TAXATION AND CORPORATE GOVERNANCE

Ariel Siman* & Reuven Avi-Yonah**

Abstract

Legal and economic scholars have examined the intersection between corporate governance and taxation; however, recent legal scholarship has generally focused on the interplay between director compensation, management measures in the face of the market for corporate control, and the double taxation of inter-corporate dividends. Other aspects of the relationship between corporate governance and taxation have received limited attention. This article aims to fill this gap in the literature. First, this paper discusses the corporate agency problem and the existing justifications for the corporate tax. Second, this paper argues that the corporate tax can be justified on the ground that it mitigates the corporate agency problem more effectively and with fewer adverse consequences than alternative taxation systems.

* LL.M., University of Michigan Law School; M.B.A., The Hebrew University of Jerusalem; LL.B., The Hebrew University of Jerusalem.

** Irwin I. Cohn Professor of Law, University of Michigan Law School.

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I. INTRODUCTION

In recent years, legal and economic research has shown a growing interest in the interaction between corporate governance and taxation.[1] Some specific aspects have drawn more interest, particularly the tax rules related to the remuneration of directors,[2] measures taken by management in the context of market for corporate control,[3] and the double taxation of inter-corporate dividends;[4] however, there is still little legal literature on many other aspects of the interplay between the two systems, and several authors have mentioned this gap in the literature and the dire need for further study in this "fertile area of research."[5]

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[1] *See, e.g.*, Paul Caron, *Oh Presents How Does The Corporate Tax Distort Choice Of Corporate Governance? Today At Pepperdine*, TAXPROF BLOG (Jan. 22, 2024), https://web.archive.org/web/20240618021112/https://taxprof.typepad.com/taxprof_blog/2024/01/oh-presents-how-does-the-corporate-tax-distort-choice-of-corporate-governance-today-at-pepperdine.html [https://perma.cc/VXQ6-6UE3].

[2] *See* Gregg D. Polsky, *Controlling Executive Compensation Through the Tax Code*, 64 WASH. & LEE L. REV. 877 (2007); Robert M. Halperin, Young K. Kwon & Shelley C. Rhoades-Catanach, *The Impact of Deductibility Limits on Compensation Contracts: A Theoretical Examination*, 23 J. AM. TAX. ASS'N 52 (2001); John Graham & Yonghan Julia Wu, *Executive Compensation, Interlocked Compensation Committees, and the 162(m) Cap on Tax Deductibility* 7 (Jan. 2007) (unpublished manuscript) (on file with Social Science Research Network (SSRN)); Antonio Paulo Machado Gomes, *Corporate Governance Characteristics as a Stimulus to Tax Management*, 27 SCIELO BRAZIL 149 (2016).

[3] *See generally* Kurt Hartmann, *The Market for Corporate Confusion: Federal Attempts to Regulate the Market for Corporate Control Through the Federal Tax Code*, 6 DEPAUL BUS. L.J. 159 (1993); Schuyler M. Moore & Edwin G. Schuck, Jr., *Tax Aspects of Defensive Strategies to Corporate Takeovers*, 69 J. TAX'N 212 (1988); Eric Engle, *Green With Envy? Greenmail is Good! Rational Economic Responses to Greenmail in a Competitive Market for Capital and Managers*, 5 DEPAUL BUS. & COM. L.J. 427 (2007).

[4] *See* William W. Bratton, *The New Dividend Puzzle*, 93 GEO. L.J 845 (2005); Steven A. Bank, *Is Double Taxation a Scapegoat for Declining Dividends? Evidence from History*, 56 TAX L. REV 463 (2003); Skyler Santomartino, *Double Tax Is Double the Trouble: The Solution? Moving Toward a System of Corporate Integration*, 15 J. BUS. & TECH. L. 345 (2020). Another area that has garnered significant attention from academics, particularly in the last decade, is the influence of corporate governance on the level of tax avoidance. For a comprehensive review of this line of literature, see Jost Kovermann and Patrick Velte, *The impact of corporate governance on corporate tax avoidance - A literature review*, 36 J. INT'L ACCOUNTING, AUDITING AND TAXATION (2019).

[5] Mihir A. Desai & Dhammika Dharmapala, *Taxation and Corporate Governance: An Economic Approach in* TAX AND CORPORATE GOVERNANCE 13, 29 (Wolfgang Schon ed. 2008) (arguing "[t]he historic divide between the study of taxation and the analysis of corporate governance appears to have obscured many fertile areas of research… the impact of the tax system on the market for corporate control remains substantially under-explored"); Jaron H. Wilde, *The Deterrent Effect of Employee Whistleblowing on Firms' Financial Misreporting and Tax Aggressiveness*, THE ACCT. REV. 92, 247, 247 (2017); Jeri K. Seidman & Bridget Stomberg, E*quity Compensation and Tax Avoidance: Disentangling Managerial Incentives from Tax Benefits and Reexamining the Effect of Shareholder Rights*, 39 The J. OF THE AM. TAX'N ASS'N 21, 21 (2017); Arne Friese, Simon Link & Stefan Mayer, *Taxation and Corporate Governance – The State of the Art in* TAX AND CORPORATE GOVERNANCE 358, 359 (Wolfgang Schon ed. 2008) (arguing "there is relatively little literature on the interaction of corporate governance and taxation"). Yariv Brauner, *The Non-Sense Tax: A Reply to New Corporate Income Tax Advocacy*, 2008 MICH. ST. L. REV. 591, 619 (2008) (arguing "[n]otably little work has been done on the relationship between tax and corporate governance to date, yet lately there is increasing interest in this interaction"; "… As will be apparent, this issue

The aim of the article is to begin filling this gap by exploring some of the more intriguing aspects of this interplay between the two systems. Among other things, can the corporate tax be justified on the grounds that it reduces the corporate agency problem and that alternative systems have fewer desirable effects?

The article proceeds as follows: in Part II, we will briefly provide the relevant background. It will start by defining the term "corporate governance" and the agency theory that underlines this area. It will be followed by an explanation of the major interplays between taxation and corporate governance. Part III will present the current views concerning the justification for the corporate tax and criticize them. Part IV will discuss the key role of the corporate tax in the financial reporting system and its relationship to the corporate governance debate. Part V will return to the role of tax in corporate governance and argue that the corporate tax can help reduce agency costs and that other ways of doing so have fewer desirable effects. Part VI will conclude that the corporate tax can be justified by its ability to adequately address and mitigate the agency concern.

II. BACKGROUND

A. Corporate Governance and the Agency Problem

Corporate governance may be defined broadly as:

> "the private and public institutions, including laws, regulations and accepted business practices, which together govern the relationship, in a market economy, between corporate managers and entrepreneurs ('corporate insiders') on one hand, and those who invest resources in corporations, on the other. Investors can include suppliers of equity finance (shareholders), suppliers of debt finance (creditors), suppliers of relatively firm–specific human capital (employees) and suppliers of other tangible and intangible assets that corporations may use to operate and grow."[6]

The key focus of U.S. corporate governance systems is the "agency problem," which arises when the owners of the corporation, the shareholders, are not the managers who are in control.[7] This disparity creates an opportunity for the managers of the corporation to promote their own personal interests over those of the shareholders. The managers' preference for their own personal interests can be expressed through inefficient management, the receipt of perquisites by the managers at the corporation's expense, and other such problems reflective of the shareholder's lack of representation and agency within decision-making. This problem is endemic to corporations in the U.S., since most U.S. corporations are

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picked up the interest of tax scholars, primarily economists, only lately. There is almost no relevant legal scholarship…").

[6] Charles P. Oman, *Corporate Governance and National Development*, 1, 13 (OECD Dev. Ctr.. Working Paper No. 180, 2001).

[7] Sanjai Bhagat, Brian Bolton & Roberta Romano, *The Promise and Peril of Corporate Governance Indices*, 108 COLUM. L. REV. 1803, 1809-10 (2008).

widely held by a large group of shareholders.[8]

An entirely different manifestation of the agency problem may occur when a small group of shareholders (or an individual shareholder) holds a controlling block of shares. In such a case, the agency problem occurs between the controlling shareholder and minority shareholders. The controlling shareholders have the power to make all decisions about the fate of the corporation, even though the minority also invests its assets in the corporation. The minority essentially transfers the control over its assets (its investment) to the controlling party (e.g., the agent). By doing so it exposes itself to the agency problem and the risk is that the controlling shareholder might prefer individual interest over the good of the group, thereby harming the minority's interests. The control problem is endemic to companies outside the U.S. and U.K. (e.g., in Israel most of the corporations, including publicly traded corporations, are controlled by an individual shareholder), although some of the largest U.S. corporations (e.g., Meta[9]) are also controlled by their founders.[10]

Corporate law and corporate governance seek to mitigate the agency problem by providing an organizing framework to facilitate and support mechanisms of firms' corporate governance by which managers are incentivized and constrained to act in the shareholders' interest (in order to mitigate the management problem) and the controlling shareholders are incentivized and constrained to act in the minority's interest (in order to mitigate the control problem). "The most elemental components of" this organizing framework "are the board of directors, shareholder meetings and voting, and executive compensation."[11]

B. Tax and Corporate Governance: Main Interplays

The interplays between tax and corporate governance can be roughly divided into two resulting phenomena. On the one hand, the rules and mechanisms of corporate governance might have some effects on the way corporations handle their tax affairs and fulfill their tax obligations. On the other hand, taxation might have an effect on corporate governance, and more specifically, on the relationship between shareholders and corporate managers (the management problem) and between the controlling shareholders and the minority (the control problem). It should be noted that this article will not make a comprehensive review of the entire literature which deals with these interplays. Such a review of the literature exceeds the scope of this article and can be found in other research.[12]

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[8] Zohar Goshen, *Controlling Corporate Agency Costs: A United States – Israeli Comparative View*, 6 CARDOZO J. INT'L & COMP. L. 99. 101 (1998).

[9] *See* Meta Platforms Inc., Schedule 14A Information (May 29, 2024).

[10] *See* Goshen, *supra* note 8 at 115; *see also* John Armour, Henry Hansmann & Reinier Kraakman, *Agency Problems and Legal Strategies in* THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 29, 29-30 (Oxford University Press 2009).

[11] Bhagat et al., *supra* note 7 at 1810; *see also* H. Kent Baker & Ronald Anderson, *An Overview of Corporate Governance in* CORPORATE GOVERNANCE: A SYNTHESIS OF THEORY, RESEARCH, AND PRACTICE 1, 3-4 (Baker & Anderson eds. 2010).

[12] *See* Friese et al., *supra* note 5; Nicola Sartori, *Effects of Strategic Tax Behaviors on Corporate*

III. EXISTING JUSTIFICATIONS FOR THE CORPORATE TAX

A. Overview

Can the corporate tax be justified on the grounds that it reduces the corporate agency problem and that alternative systems have fewer desirable effects? Part IV of the article will try to establish this claim, but first we will discuss the existing justifications for the corporate tax.

As a preliminary note, it should be mentioned that Yariv Brauner has already analyzed "[T]he argument that the corporate income tax has desirable corporate governance implications that justify its preservation."[13] Brauner rejects this argument, but acknowledges that "the corporate governance argument has not been directly and comprehensively articulated in the legal literature" and that: "[n]one of the studies mentioned in this Part limits itself to the defense of the corporate income tax, so they all fail to balance the potential benefits of the tax against its costs."[14]

B. Current Justifications for the Corporate Tax

There are currently four main views concerning the justifications for the corporate tax.[15]

1. Lack of Justification View

The first and most common view is simply that there is no justification for the corporate tax. Under this view, the planning and compliance costs it induces are extremely high relative to the revenue raised by the government on this income. This argument finds support in the fact that corporate tax is very complicated and imposes significant transaction costs on society. Additionally, the corporate tax base is being eroded in practice and the corporate tax accounts today for less than a tenth of revenues, and that number is declining. Further, the fact that the corporate tax applies in practice almost solely to publicly held C corporations leads to significant welfare losses to society as the tax drives business owners away from issuing public shares in their corporations. Many supporters of this view suggest replacing the corporate income tax with a tax on the appreciation of stakes (shares) in publicly traded corporations (mark to market rules) and a look-through taxation system for shareholders of non-publicly traded corporations.

Governance (Sept. 2008) (unpublished manuscript) (on file with Social Science Research Network (SSRN)); Nicola Sartori, *Corporate Governance Dynamics and Tax Compliance*, INT'L TRADE AND BUS. L. REV. (2009); Carlo Garbarino, *Aggressive Tax Strategies and Corporate Tax Governance: An Institutional Approach*, SDA Bocconi Research Paper No. 188 (Dec. 2008); Jost Kovermann & Patrick Velte, *The Impact of Corporate Governance on Corporate Tax Avoidance–A Literature Review*, 36 J. OF INT'L ACCT. AUDITING AND TAX'N 1 (2019).

[13] Brauner, *supra* note 5 at 597.

[14] *Id.* at 619.

[15] *See generally* Reuven S. Avi-Yonah, C*orporations, Society, and the State: A Defense of the Corporate Tax*, 90 VA. L. REV. 1193 (2004); Brauner, *supra* note 5.

2. *Corporate Tax as an Indirect Way of Taxing Shareholders*

The most common justification for the corporate tax is its ability to indirectly tax the shareholders. Under this view there are two main advantages to the corporate tax: First, from the timing perspective, the corporate tax allows taxing the income as the corporation gains income. It is argued that without the corporate tax, individuals could shelter their income from tax by earning it through corporations. If that individual holds the stocks until his death and the estate receives a stepped-up basis, this might even lead to a complete tax exemption. Second, from an administrative perspective, it is easier to collect tax from a few corporations than from many shareholders. However, it was argued that these advantages might be attained through other means. For example, replacing the corporate income tax with a mark to market taxation regime on publicly traded corporations and a look-through taxation system for shareholders of non-publicly traded corporations.

3. *Corporate Tax as Payment for Benefits Conferred by the U.S. Government*

Under this view, the tax is conceived as a payment in return for the benefits provided by the U.S. government. One such benefit is the benefit of incorporation, and mainly the limited liability protection. However, it is well known that many entities benefit from the same benefits as incorporated entities, without being subject to the corporate tax (e.g., LLCs, S corporations, LLPs, and so on).

Another possible benefit is the access to the public equity market. Rebecca Rudnick argues that the corporate tax can be justified as a payment for the greater liquidity afforded by access to the public equity market.[16] Recall that the corporate tax applies almost only to publicly held C corporations. This fact creates a correlation between access to public equity markets and the corporate tax. However, the current corporate tax does not reflect the liquidity of the corporation and is not even linked to it (e.g., it is not linked to the outstanding corporate equity). Hence, it seems that this approach supports a different system of taxation, rather than the current corporate tax.

4. *Restraining Undesirable Corporate Management Accumulation of Power*

Reuven Avi-Yonah defended the corporate tax as a means of curbing excessive accumulation of economic power by corporate managers. Avi-Yonah acknowledges that some of the potential harms of this accumulation of powers are already specifically regulated (environmental, labor, etc.). However, Avi-Yonah adds that these regulations fail to adequately address the ordinary accumulation of corporate power through straightforward money-making businesses. Hence, only taxation can achieve regulation of excessive accumulation of economic power by

[16] Rebecca S. Rudnick, *Who Should Pay the Corporate Tax in a Flat Tax World?*, 39 CASE W. RSRV. L. REV. 965, 985–86 (1989).

corporate managers.[17]

In the article we raise a counterargument to Avi-Yonah's argument (which is distinct from the counterarguments raised by Brauner).[18] It appears to us that Avi-Yonah's argument depends on two questions, which are highly controversial among economists: (1) who bears the economic burden of the corporate tax? and (2) what are the effects of the corporate tax on the retention of profit?

The next example will illustrate this counterargument: assume a world without a corporate tax. In addition, assume that a publicly held corporation has an income of $100 million a year. Each year 40% of the profits are distributed ($40 million a year) and 60% of the income is retained in the corporation ($60 million a year). These $60 million a year are accumulated in the corporation and are creating the undesirable corporate management accumulation of power.

Now, assume that a corporate tax of 20% is levied. What would be the result? Under one scenario, it is possible that the after-tax income of the corporation will be $80 million and 60% of it will be retained, such that the manager will control only additional $48 million (60%*$80 million). But this is not the only possible scenario.

An alternative scenario is that the customers or the employees will bear the economic burden of the tax. For example, the customers might pay higher prices for the corporation's products, or the corporation might lower the employee's salaries; as a result, the corporation may retain the same amount of after-tax income. Under this scenario, the managers will retain control on the same amount of money.

Another possible scenario is that the after-tax income of the corporation will be indeed reduced to $80 million. However, under this scenario, the corporation might decide to reduce the amount of its distributions. For example, they may convince the shareholders that the corporation needs to retain $60 million a year; and as a result, under these circumstances, the managers will, again, retain the same amount of profits under their control. This example illustrates that Avi-Yonah's argument depends on the two following questions: (1) who bears the economic burden of the corporate tax, and (2) what are the effects of the corporate tax on the retention of profit?

For all of the above reasons, the dominant view in the academic literature is that there is no persuasive justification for the corporate tax. In Part IV below, we will try to develop an alternative justification, based on corporate governance considerations.

IV. KEY ROLE OF THE CORPORATE TAX IN THE FINANCIAL REPORTING SYSTEM

A. Context: The Corporate Tax as Exterior Corporate Governance

According to modern firm theories, there are three main types of agency

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[17] Avi-Yonah, *supra* note 15 at 1243-44.

[18] In his more recent works, Avi-Yonah de-emphasized the limitation on managerial power argument and instead argued that the corporate tax is a useful tool to regulate corporate behavior. See, e.g., Avi-Yonah, *A New Corporate Tax*, TAX NOTES (2020); Avi-Yonah, *Introduction* to *Research Handbook on Corporate Tax, 2* (Avi-Yonah ed., Elgar Publishing 2023). This argument is not related to corporate governance so we will not address it further.

problems: (i) conflicts of interests between shareholders and managers ("agency costs of equity");[19] (ii) conflicts of interests between controlling shareholders and outside minority shareholders ("agency cost of controlling shareholder");[20] and (iii) conflicts of interests between shareholders and debtholders ("agency cost of debt").[21] In these principal-agent relationships, shareholders rely on managers, outside minority shareholders rely on controlling shareholders, and debtholders rely on shareholders to maximize their interests. Unfortunately, due to the problems of moral hazard and asymmetric information, it is necessary for the principals (the outside shareholders, the minority shareholders or the debtholders) to monitor and overlook the agents (the controlling shareholders or the managers).[22]

Traditionally, there are two forms of supervision mechanisms—internal and external—that allow the outside shareholders (the principals) to monitor and overlook the corporate management (the agents).[23] Internal mechanisms include, for example, ownership structure, board of directors, stock options and other forms

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[19] The agency cost of equity arises where the shareholders, who own residual claims and assume residual risks, are not the managers who are in control. This separation of ownership and control creates an opportunity for the managers of the corporation to promote their own personal interests over those of the shareholders. The managers' preference for their own personal interests can be expressed, for example, through inefficient management or the receipt of perquisites by the managers at the corporation's expense. This problem is characteristic to corporations in the U.S. and is the key focus of U.S. corporate governance systems, since most U.S. publicly traded corporations are widely held by a large group of shareholders. *See* Goshen, *supra* note 8 at 100-01 Michael C. Jensen, *The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems*, 48 THE J. OF FIN. 831, 848 (1993).

[20] The agency cost of controlling shareholder arises where a small group of shareholders (or an individual shareholder) holds a controlling block of shares. The minority (the principal) essentially transfers the control over its investment to the controlling party (the agent). By doing so it exposes itself to the agency problem and to the risk that the controlling shareholders will use the corporate resources for their own interests while other stakeholders will bear the costs. The transfer of company resources by controlling shareholders comes in many forms, including consuming perks, setting excessive salaries, stealing investment opportunities, and making inefficient investment. The control problem is characteristic of markets outside the U.S. and U.K., where ownership concentration is more pronounced. *See* Yupana Wiwattanakantang, *Controlling Shareholders and Corporate Value: Evidence from Thailan*d, 9 PACIFIC-BASIN FIN. J. 323, 324 (2001); Goshen, *supra* note 8 at 101; Armour et al., *supra* note 10, at 30.

[21] The agency cost of debt is often described in terms of the risk shifting problem. The potential conflict between debtholders and shareholders is such that shareholders expropriate wealth from debtholders by investing in new projects that are riskier than those presently held in the firm's portfolio. Under this scenario, since shareholders do not bear the full cost of low returns, they have incentives to take riskier projects, potentially extracting value from the debtholders. *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. OF FIN. ECON. 305, 308 (1976); Ronald C. Anderson, Sattar A. Mansi & David M. Reeb, *Founding Family Ownership and the Agency Cost of Debt*, 68 J. OF FIN. ECON. 263, 266 (2003); Gustavo Manso, *Investment Reversibility and Agency Cost of Debt*, 76 ECONOMETRICA 437, 437 (2008).

[22] Kim Byungmo & Inmoo Lee, *Agency Problems and Performance of Korean Companies during the Asian Financial Crisis: Chaebol vs. Non-chaebol firms*, 11 PACIFIC-BASIN FIN. J. 327, 327-48 (2003); *see also* Christopher S. Armstrong et al., *Corporate Governance, Incentives, and Tax Avoidance*, 60 J. ACCT. & ECON. 1, 1 (2015), in which the authors found that "unresolved agency problems may lead managers to engage in more or less corporate tax avoidance than shareholders would otherwise prefer."

[23] *See generally* Jensen, *supra* note 19 at 831; Jensen & Meckling, *supra* note 21 at 338.

of performance-based payment schemes. External mechanisms include, among others, hostile takeover, contest of voting proxy, and product market competition.[24] Since the expression "agency costs" was first introduced by Jensen and Meckling in 1976,[25] there have been hundreds of studies on corporate governance mechanisms.[26] Many important insights from these studies were well implemented in the legal literature and have influenced lawmakers.[27]

For many years, the financial literature has ignored one important external mechanism of firms: the corporate tax.[28] Not surprisingly, in the absence of financial studies, the legal literature has ignored, as well, the governance role of the corporate tax. In recent years, the potential governance role of taxes has attracted a growing attention by financial scholars, who have explored the interplay between the basic functions of corporate tax and corporate governance.

The aim of this part of the article is to arm us with a new understanding concerning the governance role of corporate tax, particularly in reducing the "agency costs of equity." More specifically, section B will present the "Madisonian" Function and the "shedding light" function of the tax (the financial functions). Section C will present the "monitoring" function of the tax. Section D, then, will examine under what conditions the IRS has a comparative advantage relative to the SEC in improving corporate governance. Section E will discuss the new corporate alternative minimum tax (AMT) enacted in 2022, which is based on financial accounting (book) income, and rebut some common criticism of it.

B. Corporate Tax can Strengthen the Financial Reporting System

The importance of financial reports[29] is directly related to the need to protect investors, since "[m]any existing and potential investors, lenders and other creditors cannot require reporting entities to provide information directly to them and must rely on general purpose financial reports for much of the financial information they need. Consequently, they are the primary users to whom general purpose financial

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[24] Weichu Xu, Yamin Zeng & Junsheng Zhang, *Tax Enforcement as a Corporate Governance Mechanism: Empirical Evidence from China*, 19 CORP. GOVERNANCE: AN INT'L REV. 25, 26 (2011).

[25] Jensen & Meckling, *supra* note 21, at 305.

[26] A simplistic search in "google scholar" of the expressions "corporate governance mechanisms" combined with "agency costs" from 1976 onwards finds 17,800 results.

[27] A simplistic search in "LexisNexis Academic" of the expressions "agency costs" finds 466 articles in law reviews and law journals.

[28] *See* Mihir A. Desai, Alexander Dyck, & Luigi Zingales, *Theft and Taxes* 1, 2 (Nat'l Bureau of Econ. Rsch., Working Paper No. 10978, 2004)["…the state's actions are not part of the standard analysis of corporate governance, which has typically emphasized legal protections for outside investors …, the role of boards... and the presence of large shareholders…] ("At the same time, the public finance literature on taxation typically ignores any effects of governance on the functioning of the corporate tax system").

[29] *See* Robert M. Bushman & Abbie J. Smith, *Transparency, Financial Accounting Information, and Corporate Governance*, 9 ECON. POL'Y REV. 65, 65 (2003) (explaining that financial reporting can be defined as the "the product of corporate accounting and external reporting systems that measure and routinely disclose audited, quantitative data concerning the financial position and performance of publicly held firms").

reports are directed."[30] Indeed, Skinner and Milburn claim that "there is a strong tradition in accounting history to the effect that the purpose of accounting is to report on the stewardship of management."[31] They write that some suggest that financial reports are "vital to facilitate contracting and the operation of control devices to ensure the enforcement of contracts… between owners of an entity and its management, between the entity and creditors, and between management and subordinates."[32]

Corporate tax can strengthen the financial reporting system in two ways: firstly, it can mitigate the problem of inflated reported earnings ("Madisonian" function). Secondly, the corporate tax can provide further information to investors ("shedding light" function).

1. "Madisonian" Function: Mitigating Incentives to Inflate Income

One of the main agency problems associated with financial reports is earnings management and particularly inflation of reported income.[33] Earnings management is often defined as "when managers use judgment in financial reporting … to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company, or to influence contractual outcomes that depend on reported accounting numbers."[34] Studies[35] provide

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[30] FINANCIAL ACCOUNTING STANDARDS BOARD, STATEMENT OF FINANCIAL ACCOUNTING CONCEPTS NO. 8 AS AMENDED, at 215 (2021) ("The Board agreed with these respondents and noted that, in most cases, information designed for resource allocation decisions also would be useful for assessing management's performance"); ("Both [assessing prospects for future cash flow and assessing the quality of management's stewardship] are important for making decisions about providing resources to an entity, and information about stewardship also is important for resource providers who have the ability to vote on, or otherwise influence, management's actions").

[31] Skinner, R.M. and Milburn, J.A., 2001, ACCOUNTING STANDARDS IN EVOLUTION (2d ed. 2001) 586.

[32] *Id.*

[33] Daniel Shaviro, *The Optimal Relationship Between Taxable Income and Financial Accounting Income: Analysis and a Proposal*, 97 GEO. L. J. 423, 425-26 (2009) (arguing earnings management, and in particular systematically inflating reported earnings, "undermines financial markets by reducing their transparency, along with shareholders' ability to monitor managers"). Indeed, a recent study employs a dynamic model, based on data on earnings restatements, to estimate that the cost to a typical CEO of misstating earnings is relatively low, with the probability of detection being less than 15%. Notably, the model does not account for the tax costs of earning misstatements. *See* Anastasia A. Zakolyukina, *How Common Are Intentional GAAP Violations? Estimates from a Dynamic Model*, 56 J. ACCT. RES., 5–44 (2018).

[34] Paul M. Healy & James Michael Wahlen, A Review of the Earnings Management Literature and its Implications for Standard Setting 1, 6 (Nov. 1998) (unpublished manuscript) (on file with Social Science Research Network (SSRN)).

[35] Scott D. Dyreng, Michelle Hanlon, & Edward L. Maydew, *Where Do Firms Manage Earnings?*, 17 REV. OF ACCT. STUD. 649, 650 (2012) ("The study of earnings management dates back to at least Healy (1985). In the subsequent decades, researchers have conducted hundreds of studies of earnings management. Among other things, these studies have provided insights into when firms manage earnings, what types of accounts they manage, why they manage earnings, and how they manage earnings"). It should be noted that in certain circumstances firms have incentives to report lower income (e.g., due to political costs (Watts & Zimmerman, *Positive Accounting Theory: A Review*, 13 ACCT., ORG. AND SOC'Y, 623, 626 (1986)) and compensation contracts

evidence that managers manipulate earnings for a variety of reasons, including to increase managers' bonus and option compensation and the value of managers' stock holdings, to increase managers' job security, to avoid violating lending contracts, and to reduce regulatory costs and to increase stock price in anticipation of an equity offering.[36] The effects of earning management are indeed serious. Earning management and particularly inflation of reported income undermine financial markets by reducing their transparency, along with shareholders' ability to monitor managers. Jensen has described the severe consequences of inflation of reported income: "when they [managers] do this [inflate reported income] they are taking actions that actually destroy value in the long run but generate the appearance of improved performance in the short run. And the effects in the extreme can destroy the underlying core value of the firm."[37]

The corporate tax can potentially mitigate the problem of inflation of reported earnings in a simple and quite straightforward way: by taxing the reported income of the corporation. This effect is well known in the financial literature as the "book-tax trade-off," since firms can be forced to make a "trade-off" between the benefits of inflating book earnings and the direct tax costs of increasing taxable income.[38] German writers call this effect "a general conflict-solving mechanism", since the tax can put the corporate management in a dilemma and force them to

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(Healy, *The Effect of Bonus Schemes on Accounting Decisions*, 7 J. OF ACCT. AND ECON. 85, 106 (1985)).

[36] *See* Healy & Wahlen, *supra* note 34 at 3-4 ("In general, the evidence is consistent with firms managing earnings to window-dress financial statements prior to public securities' offering, to increase corporate managers' compensation and job security, to avoid violating lending contracts and to reduce regulatory costs"); Merle Erickson et al., *How Much Will Firms Pay for Earnings That Do Not Exist? Evidence of Taxes Paid on Allegedly Fraudulent Earnings*, 79 THE ACCT. REV. 387, 390 (2004) ("These studies provide evidence that managers manipulate earnings for many reasons, including to increase their compensation (citation omitted), to avoid debt covenant restrictions (citations omitted), and to increase stock price in anticipation of an equity offering (citations omitted)").

[37] Michael C. Jensen, *The Agency Costs of Overvalued Equity and the Current State of Corporate Finance,* 10 EUR. FIN. MGMT. 549, 555 (2004).

[38] Douglas A. Shackelford, Joel Slemrod, & James M. Sallee, *A Unifying Model of How the Tax System and Generally Accepted Accounting Principles Affect Corporate Behavior*, 1, 7 (Nat'l Bureau of Econ. Rsch., Working Paper No. 12873, (2007) ("Financial reporting costs often conflict with tax minimization because reductions in taxable income frequently result in lower book profits and/or equity. This tension forces firms to trade-off book and tax considerations"); Wolfgang Schon, *The Odd Couple: A Common Future for Financial and Tax Accounting?*, 58 TAX L. REV. 111, 143 (2004)("[B]ook-tax conformity could lead to a balance between the over-optimistic management bias in the capital market context and the over-conservative estimates of management in the tax context. This 'book-tax trade-off' causes a substantial 'friction' with respect to aggressive tax planning. German writers call it a general conflict-solving mechanism. Recent research has shown that the gradual disconnection of tax and book accounting under German law has led to a dramatic loss of 'prudence' in the drafting of financial accounts; provisions for future losses were heavily reduced and depreciation periods massively extended"); Michelle Hanlon, Stacie Kelley Laplante, & Terry Shevlin, *Evidence for the Possible Information Loss of Conforming Book Income and Taxable Income*, 48 The J. L. & ECON. 407 (2005); Mary Margaret Frank et al., *Tax Reporting Aggressiveness and Its Relation to Aggressive Financial* Reporting, 84 THE ACCT. REV. 467, 470 (2009) ("[F]irms generally report either higher financial income to shareholders or lower taxable income to tax authorities because conformity between GAAP and tax law compel firms to decide which measure of income is more important to manage …").

choose between achieving the earnings management goal of increasing financial reported income and the tax planning goal of reducing the taxable income.[39] The best description of this effect, in our opinion, was given by Shaviro who names it the "Madisonian" dilemma:

James Madison famously described the constitutional strategy of using "[a]mbition … to counteract ambition" such as through the separation of powers.[40] Here, though different parties' ambitions are not being set against each other in classic Madisonian style, at least this is happening as to two different ambitions of the same people. Setting the goals of reducing and increasing 'income' against each other, rather than permitting untrammeled pursuit of both objectives, may reduce the scope of incentive problems even if not eliminating them.[41]

The "Madisonian" function can "lead to a balance between the over-optimistic management bias in the capital market context and the over-conservative estimates of management in the tax context."[42] Suppose that the highly incentivized CEO of a public company is considering increasing the reported financial income of the company. Absent the corporate tax, there would not be any direct cost to this strategy. The corporate tax has the potential to impose an additional cost to this strategy and thus to mitigate the incentive to use it. In other words, the corporate tax can potentially provide the corporate management with some built-in incentives to be less aggressive in inflating financial reported earnings.

2. *"Shedding Light" Function: Expanding Market Information*

Corporate tax and disclosure of corporate tax returns can shed new light on financial reports and improve their quality. The notion is that publicity of corporate tax information can enable market participants (e.g., minority stockholders, credit agencies and creditors) to compare the financial reports information with the contents of the tax returns, so they can "more easily catch inaccuracies in financial reporting… the additional information provided in the calculation of income tax could help in assessing the financial health of the company."[43]

Even if comparing tax returns with financial reports is challenging given sufficient time and resources and the incentive to invest in those resources:

"…we believe that experts could compare tax return information

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[39] Schon, *supra* note 38, at 143.

[40] The Federalist No. 51 (James Madison).

[41] Shaviro, *supra* note 33, at 428-29. A counter-argument is that firms may have strong incentives to report high book income, rendering the "Madisonian" function relatively weak. Indeed, a recent article analyzed the enactment of the corporate alternative minimum tax introduced by the Tax Reform Act of 1986. This tax base under the alternative minimum tax replaced many tax accounting methods with book accounting methods. The study found "zero average tax base responses" to the alternative minimum tax (i.e., on average, firms did not reduce their book income in a response to the enactment of the alternative minimum tax). *See* Jordan Richmond, *Firm Responses to Book Income Alternative Minimum Taxes*, 236 J. PUB. ECON. (2024). However, the study only examined the incremental effects of the corporate alternative minimum tax and did not evaluate the "Madisonian" function of the corporate tax itself.

[42] Schon, *supra* note 38, at 143.

[43] David Lenter, Joel Slemrod, & Douglas Shackelford, *Public Disclosure of Corporate Tax Return Information: Accounting, Economics, and Legal Perspectives*, 56 NAT'L TAX J. 803, 816 (2003).

> with financial statements to gain insight into the company's situation that could not be garnered from financial statements by themselves. Moreover, if companies know that investors and other interested individuals and organizations will scrutinize tax returns information alongside their financial statements, they may be encouraged to provide fuller financial information…"[44]

Thus, the tax may help keep the integrity of the financial reporting system.

It should be noted that while the "Madisonian" function and the "shedding light" function of corporate tax are directly related to each other, they are not the same. On the one hand, the "Madisonian" function is focused on the bottom line of the tax return and deals with the one specific (but very important) problem of inflation of reported income; on the other hand, the "shedding light" function is focused on the broader information contained in tax returns and generally helps investors catch inaccuracies in financial reports and better assess the financial health of publicly traded companies.

C. The "Monitoring" Function

Congress has been endowed with a far reaching and expansive information-gathering authority to administer and enforce tax law, which includes the broad mandate to compel disclosures and to investigate and audit.[45] While the explicit purpose of these powers is to enable the tax authorities to effectively perform the "congressionally imposed responsibilities to enforce the tax code,"[46] tax authorities can employ these powers to mitigate the agency problem. Desai et al., in their notable article "Theft and Taxes," were the first to make this claim that tax authorities can use these extensive powers to protect the principals from the agency problem (the non-controlling stakeholders) from diversion of corporate assets and extraction of private benefits by the agents (the controlling stakeholders or management).[47]

Desai et al. begin with a simple observation that the state, thanks to its tax claims on cash flows, is de facto the largest minority shareholder in almost all corporations.[48] In corporate governance terms, the article argues that there is an alignment of interests between the non-controlling shareholders and the IRS. The authors note that many procedures aimed at enforcing a corporate tax liability make it more difficult for controlling shareholders to divert corporate value to their own advantage. Similarly, many transactions aimed at diverting corporate value toward controlling shareholders reduce corporate tax liabilities. Since managerial diversion hurts both tax authorities and non-controlling shareholders, the two parties have a common goal: reducing managerial diversion.

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[44] *Id*. at 816-17.
[45] *See generally* CONG. RSCH. SERV., *Art1.S8C1.1.4 Taxes to Regulate* Conduct, CONSTITUTION ANNOTATED, https://constitution.congress.gov/browse/essay/artI-S8-C1-1-4/ALDE_00013390/ (last visited Sept. 13, 2024).
[46] United States v. Euge, 444 U.S. 707, 711 (1980).
[47] Desai et al., *supra* note 28, at 592.
[48] *Id.*

Thus, Desai et al. predict that an increase in tax enforcement will increase the probability that diversion will be detected: "the existence of a corporate tax introduces an additional monitor (the tax authority) which increases the probability that diversion will be detected and, hence, increases the expected cost of diversion."[49]

Indeed, tax authorities can reduce the incentive of managers and control shareholders to divert corporate assets and extract private benefits by increasing the expected cost of diversion. The expected cost of diversion equals the product of the probability of detection and the amount of punishment.[50] The IRS can both increase the probability of detection and can increase the amount of punishment. Firstly, if the diversion harmed the government (e.g., the diversion activity illegally reduced the amount of taxes paid), then the IRS can impose penalties on the corporations in an amount of the taxes withheld. Since the manager's compensation is highly correlated to the corporate performance, such a penalty indirectly affects the managers as well. The corporate executives may also incur personal risks due to tax evasion, such as loss of reputation, penalties or even the threat of legal prosecution. In this regard, the IRS can subject all the "responsible persons" who willfully retain due taxes from the government to a penalty equal to the taxes withheld. Moreover, when managers are involved in extreme forms of diversion, they are at risk of legal prosecution for violating rules concerning individual income tax provisions, as demonstrated in some recent notorious cases.

Secondly—not less important—the IRS can help other agencies in the investigation and enforcement of criminal statutes. The IRS can potentially provide tax information (concerning the taxpayer or other taxpayers) to other agencies and, thus, help them, which increases the likelihood that a punishment will be imposed on the accused once a diversion activity was detected.[51]

Overall, this analysis predicts that the existence of the corporate tax introduces an additional monitor, the tax authority. The tax authorities can increase both the probability that diversion will be detected and the amount of punishment. As a result, the IRS increases the expected cost of diversion.

D. Comparative Advantage of Corporate Tax (and IRS) Relative to SEC

Sections B and C demonstrated that the corporate tax can potentially have three governance functions. The tax can strengthen financial markets, by, first, providing corporate executives with some automatic incentives to be less aggressive in inflating financial reported earnings ("Madisonian" function) and, secondly, by providing information to the market (the "shedding light" function). Third, tax enforcement can increase the cost of diversion, by increasing the

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[49] *Id*. at 595.

[50] *E.g.*, literature concerning criminal activity. *See* Gary. S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL ECON. (1968) (arguing that criminals are rational persons that behave in accordance with the expected utility arising out of the criminal activity taking into account the probability of detection and the amount of the fine).

[51] It should be noted that I.R.C. § 6103 does not include a specific provision that allows the IRS to grant the SEC access to tax-returns for the early stages of the investigations in order to examine if there is a reasonable cause to believe that a crime was committed.

likelihood that such activity would be detected and increasing the amount of punishment (the "monitoring" function).

Why can other government agencies not provide similar services? More specifically, when and under what conditions would corporate tax (and tax authorities) have a comparative advantage relative to the SEC in providing corporate governance services?

Our task in this section is to show that, in some respects, the corporate tax can have a comparative advantage in protecting investors and maintaining efficient markets relative to the SEC. It should be emphasized that we do not claim that the corporate tax plays a more important role than the SEC in improving corporate governance; but rather that corporate tax has unique features that protect investors and maintain the integrity of the financial reporting system by strengthening the financial reporting system and increasing the overall cost of diversion activity.

The SEC was established under the Securities Exchange Act of 1934 as an independent regulatory agency designed to "protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation."[52] The SEC was charged with administering federal securities laws, which are characterized as disclosure statutes and based on the assumption that: "[s]unlight is said to be the best of disinfectants; electric light the most efficient policeman."[53] Accordingly, the SEC is granted with the power to regularly require extensive company disclosures, such as annual reports, quarterly reports, current reports "to report certain specified events, within four business days after occurrence of the event."[54] Crucial to the SEC's effectiveness in these areas is its enforcement authority. The SEC's ability to regulate companies and safeguard shareholders is augmented by their capacity to enforce federal laws.[55] Accordingly, the SEC can recommend the commencement of investigations of securities law violations, by bringing civil actions in federal court or before an administrative law judge. The SEC can also help law enforcement agencies bring criminal cases when appropriate.

In light of these extensive powers, the effectiveness of corporate tax and tax authorities in protecting investors seems questionable. One may claim that the disclosure of corporate tax returns information has no comparative advantage relative to other disclosures. As noted above, the SEC can require disclosure of information; and if some information is necessary or appropriate in the public interest or for the protection of investors, then the SEC can independently require the disclosure of it and there is no special value to the disclosure of tax. Moreover, since the SEC can subject aggressive accounting choices to greater scrutiny, the agency can provide incentives for management to avoid inflating reported income (also effectuating the "shedding light" function). The SEC can also provide monitoring services and can bring civil action against companies or individuals

[52] *About*, U.S. SECURITIES AND EXCHANGE COMMISSION, (June 29, 2024), https://www.sec.gov/about.

[53] Louis D. Brandeis, *What Publicity Can Do, in* OTHER PEOPLE'S MONEY: AND HOW THE BANKERS USE IT 62, 62. (1933).

[54] *Exchange Act Reporting and Registration*, U.S. SECURITIES AND EXCHANGE COMMISSION (June 24, 2024), https://www.sec.gov/education/smallbusiness/goingpublic/exchangeactreporting.

[55] *Mission*, U.S. SECURITIES AND EXCHANGE COMMISSION, (Aug. 9, 2023), https://www.sec.gov/about/mission.

implicated in diversion activity (also effectuating the "monitoring" function).

Notwithstanding these arguments, the corporate tax and tax authorities have many comparative advantages relative to the SEC in protecting investors and maintaining efficient markets.

1. Economies of Scope

Economies of scope is when combined production is more cost efficient than individual production. In other words, it is cheaper to produce certain goods together than producing each good separately. In the tax context, it was claimed that one of the advantages in using tax laws as a regulatory tool stem from this rationale: "[t]he use of tax laws instead of direct regulation allows the government to rely on existing and established system (the tax system). The costs incurred by the government to slightly modify an existing and established system would be lower than the costs needed to create, manage and administer a new system (the regulatory system) …"[56]

While this explanation may be less compelling for developed countries with special designated agencies dedicated to protecting investors,[57] this rationale still has some merits even in the U.S. The notion is that the taxpayers' duty to assess their own tax liability and to file tax returns provides the IRS with an expansive database; Congress has already "recognized that the IRS had more information about citizens than any other federal agency. . . "[58] The tax code imposes three basic obligations on all taxpayers (including individuals and corporations): to assess their own tax liability, to file an annual tax return reporting that liability, and to pay that liability when due. In addition, third parties doing business with or providing services to those taxpayers are required to provide information that is used to supplement and verify that self-reported information. Hence, in auditing a corporate tax return, the IRS can turn not only to the corporate's own returns for past years, but also to returns filed by related corporations, partnerships, and individuals, including returns filed by customers, suppliers, employees, shareholders and payors of various type of income subject to income gathering. Sharing this tax information with other agencies might be costly (e.g., the need to ensure that the information would not leak) and raises a long list of concerns. In sum, an extensive and unique database about taxpayers may give tax authorities a comparative advantage relative

[56] Sartori, *supra* note 12, at 6.

[57] In an early version of the article "Theft and Taxes," Desai et al. explained that "economies of scope" may give tax authorities a comparative advantage: "Every country has a government agency specialized in collecting revenues. It is much easier, faster, and more effective to extend the tasks of these experts, than to create another ad hoc agency. For example, in Russia, when the local securities and exchange commission wanted to improve enforcement, they asked the tax police for assistance as they were the only ones with the appropriate expertise. In the United States in 1909, this extension of the tax authorities' scope to corporate returns was apparently well within their existing capabilities. This explanation may be less compelling for a country like the United States today, where an agency solely dedicated to the enforcement of security laws has been in place for the last seventy years." (*See* https://www.ecgi.global/sites/default/files/working_papers/documents/ssrn-id629350.pdf).

[58] Memorandum from the Office of Chief Counsel Internal Revenue Service to Technical Advisor, Criminal Investigation Office of Governmental Liaison and Disclosure, (July 18, 2011) (on file with the IRS).

to other agencies, including the SEC in investigating diversion activity, which harms both the government and outside shareholders.

2. *"Skin in the (Disclosure) Game"*

SEC enforcement against management who manipulate financial reports (e.g., transferring sales from one market to another) or inflate earnings faces a complex challenge. Given the considerable discretion management has in making choices that will affect the reported income, it may be difficult for the SEC to distinguish between changes in financial reports attributable to the operation of the firm and those that are attributable to manipulation by management. More specifically, management can influence financial reports through legal activities, which are "within the discretion allowed by law,"[59] and thus it may be impossible for the SEC or the DOJ to punish managers who are involved in such "legal" manipulation.

The information contained in tax returns concerning the health of the corporation is distinguishable from the information contained in financial statements. The reason is straightforward: companies have "skin in the game" when their tax returns are filed with the tax authorities, since tax return information has a direct influence over the company's tax liability.[60] While managers may indeed manipulate the information contained in corporate tax returns (to reduce their taxable income), the direction will most probably be different than the direction of manipulation of financial returns. The existence of two independent sources of information can enable market participants to each other and gain insight into the company's situation that could not be garnered from financial statements alone. This automatic incentive does not require identifying the source of the increase in the reported income. Corporate tax can reduce the incentive to inflate income by using transactions that are legally permissible, and thus would survive SEC scrutiny, and "yet that serve no good social purpose beyond advancing the managers' income manipulation goal."[61] Since corporate tax can impose a levy on corporate income (while the SEC cannot do so), it has a comparative advantage in coping with the earning management problem and in providing valuable information to the market.

It should be noted that other corporate governance mechanisms have a real challenge in coping with the earning management problem and some corporate

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[59] Eitan Goldman & Steve L. Slezak, *An Equilibrium Model of Incentive Contracts in the Presence of Information Manipulation*, 80 J. OF FIN. ECON. 603, 604 (2006).

[60] *See* Tanya Tang, *Does book-tax conformity deter opportunistic book and tax reporting? An international analysis*, 24 EUR. ACCT. REV. 3, 441-469 (2015). (Using publicly available financial statements from 1994 to 2007 for 16,739 firms across 32 countries, the article constructs "a new proxy for mandatory conformity and document[s] that high book-tax conformity is associated with lower levels of earnings management and tax avoidance. These results persist even after controlling for firm characteristics and institutional factors, such as legal enforcement, investor protection, legal systems, capital market development, and the adoption of International Financial Reporting Standards.").

[61] Daniel Shaviro, *The Optimal Relationship Between Taxable Income and Financial Accounting Income: Analysis and a Proposal*, N.Y.U. L. & Econ. Research Paper No. 07-38, GEO. L. J. Vol. 97 at 1, 64 (2008).

governance mechanisms are considered part of the problem. For example, during the last decades, many financial scholars have emphasized the importance of equity incentives, as an internal corporate governance mechanism which "automatically" aligns the interests of the management with the interest of the shareholders. Indeed, empirical evidence shows that equity incentives induce managers to exert productive effort. However, rather than coping with the problem of earning management, it is well documented that equity incentives "places pressure on managers to increase accounting earnings often at the cost of real economic value."[62] The effect of stock incentive is sometimes referred to as a "double-edged sword, inducing managers to exert effort, which improves firm value, but also inducing managers to inflate or exaggerate performance, which, given the opportunity cost of the firm's resources, reduces firm value."[63]

Many other corporate governance mechanisms are also only making the problem worse; as Jenssen mentioned: "overvalued equity is managerial or organizational heroin. And the managers are a part of the problem; investment bankers and security analysts are a part of the problem, and so too are the auditors who have ended up collaborating."[64]

Hence, the corporate tax can potentially have a comparative advantage in

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[62] Daniel A. Cohen, Aiyesha Dey, and Thomas Z. Lys, *Real and Accrual-Based Earnings Management in the Pre- and Post-Sarbanes-Oxley Periods*, 83 ACCT. REV. 757 (2008) (arguing that earnings management increased steadily from 1987 until 2002, and options and stock-based compensation was a particularly strong predictor of aggressive accounting behavior); Natasha Burns & Simi Kedia, *The Impact of Performance-Based Compensation on Misreporting*, 79 J. FIN. ECON. 35 (2006) (arguing that firms whose CEOs have large options positions were more likely to file earnings restatements); Pengjie Gao & Ronald E. Shrieves, *Earnings Management and Executive Compensation: A Case of Overdose of Option and Underdose of Salary* (2002) (unpublished manuscript) (on file with Social Science Research Network (SSRN)) (arguing that magnitude of discretionary accruals is greater and earnings management is more prevalent at firms in which managers' wealth is more closely tied to the value of stock); Daniel Bergstresser & Thomas Philippon, CEO Incentives and Earnings Management, 80 J. FIN. ECON. 511 (2006); Qiang Cheng & Terry D. Warfield, *Equity Incentives and Earnings Management*, 80 ACCT. REV. 441 (2005); Michael C. Jensen, *The Agency Costs of Overvalued Equity and the Current State of Corporate Finance*, 10 EUR. FIN. MGMT. 549 (2004); Eric Ohrn, Does Corporate Governance Induce Earnings Management? Evidence from Bonus Depreciation and the Fiscal Cliff 1, 4 (2014) (unpublished manuscript) (on file with University of Michigan library) ("While the majority of empirical results have highlighted the benefits of stronger governance, Jensen (2004) suggested that equity incentives may lead to unintended, counterproductive consequences. Jensen (2004) considered the effect of high managerial equity incentives when analysts project high earnings and stock prices are overvalued. Overvaluation places pressure on managers to increase accounting earnings often at the cost of real economic value. Jensen pointed out that the pressure to engage in earnings management behaviors to artificially inflate earnings to hit targets increases as management owns a larger portion of outstanding equity.").

[63] Goldman & Slezak, *supra* note 60, at 605.

[64] Michael C. Jensen, *The Agency Cost of Overvalued Equity and the Current State of Corporate Finance*, Harv. (NOM Working Paper No. 04-29, at 554.) Or another example: while the use of debt can work as a governance mechanism in other contexts, it can induce earning management and it was noted that "Several studies find that firms close to violating lending covenants manage earnings … These studies suggest that avoidance of penalties associated with the violations of debt covenants is a motivation to manage earnings. A firm would manage earnings to issue new debt if earnings management allows the firm to obtain debt at more favorable terms. A firm that meets restrictive covenants can obtain more favorable financing. . .". Katsiaryna Salavei Bardos and Nataliya Zaiats, "Equity and debt issuance by firms violating GAAP." 52 ACCT. & FIN. AT 14 (2012).

strengthening the financial reporting system relative to the SEC (and to many other corporate governance mechanisms).

3. *"Political Clout"*

The third comparative advantage of tax authorities relative to the SEC in protecting investors stems from the distinctive revenue implications of actions by the IRS. In an unpublished version of the article "Theft and Taxes," Desai et al. raised this claim and stated:

> The IRS enjoys more political clout (and a better budget) because it generates more revenues for the Government, while the SEC relies on annual appropriations unrelated to its enforcement actions. Even if the SEC generates revenues through its enforcement actions, there remains a fundamental difference. By increasing enforcement, the IRS increases revenues not only from the company investigated, but also from all other companies, which are not investigated but improve their compliance out of fear. By contrast, by increasing enforcement, the SEC raises revenues only from the company investigated, while losing them from other companies, which would be more compliant and hence pay fewer fines.[65]

The space that the IRS occupies within the political system allows it to more efficiently and effectively act as a corporate governance force for strengthening financial reporting and monitoring services.

E. The Corporate Alternative Minimum Tax and Its Critics

In 2022, Congress enacted a new 15% corporate alternative minimum tax (AMT) based on book (financial reporting) income. This tax must be paid if it exceeds the regular corporate tax set at 21% of taxable (not book) income.[66] The corporate AMT fulfills the Madisonian, shedding light, and monitoring functions described above in sections B and C, respectively.

The corporate AMT, however, has been subject to fierce criticism.[67] For example, a recent article by Li Dang, Rodney Mock, and David Chamberlain sharply criticized the corporate AMT. The following are some counterarguments that readers may wish to consider in addition to the explanation for the rationales set out above:

1. Dang, Mock, and Chamberlain write that:

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[65] M.A. Desai, A. Dyck, & L. Zingales, *Theft and Taxes*, 84 J. OF FIN. ECON. 3, 591-623 (2007).

[66] I.R.S., *IRS Clarifies Rules for New Corporate Alternative Minimum Tax* (2023), https://www.irs.gov/newsroom/irs-clarifies-rules-for-corporate-alternative-minimum-tax [https://perma.cc/V2CQ-BDSZ].

[67] The following is based on Reuven Avi-Yonah, *Taxing the Right Book: Arguments for the Corporate AMT*, 181 TAX NOTES FED. 1645 (Nov. 27, 2023).

> "With financial accounting, companies want to increase their earnings for shareholders, creditors, financial analysts, and other stakeholders. Managers are motivated to manage earnings by decreasing (or deferring) losses and increasing (or accelerating) income. The objectives in tax accounting are the exact opposite: tax practitioners engage in complex tax avoidance strategies to reduce taxable income."[68]

In our view that is exactly the main advantage of the corporate AMT: because companies want to increase their earnings, they are constrained by how much they can reduce taxable income (i.e., the "Madisonian" function). Since managers care more about earnings per share (which affects the value of their stock options) than about taxable income, the result is a higher likelihood that the largest U.S. and foreign corporations (the only corporations subject to the corporate AMT) will pay something close to a 15 percent effective tax rate.

As for the risk of earnings management to decrease taxation, Wolfgang Schoen published an incisive critique of this argument based on the long German experience of using corporate book income as the taxable base.[69]

2. The author argues that:

> "Unlike financial accounting, tax law comes from the U.S. Constitution, treaties, the IRC, administrative pronouncements, and judicial opinions. These authorities have the force of law, as they are created by duly authorized government officials via the 16th Amendment, the Administrative Procedure Act of 1946, elected judges, and so on. A system that determines the corporate tax base outside of tax law makes no sense and is not good tax policy. It merely degrades the taxation process by capitalizing on the public's lack of understanding regarding the significant differences between the two systems."[70]

This ignores the fact that the corporate AMT is part of the Internal Revenue Code of 1986, as amended (26 USC), duly passed by both houses of Congress and signed into law by the president. It is subject to the same IRS and judicial review as any other part of the Code. While generally accepted accounting principles are not set by Congress, Congress is free to change them for the corporate AMT whenever it feels the results are not appropriate, as it did for the application of refundable and transferable credits under the Inflation Reduction Act.[71]

3. The authors write that:

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[68] Li Dang, Rodney P. Mock, & David G. Chamberlain, *Taxing the Wrong Book*, 181 Tax Notes Fed. 1377 (2023).
[69] Schon, *supra* note 38, at 115.
[70] *Id*.
[71] Inflation Reduction Act of 2022, H.R. 5376, 117th Cong. (2022) (enacted).

> "The original purpose of the federal income tax was to fund the operations of the federal government."[72]

That is partly true for the individual income tax, although a major reason for the adoption of the 16th Amendment was to reduce inequality (the government could have continued to be funded by tariffs like it previously was, instead of a tax that fell only on the rich). But it was not the purpose of the corporate tax of 1909 (originally set at 1 percent); that was to regulate monopolistic corporations, as shown by the legislative history.[73]

4. The authors write that after 1954:

> "The entire IRC is an elaborate system of sticks and carrots to control taxpayer behavior."

That was true before 1954 as well, as Stanley S. Surrey shows in his memoir.[74] But there is nothing wrong with that until corporate tax planning results in too low a level of tax, because then the legal incentives do not work. That is why it is so important that the corporate AMT applies to all global income as opposed to just global intangible low-taxed income (GILTI), since under GILTI there are incentives to shift income to zero-tax jurisdictions and avoid the tax's regulatory goals.

5. The authors write that:

> "Despite these fundamental differences, Congress's new corporate alternative minimum tax looks to book income rather than taxable income as an alternative tax base. In addition to the conceptual differences, delegating the corporate tax base to [the Financial Accounting Standards Board] and Treasury creates many practical administrative and constitutional issues."[75]

This conveniently omits the fact that the global corporate minimum tax (pillar 2 of the current international tax reform effort led by the G20 and the OECD and agreed to by over 140 countries including the US) also looks to book income. So, if Congress did not enact a corporate AMT set at 15 percent of book income, the result would simply be that other countries would get to collect the difference. Luckily, the United States was able to better align the corporate AMT with pillar 2 by persuading the OECD to accept the exclusion of transferable credits. The

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[72] Li Dang et al., *Taxing the Wrong Book*, 181 Tax Notes Fed. 1377 (2023).
[73] *See* Reuven S. Avi-Yonah, *Corporations, Society and the State: A Defense of the Corporate Tax*, 90 VA. L. REV. 1193 (2004); Avi-Yonah, *A New Corporate Tax*, Tax Notes Fed., July 27, 2020, at 654.
[74] Stanley S. Surrey, *A Half-Century With the Internal Revenue Code: The Memoirs of Stanley S. Surrey* (2022); *see also* Avi-Yonah & Nir Fishbien, *Stanley Surrey, the Code and the Regime*, 25 FLA. TAX REV. 119 (2021).
[75] Li Dang et al., *supra* note 68, at 1378.

corporate AMT is as close as we get to a qualified domestic minimum top-up tax (as included in pillar 2), at least in the foreseeable future. And the qualified domestic minimum top-up tax is the only defense countries have against the undertaxed profits rule, which subjects multinationals to tax if neither the residence country nor the source country taxes it at 15% of book income.

6. The authors write that:

> "[u]sing book income as the tax base for a minimum tax in the international context is a different story in light of the varying jurisdictions and laws. Domestically, our politicians can do better. We need a stable (and equitable) corporate tax base."[76]

This ignores the inconvenient fact that the international rules apply domestically as well, as noted above. Our politicians cannot do better domestically because the United States does not call the shots like it used to.

7. Finally, the authors write that:

> "Legislatively postured as somehow being fairer, the new corporate AMT is not very fair at all. For example, companies that do not satisfy the three-year [adjusted financial statement income] $1 billion test are not subject to the new tax, regardless of how little they pay in taxes or how low their effective tax rate is. How exactly is this equitable? Why does the corporate AMT only target the newsworthy megacorporations used as bait to stir outrage, playing on the public's complete lack of understanding of the difference between book and tax accounting? Unlike the prior corporate AMT or the AMT for individuals, why such a narrow base of taxpayers?"[77]

There is a very good reason to only target the largest corporations — they are much more likely to be earning economic rents not subject to competition, and therefore should be subject to higher taxes than smaller corporations.[78]

It is possible that these kinds of critiques will persuade a future Congress to abolish the corporate AMT.[79] For the critics that complain about the complexity of two corporate tax bases, we have a better suggestion: abolish the regular corporate tax and use the corporate AMT base to tax our largest corporations adequately at a much higher rate than 15 percent. Given that this tax falls on the shareholders who are not otherwise taxable because they are tax exempt or foreign or can borrow against unrealized appreciation, and that it is also efficient because these corporations are not operating in a competitive marketplace, that would be a good

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[76] *Id.* at 1379-80.
[77] *Id.*
[78] For the empirical evidence, see Avi-Yonah, "A New Corporate Tax," *supra* note 18.
[79] The arguments are not new. *See* Avi-Yonah, *The Case for Reviving the Corporate AMT*, Tax Notes Fed., Nov. 8, 2021.

reform. It would also better align corporate taxation with the three functions discussed above.

F. Summary

This part of the article arms us with a new understanding concerning the governance role of corporate tax. Corporate tax can potentially improve corporate governance, through three main functions. The tax can strengthen financial markets, by providing corporate executives with some automatic incentives to be less aggressive in inflating financial reported earnings (the "Madisonian" function) and by providing information to the market (the "shedding light" function). In addition, tax enforcement can increase the cost of diversion, by increasing the likelihood that such activity would be detected and the amount of punishment (the "monitoring" function).

V. The Corporate Governance Justification(s) for Corporate Tax

Below, we will try to argue that imposing a corporate tax can be a way to reduce some of the agency problems that frame the corporate governance problem. In other words, the corporate tax can help prevent the management from diverting corporate resources to their own pockets.

This argument relies on the groundbreaking essay of Desai, Dyck, and Zingales' "Theft and Taxes."[80] These authors explore the alignment of the interests of the corporate minority or "outside" shareholders and the IRS. They argue that the tax's enforcement limits the benefits extracted by corporate insiders, by requiring tax returns and the furnishing of information. Fraudulent diversion is curbed because minority shareholders have not only their monitoring capacity, but also that of the government. In other words, if the corporate income must be declared for tax purposes, it becomes harder to conceal its theft from the corporation's shareholders.

In addition, the corporate income tax balances the dual reporting system and functions as a monitoring, cost-reducing mechanism. Thanks to the corporate tax, the management faces an internal conflict with respect to profit reporting: the desire to report as much profit as possible to the market while reporting as little profit as possible to the tax authorities. This conflict keeps the system balanced. Therefore, a possible conclusion is that the corporate tax may be desirable because the tax ameliorates the agency problem between outside and inside shareholders (majority and minority shareholders). This justification can explain why the corporate tax applies, in practice, only to publicly held corporations, where the agency problem arises more often.

Avi-Yonah has rejected these arguments and wrote that:

> "More recently, Professor Mihir Desai and his colleagues have argued that imposing a corporate tax can be a way of preventing management from diverting corporate resources to their own

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[80] Desai et al., *supra* note 47.

> pockets. Specifically, if corporate income must be declared for tax purposes, it becomes harder to conceal its theft from the corporation's shareholders. This is an ingenious argument, which (as we shall see) also reflects some of the original intent in enacting the corporate tax in 1909. From today's perspective, however, it seems like a shaky foundation for the entire corporate tax. Management theft can be combated by other means, and a requirement to report income without tax (or with only a minimal tax) would do just as well to achieve the goal promoted by Desai."[81]

Brauner has also rejected this justification. He claims that the corporate tax increases the opportunities for tax fraud, since there are simply more rules and more accounts, and the system is more complex and that:

> "[i]f we agree that corporate tax returns will probably never be made public, then clearly the alternative will be superior even if not less complex or costly. This is because in the alternative, all accounts will be somehow attributed to shareholders and eventually to individuals who can monitor them, resulting in an inherently more transparent system."[82]

In addition, he mentions that the corporate tax provides management a powerful evasion device. He claims that the management uses taxes in general and the corporate income tax in particular, as an excuse for rent extraction activities that do not necessarily result in reduction of effective taxation of shareholders.

As an example, he mentions that certain tax advantages benefit only corporations (tax-free mergers and acquisitions, certain accelerated depreciation schemes, special credits, deductions, and similar measures) and that management uses these special provisions to avoid distributions and transparency in general. In this regard, he claimed that all the research fails to balance the potential benefits of the corporate tax against its costs. Moreover, he claims that the distancing of the corporate tax reporting from financial reporting makes the argument for the balancing power of the corporate tax a "non-starter."[83]

In this section, we will try to cope with these and other counterarguments. First, we will argue that a proper normative evaluation of the arguments in support of the corporate income tax requires a comparison to a state of the world with an alternative tax and that existing literature has underestimated the cost and disadvantages of the suggested alternative tax system. In this regard, it seems that adopting a broad regime of a "mark to market" has significant disadvantages that were not fully discussed by Brauner and other scholars (e.g., taxation of foreign residents' passive income,[84] taxation of tax-exempt entities, stability of revenues

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[81] Avi-Yonah, s*upra* note 15, at 1209-10.

[82] Brauner, *supra* note 5, at 622.

[83] *Id*. at 629.

[84] *See* Avi-Yonah, s*upra* note 15, at 1205. Basically, foreign taxpayers would probably not be subject to the "mark to market tax" (foreign source income of foreign residents), while corporations

from collection of the tax, the well-known problem of "phantom gains," liquidity problem for non-portfolio/non-dealer shareholders, characterization of the income and so on). In addition, we will claim that the corporate tax has some advantages that cannot be reached by other regulatory means (or that it would be very costly and ineffective to use them).

A. "Fee for (Governance) Services Justification"

Under the benefit justification, "the tax is a part of the profits which must be paid to a 'senior partner' [of] the government, in return for services rendered."[85] The relevant benefits are the benefit of incorporation and particularly the benefit of "limited liability." However, this justification was rejected, since non-incorporated entities also have characteristics that were traditionally associated with corporations (e.g., limited liability) and are not subject to corporate tax. This justification is also not consistent with the provision of the benefit of incorporation by the states, while the corporate tax is paid to the federal government.

Armed with the new understanding of the role of the corporate tax, we can reshape the benefit justification and name it the "Fee for (Governance) Services." This justification is directly related to the broader approach of "benefit based taxation," under which "people ought to pay taxes that depend on how much they benefit from public goods."[86] Accordingly, corporate tax could be viewed as a "fee" paid by publicly traded corporations for the governance services provided by tax authorities.[87] Since corporations receive services (benefit) from the government, they also must pay a fee (tax) in return.[88] In other words, corporations pay for the

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are subject to the corporate tax even if they are held by foreign taxpayers. I find this problem as a major disadvantage of the mark to market regime, due to the significant number of foreign shareholders who hold U.S. based companies and due to the concern that U.S. shareholders would find ways to be treated as foreign taxpayers (e.g., establishing foreign corporations that will hold for them their shares in U.S. corporations).

[85] Journal of Accountancy, *What are Corporate Income Taxes?*, 77 J. ACCT. 303 (1944).

[86] Matthew Weinzierl, *Revisiting the Classical View of Benefit-Based Taxation*, Nat'l Bureau of Econ. Rsch., Working Paper No. 20735, at 1, 2 (2014) ("In 2011, U.S. President Barack Obama also sought to increase top marginal income tax rates. He applied this reasoning: 'As a country that values fairness, wealthier individuals have traditionally borne a greater share of this [tax] burden than the middle class or those less fortunate. Everybody pays, but the wealthier have borne a little more. This is not because we begrudge those who've done well. We rightly celebrate their success. Instead, it's a basic reflection of our belief that those who've benefited most from our way of life can afford to give back a little bit more.' … As the remarkable surveys by Edwin Seligman (1908) and Richard Musgrave (1959) make clear, benefit based reasoning was a prominent, at times leading, approach among tax theorists through the 19th century. William (1677), in particular, anticipated Smith's view, and Hobbes, Hume, and Rousseau among others subscribed to it in some form").

[87] Desai et al., *supra* note 47, at 619 (Desai et al. stated their support in this justification, by stating: "Our approach can also be used to provide a new rationale for the very existence of a separate tax rate on corporate income. Since minority shareholders face a free rider problem in monitoring, the corporate tax can be seen as a payment for certification services provided by the tax authorities").

[88] The corporate theory that views corporations as "real entities" perfectly fits with this justification; Reuven S. Avi-Yonah, *The Cyclical Transformations of the Corporate Form: A Historical Perspective on Corporate Social Responsibility*, 30 DEL. J. CORP. L. 767, 771, 810 (2005) ("the real entity theory…views the corporation as neither the sum of its owners nor an extension of the state,

services they receive.

However, one may claim that while investors (capital providers) benefit from reduction in agency costs,[89] other groups actually bear the burden of the tax. This claim raises the issue of the incidence of corporate tax or (put more simply) who ultimately pays the cost of the tax.[90] Economists argue that shareholders bear the cost of the corporate tax through lower profits.[91] Indeed, until 2008, the Department of the Treasury assumed that the entire burden of corporate tax was assumed to be borne by owners of capital.[92] Recently, "economists have begun to question this conclusion, finding that, in the modern economy, workers often bear a significant portion of the tax in the form of lower wages, lower employment, or both."[93] A number of theoretical studies even claim that under some circumstances labor bears the majority of the tax burden.[94] In 2008 the Department of the Treasury revised the method for estimating the distribution of corporate tax burden. Overall, the revised method assigns 82% of the corporate income tax burden to owners of capital and 18% to labor.[95]

As was indicated earlier, the incidence of corporate tax is highly relevant for our evaluation of the consistency of the "Fee for Services." If corporate tax is fully shifted to labor, the "Fee for Services" justification seems quite questionable: on the one hand the investors directly and primarily benefit from the governance functions of corporate tax (by reducing agency costs); on the other hand, workers pay for it. However, if the investors ultimately bear the largest part of corporate tax (as assumed by the Department of the Treasury), then the tax is (roughly) paid by the same group of people who benefit from it. This result is fully consistent with the "Fee for Services."

The "Fee for Services" deals satisfactorily with the counterarguments that were raised against the original benefit-based justification. First, the justification applies quite well to the current scope of corporate tax. The reason is simple:

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but as a separate entity controlled by its manager [...] The Delaware court, in enhancing managerial power, effectively endorsed the real entity view: a corporation was an entity with its own corporate culture, which should not be subordinated to the shareholders or to the state").

[89] The term agency cost is the sum of: (a) the monitoring expenditures by the principals; (b) the bonding expenditures by the agent and (c) the residual loss. The term residual loss is defined as "the dollar equivalent of the reduction in welfare experienced by the principal due to the divergence of interests (with the agent)." *See* Jensen & Meckling, *supra* note 21, at 308. Hence, any reduction in agency costs (while keeping the bonding expenditures constant) increases investors' wealth.

[90] Arnold Harberger, *The Incidence of the Corporation Income Tax*, 70 J. POL. ECON. 215 (1962); other studies refine the classic work, *see* Anthony B. Atkinson & Joseph E. Stiglitz, *Lectures on Public Economics* 222–26 (1980); Jennifer C. Gravelle, *Congressional Budget Office, Corporate Tax Incidence: Review of General Equilibrium Estimates and Analysis* (2010). Under check-the-box regulation non-incorporated entities, if not publicly traded, can elect either corporate or non-corporate classification for tax purposes and taxpayers typically want to avoid C-corporation status. *See* Treas. Reg. § 301.7701-1; *see also* Caron, *supra* note 1.

[91] *See* Arnold C. Harberger, *The Incidence of the Corporation Income Tax*, 70 J. POL. ECON. 215 (1962).

[92] Julie A. Cronin et al., *Distributing the Corporate Income Tax: Revised U.S. Treasury Methodology*, 66 NAT'L TAX J. 239 (2013).

[93] Adam H. Rosenzweig, *A Corporate Tax for the Next One Hundred Years: A Proposal for a Dynamic, Self-Adjusting Corporate Tax Rate*, 108 NW. U. L. REV. No. 3, 1029, 1032 (2014).

[94] A review and critique of recent theoretical research can be found in Gravelle, *supra* note 90.

[95] Cronin et al., *supra* note 92, at 239.

corporate tax is imposed primarily on publicly traded enterprises[96] and on the same time, it is primarily publicly traded entities that exhibit agency problems[97] and, thus, benefit from governance services provided by tax authorities. Secondly, this justification is consistent with the federal government collecting corporate tax, rather than the states. Since the governance functions are provided by the federal tax authorities, the federal government has the right to collect the "fees" for these services. Lastly, this justification is consistent with the legislative history, which demonstrated that protecting investors was one of the main rationales behind the enactment of the corporate tax in 1909.

The "Fee for Services" is not a plausible justification for corporate tax if the "benefit" is overwhelmed by the "fee." In other words, this justification is not plausible if the increase in the shareholders' wealth due to the governance services provided by corporate tax (the reduction of the agency costs) is much lower than the actual amount of corporate tax collected by the government ("the fee"). In such a case, the shareholders of publicly traded corporations, as a group, are better off absent the enactment of the tax. Hence, if the reduction in the agency costs achieved thanks to the governance functions of corporate tax is higher than the taxes paid by corporations, this rationale for corporate tax is plausible. Of course, it should be noted that the "benefit" is provided to the publicly traded companies as a group and not to specific ones. Rather than asking whether the reduction in "agency costs" for a company is higher than the amount of tax paid by it, the question is whether the overall corporate tax collected is higher than the overall reduction in agency costs.

B. "The Governance Approach to the Economic Justification"

The "Economic Justification" for the corporate tax has two versions. Under the principle version, the use of publicly traded corporations is sufficiently inelastic,

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[96] Under check-the-box regulation non-incorporated entities, if not publicly traded, can elect either corporate or non-corporate classification for tax purposes and taxpayers typically want to avoid C-corporation status. *See* Treas. Reg. § 301.7701-1; and *see* Caron*, supra* note 1.

[97] For example, Jensen & Meckling, *supra* note 21, at 309 ("Since the relationship between the stockholders and manager of a corporation fit the definition of a pure agency relationship it should be no surprise to discover that the issues associated with the 'separation of ownership and control' in the modern diffuse ownership corporation are intimately associated with the general problem of agency"); Eugene F. Fama & Michael C. Jensen, *Agency Problems and Residual Claims*, 26 J. L. & ECON 327, 332 (1983) ("For control of the agency problems in the decision process, the common characteristic of the residual claims of proprietorships, partnerships, and closed corporations that distinguishes them from open corporations is that the residual claims are largely restricted to important decision agents. This restriction avoids the agency problems between residual claimants and decision agents that arise because of separation of risk-bearing and decision functions in open corporations. Thus, costly mechanisms for separating the management and control of decisions are avoided"). For the approach, under which while the agency costs caused by the separation of ownership and management may be reduced to some extent in family firms, other types of problems arise, *see* William S. Schulze, Michael H. Lubatkin, Richard N. Dino, & Ann K. Buchholtz, *Agency Relationships in Family Firms: Theory and Evidence*, 12 ORG. SCI 99, 108 (2001) ("We attempt to explain why private ownership, owner management, and family do not eliminate the agency costs of ownership. Drawing on various economic theories, we describe problems that accompany private ownership and owner management, noting that each exposes the firm to agency problems that are overlooked by the J/M model").

due to the liquidity advantage, to make corporate tax relatively efficient.[98] However, scholars have rejected this rationale since "mark to market" taxation also addresses the liquidity advantage inherent in publicly-traded stock and is directly responsive to such advantage.[99] In other words, this rationale is inconsistent with the fact that corporate tax is based on the corporate income, rather than on liquidity factors, such as the value of the stocks. Under the second version of the "Economic Justification," corporate tax can be viewed as a Pigouvian tax that is imposed on corporations due to the externalities of limited liability. This rationale is inconsistent both with the current scope of corporate tax, which does not apply to many entities with limited liability (e.g., LLCs or S corporations) and with the fact that corporate tax is based on the corporate income, rather than on factors which better reflect the externalities of limited liability (e.g., basing the tax according to the risk for insolvency).

Armed with the new understanding of the corporate tax, we can reshape the Economic justification and name it the "The Governance approach to the Economic Justification." The goal of corporate tax, according to this justification, is to maximize economic welfare. Corporate tax is an efficient vehicle to collect taxes, since tax authorities do not only collect taxes for the government, but also provide governance services to the investors. In this perspective, the governance functions of corporate tax can be viewed as positive "externalities" of the tax. While other methods of taxation of corporate entities (e.g., mark to market) do not provide governance services, corporate tax does so.

Unlike the "Fee for Services" justification, "The Governance approach to the Economic Justification" is concentrated with more than the investors' welfare. While the goal of the investors is to get the highest possible return on their investment, the goal of corporate tax is to maximize economic welfare.[100] However, there is a close link between corporate governance and economic growth and, thus, economic welfare. Economic welfare (the goal of corporate tax) and improvement in corporate governance (the claimed effect of the tax) are related to each other primarily through finance.[101] The link between corporate governance and economic growth, through finance, has been explained as follows:

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[98] Rebecca S. Rudnick, *Who Should Pay the Corporate Tax in a Flat Tax World?*, 39 Case W. RSRV. L. REV. 965, 985–86 (1989).

[99] Charles Delmotte & Nick Cowen, *The Mirage of Mark-to-Market: Distributive Justice and Alternatives to Capital Taxation*, 25 CRITICAL REV.INT' SOC. & POL.PHIL. 211, 225-26 (2022).

[100] Alessio M. Pacces, Rethinking Corporate Governance: The Law and Economics of Control Powers 1-2 (2012); *see also* Panayotis Kapopoulos & Sophia Lazaretou, *Does Corporate Ownership Structure Matter for Economic Growth? A Cross-Country Analysis*, 30 MANAGERIAL &DECISION ECON. 155, 155 (2009) ("Corporate governance features seem to be central to the dynamics by which successful firms and economies improve their performance over time as well as relative to each other").

[101] Pacces, *supra* note 100, at 2 (Finance "is not just what allows investors to make money on their savings, but more importantly, what allows firms to raise the funds necessary to be established, to commit resources to production and its development, and to grow. … Most prominent international organizations (as the OECD and the World Bank) consider 'good' corporate governance a key recipe against underdevelopment"); *see also* Kapopoulos & Lazaretou, *supra* note 100, at 155 ("Corporate governance features seem to be central to the dynamics by which successful firms and economies improve their performance over time as well as relative to each other").

> Corporate governance is central to understanding economic growth in general and the role of financial factors in particular. The degree to which the providers of capital to a firm can effectively monitor and influence how firms use that capital has ramifications on both savings and allocation decisions. To the extent that shareholders and creditors effectively monitor firms and induce managers to maximize firm value, this will improve the efficiency with which firms allocate resources and make savers more willing to finance production and innovation. In turn, the absence of financial arrangements that enhance corporate governance may impede the mobilization of savings from disparate agents and keep capital from flowing to profitable investments … Thus, the effectiveness of corporate governance mechanisms directly impacts firm performance with potentially large ramifications on national growth rates.[102]

The "Governance approach to the Economic Justification" deals satisfactorily with the counterarguments that were raised against the original economic justification. The new justification is consistent with current scope of corporate tax, since primarily publicly traded entities primarily exhibit agency problems.

This justification is also consistent with levying the tax based on the corporate income. The corporate tax must be levied on the corporate income to fulfill the governance role of the tax. Firstly, levying a tax on the corporate income creates the basic alignment of interests between the government and the outside shareholders, so the government has an incentive to protect investors from many forms of value extracting activity which harms both the government and outside shareholders.[103] Secondly, levying a tax on the corporate income creates the "book-tax" tradeoff and a corporation's management cannot inflate the reported income through conforming earning management, without paying tax on that income. Thirdly, levying a tax on the corporate income provides information to the market (information about the "taxable income") and market participants can utilize this information in assessing the financial health of the firm (e.g., using the data concerning the "book-tax" difference). While some features of corporate tax should be fine-tuned to provide better governance services to outside shareholders, the current features of corporate tax are quite consistent with the "The Governance

[102] Ross Levine, *Finance and Growth: Theory and Evidence, in* Handbook of Economic Growth 865, 865-934 (Philippe Aghion & Steven Durlauf eds. 2005). However, Ross mentions that Robert Lucas (Nobel Laureate) dismissed finance as an "over-stressed" determinant of economic growth; Robert E. Lucas Jr., *On the Mechanics of Economic Development*, 22 J. MONETARY ECON. 3 (1988), and that Robinson famously argued that "where enterprise leads finance follows;" Joan Robinson, THE RATE OF INTEREST AND OTHER ESSAYS (1952); Ross also notes that Nobel Laureate Merton Miller replied to these arguments by saying: "[the idea] that financial markets contribute to economic growth is a proposition too obvious for serious discussion;" Merton H. Miller, *Financial Markets and Economic Growth*, 11 J. APPLIED CORP. FIN. 8, 11 (2005).

[103] Desai et al. referred to this reasoning in an *unpublished* version of their article "Theft and Taxes," by stating: "A separate tax on corporate profits generates an incentive for the government to verify income, ameliorating the agency problem between insiders and outside shareholders."

approach to the Economic Justification," unlike other justifications based on optimal taxation theory suggested by the literature.

The "Governance approach to the Economic Justification" is a plausible justification only if the increase in the economic welfare achieved thanks to improvement in the corporate governance is higher than the additional costs associated with corporate tax. This requirement, however, should be distinguished from the requirement needed in order to accept the "Fee for Services." The next example will illustrate this distinction.

Assume that, overall, corporate tax reduces the agency costs of publicly traded corporations by an amount of $50 billion (due to the governance services it provides) and that the total amount of tax collected through corporate tax is $300 billion. Under such a simplistic scenario, levying corporate tax will reduce the value of publicly traded corporation's by $250 billion. In other words, the shareholders as a group are worse off after the enactment of corporate tax. Of course, in such a scenario, the "benefit" from corporate tax is overwhelmed by the "fee" collected and the "The Fee for Services Justification" does not seem like a plausible justification for corporate tax. However, corporate tax may still be the most efficient vehicle to collect revenues, if – for example – the additional costs associated with corporate tax (e.g., economic distortions created by corporate tax) are less than $50 billion. Hence, even if the shareholders are better off absent the existence of corporate tax, still the "The Governance approach to the Economic Justification" is a plausible justification for corporate tax.

C. "Executives Regulation" Justification

Under the "Regulation Justification," corporate tax is desirable as a means to restrict and regulate corporate power. The tax restricts the corporate power because it reduces corporate income, and consequently reduces the amount of cash and hence power available for the corporation (the "limiting" function). The tax regulates corporate power, because the use of corporate assets may be impacted by the threat that the tax rate will rise if Congress perceives that the assets are not used for the betterment of society (the "regulatory" function).

This explanation should be rejected for two reasons. First, this justification cannot explain why corporate tax is based on the income of the corporation, rather than on retained earnings. Second, this justification may be accepted only if corporate tax can regulate firms in a unique manner that cannot be achieved by other forms of regulation and Avi-Yonah's explanation fails to show why other forms of direct regulation cannot limit abuse of managerial powers. In other words, beyond the restriction function (which can be better achieved by taxing retained earnings), Avi-Yonah fails to show the comparative advantages of corporate tax in limiting abuses of managerial power.

Armed with the new understanding of corporate tax's role, we can reshape the "Regulation Justification" and name it the "Executives Regulation Justification." Similarly, to the previous two governance justifications for corporate tax, the "Executives Regulation Justification" is based on the understanding that corporate tax has an important role in improving corporate governance. However, rather than being focused on increasing investor's wealth or increasing the society's

economic welfare, this justification is focused on the interest of a liberal democratic state in restricting managerial abuses of excessive powers. As noted by Avi-Yonah, there are two principal arguments why a liberal democratic state should curb excessive accumulation of power: the democratic argument and the liberal conception of equality. Curbing the managerial power is directly related to improving corporate governance, since the excessive power held by management is, at least partly, the result of lack of supervision by the non-controlling shareholders.

At the beginning of the twentieth century, Berle has already expressed the view that the separation of ownership and control (in the broad sense)[104] gives management huge powers and noted that it "led to a society in which production is carried on under the ultimate control of a handful of individuals. The economic power in the hands of the few persons who control a giant corporation is a tremendous force which can harm or benefit a multitude of individuals, affect whole districts, shift the currents of trade, bring ruin to one community and prosperity to another."[105] Furthermore, Berle has noted that the separation of ownership and control has abolished the restrictions that formerly limited the use of these tremendous powers: "[t]he separation of ownership from control produces a condition where the interests of owner and of ultimate manager may, and often do, diverge, and where many of the checks which formerly operated to limit the use of power disappear. . . .".[106]

Since corporate tax and tax authorities have a comparative advantage relative to the SEC in restricting abuses of excessive managerial powers, a liberal democratic state should use both tools in order to curb managerial powers.

Corporate tax curbs managerial abuses of excessive powers through five functions. In addition to the "limiting" function and "regulatory" function (as suggested by Avi-Yonah), the corporate tax has three other functions which prevent managerial abuses of excessive powers: "monitoring" function; "Madisonian" function and the "shedding light" function. The "monitoring" function helps in preventing general diversion activity by the corporate management, particularly in the vast cases where there is an alignment of interests between the IRS and the non-controlling shareholders. The "Madisonian" function helps in preventing a specific, but important, sort of managerial abuse: inflation of reported income. The "shedding light" function helps in providing information to the market. It should be emphasized that even if these functions cannot prevent managerial abuses of excessive powers, they can decently help in restricting such abuses. In sum, the "The Corporate Governance Regulation Justification" provides that the goal of corporate tax is to promote the values of a democratic-liberal society by curbing managerial powers and improving corporate governance, through functions that

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[104] Adolf. A Berle & Gardiner C. Means, THE MODERN CORPORATION & PRIVATE PROPERTY 5-6 (Transaction Publishers eds., 1933). In the terms of Berle, the term "separation of ownership from control" refers also to the case where the majority shareholder is in control while the minority shareholders are not in control: "[s]uch separation may exist in varying degrees. Where the men ultimately responsible for running a corporation own a majority of the voting stock while the remainder is widely diffused, control and part ownership are in their hands. Only for the remaining owners is there separation from control."

[105] *Id*. at 46.

[106] *Id*. at 6.

cannot be achieved by other corporate governance mechanisms.

The previously stated counterarguments that were raised against the original regulatory justification do not apply for "The Corporate Governance Regulation Justification." This new justification is consistent with the fact that corporate tax is based on the income of the corporation, since—as noted earlier—imposing tax on the corporate income is necessary in order to enable the governance functions of corporate tax. In addition, in many important circumstances the corporate tax has a comparative advantage relative to the SEC in improving corporate governance.

Since the primary purpose of corporate tax—under the "Executives Regulation Justification"—is to enhance liberal-democratic values, this justification is plausible even if the enactment of the tax reduces investors' wealth. Moreover, because this justification stems from intrinsic motivation, the justification is theoretically plausible even if corporate tax reduces the overall economic welfare, if it enhances liberal-democratic values, by curbing excessive accumulation of power. The next example will illustrate this distinction.

Assume again, that overall corporate tax reduces the agency costs of publicly traded corporations by an amount of $50 billion (due to the governance services it provides), that the total amount of tax collected through corporate tax is $300 billion and that the additional cost associated with corporate tax (e.g., economic distortions created by corporate tax) are in amount of $51 billion. Of course, in such a scenario, it is difficult to justify the corporate tax as a fee for the benefits provided by the tax authorities, since the "benefit" is overwhelmed by the "fee." It is also difficult to justify the corporate tax based on an optimal tax theory since the tax is overall reducing the economic welfare of the society.

Hence, in this example, both the "the Governance Benefit Justification" and the "Corporate Governance Economic Justifications" do not seem like plausible justifications for corporate tax. However, corporate tax may still curb managerial excessive powers and, thus, promote liberal-democratic values. Hence, even if the shareholders are better off absent the existence of corporate tax and the tax reduces the economic welfare, still the "Governance Regulation Justification" is a plausible justification for corporate tax.

D. Re-evaluating the Governance Justifications

The new point of view concerning the corporate governance role of corporate tax provides us with three new possible justifications for corporate tax: the "Fee for Services," the "The Governance Approach to the Economic Justification" and the "Executives Regulation Justification." These justifications, which are based on the new role of corporate tax, rest upon three unique theories. Respectively, the justifications imply three different goals of the corporate tax, are limited by distinct sets of constraints, and lead to varying policy recommendations. Table 1 summarizes the basic differences between these three new corporate governance justifications for corporate tax.

TABLE 1: CORPORATE GOVERNANCE JUSTIFICATIONS FOR CORPORATE TAX

	Fee for Services	**Governance Approach to the Economic Justification**	**Executives Regulation Justification**
Goal of the "original" justification	Collecting a fee for the benefit of "limited liability"	Maximizing economic wealth by either taxing the liquidity advantage or as a Pigouvian tax, which reduces the externalities of "limited liability"	Curbing excessive corporate power through the "Limiting" function and "Regulatory" function
Original intent of the lawmakers	Protecting investors	N/A (this factor is not relevant)	Regulating corporations
Goal of the justification, under the new understanding of corporate tax's role	Collecting a fee for the corporate governance functions of corporate tax	Maximizing economic wealth by reducing agency costs	Curbing managerial abuses of power, through three additional functions: "monitoring" function, "Madisonian" function, and "shedding light" function
Economic threshold for accepting the justification	The aggregate increase in investors' wealth (mainly, reduction in agency costs) is higher than the total amount of corporate tax collected	The reduction is agency costs and the associated improvements in productivity are higher than the additional costs associated with corporate tax (e.g., economic distortions created by corporate tax)	The "Governance Regulatory Justification" is plausible even if the tax reduces both investors' wealth and the overall economic welfare

How can we evaluate these justifications? Which justification, if any, is the "right" one? The answer to this inquiry depends on both normative and empirical considerations. From the normative perspective the political theory that one holds is a relevant consideration. For example, if one is a utilitarian (or economic welfarist), she will be attracted primarily to the economic approach and will probably reject the "Executives Regulation Justification" (unless she thinks that promoting liberal-democratic values increases economic utility). If one is not a utilitarian (or an economic welfarist) but does not believe in the intrinsic value of a liberal-democratic society, then—again—she will probably reject the "Executives Regulation Justification."

The general approach that one holds concerning the justification for the tax system is also a relevant consideration. If one generally supports the "benefit-based taxation," under which people ought to pay taxes that depend on how much they benefit from public goods, she is probably attracted to "Fee for Services Justification." If one supports optimal tax theory, he may be more inclined to support the economic justification, and if one believes that the tax system has a regulatory function, she will be inclined to support the "Executives Regulation Justification." While the political philosophy that one holds and the general

approach to the tax system are directly related, they are not identical. For example, a utilitarian may reject benefit-based taxation (and, thus, reject the benefit-based justification for corporate tax) or accept that approach (and thus, may accept the "Fee for Services Justification").[107]

The answer also depends on some empirical issues. Obviously, the preliminary empirical issue is whether corporate tax promotes—or alternatively, can promote—good corporate governance. A positive influence is a requirement for accepting any of the three justifications for corporate tax. If corporate tax promotes or can promote good corporate governance, then one should examine each justification and the different set of empirical factors (or constraints) associated with it.

The "Fee for Services Justification" raises three empirical issues: The effect of the tax on investors' wealth (mainly the reduction in agency costs), the total amount of corporate tax collected and the incidence question. As noted earlier, if the magnitude of the positive effects of corporate tax is inherently overwhelmed by the amount of corporate tax that the government collects, one must reject the "Fee for Services Justification," since the investors' wealth is lower following the enactment of the tax. In this regard, it should be noted that under the economic model of Desai et al., under some circumstances (in a tax regime with low rate and high enforcement), the investors are better off in a world with a corporate tax, than without it. In addition, accepting the "Fee for Services justification," depends on assuming that the incidence of corporate tax is borne by – or mainly by – the investors.

"The Governance approach to the Economic Justification" raises two empirical issues: The effect of the improvement in the corporate governance due to the governance functions of corporate tax versus the distortions created by it. While there is obviously no readily available date on these subjects, one can assume that a reduced corporate tax rate (e.g., closer to the tax rate of the original corporate tax) which reduces the distortions created by the tax, combined with high level of enforcement (that strengthen the corporate governance functions of the tax) and some changes in the features of corporate tax, can end up with an overall positive effect of corporate tax.

Finally, the "Executives Regulation Justification" depends on evaluating the effects of corporate tax on curbing managerial abuses of excessive power.

VI. Conclusion

This article tried to shed some light on the interaction between the corporate tax and corporate governance. It argues that the corporate tax can serve a major role in addressing the agency concerns that lie at the heart of corporate governance debates. Specifically, it argues that the corporate tax can be justified on the grounds that it reduces the corporate agency problem and that alternative systems have fewer desirable effects.

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[107] Weinzierl, *supra* note 86, at 3 ("The first contribution of this article is the finding that the classical benefit-based view can fit neatly into the Mirrleesian approach once one makes a simple—and arguably needed—change to the standard setup: that is, allowing individual income-earning ability to be a function of both innate talent and public goods.").