).

⁷ *Id.* §§ 280G, 4999(a).

⁸ See Walker, *supra* note 4, at 346.

⁹ David M. Schizer, *Tax and Corporate Governance: The Influence of Tax on Managerial Agency Costs*, in THE OXFORD HANDBOOK OF CORPORATE LAW AND GOVERNANCE 1, 13 (Jeffrey Gordon & Wolf-Georg Ringe eds., 2015) questions the effectiveness of penalizing firms for practices that benefit managers (“... if managers really put their own interests ahead of the firm, as this regime assumes, why would a tax penalty on *the firm* deter them?”). This Article contends that this problem is greater in firms with worse governance where the managers are more likely to succeed in putting their own interests ahead of the firm.

¹⁰ See *infra* Part II.

conditions that gave rise to the agency problem might undermine the effectiveness of corrective taxes.

Second, where the tax is imposed on the managers, shifting the tax burden onto the firms, in whole or in part, would reduce their benefit and the overall efficiency gain from imposing a corrective tax.¹¹ From the shareholders' standpoint, a tax would be beneficial if it reduces the firm's agency costs to an extent exceeding the tax burden shifted onto the firm. Shareholders might also benefit when the increase in tax revenue results in a decrease in other taxes. From a broader efficiency perspective, corporate agency costs reduce investment in the corporate sector and distort the allocation of capital.¹² If some of the corrective tax were borne by the firm, it would reduce the social benefit from that corrective tax.

Third, the same corporate governance practices might be harmful in some situations and beneficial in others. If these practices were uniformly harmful, a prohibition would be desirable, but it might be suboptimal to ban practices where the effect is mixed.¹³ Imposing a tax that discourages the harmful uses of a particular practice would discourage beneficial uses as well.¹⁴ Golden parachutes encourage managers to find beneficial sales, and help in overcoming managerial entrenchment, although they might lead to harmful changes in control.¹⁵ Some related-party transactions might be used for tunneling, as discussed below, whereas others

¹¹ See Walker, *supra* note 4, at 368–69.

¹² See *id.* at 336.

¹³ For a general discussion on the differences between regulatory prohibitions, liability rules and corrective taxes, see Daniel B. Kelly, *Strategic Spillovers*, 111 COLUM. L. REV. 1641, 1700 (2011); Schizer, *supra* note 9, at 2 (“Tax also is a poor fit because it typically applies mandatorily and uniformly, while responses to agency cost should be molded to the context. For example, promoting stock options or leverage will be valuable in some settings, but disastrous in others.”).

¹⁴ See Victor Fleischer, *Curb Your Enthusiasm for Pigovian Taxes*, 68 VAND. L. REV. 1673 (2015). Fleischer argues that corrective taxation is unlikely to be efficient where the negative externality from a certain activity varies significantly across the different agents that engage in that activity. In analogy, see Georgia Maffini & John Vella, *Evidence-based Policy Making? The Commission's Proposal for an FTT 20* (Oxford University Centre for Business Taxation, WP 15/15, 2015) (“[M]ore generally, the [Financial Transaction Tax] does not discriminate between ‘good’ and ‘bad’ transactions, and so whilst it might act as a disincentive for transactions that do not enhance market efficiency it will also act as a disincentive for transactions that do.”).

¹⁵ See *infra* Section II.B.

might increase the firm's value.¹⁶ Anti-takeover arrangements might be used by an underperforming management to entrench itself, whereas the same measures may assist an excellent management against harmful bids that could destroy the firm's long-term value.¹⁷ Strengthening other mechanisms that can distinguish between harmful and beneficial applications, and allowing only the latter ones, might be superior to taxation.

Fourth, the tax system is limited in its ability to assess real risk and performance goals. The tax penalty under section 162(m) could be easily avoided, and the deferral under section 83 could be easily received, by granting compensation conditioned on easily attainable performance targets.¹⁸ The tax authorities' limited ability to assess these factors raises doubts about the effectiveness of using tax rules to incentivize pay-for-performance compensation schemes that actually reward good managerial performance. Strengthening corporate governance mechanisms, such as board and shareholders' approval processes for executive compensation packages, may be superior to using the tax system for incentivizing adopting performance-based compensation schemes.

Fifth, taxation might not have many advantages over other forms of regulation in mitigating corporate governance inefficiencies. If the government knows what the best governance terms are, command and control regulation is preferable.¹⁹ Taxation would be preferable where the government does not know which governance terms are optimal, but can assess the externalities generated by the relevant behaviors and practices, and can impose a tax equal to these externalities.²⁰ With respect to pyramidal business groups, the case for limiting this practice through a ban is more compelling. The harm caused by these structures is well documented, whereas it is hard to impose a corrective tax equal to the externality induced by each layer of the pyramid.²¹ Nonetheless, in respect of some other corporate governance practices, there is a significant difficulty on both ends: it is hard to

¹⁶ See *infra* Section II.E.

¹⁷ See *infra* Section II.F.

¹⁸ See *infra* Section II.A.

¹⁹ See Richard M. Hynes, *Taxing Control*, 38 J. CORP. L. 567, 581–83 (2013).

²⁰ See *id.*

²¹ See *infra* Section II.C.

determine what the optimal corporate governance practice is, and it is also hard to design a tax equal to the negative externality from each practice. Unlike a ban on a particular practice, a tax allows an action to take place if the benefit exceeds the cost of the tax.²² A tax would allow an action to take place where the benefit from a particular action exceeds the tax, whereas a ban would prevent any action regardless of the size of the benefit.²³ However, if insiders, and not the firm, receive the benefit while the firm is harmed from that action, the firm would be better off under a regulation forbidding that action. In addition, it may be more politically feasible to adopt a tax rather than a ban. An alternative to taxation and command and control regulation is to strengthen mechanisms, both internal and external, that can distinguish between harmful and beneficial applications of the relevant corporate governance practices, and allow only the latter ones.

General tax rules, discussed in the third part of this Article, are not corrective taxes in their essence because they do not aim to encourage or discourage a particular activity or behavior. Nonetheless, they have a significant influence on corporate governance. These effects should be taken into account when designing corporate and dividend tax rules. Lowering tax rates while increasing enforcement efforts might improve corporate governance.²⁴ In addition, it may be more efficient to use a corporate income tax rather than a dividend tax as a source of revenue because the former creates fewer distortions.²⁵ Although dividend taxes reduce the dividend payment level and worsen corporate governance, a certain level of tax on dividend distribution to individuals is needed to provide them with an incentive to invest through tax-exempt institutional investors, such as pension funds, which can mitigate the collective action problem and improve monitoring.²⁶

²² For a general discussion on the differences between taxes and regulatory prohibitions, see Kelly, *supra* note 13, at 1700.

²³ *See id.*

²⁴ *See* Mihir A. Desai, Alexander Dyck & Luigi Zingales, *Theft and Taxes*, 84 J. FIN. ECON. 591 (2007).

²⁵ *See* Raj Chetty & Emmanuel Saez, *Dividend and Corporate Taxation in an Agency Model of the Firm*, 2 AM. ECON. J. ECON. POL'Y 1, 14 (2010).

²⁶ *See* Randall Morck & Bernard Yeung, *Dividend Taxation and Corporate Governance*, 19 J. ECON. PERSP. 163, 164 (2005).

Certain individual income tax rules also have a significant influence on the quality of corporate governance.²⁷ The Tax Code creates an incentive to receive deferred compensation in stock options and restricted stocks that are conditioned on meeting some performance requirements, as the tax on these forms of compensation is easily deferred.²⁸ The resulting effect on corporate governance is unclear. Although this form of compensation better aligns the managers' incentives with those of the shareholders, it fails to incentivize the adoption of performance-based compensation; this is because easily achievable performance goals satisfy the requirements for deferral under this tax rule.²⁹ Moreover, higher equity-based compensation does not necessarily substitute for other forms of compensation.³⁰ In addition, the tax rule regarding working condition fringe benefits encourages granting more costly perks.³¹ This might be problematic from a corporate governance standpoint because these perks are not subject to the same reporting and approval procedures as executive compensation.³²

The complexity of the Tax Code could be used to disguise earnings manipulations and tunneling. Thus, simplifying and harmonizing tax rules can eliminate tunneling opportunities and improve monitoring and transparency.³³ Other tax rules that might influence the quality of the corporate governance include the rules that affect the decision where to incorporate and the rules that influence financing choices between debt and equity.³⁴

Although this Article focuses on the effect of taxation on corporate governance, it is important to note that corporate governance practices and characteristics influence taxation.³⁵ The effect of corporate governance on taxation is also a relevant factor to be considered when evaluating the tax system and possible reforms.³⁶

²⁷ See *infra* Section III.C.

²⁸ See *id.*

²⁹ See *id.*

³⁰ See *id.*

³¹ See *id.*

³² See *id.*

³³ See Schizer, *supra* note 9, at 27–28; Mihir A. Desai & Dhammika Dharmapala, *Tax and Corporate Governance: An Economic Approach*, in *TAX AND CORPORATE GOVERNANCE* 13, 27 (Josef Drexler et al. eds., 2008).

³⁴ See *infra* Part III.

³⁵ See *infra* Part IV.

³⁶ See *id.*

There is evidence which shows that a higher level of incentive compensation is associated with an increased level of tax avoidance, especially among firms with better corporate governance.³⁷ The ownership structure also affects the level of tax avoidance, as family-owned firms and firms with dual class stock structure have a lower level of tax avoidance, whereas firms in which private equity (PE) and hedge funds have large holdings show higher levels of tax avoidance.³⁸ In addition, firms might also overpay taxes when trying to disguise fraud in reporting inflated earnings.³⁹ These findings might indicate that eliminating tax-avoidance opportunities would have a stronger effect on firms with higher levels of incentive compensation and on firms held by PE and hedge funds. A tax reform that would reduce tax avoidance opportunities, reduce corporate and dividend taxes, and increase enforcement efforts, could possibly improve corporate governance for firms with weak governance, and provide well-governed firms with stronger incentives to focus more on real improvement in performance rather than on enhancing tax efficiency.

The structure of the remaining parts of this Article is as follows. The first part reviews the main relevant corporate agency problems that corrective taxes aim to address, namely, entrenchment and tunneling, and it also discusses the efficiency consequences of corporate agency costs. The second part explores the use of corrective taxation to reduce corporate agency costs. The third part explores the effects of general tax rules on corporate governance, and how these rules can be used to reduce corporate agency costs. The fourth part identifies the effects of corporate governance practices and characteristics that may affect taxation.

I. CORPORATE GOVERNANCE INEFFICIENCIES

A. *Overview of the Relevant Agency Problems*

The agency problem is central to the intersection of taxation and corporate governance.⁴⁰ Where a wholly owned corporation that is managed by a sole shareholder avoids tax, it does not have any

³⁷ *See id.*

³⁸ *See id.*

³⁹ *See id.*

⁴⁰ *See* Desai & Dharmapala, *supra* note 33, at 14.

consequences on its corporate governance. This tax avoidance merely diverts resources from the state to the shareholder.⁴¹ A meaningful intersection of taxation and corporate governance appears where an agency problem exists.⁴² The research on this intersection identifies whether the tax system mitigates or aggravates corporate governance agency problems.⁴³

The main relevant categories of corporate governance agency problems are managerial entrenchment and tunneling. Managerial entrenchment occurs where managers make it impractical or very costly for shareholders to replace them.⁴⁴ In general, not taxing the nonpecuniary benefits of control would increase the entrepreneurs' incentives to retain control beyond the socially optimal level.⁴⁵ Managers can use anti-takeover devices, such as poison pills, to insulate themselves from the risk of being replaced.⁴⁶ Managers therefore have an incentive to entrench themselves to prevent a takeover that might result in their replacement, even if this takeover is beneficial for the shareholders. If managers can counter the disciplinary force of the market for corporate control and entrench themselves, it would cause suboptimal managerial incentives because the managers are not exposed to the risk of being replaced for underperformance.⁴⁷ In cases where managers hold a large stake of the firm's cash flow rights, they will still have incentives to maximize the value of the firm even if they are entrenched.⁴⁸ The incentive problem would be greater where managers hold fewer equity rights because their interests are not aligned with the shareholders' interest and do not provide adequate incentives to maximize the firm's value.⁴⁹

⁴¹ *See id.*

⁴² *See id.*

⁴³ *See id.*

⁴⁴ *See* Andrei Shleifer & Robert W. Vishny, *Management Entrenchment: The Case of Manager-Specific Investments*, 25 J. FIN. ECON. 123, 126 (1989).

⁴⁵ *See* Hynes, *supra* note 19, at 581.

⁴⁶ For a general discussion on the reasons why firms adopt antitakeover arrangements, see Lucian Bebchuk, *Why Firms Adopt Antitakeover Arrangements*, 152 U. PENN. L. REV. 713 (2003).

⁴⁷ *See* Bebchuk, *infra* note 174, at 7.

⁴⁸ *See id.* at 11.

⁴⁹ *See id.*

Tunneling occurs where resources are transferred out of a firm to its managers or controllers.⁵⁰ Atanasov et al. use a taxonomy that divides tunneling into three basic types: cash flow tunneling, asset tunneling and equity tunneling.⁵¹ Cash flow tunneling is defined as a transfer of a portion of the current year's cash flow, without affecting the firm's long-term assets.⁵² One important form of cash flow tunneling involves price manipulation: the firm might buy inputs from insiders at a price higher than market value, or sell outputs to them at a price below market value.⁵³ Another significant form of cash flow tunneling involves excessive executive compensation and excessive spending on perks.⁵⁴

Asset tunneling involves the transfer of significant, productive, long-term assets from the firm, or to the firm, for a price different from the fair market value.⁵⁵ It usually involves self-dealing transactions in which an insider sells overpriced assets to the firm, or buys assets from the firm for a price below the fair value.⁵⁶ One common form of asset tunneling is to make an investment in an affiliated company in terms that outside investors would not accept.⁵⁷ Intangible assets can be used for this kind of tunneling, as it is difficult for minority shareholders to prove that the price is unfair.⁵⁸ Asset tunneling includes many tunneling practices, such as investing in a troubled affiliate, repurchasing of shares from insiders for a price above the market value, and providing intellectual property rights to related parties at a discount or buying rights from them at a premium.⁵⁹

Equity tunneling involves an increase in the insider's share of the firm at the expense of the outside shareholders, without changing the firm's assets or cash flow.⁶⁰ This kind of tunneling

⁵⁰ See Vladimir Atanasov, Bernard Black & Conrad S. Ciccotello, *Law and Tunneling*, 37(1) J. CORP. L. 1, 5 (2011).

⁵¹ See *id.*

⁵² See *id.*

⁵³ See *id.* at 6–7.

⁵⁴ See *id.* at 7.

⁵⁵ See Atanasov et al., *supra* note 50, at 5.

⁵⁶ See *id.*

⁵⁷ See *id.* at 7–8.

⁵⁸ See *id.* at 8.

⁵⁹ See *id.* at 7–8. The distinction between cash flow and asset tunneling might not be convincing because cash is not different from other assets.

⁶⁰ See Atanasov et al., *supra* note 50, at 8–9.

includes various forms, such as dilutive equity offerings in which shares or stock options are offered to insiders for below the market value, freezeouts for less than the stock's fair market value, sale of control without offering to buy minority shares, repurchases of insiders' shares for more than the fair value, and excessive equity-based executive compensation.⁶¹ Some transactions involve more than one type of tunneling.⁶²

B. The Efficiency Consequences of Managerial Agency Costs

Although it is commonly assumed that managerial agency costs are borne by shareholders, this assumption is questionable, especially in the long run.⁶³ An analogy can be drawn between the incidence of corporate income taxation and managerial agency costs, as both can be thought of as taxes on the return from an investment in corporate equity.⁶⁴ If the incidences of corporate income tax and systematic agency costs are similar, then a large share of the burden of the corporate agency costs is likely to be borne in the long run by immobile factors, such as noncorporate capital and labor.⁶⁵ The Joint Committee on Taxation estimated that in the long run 75 percent of corporate income taxes are borne by capital owners, and 25 percent are borne by domestic labor.⁶⁶

In many cases, shareholders can observe agency costs, either directly or indirectly through a lower rate of return.⁶⁷ When shareholders and potential investors can predict the agency costs and the lower return, they would reduce their investment and shift their capital to other investment channels.⁶⁸ If capital is shifted out of the public company sector onto other sectors because

⁶¹ See *id.* at 9.

⁶² See *id.* at 7.

⁶³ See David I. Walker, *Who Bears the Cost of Excessive Executive Compensation (and Other Corporate Agency Costs)?*, 57 VILL. L. REV. 653, 654 (2012).

⁶⁴ See *id.*

⁶⁵ See *id.* at 666.

⁶⁶ See Joint Committee on Taxation, *Modeling the Distribution of Taxes on Business Income* 4 (2013), <https://www.jct.gov/publications.html?func=startdown&id=4528> [<https://perma.cc/3T4R-G2MU>].

⁶⁷ See Walker, *supra* note 63, at 664–66.

⁶⁸ See *id.* at 661–62.

of agency costs, it would distort the efficient capital allocation in the market and reduce social welfare.⁶⁹

The argument for regulation would be more compelling if corporate governance inefficiencies have significant implications on overall social welfare and various third parties.⁷⁰ From a distributive perspective, a transfer of wealth from shareholders to executives might not be perceived as too problematic, whereas imposing costs on labor is likely to prompt more governmental intervention.⁷¹

II. USING CORRECTIVE TAXES TO MITIGATE CORPORATE GOVERNANCE INEFFICIENCIES

The discussion below analyzes the current use of corrective taxation in the contexts of performance-based compensation, golden parachutes, and pyramidal business groups. It also examines potential uses of taxation in the contexts of executive compensation, related party transactions, and anti-takeover devices.⁷²

In general, corrective taxes and subsidies aim to encourage or discourage a specific behavior or practice.⁷³ According to the economic theory, an optimal corrective tax or subsidy should

⁶⁹ See *id.* at 669.

⁷⁰ See *id.* at 671–72.

⁷¹ See *id.* at 670–71.

⁷² There is a question in the corporate governance literature whether private ordering can mitigate corporate governance inefficiencies: whether shareholders can resolve these problems on their own, without any regulation or governmental intervention. The supporters of regulation contend that shareholders alone cannot successfully mitigate many corporate governance inefficiencies because of various reasons: individual shareholders of widely held companies are uninformed and suffer from a collective action problem, and are therefore unable to effectively monitor managerial actions; institutional investors also suffer from inadequate incentives, conflict of interests, and regulatory constraints that impede their ability to act like real owners. See, e.g., Lucian A. Bebchuk & Scott Hirst, *Private Ordering and the Proxy Access Debate*, 65 BUS. LAW. 329, 335–36 (2010); Bernard S. Black, *Agents Watching Agents: the Promise of Institutional Investor Voice*, 39 UCLA L. REV. 812, 813 (1992); Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1048 (2007). In general, contractual problems of adverse selection, moral hazard, and incompleteness limit the effectiveness of contract-based private ordering.

⁷³ See generally ARTHUR C. PIGOU, *THE ECONOMICS OF WELFARE* (1920) and the extensive literature on corrective (Pigovian) taxes and subsidies.

equal the marginal external social cost or benefit.⁷⁴ Many countries have adopted various corrective taxes, such as taxes on gasoline, carbon emissions, and alcohol and tobacco products.⁷⁵ Many countries have also introduced corrective subsidies, usually in the form of tax benefits, to incentivize particular behaviors, activities and investments, such as charitable donations, retirement savings, research and development activities, and foreign direct investments.⁷⁶

A. *Encouraging Performance-Based Compensation*

1. *The Rationale for Encouraging Performance-Based Compensation*

At the beginning of the 1990s, prominent economists urged shareholders to support large pay packages that would provide high-powered incentives.⁷⁷ According to their view, shareholders should be more concerned about providing the managers with sufficiently strong incentives than about the size of the executive compensation.⁷⁸ In theory, performance-based compensation should align the interests of the managers with those of the shareholders, and provide managers with incentives to maximize the firm's value.⁷⁹

The empirical evidence indicates that cash compensation, including bonuses, is weakly correlated with firms' industry-adjusted performance.⁸⁰ Less salient forms of non-equity compensation, such as pension benefits, loans and other perks, are also insensitive to managerial performance.⁸¹ Equity-based compensation can provide managers with the desirable incentives.⁸² However,

⁷⁴ See LOUIS KAPLOW, *THE THEORY OF TAXATION AND PUBLIC ECONOMICS* 212–13 (2008).

⁷⁵ For a discussion on different kinds of corrective taxes, see Fleischer, *supra* note 14, at 1700–01 (food taxes), 1703–04 (environmental taxes), 1706–08 (tobacco and alcohol taxes), and throughout that article.

⁷⁶ For a discussion on corrective subsidies, see Fleischer, *supra* note 14, at 1681, 1685, 1709–10.

⁷⁷ See, e.g., Michael C. Jensen & Kevin J. Murphy, *Performance Pay and Top-Management Incentives*, 98 *J. POL. ECON.* 225, 226 (1990).

⁷⁸ See LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* 6 (2004).

⁷⁹ See *id.*

⁸⁰ See *id.* at 7.

⁸¹ See *id.*

⁸² See *id.*

according to Bebchuk and Fried, managers frequently use their influence to receive large benefits from equity-based compensation even when their performance is poor.⁸³ For example, a large majority of firms grant stock options without filtering out the stock price rises which occur due to industry and general market trends, which are unrelated to the managers' performance that increased the firm's value.⁸⁴ Bebchuk and Fried suggest adopting policies that provide managers with compensation that is truly based on their performance.⁸⁵ In their view, institutional investors should pressure firms to use equity-based forms that filter out windfalls, tie compensation to the management's performance, and limit the executives' ability to unload their equity incentives.⁸⁶

2. Section 162(m)

Under section 162(m), a publicly held corporation cannot deduct compensation with respect to its CEO or its three next most highly compensated officers other than its CFO to the extent that the amount of the annual compensation paid to that executive exceeds \$1 million.⁸⁷ However, compensation that qualifies as "performance-based compensation" can be deducted with no limitation.⁸⁸

The performance-based compensation should be granted in accordance with the following requirements: the compensation must be paid only if the pre-established, objective performance goals have been achieved; a committee with two or more outside directors should establish the performance goals, in writing, at a time when the outcome is substantially uncertain, no later than ninety days after the beginning of the performance period, and not after 25 percent of the performance period has passed; whether the performance goals have been met should be determined by using objectively determinable criteria; the committee has discretion to reduce compensation, but cannot increase it on a discretionary basis; the material terms of the award must be disclosed to shareholders, who vote whether to approve them; and before

⁸³ *See id.*

⁸⁴ *See id.*

⁸⁵ *See id.* at 10–11.

⁸⁶ *See id.* at 184.

⁸⁷ § 162(m)(1).

⁸⁸ *Id.* § 162(m)(4)(C); Treas. Reg. § 1.162-27(e).

granting the compensation, the committee must certify in writing that the performance goals have been satisfied.⁸⁹

A special rule applies to stock options. In general, compensation awarded as stock options or as stock appreciation rights is deemed to qualify as performance-based compensation if the compensation plan is made by the abovementioned committee, the compensation plan states the maximum number of shares of options or rights that can be granted during a specified period to any executive, and the exercise price of the option is not less than the fair market value of a share on the date the option is granted.⁹⁰ Restricted stocks and other equity compensation forms that do not qualify for this special rule will not qualify as performance-based compensation unless the general requirements under section 162(m), listed above, are met.⁹¹

When section 162(m) was enacted in 1992, a compensation of \$1 million per year was at the high end of executives' salary range.⁹² Enacting this tax rule affected compensation schemes, as more firms shifted executive pay into performance-based compensation plans.⁹³ It also served as a benchmark for executives who earned below \$1 million: they pressured their boards to increase their nonperformance-based compensation to \$1 million.⁹⁴ Consequently, many firms increased their executive compensation levels.⁹⁵ It is important to note that compensation levels have increased significantly since the early 1990s.⁹⁶ Firms today routinely exceed the \$1 million nonperformance-based compensation threshold.⁹⁷

⁸⁹ See *id.* The “material terms” that must be approved by shareholders include the executives eligible to receive compensation, a description of the criteria on which the performance goals are based, and either the maximal compensation or the formula used to calculate the compensation to be paid if the performance goals are met. Treas. Reg. § 1.162-27(e)(4)(i).

⁹⁰ Treas. Reg. § 1.162-27(e)(2)(vi)(A).

⁹¹ See *id.*

⁹² See Walker, *supra* note 4, at 361.

⁹³ See *id.* at 361–62.

⁹⁴ See *id.*

⁹⁵ See David G. Harris & Jane R. Livingstone, *Federal Tax Legislation as an Implicit Contracting Cost Benchmark: The Definition of Excessive Executive Compensation*, 77 ACCT. REV. 997, 998 (2002).

⁹⁶ See Steven N. Kaplan, *CEO Pay and Corporate Governance in the U.S.: Perceptions, Facts, and Challenges*, 25 J. APPLIED CORP. FIN. 8, 10 (2013).

⁹⁷ See Walker, *supra* note 4, at 383. According to Michael Doran, *Uncapping Executive Pay*, 90 S. CAL. L. REV. 101, 116–17 (2017), 58 percent of the S&P

These firms state in their proxy statements that the tax consequence is only one of the considerations the board considers when deciding on the executive compensation.⁹⁸

In addition, many firms adopt performance-based compensation plans that are deductible under section 162(m).⁹⁹ First, as noted above, stock options are usually deductible if the exercise price of the option is not less than the fair market value of a share on the date the option is granted.¹⁰⁰ Second, firms can adopt performance targets that are easily attainable.¹⁰¹ Per Bebchuk and Fried, performance-based payments are often conditioned on easily achieved performance targets that do not reflect good performance relative to peer firms.¹⁰² Performance-based plans often grant executives a higher compensation for events that are not necessarily connected to good managerial performance, such as positive developments in the market or making acquisitions.¹⁰³ Thus, to circumvent this rule, firms might adopt risky pay strategies that are still not performance-based.¹⁰⁴ Third, section 162(m) does not apply after the executive retires, so this rule can be circumvented if nonperformance-based compensation is granted as retirement benefits.¹⁰⁵

Although section 162(m) requires the shareholders' approval for the "material terms" of the performance-based compensation plan,¹⁰⁶ shareholders have little influence on the actual compensation schemes. The material terms on which shareholders vote do not usually specify the design of any pay package.¹⁰⁷ Instead, the material terms usually include only general parameters and vague targets.¹⁰⁸ In addition, as argued by Bebchuk and

500 companies paid their CEO nonperformance salaries exceeding \$1 million in 2014. Doran also finds that companies have become more willing to exceed the \$1 million cap over time. *See id.* at 109–12.

⁹⁸ *See* Walker, *supra* note 4, at 383.

⁹⁹ *See id.* at 361.

¹⁰⁰ *See supra* note 90.

¹⁰¹ *See* Doran, *supra* note 97, at 121; Walker, *supra* note 4, at 384.

¹⁰² *See* BEBCHUK & FRIED, *supra* note 78, at 135.

¹⁰³ *See id.*

¹⁰⁴ *See id.* at 138.

¹⁰⁵ *See id.* at 110–11.

¹⁰⁶ § 162(m)(4)(c)(ii).

¹⁰⁷ *See* BEBCHUK & FRIED, *supra* note 78, at 196.

¹⁰⁸ *See id.*

Fried, shareholders can fail to approve a compensation plan, but such a veto might not make them better off.¹⁰⁹ Bebchuk and Fried also argue that the enthusiasm in the last two decades in favor of performance-based compensation, supported by Congress in enacting section 162(m), was used by managers by adding more such compensation without a corresponding downward adjustment in cash compensation.¹¹⁰

3. Using Taxation to Encourage Performance-Based Compensation

Taxation can be used to incentivize the adoption of certain compensation schemes. If a tax is imposed on nonperformance-based compensation, it increases the cost of such compensation scheme.¹¹¹ If this tax burden is borne by managers, even partially, they would have a greater incentive to prefer performance-based compensation.¹¹² If shareholders benefit from performance-based executive compensation, they should support it even without a tax penalty on nonperformance-based compensation.¹¹³ However, as noted by Bebchuk and Fried, the shareholders' ability to successfully object and negotiate efficient compensation packages might be limited.¹¹⁴

The experience with section 162(m) indicates that managers in some firms have a lot of power over the compensation-setting process, and this can be used to approve pay plans that result in triggering a tax penalty to the corporation.¹¹⁵ If firms with worse corporate governance are more likely to adopt payment schemes that trigger a tax penalty, this tax rule might aggravate the harm to the shareholders investing in these firms and also to the overall social deadweight loss.¹¹⁶

¹⁰⁹ *See id.* at 49.

¹¹⁰ *See id.* at 73.

¹¹¹ *See id.* at 122.

¹¹² *See id.*

¹¹³ *See id.*

¹¹⁴ *See id.* at 49.

¹¹⁵ See Doran, *supra* note 97, at 116–17, for a review of S&P 500 companies that grant compensation that triggers this tax penalty.

¹¹⁶ As discussed above, these costs might be borne by immobile factors such as labor. *See also id.* at 120.

Moreover, a tax rule that disallows the deduction of a certain expense would affect different firms differently, depending on their relevant tax rates.¹¹⁷ If a firm is subject to a marginal corporate income tax rate of 35 percent, the cost of disallowing deduction would be 35 percent times the expense. However, if the marginal tax rate is only about 3 percent, the cost of disallowing the deduction of an expense would be much lower. Although the statutory corporate income tax rate in the United States is 35 percent, most large firms use tax planning to lower that tax rate significantly, and it is possible that a non-deduction rule would be less costly to some firms.¹¹⁸ Companies that can carry forward losses (which may be a result of poor managerial decisions) can avoid paying corporate income tax,¹¹⁹ thus resulting in low effectiveness of disallowing a deduction. Generally, firms that incur a lower tax penalty would have a weaker incentive to adopt performance-based compensation plans. As a lower tax rate might not be associated with better or worse managerial performance, it is unclear if there should be a different treatment of firms based on the tax rates they are subject to.¹²⁰ One solution for this would be

¹¹⁷ See Schizer, *supra* note 9, at 5. This is a general problem where corrective taxes are imposed on income, and the applicable tax rates vary across taxpayers.

¹¹⁸ See, e.g., Philip Van Doorn, *Here are the actual tax rates the biggest companies in America pay*, MARKETWATCH (Oct. 14, 2017), <http://www.marketwatch.com/story/these-companies-may-enjoy-a-windfall-under-trumps-tax-plan-2017-09-29> [<https://perma.cc/7ZGK-FKYM>] (showing that the effective tax rates that Dow Jones companies pay vary greatly); U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-16-363, CORPORATE INCOME TAX: MOST LARGE PROFITABLE U.S. CORPORATIONS PAID TAX BUT EFFECTIVE TAX RATES DIFFERED SIGNIFICANTLY FROM THE STATUTORY RATE i, 13, (2016), <http://www.gao.gov/assets/680/675844.pdf> [<https://perma.cc/D2U5-2NWA>] (showing that large firms paid an average of 16.1 percent of reported income in 2012, which is well below the statutory rate of 35 percent).

¹¹⁹ U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 118, at 5.

¹²⁰ Schizer, *supra* note 9, at 5, notes that “a firm with substantial net operating losses, which would not pay taxes anyway, could be immune from the penalty. If anything, this seems backwards. Firms may be unprofitable *because of* agency costs, and these firms should not be left out.” However, as discussed in Section IV.A below, there is evidence suggesting that firms with entrenched managers engage in less tax-avoidance. See *infra* Section IV.A. A profitable, well-governed firm can report a loss for tax purposes in the United States while shifting profits offshore. Therefore, it is uncertain whether lower applicable tax rates are generally associated with better or worse governance and managerial performance.

to set a corrective tax irrespective of the corporate income tax liability.¹²¹ For example, the corrective tax imposed on the firm or on the executive can be a fixed percentage of the nonperformance-based compensation.

The experience with section 162(m) also shows that a broad and vague definition of performance-based compensation can significantly undermine the effectiveness of that rule in promoting a real performance-based compensation. As discussed above, many forms of performance-based compensation, deductible under this section, could be based on easily attainable targets, activities that do not increase shareholder value, or windfalls.¹²² A more sophisticated tax rule could, in theory, allow the deduction of performance-based compensation only if it filters out all nonperformance factors. The tax rule can also impose other limitations suggested by Bebchuk and Fried, such as limitations on executives' ability to unload equity incentives.¹²³ However, enforcing a sophisticated tax rule that requires filtering out all the nonperformance factors and windfalls might be very complicated and costly, and the tax authority might not have the expertise to administer such rule.¹²⁴ Moreover, a narrow approach to a deductible performance-based compensation might result in more firms, especially those with worse corporate governance, choosing to pay high nonperformance-based compensation while incurring higher tax.¹²⁵ Therefore, it is possible that even though a more targeted tax rule could allow favorable treatment only of real performance-based compensation, this rule might not solve the problem of managers having an excessive power over the compensation-setting process and rewarding themselves in compensation that is not linked to performance.

In summary, section 162(m) fails to achieve its goal to encourage real performance-based compensation, while it increases

¹²¹ It is possible to determine that the additional taxable income, resulting from a non-deduction rule, will be taxed at the highest corporate income tax rate, similar to § 7874. I.R.C. § 7874(e)(2)(C).

¹²² See Doran, *supra* note 97, at 121; Walker, *supra* note 4, at 384.

¹²³ See BEBCHUK & FRIED, *supra* note 78, at 10. For a discussion on reform proposals that would narrow the deduction under section 162(m), see Doran, *supra* note 97, at 123–36.

¹²⁴ See Schizer, *supra* note 9, at 4 (discussing the mismatch in institutional focus and expertise where government tax experts administer rules that address corporate governance problems).

¹²⁵ See *infra* Section II.G.

the costs for companies and the overall deadweight loss, especially for companies with worse corporate governance as they are more likely to trigger the tax penalty. Thus, repealing this tax rule is socially desirable.¹²⁶ As the tax system cannot effectively assess what a real performance-based compensation is, encouraging pay-for-performance should be done through corporate governance mechanisms and not through the tax system.

B. Preventing Harmful Changes in Control

1. Golden Parachutes

Golden parachutes are any form of compensation granted to executives in connection with a change in control.¹²⁷ There are several reasons why firms like granting golden parachutes. Even excellent managers might oppose a value-increasing change in control if the new controller might replace them.¹²⁸ Granting managers golden parachutes would encourage them to support a beneficial sale of the firm, a sale that they might otherwise oppose. Where the management is entrenched, giving underperforming executives a golden parachute if they are to cede control would compensate them for forgoing the private benefits of control.¹²⁹ This may increase the value of the firm if a better management replaces the entrenched one. Empirical evidence shows that firms that offer golden parachute packages have a higher likelihood of receiving an acquisition offer and being acquired.¹³⁰ Golden parachutes are associated with a higher acquisition premium and this association is explained at least partly by the effect of golden parachutes on executive incentives.¹³¹

However, golden parachutes might have negative consequences.¹³² One rationale for limiting golden parachutes may be connected to a general motivation to reduce excessive executive

¹²⁶ See Doran, *supra* note 97, at 147–50.

¹²⁷ § 280(G)(2)(A).

¹²⁸ See Schizer, *supra* note 9, at 10.

¹²⁹ See *id.*

¹³⁰ See Lucian Bebchuk, Alma Cohen & Charles C.Y. Wang, *Golden Parachutes and the Wealth of Shareholders*, 25 J. CORP. FIN. 140 (2014).

¹³¹ See *id.*

¹³² See *id.*

compensation. This topic is further discussed below.¹³³ It is unclear if there should be a special treatment of golden parachutes on that basis because golden parachutes are only one form of compensation. Another reason to reduce the use of golden parachutes is to prevent inefficient and value-decreasing changes in control that are backed by the management because it receives large private benefits in the form of golden parachutes.¹³⁴ Where the managers' employment is terminated after the control has been changed, they might be less sensitive to reputational costs and may not be held accountable for future poor performance.¹³⁵ Even if shareholders can veto some events of change in control, managers still have a strong influence on the approval processes and the information provided to the shareholders. If they have a strong personal benefit from approving such changes, they might try to reduce the shareholders' ability to effectively monitor and prevent harmful changes in control.

Golden parachutes affect executive incentives in general, not only with respect to a sale of the firm.¹³⁶ Firms that adopted golden parachutes have lower risk-adjusted stock returns relative to their industry peers that did not adopt golden parachutes, both during the two-year period surrounding the adoption and in the subsequent several years.¹³⁷ It is not clear what causes these low returns.¹³⁸ Bebchuk et al. suggest that it can be explained, at least partially, by the effect of golden parachutes on executive incentives and performance not facing an acquisition offer.¹³⁹ They argue that the market for corporate control disciplines managers because they know that they might lose their job if they underperform, and that this disciplinary force is weakened where the managers are guaranteed a large benefit in the event of a change in control.¹⁴⁰ This explanation might not be relevant to firms with

¹³³ See *infra* Section II.D.

¹³⁴ See *id.*

¹³⁵ See Walker, *supra* note 4, at 356 ("The constraint created by investor and financial press outrage over perceived executive pay abuses would have much less force on departing executives and overseers.").

¹³⁶ See Bebchuk et al., *supra* note 130, at 141.

¹³⁷ See *id.*

¹³⁸ See *id.*

¹³⁹ See *id.*

¹⁴⁰ See *id.*

entrenched management, as the executives in these firms are already insulated from the market for corporate control. Alternatively, it is possible that golden parachutes are associated with worse performance, but do not cause it.¹⁴¹ More research analyzing these effects is needed.

In summary, rules that discourage the use of golden parachutes may improve managers' incentives with respect to undesirable sales and increase the disciplinary force of the market for corporate control on executive incentives.¹⁴² However, the use of golden parachutes can increase the value for shareholders by providing executive incentives to pursue beneficial sales,¹⁴³ especially where the management is entrenched.

2. *The Golden Parachute Tax Rule*

In general, a large "golden parachute" payment is not deductible to the corporation,¹⁴⁴ and the receiving executive is subject to a 20 percent excise tax on such payment.¹⁴⁵ The following paragraphs review this tax treatment.

Section 280G disallows the deduction of excessive parachute payments, triggered by change in control to disqualified individuals.¹⁴⁶ The term "parachute payment" includes all compensation forms granted to a disqualified individual in connection with a change in control.¹⁴⁷ A change in control includes any of the following three events: a change in ownership of the corporation's stock; a change in ownership of a substantial portion of the corporation's assets; or a change in effective control of the corporation.¹⁴⁸ Disqualified individuals include officers of the corporation, shareholders who own more than 1 percent of the fair market value of the corporation's stock, and highly compensated individuals.¹⁴⁹

Parachute payments are excessive if the amount of the parachute payments exceeds a threshold amount, which is calculated

¹⁴¹ *See id.*

¹⁴² *See id.*

¹⁴³ *See* Schizer, *supra* note 9, at 10.

¹⁴⁴ § 4999(a).

¹⁴⁵ *Id.* § 280G.

¹⁴⁶ *See id.*

¹⁴⁷ *See id.*

¹⁴⁸ *See id.*

¹⁴⁹ § 280G(c).

as three times the disqualified individual's "base amount" (the average annual compensation of the individual over the past five years).¹⁵⁰ The "three times base amount" is a threshold test, so if the parachute payments exceed three times the base amount, the total excessive parachute payments equal the total parachute payments less one times the base amount.¹⁵¹ An amount of up to three times the base amount will not trigger this unfavorable tax treatment.¹⁵²

Under section 4999, the disqualified individual should pay a 20 percent tax on all excessive parachute payments which he or she receives, in addition to the ordinary income tax on such income.¹⁵³ The firm may gross up the payment to the disqualified individual for the excise tax, but the gross-up payments will be considered as excessive parachute payments, subject to the 20 percent excise tax, and will not be deductible to the corporation.¹⁵⁴ Many firms provide their executives with golden parachute tax gross-ups, even though these are very costly.¹⁵⁵ However, these gross-ups have become a target for criticism because of their high cost, and public firms are under pressure to eliminate these arrangements.¹⁵⁶

3. Using Taxation to Prevent Harmful Sales

Taxing golden parachutes should reduce the use of compensation granted based on a change in control. The benefits from reducing the use of golden parachutes are lower incentives to approve value-decreasing sales, and possibly better exposure to the disciplinary force of the market for corporate control.¹⁵⁷ The costs from reducing the use of golden parachutes derive from lower incentives for executives to facilitate a beneficial sale that might

¹⁵⁰ § 280G(b).

¹⁵¹ *See id.*

¹⁵² *See id.*

¹⁵³ *Id.* § 4999.

¹⁵⁴ *Golden Parachute Payments Guide: Audit Techniques Guide*, INTERNAL REVENUE SERVICE (Jan. 20, 2017), <https://www.irs.gov/pub/irs-utl/goldenparachuteatg.pdf> [<https://perma.cc/MNF2-FMR5>].

¹⁵⁵ *See* Jennifer S. Conway & Nicole F. Foster, *Golden Parachute Tax Gross-Ups: Weathering the Storm*, 3 BLOOMBERG L. REP. EMP. BEN. No. 22, 1 (Oct. 25, 2010).

¹⁵⁶ *See id.* at 1–4.

¹⁵⁷ *See* Bebchuk et al., *supra* note 130, at 141 (noting that by making acquisitions less costly or even beneficial to executives, golden parachutes weaken the disciplinary force of the market for corporate control).

result in their replacement.¹⁵⁸ Shareholders in firms that reduce their golden parachutes benefit from a lower cost of compensation for the managers, whereas shareholders in firms that grant high golden parachutes incur the additional cost of the tax.

It is possible that firms with worse corporate governance are more likely to grant large golden parachute packages despite their high cost.¹⁵⁹ This may mitigate the problem of entrenchment, as managers would have higher incentives to sell, but would not mitigate the threat of a value-decreasing change in control, which might be greater in firms with poor corporate governance and ineffective monitoring.¹⁶⁰ Poorly governed firms that do not grant their entrenched managers golden parachutes are less likely to be sold, and underperforming managers are less likely to be replaced.¹⁶¹

Executives in well-governed firms are more likely to reduce to size of golden parachute packages in response to a high tax penalty.¹⁶² However, executives in well-governed firms are already less likely to agree to a value-decreasing change in control, so the benefit from preventing harmful changes in control might be limited in respect of these firms.¹⁶³ As discussed above, executives in all firms may oppose a beneficial sale that might risk their future employment if they are not provided with an incentive to agree to such sale.¹⁶⁴ Thus, the tax penalty would likely result in less value-increasing sales.

It is unclear whether the overall benefits from imposing a corrective tax on golden parachutes exceed the costs. The mixed benefits and costs make the assessment of whether golden parachutes are good or bad a context-specific question, and the general net long-term effect is ambiguous.¹⁶⁵ Imposing a tax on golden

¹⁵⁸ *See id.* at 151; Schizer, *supra* note 9, at 10.

¹⁵⁹ *See infra* Section II.G.

¹⁶⁰ *See supra* Section II.B.1.

¹⁶¹ *See infra* Section II.G.

¹⁶² *See id.*

¹⁶³ *See id.*

¹⁶⁴ *See supra* Section II.B.1.

¹⁶⁵ *See generally* Bebchuk et al., *supra* note 130, at 140–41 (finding that golden parachute payments are, on average, “associated with reduced value for shareholders” but golden parachute payments in some contexts may result in increased value for shareholders).

parachutes would reduce some of the inefficiencies created by them, but also some of the beneficial incentives they create. In addition, executives of some firms shift the tax burden onto their firms,¹⁶⁶ and this additional cost increases the overall social costs.

Is a tax on golden parachutes superior to other forms of regulation? One form of regulation is to impose a ban on granting any compensation above a certain threshold in connection with a change in control.¹⁶⁷ The difference between a ban and a corrective tax is that under a tax, the firms can choose whether they prefer to pay the additional tax and grant the golden parachute.¹⁶⁸ A general ban on golden parachutes might be problematic because it prevents beneficial uses of golden parachutes. As mentioned above, it is unclear whether granting golden parachutes despite the tax penalty reduces the agency costs or aggravates them, thereby further decreasing the shareholder value.

Another possible regulation is to empower shareholders and increase their monitoring on golden parachute contracts. The 2010 Dodd-Frank Act mandated advisory shareholder votes on all future adoptions of golden parachutes by public firms.¹⁶⁹ Corporate laws can adopt a stricter policy, such as requiring shareholder approval for golden parachutes, and not only an advisory vote. It is possible that empowered shareholders would be able to limit the use of a golden parachute when it is against their interest, and allow it when it is beneficial for them. However, the shareholders might face similar ambiguities when deciding whether golden parachutes serve their interest or not; this is because their overall effect on executive incentives is uncertain.¹⁷⁰

Another policy alternative is to impose a performance-based corrective taxation on the golden parachute payments. The tax

¹⁶⁶ See generally Walker, *supra* note 4, for a discussion whether managers are able to shift taxes to the firms.

¹⁶⁷ See, e.g., Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 111(b)(2)(C), 122 Stat. 3765 (imposing a ban on golden parachute payments by bailed-out financial institutions to executives during the period in which the Treasury holds an equity or debt position).

¹⁶⁸ For a general discussion on the differences between a tax and a ban, see *supra* text accompanying notes 22 and 23.

¹⁶⁹ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, § 951, 124 Stat. 1376, 1899, 1900 (2010).

¹⁷⁰ See Bebchuk et al., *supra* note 130, for a discussion of the various effects.

will be imposed after a certain period has passed since the change in control, when it is possible to assess whether the sale has increased value to shareholders, filtering out negative and positive effects caused by market trends and other windfalls. The assessment of the excess return, the benefit resulting from the change in control, can be done by economists in an independent agency separated from the IRS to isolate it from pressures to raise more revenues. A more sophisticated form of a performance-based corrective tax would tie the size of the golden parachute, the benefit or cost to the corporation from the change in control, and the tax rate.¹⁷¹ As suggested by Walker in his proposal mentioned below, it is possible to grant the investors a tax relief equal to the tax paid by the executives.¹⁷² Alternatively, the golden parachute itself could be designed this way, in an agreement that resembles a clawback provision.¹⁷³

To conclude, it is questionable whether taxing golden parachutes results in better incentives for managers and in a higher firm value, especially in poorly governed firms. Other forms of regulation, such as strengthening external and internal monitoring on changes in control, might be superior to corrective taxation.

C. Breaking Pyramidal Business Structures

1. The Rationales for Breaking Pyramidal Business Structures

The main corporate governance concern regarding pyramidal business structures is the separation between ownership and control, which is also described in the literature as a separation

¹⁷¹ For example, assume that the change in control resulted in an excess return of \$10 million to the shareholders. This valuation is made two years after the change in control, so that its negative and positive effects are better known. If the golden parachute was of \$5 million, it should go untaxed. If it was of \$15 million, it should be taxed at a rate of at least 33 percent. If the change of control did not result in any excess return to the shareholders, it is possible to tax the golden parachute at a rate of 100 percent. If the change of control resulted in excess losses to the shareholders, it is possible even to fine the executives for approving it.

¹⁷² See Walker, *supra* note 4, at 346, 368–70.

¹⁷³ For a discussion on clawbacks, see Jesse Fried & Nitzan Shilon, *Excess-Pay Clawbacks*, 36 J. CORP. L. 721, 723 (2011).

between cash flow rights and voting rights.¹⁷⁴ Control achieved through a pyramidal structure could be beneficial for the controller where the private benefits of control are large.¹⁷⁵

Separation of ownership and control might have serious corporate governance ramifications. One major threat is managerial entrenchment: managers that do not maximize the value of the corporation and cannot be voted out by shareholders because they control the top of the pyramid of the business group.¹⁷⁶ An entrenched controller with most of the cash flow rights would not be disciplined by the market for corporate control, but would still be incentivized to increase the firm's value because he or she holds a large stake of the cash flow rights.¹⁷⁷ However, where both market discipline and financial incentives are absent, like in business pyramids with multiple layers and a large gap between voting rights and cash flow rights, entrenchment might result in having managers not promoting the interest of the other stakeholders.¹⁷⁸

Another major concern is that pyramidal structures provide the controller with greater tunneling opportunities. Tunneling can take place where assets are transferred for less than their actual value from a firm in which the controller's share of ownership is low to a firm in which the controller's share of ownership is high.¹⁷⁹ The controller may be able to take opportunities of the business group and exploit them in a manner that benefits him or her at the expense of other shareholders.¹⁸⁰ In addition, complexity in pyramidal business structures can be used to disguise diversion and accounting manipulations that would be more transparent in a flatter and less complex structure.¹⁸¹ Tunneling can also take

¹⁷⁴ See Lucian A. Bebchuk, *Corporate Pyramids in the Israeli Economy: Problems and Policies—A Report Prepared for the Committee on Increasing Competitiveness in the Economy*, at 5 (Mar. 2012), http://www.financeisrael.mof.gov.il/financeisrael/Docs/En/publications/opinion_2.pdf [<https://perma.cc/FEN7-GWBA>]. For example, a controller that owns 50 percent of a firm that owns 50 percent of another firm achieves control of the latter firm, whereas it owns only 25 percent of its equity. If the latter firm owns 50 percent of another firm, the cash flow rights of the controller in that firm would be 12.5 percent.

¹⁷⁵ See Bebchuk, *supra* note 174, at 7–8.

¹⁷⁶ See Morek, *supra* note 1, at 160–62.

¹⁷⁷ See *supra* text accompanying notes 48 and 49.

¹⁷⁸ See *id.*

¹⁷⁹ See Bebchuk, *supra* note 174, at 8–9.

¹⁸⁰ See *id.*

¹⁸¹ See *id.*

place through the employment of family members and friends as executives and directors in the various firms in the pyramid.¹⁸²

A pyramidal structure might also create suboptimal incentives for business decisions regarding expanding and contracting. Controllers of pyramidal business groups might have incentives to expand more than is desirable, as well as stronger incentives to avoid contracting.¹⁸³ These incentives arise because the controller can extract private benefits from capital that is inside the business group, while bearing only a fraction of the costs associated with raising this capital.¹⁸⁴

The greater the gap between the cash flow rights and the voting rights held by the controller, the more serious the distortions are, as incentives for tunneling and underperformance due to entrenchment increase.¹⁸⁵ Several studies have documented these phenomena in various countries, including India,¹⁸⁶ South Korea,¹⁸⁷ China,¹⁸⁸ Hong Kong,¹⁸⁹ Taiwan,¹⁹⁰ and Italy.¹⁹¹ There is a significant body of empirical literature which shows that pyramidal business structures are associated with a lower value for outside shareholders, and that this reduction in value is higher when the gap between cash flow rights and voting rights increases.¹⁹²

¹⁸² *See id.*

¹⁸³ *See id.* at 10.

¹⁸⁴ *See id.*

¹⁸⁵ *See supra* text accompanying notes 48–49.

¹⁸⁶ *See* Marianne Bertrand et al., *Ferretting Out Tunneling: An Application to Indian Business Groups*, 117 *QUART. J. ECON.* 121 (2002).

¹⁸⁷ *See* Kee-Hong Bae et al., *Tunneling or Value Added? Evidence from Mergers by Korean Business Groups*, 57 *J. FIN.* 2695, 2695–96 (2002); Jae-Seung Baek et al., *Business Groups and Tunneling: Evidence from Private Securities Offerings by Korean Chaebols*, 61 *J. FIN.* 2415, 2415–16 (2006).

¹⁸⁸ *See* Guohua Jiang et al., *Tunneling Through Intercorporate Loans: The China Experience*, 98 *J. FIN. ECON.* 1 (2010).

¹⁸⁹ *See* Yan-Leung Cheung et al., *Tunneling, Propping, and Expropriation: Evidence from Connected Party Transactions in Hong Kong*, 82 *J. FIN. ECON.* 343, 343–44 (2006).

¹⁹⁰ *See* Yin-Hua Yeh & Tracie Woidtke, *Commitment or Entrenchment?: Controlling Shareholders and Board Composition*, 29 *J. BANKING & FIN.* 1857, 1857–58 (2005).

¹⁹¹ *See* Paolo Volpin, *Governance with Poor Investor Protection: Evidence from Top Executive Turnover in Italy*, 64 *J. FIN. ECON.* 61, 61–62 (2002).

¹⁹² *See* Bebchuk, *supra* note 174, at 19–20.

Some arguments in support of pyramidal structures are relevant mostly to developing countries. In a developing country, large business groups can substitute for weak external institutions by raising capital, contracting, and developing human capital within the pyramidal business group.¹⁹³ These advantages are likely very small in developed countries.¹⁹⁴ Other considerations supporting eliminating pyramidal business structures include concerns regarding competition and political power of these groups, as well as the tax-avoidance opportunities that these structures might enable.¹⁹⁵ Private ordering without regulatory intervention might not mitigate some of the negative effects of pyramidal business groups, as shown in evidence documenting this phenomenon in various countries.¹⁹⁶ This could be explained by the business groups' concentrated market power, strong political power, and access to funding from financial institutions.¹⁹⁷

¹⁹³ *See id.* at 16–17.

¹⁹⁴ *See id.*

¹⁹⁵ Large business groups might gain market power that could endanger competition. *See Morck, supra* note 1, at 163–64. Some countries are concerned with the increased market power of large business groups. For example, a few years ago Israel adopted a law which limits business groups' pyramidal structures because of concerns regarding concentrated market power and limited competition. *See The Law for Promotion of Competition and Reduction of Concentration, 5774-2013 (2013) (Isr.)*, <http://www.knesset.gov.il/Laws/Data/law/2420/2420.pdf> [<https://perma.cc/XGT3-WWU5>], *translated in* <http://www.anti-trust.gov.il/eng/subject/215.aspx> [<https://perma.cc/7JDW-MUJG>]. The Roosevelt administration was concerned about the strong political power of a wealthy business elite that controlled the business groups. Pyramidal corporate groups allow wealthy individuals and families to control assets worth much more than their actual wealth. In addition, once business groups are established, they are hard to dismantle because of the political power their controllers exert. Other political economy considerations, such as increased incentives for business groups to intervene in politics through lobbying instead of investing in enhancing productivity, may also support the dismantling of pyramidal business groups. *See Morck, supra* note 1, at 164–66. In addition, it is possible that a complex domestic structure provides a greater ability to shift income between affiliated entities and to avoid taxation. Tax planning opportunities may exist where different affiliates have different profits and are subject to different tax regimes. *See id.* at 162–63.

¹⁹⁶ *See Bebchuk, supra* note 174, at 11–12.

¹⁹⁷ *See supra* note 195 and accompanying text.

2. *Intercorporate Dividend Taxation*

One unique tax rule in the United States is the taxation of intercorporate dividends.¹⁹⁸ In general, if a corporation receives a dividend from another corporation, the dividend is taxed at the rate of 10.5 percent.¹⁹⁹ If the corporation receiving the dividend owns between 20 percent and 80 percent of the distributing corporation's stock, the dividend is taxed at the rate of 7 percent.²⁰⁰ If the corporation receiving the dividend owns more than 80 percent of the distributing corporation, the dividend is not taxed.²⁰¹ This non-taxation applies only if the corporation paying the dividend is liable for tax in the United States.²⁰² No other major economy in the world imposes comparable taxation on dividends paid by subsidiaries to parent companies.²⁰³ In fact, the European Union forbids its members from imposing such taxes.²⁰⁴ For most countries in the world, pyramidal business groups dominate large corporate sectors.²⁰⁵

According to Morck, the intercorporate dividend tax in the United States was adopted as a part of a deliberate and successful strategy in the 1930s, which aimed to break pyramidal business groups; these were believed to cause corporate governance problems, tax avoidance, antitrust issues, and highly concentrated political influence.²⁰⁶ The Roosevelt administration convinced Congress to take major steps against business groups, including enacting intercorporate dividend taxes, abolishing consolidated tax filing for business groups, eliminating capital gains taxes on liquidated controlled subsidiaries, and banning pyramidal business groups from controlling public utility companies.²⁰⁷ It is worth noting the future of the intercorporate dividend tax is uncertain, and it might

¹⁹⁸ § 243.

¹⁹⁹ *See id.*

²⁰⁰ *See* Morck, *supra* note 1, at 145.

²⁰¹ *See id.*

²⁰² §§ 243–45.

²⁰³ *See* Morck, *supra* note 1, at 146–47.

²⁰⁴ *See id.* at 135.

²⁰⁵ *See id.* at 135–37.

²⁰⁶ *See id.*

²⁰⁷ *See id.* at 149. Some commentators argue that pyramidal business structures were already becoming uncommon in the United States for other reasons. *See* Steven A. Bank & Brian Cheffins, *The Corporate Pyramid Fable*, 84 BUS. HIST. REV. 435, 436 (2010).

be eliminated in the future.²⁰⁸ The Bush administration tried eliminating the tax without success in early drafts of the Jobs and Growth Tax Relief Reconciliation Act, enacted in 2003.²⁰⁹

3. *Using Taxation to Break Pyramidal Business Structures*

As discussed above, many empirical studies show the negative implications of pyramidal business structures in developed economies, while the positive benefits are very limited. Although the negative effects are well documented, it is hard to gauge the average cost caused by using pyramidal levels.²¹⁰ Therefore, the case for banning or limiting pyramidal structures by using a ban appears more compelling than the use of corrective taxation.

It is important to distinguish between corrective taxation that aims to internalize negative externalities, and tax penalties that are used to ensure compliance with a particular rule regardless of the externalities involved.²¹¹ A sufficiently high tax penalty can be used to enforce a *de facto* ban or obligation. For example, the 30 percent withholding tax imposed on certain payments to non-participating foreign financial institutions under the Foreign Accounting Tax Compliance Act was adopted as a tax penalty to achieve the full cooperation of foreign financial institutions.²¹² One consideration that might support using tax penalties rather than a ban is the political ability to legislate these penalties. Another consideration is institutional: which agency should enforce this rule? The IRS is likely to enforce the tax penalty, whereas the SEC is more likely to enforce a ban imposed on publicly traded firms.²¹³

²⁰⁸ See Morck, *supra* note 1, at 137, 167–68.

²⁰⁹ See *id.*

²¹⁰ It is hard to assess the social costs from any additional layer in a corporate structure and the costs of different pyramidal structures may vary significantly. For a general discussion on situations where the negative externality from a certain activity varies significantly across the different agents, see Fleischer, *supra* note 14, at 1694.

²¹¹ See generally Anthony Ogus, *Corrective Taxes and Financial Impositions as Regulatory Instruments*, 61 MOD. L. REV. 767, 771 (1998) (distinguishing between taxes are used to deter a certain conduct and taxes that are used to internalize externalities).

²¹² §§ 1471–1474.

²¹³ For a general discussion on the tax system and institutional design considerations, see David A. Weisbach & Jacob Nussim, *The Integration of Tax and Spending Programs*, 113 YALE L.J. 955 (2004).

It is possible that the intercorporate taxation in the United States is a tax penalty that operates as a *de facto* ban, although it still allows pyramidal structures where the benefits are large enough. A few years ago, Israel adopted a ban on a pyramidal structure with more than two levels.²¹⁴ A controlled firm can control no more than one other firm.²¹⁵ If the lower firm controls another firm, a court will appoint a trustee to sell the remaining firm.²¹⁶ The Israeli legislature considered and rejected following the American model of taxing the intercorporate dividends.²¹⁷ It is unclear which model is superior, though it seems that either a ban or a tax penalty that is high enough can achieve similar results.

A corrective tax on pyramidal structures should be set on the negative externality resulting from that structure.²¹⁸ The inefficiencies associated with pyramids increase where the gap between voting rights and cash flow rights are larger.²¹⁹ Therefore, corrective tax should increase in a similar manner. The current tax rules in the United States impose a higher tax on holdings lower than 20 percent, a lower tax on holdings between 20 and 80 percent, and no tax where the holdings exceed 80 percent.²²⁰ This may serve as a very rough approximation of the negative externalities that increase where the controller's share is lower. One advantage of having these three categories is the simplicity of this rule. However, imposing a similar tax where the holding is 21 percent and where it is 79 percent cannot be justified on corrective grounds, as the externalities should be very different. In addition, imposing a higher tax on intercorporate dividends where there is no effective control—where the holding is lower than 20 percent—would be hard to explain as a corrective measure.

If the negative externality decreases with ownership, the tax on intercorporate dividends can track this relationship by adjusting the tax to the ownership rights. We should find the level of ownership which enables an effective control—for example, 30 percent—and the level of ownership which is high enough to provide sufficient incentives to the owner—for example, 80 percent. If the negative

²¹⁴ See *supra* note 195 and accompanying text.

²¹⁵ See *id.*

²¹⁶ See *id.*

²¹⁷ See *id.*

²¹⁸ See *supra* text accompanying notes 73–74.

²¹⁹ See *supra* text accompanying notes 48–49.

²²⁰ See *supra* text accompanying notes 198–200.

effects decrease linearly, the tax should follow this by decreasing from a high tax rate, where the ownership is 30 percent, to a zero tax rate, where the ownership is 80 percent.

One advantage of optimal corrective taxation over a ban or a tax penalty—that serves as a *de facto* ban—is that the former does not prevent efficient pyramids, where there is a value-maximizing reason to have a pyramidal structure.²²¹ However, assessing the accurate negative externalities associated with different pyramidal structures would be very hard.²²² A corrective tax which is too low would result in a social cost from having many inefficient pyramids, whereas a corrective tax which is too high would be a *de facto* ban. In addition, it may be more politically feasible to adopt a tax, including a tax penalty that is a *de facto* ban, rather than an outright ban.²²³

An alternative to a tax or a ban is regulation that imposes stricter standards on pyramidal business groups, or empowers the noncontrolling shareholders. In theory, these regulations could reduce the private benefits of control and other inefficiencies. However, the effectiveness of these measures might be limited due to information and collective action problems.²²⁴

To conclude, the abundance of evidence on the inefficiencies caused by pyramidal structures, and the dearth of evidence supporting positive benefits from pyramids, support adopting a ban or a tax penalty that operates as a *de facto* ban rather than a corrective tax.

D. Reducing Excessive Executive Compensation

1. Executive Compensation

According to Jensen and Meckling, a board of directors that cannot fully observe the effort and effectiveness of the firm's executives would negotiate a contract in order to minimize agency

²²¹ For a general discussion on the differences between a tax and a ban, see *supra* text accompanying notes 22–23.

²²² See *supra* note 210 and accompanying text.

²²³ This depends on the specific political situation and the relevant taxes and bans under consideration.

²²⁴ These problems may explain why pyramidal structures are very prevalent in many countries, as discussed in *supra* Section II.C.1.

costs and maximize shareholder value.²²⁵ An alternative theory contends that the outside directors who decide on executive compensation lack proper incentives to set executive compensation that maximizes shareholder value, and that the executives' influence over the board undermines the directors' independence and ability to serve the firm's best interest.²²⁶ In addition, if a substantial number of firms pay excessive executive compensation, other firms will also increase their compensation level through benchmarking, and the overall level of compensation will go up.²²⁷

While the average executive pay of large listed companies increased substantially since the 1980s,²²⁸ some analysts argue that this does not necessarily mean current prevalent executive compensation levels are excessive. Kaplan found the ratio of large-company CEO pay compared to firm market value is roughly similar to its level in the late 1970s, and lower than its levels before the 1960s.²²⁹ CEO pay levels relative to other highly paid groups today are comparable to their average levels in the early 1990s.²³⁰ These patterns may suggest that similar forces, such as technology and scale, have played a meaningful role in driving executive compensation, as well as the pay of others with top incomes.²³¹ Kaplan contends that although pay levels are very high relative to the typical household, a meaningful part of CEO pay appears to be driven by the market for talent.²³²

Excessive executive compensation might still exist where there are corporate governance failures and pay outliers. Excessive compensation, which is a form of tunneling, is inefficient because it imposes an additional cost on investment in the corporate sector, resulting in the distortion of capital allocation.²³³ Walker contends that economic cost created by excessive compensation

²²⁵ See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 321 (1976).

²²⁶ See Walker, *supra* note 4, at 332–34.

²²⁷ See *id.*

²²⁸ See *id.* at 330.

²²⁹ See Kaplan, *supra* note 96, at 147.

²³⁰ See *id.*

²³¹ See *id.*

²³² See *id.* at 103.

²³³ See Walker, *supra* note 4, at 336–41.

reduces the investors' return from investment in the corporate sector, in a manner that is analogous to corporate income tax.²³⁴ If the incidence of corporate taxation is at least partially similar to the incidence of excessive executive compensation, it is likely that a significant portion of this cost is shifted in the long run from shareholders to immobile production factors, such as labor.²³⁵ In the short run, unexpected increases in executive compensation might be borne by existing shareholders.²³⁶ However, predicted levels of excessive pay would reduce the return on domestic stocks, and some capital that would have been invested in stocks would flow to other investment opportunities.²³⁷ Excessive executive compensation may also be objectionable because of its distributive consequences.²³⁸ Excessive compensation may have been a contributing factor to the increase in the inequality of wealth distribution in the United States in the last recent decades.²³⁹

2. Using Taxation to Reduce Excessive Executive Compensation

Taxation can be used to mitigate a market failure with respect to excessive executive compensation in publicly traded firms. Walker suggests imposing a surtax on executive compensation in excess of a certain threshold, combined with granting shareholders a tax relief equal to the tax paid by their executives.²⁴⁰ Walker predicts that this surtax would create only minor distortions, as the evidence on the elasticity of executive labor supply and taxable income indicates that a modest increase of the tax on executive compensation would have little influence on hours worked.²⁴¹ If, however, managers were able to shift this tax onto the firm by increasing the pre-tax compensation level, it could undermine the

²³⁴ *See id.*

²³⁵ *See id.* at 341.

²³⁶ *See id.*

²³⁷ *See id.* at 335–42.

²³⁸ *See supra* text accompanying note 76.

²³⁹ *See Walker, supra* note 4, at 342–44. For a discussion on excessive executive pay as a factor in income inequality, see generally Daniel J. Morrissey, *Executive Compensation and Income Inequality*, 4 WM. & MARY BUS. L. REV. 1 (2013).

²⁴⁰ *See Walker, supra* note 4, at 346.

²⁴¹ *See id.* at 353–58.

purpose of this proposal.²⁴² Although the experience with the “golden parachute” tax suggests a portion of the surtax might be shifted from managers to investors, Walker believes the ability to shift this tax would be limited, and the surtax could be increased as a response to an increase in the pre-tax compensation level.²⁴³ He also contends that there is no high likelihood this surtax would cause a significant number of private firms to avoid becoming public, or that public firms would go private.²⁴⁴

Walker suggests adopting a combined approach of imposing a surtax combined with providing a tax relief, mainly because of the risk that some of the surtax would be shifted to investors.²⁴⁵ If excessive executive compensation is inefficient because it imposes an additional cost on investment in the corporate sector, and if the surtax could be partially shifted onto investors, then this surtax might exacerbate the distortion and further suppress investment in the corporate sector.²⁴⁶ Providing tax relief equal to the surtax would mitigate this distortion.²⁴⁷ The tax relief could be firm-specific or general, and can be structured in a few ways.²⁴⁸ Although firm-specific tax relief would mitigate the distortion created by the tax, firms might be more willing to increase the compensation if they receive a firm-specific tax relief equal to the tax.²⁴⁹

This proposal has the potential to reduce executive compensation. However, similar to the discussion above regarding section 162(m) and golden parachutes, executives in poorly governed firms are more likely to shift the tax burden onto their firms, in whole or in part.²⁵⁰ Consequently, the effectiveness of this tool might be limited, especially with respect to poorly governed firms. It is unclear whether reducing compensation levels of executives in well-governed firms is desirable. As noted by Walker, it is possible that the compensation packages of executives in such firms are excessive as a result of benchmarking and upward ratcheting.²⁵¹

²⁴² *See id.*

²⁴³ *See id.*

²⁴⁴ *See id.*

²⁴⁵ *See id.* at 368–70.

²⁴⁶ *See id.*

²⁴⁷ *See id.*

²⁴⁸ *See id.*, at 370–73.

²⁴⁹ *See id.*; Doran, *supra* note 97, at 140–41.

²⁵⁰ *See Walker, supra* note 4, at 328.

²⁵¹ *See id.* at 335.

However, if the prevalent current pay levels are not excessive in these firms, as suggested by Kaplan, corrective taxation might distort the market for corporate managers.²⁵² Therefore, there is a risk that using corrective taxation to reduce the level of executive compensation might be ineffective for poorly governed firms, and distortive for well-governed firms.

If the optimal levels of compensation vary across firms and industries, the use of corrective taxation which is calculated based on the average negative externality would likely be suboptimal.²⁵³ As noted by Walker, it is possible to customize the corrective tax based on factors such as firm size and risk.²⁵⁴ However, it is unclear whether the government has enough information to be able to define groups of companies that should have similar levels of compensation, define the optimal level of compensation, and determine what would be the optimal corrective taxation for each group.

Defining the thresholds of excessive compensation in legislation might create other distortions, such as the ratcheting-up effect caused by the \$1 million amount in section 162(m).²⁵⁵ This is the reason why Walker suggests adopting relatively low thresholds.²⁵⁶ However, if the prevalent current pay levels are not excessive, as suggested by Kaplan, low thresholds might distort the market for corporate managers.²⁵⁷

Similar to the discussion above regarding performance-based compensation, it is possible that other forms of regulation, such as empowering shareholders and strengthening board's independence, would be more effective than taxation in addressing the problem of executive compensation.²⁵⁸

E. Reducing Tunneling Through Related-Party Transactions

1. Related-Party Transactions

Related-party transactions typically involve a deal between a firm and its controller, or one of its executives, or a transaction

²⁵² See Kaplan, *supra* note 96, at 152–53.

²⁵³ See generally Fleischer, *supra* note 14, at 1694.

²⁵⁴ See Walker, *supra* note 4, at 347.

²⁵⁵ See *id.* at 361–62.

²⁵⁶ See *id.* at 362.

²⁵⁷ See Kaplan, *supra* note 96, at 152–53.

²⁵⁸ See *infra* Section II.G.

between affiliated entities.²⁵⁹ The main concern in related-party transactions is that the deal might be used for tunneling, serving the interest of an insider, usually the executive or the controller, at the expense of the corporation and the outside shareholders.²⁶⁰ This is usually done through pricing that does not follow the arm's length principle, where insiders sell overpriced assets or services to the firm, or buy assets or services from the firm for a price below their fair value.²⁶¹ The concern is greater where the party who benefits from the transaction has fewer cash flow rights in the firm.²⁶²

Related-party transactions could be beneficial to the corporation in some cases, despite the risk that they might enable tunneling. Their value might be low where a similar transaction can be done with an unrelated party. However, there are cases in which a related-party transaction could not be easily substituted with a transaction with unrelated parties. It might be the case where the transaction involves unique assets or if there are asymmetric information problems that reduce the attractiveness of offers from external parties. It is also possible that some related-party transactions would produce rents from synergy where related parties collaborate. Nonetheless, in these cases where there are no market benchmarks for similar arm's length transactions, it is harder to determine whether the transaction is beneficial to the corporation.

Related-party transactions are usually regulated but not banned.²⁶³ They are subject to disclosure requirements and special audit standards.²⁶⁴ For example, Delaware Corporate Law sets requirements for an approval of a transaction between a corporation and its directors, officers, or parties related to them.²⁶⁵ It requires that the transaction should be fair to the corporation, that there be a full disclosure of the interest to the board and shareholders, and also an approval by the shareholders and the disinterested directors.²⁶⁶

²⁵⁹ See Atanasov et al., *supra* note 50, at 11.

²⁶⁰ See *id.* at 5–6.

²⁶¹ See *id.* at 6–9.

²⁶² See *supra* text accompanying notes 48 and 49.

²⁶³ See, e.g., DEL. CODE ANN. tit. 8, § 144 (2017) (detailing how Delaware regulates related-party transactions).

²⁶⁴ See AS 2410: *Related Parties*, PUBL. COMPANY ACCT. OVERSIGHT BOARD, <https://www.pcaobus.org/Standards/Auditing/Pages/AS2410.aspx> [<https://perma.cc/B72D-Y39U>] (reviewing the related-party transactions rule).

²⁶⁵ DEL. CODE ANN. tit. 8, § 144.

²⁶⁶ See *id.*

2. *Using Taxation to Reduce Tunneling Through Related-Party Transactions*

What would be the effect of imposing a surtax on related-party transactions? Assume that a surtax is imposed on the insider dealing with the firm or on the firm itself. The surtax could be calculated as a percentage of the value transferred or as a percentage of the profit from the transaction. Where tunneling is done through an overpriced sale of an asset from the insider to the firm, a surtax on the sale profit or the gross receipt may eliminate the insider's benefit, unless he or she can shift the tax burden onto the firm. Where tunneling takes place through an underpriced sale of an asset from the firm to an insider, a tax calculated as a percentage of the purchase could be used to eliminate the benefit.

Where there is no comparable arm's length transaction, it is hard to determine which party is gaining or losing. Such a surtax would likely reduce some bad transactions that are used for tunneling and some good transactions that are beneficial to the firm. A surtax that is not too high would allow the very beneficial related-party transactions to take place, while preventing the moderately beneficial ones. Likewise, it would prevent the moderately bad transactions, while maintaining managerial incentives to conduct transactions in which the tunneled value is very high. It is possible that the very bad transactions would be prevented by other corporate governance mechanisms, such as the fiduciary duties of care and loyalty. Remaining transactions that get through in spite of the tax would be subject to more attention, and require a strong justification, and therefore monitoring might be easier.

It is unclear if the benefit from preventing bad related-party transactions exceeds the cost from preventing beneficial related-party transactions. A tax might be superior to a complete ban on related-party transactions, as the very good transactions would take place under a tax, whereas they would be prevented under a ban.²⁶⁷ However, as the costs and benefits from related-party transactions vary significantly, depending on the specific transaction, a corrective tax is unlikely to be the optimal regulatory instrument.²⁶⁸ In addition, poorly governed firms might still approve transactions that trigger the tax, although they do not benefit the

²⁶⁷ For a general discussion on the differences between a tax and a ban, see *supra* text accompanying notes 22–23.

²⁶⁸ See generally Fleischer, *supra* note 14, at 1694.

firm, thereby exacerbating the harm to shareholders and the social deadweight loss. Therefore, the case for imposing a surtax on related-party transactions to reduce tunneling through such transactions appears unconvincing.

Other forms of regulation could possibly lead to approving good transactions and rejecting bad ones. Corporate law rules, requiring an approval by a majority of the uninterested directors and shareholders, might serve as a more precise mechanism for that purpose.²⁶⁹ This mechanism has other limitations that are beyond the scope of this Article, and it is possible that even under this mechanism harmful transactions would be approved and some beneficial transactions would be prevented.²⁷⁰

Tax authorities can interfere where the prices used in related-party transactions do not reflect fair market values under the arm's length principle.²⁷¹ However, tax authorities only have an interest in such transactions if they result in lower tax revenues.²⁷² In many cases, where the assets move from one taxable entity to another, tunneling through related-party transactions does not result in lower tax revenues.²⁷³ Even where taxable income is reduced, tax authorities have limited success in effectively enforcing the arm's length principle.

F. Reducing Agency Costs from Entrenchment

1. Entrenchment

As discussed above, managerial entrenchment occurs where managers make it impractical or very costly for shareholders to replace them.²⁷⁴ One of the main arguments in the corporate governance literature is that anti-takeover devices are socially inefficient.²⁷⁵ Anti-takeover devices, such as dual class stocks and poison pills, make it harder for shareholders to remove underperforming managers.²⁷⁶ If managers can counter disciplinary forces and entrench

²⁶⁹ See Atanasov et al., *supra* note 50, at 11.

²⁷⁰ See *id.* at 13.

²⁷¹ § 482.

²⁷² Tax authorities do not have an incentive to dispute overpayment of tax.

²⁷³ See Atanasov et al., *supra* note 50, at 15–16.

²⁷⁴ See Shleifer & Vishny, *supra* note 44, at 123.

²⁷⁵ See Bebchuk, *supra* note 46, at 745.

²⁷⁶ See Hynes, *supra* note 19, at 571.

themselves, this would cause suboptimal managerial incentives because managers are not exposed to the risk of being replaced for underperformance.²⁷⁷ In cases where managers hold a large stake of the firm's cash flow rights, they will still have incentives to maximize the value of the firm.²⁷⁸ However, the incentive problem would be greater where managers do not hold equity rights high enough to align their interests with shareholders and provide them with incentives to maximize the firm's value.²⁷⁹

Supporters of the use of anti-takeover arrangements emphasize their importance in preventing harmful takeovers.²⁸⁰ Per this view, anti-takeover measures serve an important role in preventing negative interventions and pressures from short-term-oriented activists and harmful hostile takeovers.²⁸¹

2. Using Taxation to Reduce Agency Costs from Entrenchment

The current tax system does not tax anti-takeover devices.²⁸² Issuing poison pills and dual class stocks is a non-taxable event.²⁸³ Staggered board structure is a corporate governance practice that does not have any tax consequence.²⁸⁴ Nonetheless, as suggested by Hynes, it is possible to impose a tax on firms or on their managers if they adopt anti-takeover devices.²⁸⁵

This tax would prevent some harmful and some beneficial uses of these devices, as discussed above. It would also discourage some firms from going public or from issuing a large amount of stocks

²⁷⁷ See Bebchuk, *supra* note 46, at 719–20.

²⁷⁸ See *supra* text accompanying notes 48–49.

²⁷⁹ See *id.*

²⁸⁰ See, e.g., Martin Lipton & Theodore Mirvis, *Harvard's Shareholders Rights Project is Wrong*, HLS FORUM ON CORP. GOV. & FIN. REG. (Mar. 23, 2012), <https://corpgov.law.harvard.edu/2012/03/23/harvards-shareholder-rights-project-is-wrong/> [<https://perma.cc/AD6A-XUD2>].

²⁸¹ See *id.*

²⁸² See Desai & Dharmapala, *supra* note 33, at 29 (giving an example of poison pills as a non-taxable event).

²⁸³ See *id.*

²⁸⁴ See Hynes, *supra* note 19, at 570 (explaining that staggered board structure is a type of anti-takeover device and therefore not taxed).

²⁸⁵ See Hynes, *supra* note 19, at 569–70, 384 (“[T]he government could assess an additional tax on public corporations based on the anti-takeover provisions that they adopt.”).

resulting in increasing the risk of a takeover.²⁸⁶ In addition, it is possible that firms with worse corporate governance would be more likely to adopt anti-takeover devices despite the tax penalty.²⁸⁷ It is unclear what would be the net social gain from this corrective taxation. Moreover, it is very hard to assess the economic cost associated with the use of these devices.²⁸⁸ As a result, it would be hard to set a corrective tax equal to the negative externality. A tax rate too low or too high would result in the suboptimal use of anti-takeover devices.²⁸⁹ Therefore, the case for taxing anti-takeover devices to reduce agency costs from entrenchment appears unconvincing. It is possible that mechanisms that strengthen the outside shareholders' ability to periodically approve or veto the use of these devices would be superior to taxation.

G. Considerations for Using Corrective Taxation

Based on the analysis above, this part identifies the factors that limit the effectiveness of taxation in mitigating corporate governance inefficiencies. First, because firms with different corporate governance characteristics vary in their reaction to taxation,²⁹⁰ imposing the same tax on firms with different characteristics might not prompt the desired response. This may be especially true for firms with poor corporate governance. The experiences with many firms in adopting nonperformance-based compensation and large golden parachutes indicate that taxation might not be an effective means to change practices in poorly governed firms. Firms with better corporate governance are more likely to alter their practices in response to a corrective tax, whereas firms with worse corporate governance might decide to incur the tax penalty rather than change their practices. If the tax is formally imposed on managers, managers in poorly governed firms are more likely to trigger the tax and shift the tax burden onto the firm. Therefore, unlike negative externalities that can be internalized through corrective taxation, taxation may not effectively counter corporate governance agency problems since the same conditions that gave rise to the agency problem might undermine the effectiveness of the corrective taxes.

²⁸⁶ *See id.* at 583.

²⁸⁷ *See infra* Section II.G.

²⁸⁸ *See Hynes, supra* note 19, at 582.

²⁸⁹ *Cf. supra* text accompanying note 222.

²⁹⁰ *See, e.g.,* Desai et al., *supra* note 24, at 599; *infra* Part III.

Second, if the tax burden is shifted onto shareholders, in whole or in part, it would reduce the taxes' benefit and the efficiency gain from imposing them. From the shareholders' standpoint, a beneficial tax would be one that reduces the costs from corporate governance inefficiencies to such an extent that exceeds the tax burden shifted onto the firm. Shareholders might also benefit when the increase in tax revenue results in a decrease in other taxes.²⁹¹ From a broader efficiency perspective, corporate agency costs reduce investment in the corporate sector and distort the allocation of capital.²⁹² If the corrective tax is borne by the firm, it would reduce the social benefit from that corrective tax. Walker's proposal, to impose a surtax on excessive executive compensation, tries to mitigate this problem by granting the investors a tax relief equal to the surtax paid by the executives.²⁹³ However, granting such a tax relief increases the likelihood that managers would shift the tax costs onto firms, especially in poorly governed firms.²⁹⁴

Third, the same corporate governance practices that are harmful in some situations may be beneficial in others. Imposing a tax that discourages the harmful uses of a particular practice would discourage the beneficial uses as well.²⁹⁵ Golden parachutes encourage managers to find beneficial sales and may overcome managerial entrenchment, but they can also lead to harmful changes in control.²⁹⁶ Some related-party transactions may be used for tunneling, while others can increase firm value.²⁹⁷ Anti-takeover arrangements might be used by an underperforming management to entrench itself, but the same measures could allow a firm with excellent management to oppose harmful bids that might destroy the firm's long-term value.²⁹⁸ It would be very hard to design a corrective tax that targets only the harmful uses

²⁹¹ For example, increasing taxation at the corporate level while reducing the taxation on dividend distribution may benefit the shareholders as further discussed in *infra* Section III.B.

²⁹² See Walker, *supra* note 4, at 336.

²⁹³ See *id.* at 368–70.

²⁹⁴ See *id.* at 371–73. As noted by Walker, this effect will be smaller if the tax relief is general and not firm-specific.

²⁹⁵ See generally Fleischer, *supra* note 14, at 1694.

²⁹⁶ See *supra* Section II.B.1.

²⁹⁷ See *supra* Section II.E.1.

²⁹⁸ See *supra* Section II.F.1.

of these practices. Usually in cases where a corrective taxation is considered and imposed, there is a clear negative externality associated with a particular action (*e.g.*, polluting), but that may not be the case with corporate governance practices. Since some of the corporate governance practices have mixed effects, using a tax that would reduce both the harmful and the beneficial uses of these practices might not be optimal.²⁹⁹

A corrective tax should equal the average externality where heterogeneity exists. A tax equal to the average externality, calculated by taking into account the offsetting effect of the positive externality, could result in not internalizing the negative externality of the harmful uses of these practices.³⁰⁰ At the same time, it would discourage beneficial uses of these practices. Strengthening mechanisms that can distinguish between harmful and beneficial applications, and then allowing only the latter ones, could be superior to taxation.

Fourth, the tax system is limited in its ability to assess real risk and performance goals. As discussed above, the tax penalty under section 162(m) could be easily avoided by granting compensation conditioned on easily attainable performance targets.³⁰¹ The tax authorities' limited ability to assess these factors raises doubts about the effectiveness of using tax rules to incentivize pay-for-performance.

Fifth, taxation might not have much advantage over other forms of regulation in reducing corporate governance inefficiencies. Corrective taxation would be preferable where the government does not know what terms are optimal, but can assess the externalities generated by the relevant behaviors and practices, and can impose a tax equal to these externalities.³⁰² If the government knows what the best governance terms are, command and control regulation would be preferable.³⁰³ For example, substantial evidence showing the negative implications of pyramidal business structures might justify a ban.³⁰⁴ With respect to golden parachutes, related-party transactions, and anti-takeover devices, it is unclear

²⁹⁹ See *supra* text accompanying notes 13 and 14.

³⁰⁰ See *id.* For a general discussion, see Fleischer, *supra* note 14, at 1694.

³⁰¹ See Doran, *supra* note 97, at 121; Walker, *supra* note 4, at 384.

³⁰² See Hynes, *supra* note 19, at 582.

³⁰³ See *id.*

³⁰⁴ See the discussion in *supra* Section II.C.

what terms are optimal, and it is very hard to assess the externalities these practices create. As it is hard to assess the costs and benefits generated by these practices, and as the costs and benefits vary across different companies and transactions, the case for using corrective taxes against such corporate governance practices is very weak, and different forms of regulation may be preferable.

Unlike a ban, taxation results in an action to take place if the benefit exceeds the cost of the tax.³⁰⁵ Taxation would be advantageous where the benefit for the firm from a particular action exceeds the tax, whereas a ban would prevent any action regardless of the potential benefit.³⁰⁶ However, if insiders, and not the firm, receive that benefit while the firm is harmed from the action, the shareholders would prefer a ban.³⁰⁷ In addition, a tax may be more politically feasible than a ban. Though not within the scope of this Article, an alternative to taxation and bans is to strengthen the internal and external mechanisms that distinguish between the harmful and the beneficial applications of corporate governance practices.

III. HOW DO GENERAL TAX RULES AFFECT CORPORATE GOVERNANCE?

General tax rules are not corrective taxes, because they do not aim to encourage or discourage any particular activity. Nonetheless, they have a significant influence on corporate governance agency problems. This part explores the effects of general tax rules on corporate governance, and how these rules can be used to reduce corporate agency costs.

A. Corporate Income Taxation and Enforcement Efforts

A higher corporate tax rate increases the incentives for tunneling, whereas higher enforcement efforts can improve monitoring and prevent diversion. Desai et al. analyze how the corporate tax rate and enforcement efforts affect the level of managerial diversion.³⁰⁸ According to their model, “a higher tax rate increases

³⁰⁵ For a general discussion on the differences between a tax and a ban, see *supra* text accompanying notes 22–23.

³⁰⁶ *See id.*

³⁰⁷ *See id.*

³⁰⁸ *See* Desai et al., *supra* note 24, at 599.

the return to theft by insiders....”³⁰⁹ Increased tax enforcement efforts also reduce the incentives for theft by insiders, as the external monitoring by the tax authorities deters insiders from stealing.³¹⁰ Thus, an increase in tax enforcement efforts can increase the value which the outside shareholders would receive, as well as the overall value of the firm.³¹¹ Governments can improve corporate governance outcomes by lowering the corporate income tax rate, especially where corporate governance is weak,³¹² as this would reduce incentives for tunneling by insiders. An increase in tax enforcement efforts can also benefit the government with an increase in tax revenues, and the outside shareholders with a reduction of agency costs.³¹³

The positive effect of tax enforcement on corporate governance is supported by several studies. El Ghoul et al.’s study examined the impact of tax enforcement on agency problems in American publicly traded companies and found that a higher likelihood of an IRS audit lowers the equity financing costs.³¹⁴ It also found that IRS oversight is more valuable for firms with weaker corporate governance.³¹⁵ These findings suggest that investors view IRS audits as a monitoring mechanism that mitigates agency costs, especially for firms with problematic corporate governance.³¹⁶ Similarly, a study conducted in China found that tax enforcement efforts reduce agency costs and improve market performance.³¹⁷ In another study, Hanlon and Slemrod examined the

³⁰⁹ See *id.* at 592. The term “theft” in Desai et al. means diversion by insiders of otherwise taxable income, at the expense of both the outside shareholders and the state. *Id.*

³¹⁰ See *id.*

³¹¹ See *id.*

³¹² See *id.* at 594.

³¹³ See *id.*

³¹⁴ See Sadok el Ghoul, Omrane Guedhami & Jeffrey Pittman, *The Role of IRS Monitoring in Equity Pricing in Public Firms*, 28 CONT. ACCT. RES. 643, 667 (2011).

³¹⁵ See *id.*

³¹⁶ See *id.*

³¹⁷ See Weichu Xu, Yamin Zeng & Junsheng Zhang, *Tax Enforcement as a Corporate Governance Mechanism: Empirical Evidence from China*, 19 CORP. GOVERNANCE: INT’L REV. 25, 27 (2011) (arguing that tunneling is a prevalent phenomenon in emerging markets like China, and that higher tax enforcement efforts serve as an external corporate governance mechanism that reduces the incentives for tunneling).

stock price reaction to news about tax aggressiveness and found that the stock price usually declines as a reaction to news regarding the involvement of the firm in tax sheltering, although this market reaction is small in comparison to reactions to other corporate misdeeds and accounting misrepresentations.³¹⁸ The decline in the stock price is smaller for firms which have good corporate governance, and this suggests that investors in these firms are less concerned that involvement in tax sheltering is associated with tunneling at the expense of shareholders.³¹⁹

In some cases, managerial fraud actions, such as earnings management, result in paying corporate taxes higher than the amount of tax due if the earnings were reported accurately.³²⁰ Erickson et al. found that firms that were accused by the SEC of fraudulently overstating their earnings also overpaid their taxes.³²¹ This suggests that the threat of IRS monitoring caused these firms to overpay their taxes.³²² If earnings management results in shifting income between periods, and the overall reported income is similar to the income that should have been reported, then the effect of excessive tax payments might be insignificant, as the tax payments in the following periods will be lower.³²³ In addition, tax authorities, usually focusing on increasing tax revenues, do not have a strong incentive to detect incidences of inflated tax payments.³²⁴ It is also possible that inflated tax payments are harder to detect

³¹⁸ See Michelle Hanlon & Joel Slemrod, *What Does Tax Aggressiveness Signal? Evidence From Stock Price Reactions to News About Tax Shelter Involvement*, 93 J. PUB. ECON. 126, 128 (2009).

³¹⁹ Hanlon and Slemrod also found that the reaction was stronger in the retail sector, which may suggest a reputational cost from a consumer backlash. *See id.* at 127.

³²⁰ See Merle Erickson, Michelle Hanlon & Edward L. Maydew, *How Much Will Firms Pay for Earnings That Do Not Exist? Evidence of Taxes Paid on Allegedly Fraudulent Earnings*, 79 ACCT. REV. 387, 388 (2004) (finding that, in a sample of firms accused of fraudulently overstating their earnings, “many firms included the overstated financial accounting income on their tax returns.”); *id.* at 406 (finding that “managers engage[d] in this tax overpayment behavior to reduce the chances that outsiders will discover that their financial accounting earnings are overstated.”).

³²¹ *See id.* at 389 (“The mean (median) taxes paid per dollar of earnings overstatement is \$.011 (\$0.08).”).

³²² *See id.* at 390; Desai & Dharmapala, *supra* note 33, at 21.

³²³ *See* Erickson et al., *supra* note 320, at 391.

³²⁴ *See id.*

than underpayment of taxes.³²⁵ Therefore, where poor corporate governance results in a tax payment higher than required, an increase in the enforcement efforts would likely not resolve this problem.

B. Dividend Taxation

High dividend tax rates appear to have a negative influence on corporate governance and managerial incentives. Chetty and Saez contend that dividend taxation creates a deadweight loss because it distorts the tradeoff between dividend distribution and pet project investment.³²⁶ A corporate income tax does not aggravate the managers' incentives to invest inefficiently in pet projects.³²⁷ Thus, corporate income taxation is more efficient than dividend taxation because it does not distort the dividend distribution decision as dividend tax does.³²⁸ Chetty and Saez's analysis follows the results from empirical studies on the 2003 dividend tax reform: regular dividend payouts rose sharply after the 2003 tax cuts, with a stronger response in firms with many accumulated assets, firms whose executives own a large number of shares, and firms with a large shareholder serving on the board of directors.³²⁹ Chetty and Saez explain these findings as being consistent with an agency problem where a divergence between shareholders and managers arises in respect of perks and pet projects.³³⁰ When managers have stronger incentives to maximize profits for shareholders—either because of a higher level of incentive compensation, or because of a more effective monitoring by large shareholders—an increase in dividends is more likely in response to a tax reduction.³³¹

Edwards et al. found that the combined effects of dividend taxation and financial reporting incentives encourage the managers of MNEs that have high levels of cash accumulated overseas to make less profitable cash acquisitions of foreign companies than MNEs with lower levels of trapped cash.³³²

³²⁵ *See id.*

³²⁶ *See* Chetty & Saez, *supra* note 25, at 1–3.

³²⁷ *See id.*

³²⁸ *See id.*

³²⁹ *See id.*

³³⁰ *See id.*

³³¹ *See id.*

³³² *See* Alexander Edwards, Todd Kravet & Ryan Wilson, *Trapped Cash and the Profitability of Foreign Acquisitions*, 33 CONTEMP. ACCT. RES. 44, 45 (2015).

Morck and Yeung also analyze the effect of dividend taxation on corporate governance.³³³ Following Jensen,³³⁴ they argue that well-governed mature firms that generate more income than is needed to finance profitable investment opportunities should pay out their residual income, or free cash flow, as dividends.³³⁵ However, insiders might use the free cash flow to fund their private benefits.³³⁶ Jensen named this phenomenon the free cash flow agency problem.³³⁷ There is evidence which shows that many firms choose a level of reinvestment which is too high and that dividend distribution is inefficiently low.³³⁸ Moreover, there is evidence that firms with stronger shareholder rights distribute higher dividends.³³⁹ Desai et al. found that parent companies require higher dividend payouts from subsidiaries in countries with lower corporate governance standards, which may indicate that dividends are needed to control managers of foreign affiliates.³⁴⁰ Under these explanations, better corporate governance results in larger dividends.³⁴¹ Therefore, Morck and Yeung contend that a high dividend tax rate is detrimental to corporate governance, because it provides managers with a reason to retain earnings rather than to distribute them as dividends.³⁴²

One consideration which supports retaining a certain level of taxation on dividend distribution to individuals is the incentive it creates for these individuals to invest through tax-exempt institutional investment entities, such as pension funds, which reduce the collective action problems and improve monitoring.³⁴³ Thus, Morck and Yeung support lowering, but not eliminating,

³³³ See Morck & Yeung, *supra* note 26, at 163–64.

³³⁴ See Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323 (1986).

³³⁵ See Morck & Yeung, *supra* note 26, at 167.

³³⁶ See Jensen, *supra* note 334, at 323.

³³⁷ See *id.* at 329.

³³⁸ See Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737, 746 (1997).

³³⁹ See Rafael La Porta et al., *Agency Problems and Dividend Policies around the World*, 55 J. FIN. 1 (2000).

³⁴⁰ See Mihir A. Desai, C. Fritz Foley & James R. Hines Jr., *Dividend Policy Inside the Multinational Firm*, 36 FIN. MGMT. 5, 5–6 (2007).

³⁴¹ See Morck & Yeung, *supra* note 26, at 172.

³⁴² See *id.* at 172–73.

³⁴³ See *id.*

individual taxation on dividends, while retaining the intercorporate dividend taxes as a means of preventing the resurgence of the pyramidal business groups.³⁴⁴

To conclude, the literature on corporate income taxation and on dividend taxation indicates that high corporate income and dividend tax rates have a negative influence on corporate governance and managerial incentives. Higher enforcement efforts improve corporate governance by providing a more effective external monitoring, which can benefit outside shareholders of firms with weak corporate governance.³⁴⁵ Corporate income taxation is superior to dividend taxation as a revenue source, because it creates fewer distortions.³⁴⁶ Nonetheless, a low level of dividend taxation on distribution to individuals would provide them with a stronger incentive to invest through tax-exempt institutional investors, such as pension funds, which can mitigate the collective action problem and improve monitoring.³⁴⁷

C. Individual Income Taxation

Certain individual tax rules in the United States encourage granting executive compensation in the form of unvested stock options, restricted stocks, and other forms of deferred compensation granted under future performance conditions.³⁴⁸ Section 83 grants a deferral of the tax on these forms of compensation until they are not subject to a “substantial risk of forfeiture.”³⁴⁹ However, certain performance conditions that are easily attainable are considered as creating a “substantial risk of forfeiture” for the purposes of this tax rule.³⁵⁰ The transferee can elect to be taxed on the

³⁴⁴ *See id.* at 178.

³⁴⁵ *See* Desai et al., *supra* note 340, at 5–6.

³⁴⁶ *See* Chetty & Saez, *supra* note 25, at 27.

³⁴⁷ *See* Morck & Yeung, *supra* note 26, at 173.

³⁴⁸ The property that can be transferred under this rule includes real and personal property other than either cash or an unfunded and unsecured promise to pay money or property in the future. The term also includes a beneficial interest in assets, including cash, which are transferred or set aside from the claims of creditors of the transferor, for example, in a trust or in an escrow account. *See* Treas. Reg. § 1.83-3(e).

³⁴⁹ § 83. One common example of a condition that creates a substantial risk of forfeiture is a requirement to work for the firm for a certain period of time.

³⁵⁰ *See id.*

transfer earlier, but in case the transferred property is forfeited, the tax paid is not given back.³⁵¹ The firm can deduct the cost of granting this property only when it is included in the taxable income of the transferee.³⁵² Where the executive is subject to a higher marginal tax rate than the firm, it is beneficial for both the firm and the executive to grant a large portion of the compensation in a tax-deferred manner under this rule.³⁵³

The rule in section 83 is substantially different in its purpose from the rule in section 162(m). The rule in section 162(m) is serving a non-tax purpose: namely, encouraging publicly traded firms to adopt performance-based compensation for their executives.³⁵⁴ In contrast, the purpose of the rule in section 83 is to measure income accurately. The rationale in this section is that an income should be taxed only when it is certain. If there is a substantial risk that the transferred property might be forfeited, the income is uncertain and thus should not be taxed.³⁵⁵ However, firms can adopt easily attainable performance conditions without a real significant risk of forfeiture, and yet still meet the requirements of this section. Tax authorities have significant difficulties in observing the actual risk of forfeiture, and thus, they have a limited ability to monitor whether this rule is used only when there is a real risk of forfeiture. Consequently, this rule creates an incentive for firms and executives to grant compensation in the form of unvested stock options and restricted stocks also when there is no significant risk of forfeiture.

As discussed above in the context of section 162(m), the effect of increasing equity-based compensation on the quality of corporate governance is questionable. It appears that larger equity holdings of managers mitigate some of the agency problems because they better align managers' incentives with those of shareholders.³⁵⁶ However, section 83, similar to section 162(m), fails to

³⁵¹ § 83(b). This option is attractive where the transferee expects a significant increase in the value of the stock options or the restricted stocks, so that it is beneficial to pay tax on the current lower value at ordinary tax rates.

³⁵² *Id.* § 83(h).

³⁵³ *See* Schizer, *supra* note 9, at 7–8.

³⁵⁴ *See supra* Section II.A.2.

³⁵⁵ § 83(a)(2).

³⁵⁶ As discussed above, the agency problems are generally more significant where the managers have less cash flow rights. *See supra* text accompanying notes 48 and 49.

incentivize the adoption of performance-based compensation, as easily achievable performance goals satisfy the requirements for deferral under this tax rule. Moreover, the outsiders' enthusiasm about equity-based compensation might enable managers to receive a higher compensation without reducing their cash compensation: namely, a form of equity tunneling.³⁵⁷ Therefore, it appears that a tax rule in section 83 that encourages the use of equity-based compensation may affect the quality of corporate governance, but its full effect is unclear.

Individual taxation also negatively affects corporate governance through the taxation of working condition fringe benefits. The tax rule in section 132 for working condition fringe benefits allows the deduction of some expenses by the firm, without attributing any taxable income to the employees.³⁵⁸ A working condition fringe is defined as "any property or services provided to an employee of the employer to the extent that, if the employee paid for such property or services, such payment would be allowable as a deduction[.]"³⁵⁹ Much of the costs of various managerial perks, such as expensive offices, can be deducted by the firm, while the managers are not taxed on the utility they derive from these perks. Not taxing the benefit for managers, while offering a tax deduction to the corporation, might increase spending on perks.³⁶⁰ From the shareholders' standpoint, providing the managers with tax-favored compensation is beneficial. However, creating a tax-induced incentive to increase spending on perks might harm shareholders because this form of compensation is not as salient as other forms of executive compensation, does not require approval and reporting as such, and might not substitute for other forms of compensation.³⁶¹

The lower tax rate that applies to long-term capital gains encourages shareholders to hold shares for at least one year.³⁶² The step-up in basis at the time of death also creates an incentive

³⁵⁷ See BEBCHUK & FRIED, *supra* note 78, at 83.

³⁵⁸ § 132.

³⁵⁹ *Id.* § 132(d).

³⁶⁰ For a general discussion on the tax policy consideration concerning the taxation of fringe benefits, see Yehonatan Givati, *Googling a Free Lunch: The Taxation of Fringe Benefits*, 69 TAX L. REV. 275 (2016).

³⁶¹ See *id.*

³⁶² § 1222.

to hold shares for a long time.³⁶³ A shareholder who holds shares for a longer time might have a stronger incentive to monitor the management, although it is questionable whether this effect indeed results in better monitoring.

D. Complexity of the Tax Rules

Tax rules undoubtedly add complexity to corporate structures and transactions. Financial statements do not disclose much of this complexity.³⁶⁴ It is also very hard to infer information from public financial statements regarding firms' taxable income.³⁶⁵ It is possible that this complexity can be used to disguise earnings manipulation and tunneling of value from the firm to insiders.³⁶⁶ For example, "earnings manipulation was ... central to Enron's extensive use of tax shelters."³⁶⁷ Interestingly, some of the transactions that Enron made using tax shelters to inflate its financial income suffered from high transaction costs and fees while not generating significant tax benefits.³⁶⁸ The tax-driven complexity of many corporate structures and transactions increases the cost of monitoring of outsiders on actions taken by the management.³⁶⁹ Transfer of assets between related companies, which can be explained as tax-driven transactions, can provide managers and controllers with tunneling opportunities.³⁷⁰ Therefore, simplifying and harmonizing tax rules would likely reduce corporate agency costs.

³⁶³ *Id.* § 1014.

³⁶⁴ Consolidated financial statements report the aggregated assets, liabilities, and performance of the firm and its controlled subsidiaries. In addition, there is no general reporting obligation with respect to the structure of transactions. The IRS can request information on any transaction, but in most cases this information remains confidential. Complexity reduces the effectiveness of the monitoring of the IRS as well, as more resources are needed in order to understand complicated structures and transactions.

³⁶⁵ See Michelle Hanlon, *What Can We Infer about a Firm's Taxable Income from Its Financial Statements?*, 56 NAT'L TAX J. 831, 831 (2003).

³⁶⁶ See Desai & Dharmapala, *supra* note 33, at 19–20; Schizer, *supra* note 9, at 27–28.

³⁶⁷ See Desai & Dharmapala, *supra* note 33, at 16.

³⁶⁸ See *id.*

³⁶⁹ See *id.* at 27.

³⁷⁰ See Atanasov et al., *supra* note 50, at 39–40.

E. Location of Incorporation

Tax incentives may distort the international market for corporate charters.³⁷¹ Tax-motivated corporate decisions regarding the location of incorporation can lead to an efficiency cost where corporations choose jurisdictions that are suboptimal from a corporate law standpoint.³⁷² Exit taxation may have a deterrent effect on firms seeking to relocate to a jurisdiction with a preferred regime of corporate law.³⁷³ In addition, as long as there is an overlap between corporate and tax locational rules, there might be a tradeoff: locations with low tax rates might be preferred even if they are less desirable on corporate law grounds.³⁷⁴ One proposal suggests severing the market for corporate law from the market for corporate tax law.³⁷⁵ This could be done through the global coordination of the locational rules for corporate law and corporate tax law: the “place of incorporation” rule could apply for corporate law purposes, and a residence test based on other factual factors could apply for corporate tax purposes—the “real seat” rule.³⁷⁶

F. Financing

The tax system influences a firm’s choice between debt and equity. In general, debt is favored by the tax system because interest payments are deductible, whereas dividend payments are not deductible.³⁷⁷ A preference to choose debt may affect corporate governance, as debt owed to lenders could replace the equity investments of the minority shareholders.³⁷⁸ Lenders can monitor the firm’s governance, although a tax-induced preference for debt might increase the agency problem between lenders and shareholders.³⁷⁹

³⁷¹ See Mitchell A. Kane & Edward B. Rock, *Corporate Taxation and International Charter Competition*, 106 MICH. L. REV. 1229, 1231 (2008).

³⁷² See *id.* at 1230, 1233, 1273.

³⁷³ See *id.* at 1231, 1248.

³⁷⁴ See *id.* at 1233.

³⁷⁵ See *id.* at 1257.

³⁷⁶ See *id.* at 1256–57.

³⁷⁷ See Desai & Dharmapala, *supra* note 33, at 27.

³⁷⁸ See *id.*

³⁷⁹ See *id.*

Large debt, and the prospect of bankruptcy, can motivate managers to perform better.³⁸⁰ In the context of mergers and acquisitions, the tax system treats these mergers differently based on their financing, encouraging the use of equity to finance mergers.³⁸¹ There is a need for more research on the corporate governance implications of these effects.

G. Losses and Changes in Control

Section 382 limits an acquirer's ability to use a target company's tax losses.³⁸² Therefore, companies with large accumulated tax losses that they cannot use ("net operating losses" or NOLs) currently have a strong tax-related reason for objecting to changes in ownership.³⁸³ These limits might exacerbate entrenchment, especially in companies with underperforming management.³⁸⁴

IV. HOW DOES CORPORATE GOVERNANCE AFFECT TAXATION?

Although this Article has focused on the effect of taxation on corporate governance, it is important to note that corporate governance practices and characteristics also influence taxation. Additionally, the effect of corporate governance on taxation is a relevant factor to consider when evaluating the current tax system and possible reforms.

There is evidence that shows that a higher level of incentive compensation is associated with an increased level of tax avoidance.³⁸⁵ This connection is possibly stronger among firms with better corporate governance.³⁸⁶ The ownership structure also affects the level of tax avoidance. For instance, family-owned firms and firms with a dual class stock structure have a lower level of tax avoidance, whereas firms, in which PE firms and hedge funds have large holdings, show higher levels of tax avoidance, as discussed below.

³⁸⁰ See Schizer, *supra* note 9, at 23.

³⁸¹ See Desai & Dharmapala, *supra* note 33, at 29.

³⁸² § 382; see Schizer, *supra* note 9, at 19.

³⁸³ See *id.*

³⁸⁴ See *id.*

³⁸⁵ See Desai & Dharmapala, *supra* note 33, at 19.

³⁸⁶ See *id.* at 20.

A. Impact of Incentive Compensation on Tax Avoidance

According to one theory, incentive compensation should motivate managers to reduce the diversion of rents, and to increase tax avoidance activities that increase the after-tax firm value, because greater incentive compensation helps to better align managerial incentives with those of shareholders.³⁸⁷ According to a competing theory, complementarities between diversion and tax sheltering might offset the increase of after-tax value.³⁸⁸ If a higher level of tax sheltering might facilitate more managerial rent extraction, then corporate governance should moderate the relation between incentive compensation and tax sheltering.³⁸⁹ For any relationship between diversion and sheltering, firms with better corporate governance have lower initial diversion levels and, therefore, less scope for potential reduction in diversion.³⁹⁰ Thus, higher incentive compensation is predicted to result in a higher level of tax avoidance in firms with better corporate governance.³⁹¹

One study found that, on average, increases in incentive compensation to the five highest-paid executives reduce the level of tax sheltering.³⁹² This result was seen primarily in firms with weak corporate governance, and it did not hold for firms with strong corporate governance.³⁹³ This evidence suggests that there are complementarities between sheltering and diversion and that the relation between incentive compensation and sheltering is mediated by the strength of the firm's corporate governance.³⁹⁴

Other studies found a positive association between higher levels of incentive compensation for executives and corporate tax avoidance. One study found that larger equity risk incentives for managers are associated with a higher level of corporate tax aggressiveness; the same study also found that there is little evidence that the quality of corporate governance moderates the positive

³⁸⁷ See Mihir A. Desai & Dhammika Dharmapala, *Corporate Tax Avoidance and High-Powered Incentives*, 79 J. FIN. ECON. 145, 147 (2006).

³⁸⁸ See *id.* at 148.

³⁸⁹ See *id.* at 147–48.

³⁹⁰ See *id.*

³⁹¹ See *id.*

³⁹² See *id.*

³⁹³ See *id.*

³⁹⁴ See *id.*

relation between equity risk incentives and risky tax avoidance.³⁹⁵ Another study found that when the executive compensation depends more on performance, the firm is more likely to get involved in tax planning, and that other corporate governance measures do not affect tax avoidance as does incentive compensation.³⁹⁶ Mahenthiran and Kasipillai analyzed the data of corporations in Malaysia and found that firms with high performance, and executive compensation tied with performance, are more likely to lower their effective tax rates through tax planning.³⁹⁷ Hanlon et al. found that pay-for-performance sensitivities for the top five executives are positively correlated with proposed IRS audit deficiencies.³⁹⁸ Armstrong et al. found that the executives' equity incentives and the level of tax avoidance are positively correlated, and that this correlation is stronger in the upper end of the tax-avoidance distribution.³⁹⁹

³⁹⁵ See Sonja Olhott Rego & Ryan Wilson, *Equity Risk Incentives and Corporate Tax Aggressiveness*, 50 J. ACCT. RES. 775, 781 (2012). Rego and Wilson argue that tax avoidance is a risky activity that imposes costs on both firm and managers. *Id.* These costs include spending fees paid to accountants and tax attorneys, time invested in planning for and resolving audits with tax authorities, and potential costs in case of a dispute with the tax authorities. Therefore, according to Rego and Wilson's prediction, risk-averse managers prefer undertaking less risky tax planning, whereas risk-neutral shareholders prefer implementing all tax strategies that are expected to generate net benefits. *Id.*

³⁹⁶ See Kristina Minnick & Tracy Noga, *Do Corporate Governance Characteristics Influence Tax Management?*, 16 J. CORP. FIN. 703, 707 (2010). The study also found that firms with different governance structures tend to focus on different tax avoidance strategies: companies with a higher percentage of independent directors focus more on planning strategies involving foreign taxes, whereas companies with large boards that are less entrenched tend to focus on planning strategies involving domestic taxes. *Id.*

³⁹⁷ See Sakthi Mahenthiran & Jeyapalan Kasipillai, *Influence of Ownership Structure and Corporate Governance on Effective Tax Rates and Tax Planning: Malaysian Evidence*, 27 AUSTL. TAX F. 941, 965 (2012).

³⁹⁸ Michelle Hanlon et al., *An Empirical Examination of Corporate Tax Non-compliance*, in *TAXING CORPORATE INCOME IN THE 21ST CENTURY* 171, 172 (Alan Auerbach et al. eds., 2005). Their study shows that the percentage of bonuses from the annual compensation and the level of equity incentives from stock options are positively associated with the proposed deficiencies, indicating that incentive compensation may be associated with tax aggressiveness. *Id.*

³⁹⁹ See Christopher S. Armstrong et al., *Corporate Governance, Incentives, and Tax Avoidance*, 60 J. ACCT. & ECON. 1, 10, 15 (2015). Using quintile regression, they found a positive relation between the upper tail of the tax-avoidance distribution and the financial sophistication of the boards' independence, but a

Overall, although there are mixed results, many of the studies that examine the relationships between corporate governance, incentive compensation, and tax avoidance found that, on average, a higher level of incentive compensation is associated with an increased tax-avoidance level.

B. Impact of Ownership Structure on Tax Avoidance

Different ownership structures are associated with different levels of tax avoidance. One study found that family-owned firms have a lower level of tax avoidance relative to nonfamily-owned firms.⁴⁰⁰ Another study found that firms with dual class stock ownership engage in less tax avoidance, and that the level of tax avoidance is declining as the gap between voting rights and cash flow rights increases.⁴⁰¹ These findings are consistent with the prediction that managers that are insulated from takeovers avoid the risks associated with taking tax-avoidance measures. The results may also support the view that managers in these firms are willing to forgo tax advantages to avoid concerns by noncontrolling shareholders, who may fear that tax avoidance is a disguise for insiders' rent extraction.

In addition, firms held by private equity and hedge funds show higher levels of tax avoidance. Badertscher et al. found that PE funds increase the effectiveness of tax planning for companies in which they invest—PE-backed firms.⁴⁰² This effect is stronger for companies in which PE funds hold a majority of the stocks, and where the

negative relation in the lower tail of the tax-avoidance distribution. *Id.* at 15. In other words, where the board is more independent and financially sophisticated, very high or very low levels of tax avoidance are less likely to be adopted. These extremes are likely to decrease the value for shareholders, as one extreme (very low tax avoidance) might represent an underinvestment in tax avoidance, and the other extreme (very high tax avoidance) may harm the long-run firm's interests due to a high exposure to tax disputes and reputational costs.

⁴⁰⁰ See Shuping Chen et al., *Are Family Firms More Tax Aggressive Than Non-Family Firms?*, 95 J. FIN. ECON. 41, 51 (2010). This effect is stronger for family-owned firms that expect to raise external capital and family firms with no long-term institutional investors. *Id.*

⁴⁰¹ See Sean T. McGuire, Dechun Wang & Ryan J. Wilson, *Dual Class Ownership and Tax Avoidance*, 89 ACCT. REV. 1487, 1488 (2014).

⁴⁰² See Brad Badertscher et al., *The Impact of Private Equity Ownership on Portfolio Firms' Corporate Tax Planning* 6–7 (Harvard Bus. Sch., Working Paper No. 10-004, 2010).

investing PE funds are very large.⁴⁰³ Cheng et al. found that target firms, after hedge fund intervention, have higher tax-avoidance levels in comparison to matched control firms.⁴⁰⁴ PE and hedge funds have strong incentives to engage in costly monitoring activities to improve the firms' performance, and they can push for more efficient tax strategies through their enhanced monitoring.⁴⁰⁵

These findings should be taken into account when considering reforms which aim to reduce tax-avoidance opportunities. These results might indicate that eliminating tax-avoidance opportunities would have a stronger effect on firms with higher levels of incentive compensation and firms held by PE and hedge funds. As mentioned above, it is possible that these are firms with better corporate governance, executive incentives, and monitoring. Eliminating tax-avoidance opportunities may encourage these firms to focus more on the real improvement of their performance instead of the improvement of their tax efficiency. However, PE and hedge funds might have lower incentives to invest in and improve on firms with poor corporate governance because the potential return from increasing the tax-avoidance level would be gone. To the extent that these funds generate positive externalities, a more efficient and targeted approach would be to grant them a corrective subsidy.

A tax reform that would eliminate tax-avoidance opportunities, reduce corporate and dividend taxes, and increase enforcement efforts could possibly improve corporate governance for firms with weak governance. It could also provide well-governed firms with stronger incentives to focus more on real improvement in their performance rather than on enhancing their tax efficiency.

CONCLUDING REMARKS

This Article explores how tax policy can improve corporate governance and reduce corporate agency costs. This Article identifies the reasons for the limited effectiveness of corrective taxes in mitigating corporate governance inefficiencies. Policymakers should consider repealing section 162(m) and the tax penalty on

⁴⁰³ See *id.* at 3–4.

⁴⁰⁴ See C.S. Agnes Cheng et al., *The Effect of Hedge Fund Activism on Corporate Tax Avoidance*, 87 ACCT. REV. 1493, 1522 (2012).

⁴⁰⁵ See *id.* at 1496–97.

large golden parachutes, and replacing the tax on intercompany dividends with a ban. Proposals for corrective taxes on high executive compensation, related-party transactions, and anti-takeover devices should not be adopted because it is unclear whether the overall benefits from these proposed taxes will exceed their costs.

The effects of general tax rules on corporate governance should be considered when designing a tax reform. A tax reform that lowers tax rates on corporate income and dividends, increases enforcement, and simplifies the tax system, would have a positive effect on the quality of corporate governance.